MV Capital Management Thought Content Series: Markets in Crisis

Sunrise over Asia

March 5, 2009

Katrina Lamb writes from Southeast Asia, where she is taking stock of how this part of the world is holding up under the strains of the global economic crisis.

The 32nd floor coffee lounge of the Shangri-La Group Traders Hotel in Kuala Lumpur provides a sweeping panoramic view of the busy downtown of this vibrant city, the capital of Malaysia. Much of the architecture is quite new – what is now thought of as "downtown" really came into being less than 10 years ago. There is no mistaking that we are in Asia, though. Right across from the hotel a sleek skyscraper rises up out of the city in bold steel lines whose effect is softened by a penthouse and roof structure consisting of the elegant lines of sloping red-tiled pagodas. In the park below, the turquoise dome of a mosque glistens in the intermittent sunlight. The mosque has been serving a second function as my morning alarm clock, with the 6am call to prayer intoning from the minarets and floating up to my window many floors above.

Mostly though, what I continue to remark on is how busy things are in the very commercial sense of the word. Within walking distance of the hotel there are at least five fairly large-size shopping malls, with a mix of retail offerings from the affordable likes of Japanese department stores Isetan and Sogo to the upscale offerings of Chanel and Armani. The other day I walked through the mall that takes up three levels of the Petronas Towers, the iconic twin towers of Kuala Lumpur that for a time served as the tallest building in the world. After wading through the bustling crowd of shoppers I entered the Mandarin Oriental Hotel to yet another surprise – a conference full of people from regional financial and investment firms who actually appeared to be upbeat and busy – "doing deals and hiring people" was a phrase heard with quite a bit more frequency than any of us have been used to for some time. The theme of the conference was Islamic finance, an $800 billion corner of the global financial industry expected to grow another 10-15% this year, with Malaysia as a pioneering force in innovative new structures that are attracting participants from well beyond the traditional markets of Muslim-dominant countries.

In Asia people are talking about and dealing with the global crisis, but it's a different conversation from the ones we are having in the US and Europe. The latest GDP figures show China growing at 6.8%, India at 5.3% and Malaysia just about breaking even with 0.1% growth for the year-on-year results ended 4th quarter 2008. Those are rosy numbers indeed compared to the sizable contractions we are witnessing in the so-called "developed economies", but they are not entirely without a downside. China and India in particular have quite a bit staked on the continuation of high growth – for China the rule of thumb has been that 8% growth keeps its simmering social problems from boiling over, while India's development plans are premised on the continuation of an average 7% growth every year as far as the eye can see. Whether this is achievable or not remains to be seen.

There is a fairly compelling case to make that the region will likely see its way through the tough times. What's more interesting is what happens next. Here is an assessment of what that could be.

Economic growth depends on the functioning of three key markets: finance, production (of both goods and services) and consumption. Let's start with finance. There's not much we can say with any certainty about the future shape and structure of financial markets, but here is one likely outcome: cash will be king. Over the past 25 years the financial sector grew mostly on borrowing, made attractive when borrowing costs and inflation came sharply down in the mid-1980s. At some point extensive borrowing morphed into excessive borrowing and the sky-high leverage ratios that ensued. That's all gone now, and not likely to come back any time soon. That means that liquidity – real cash, not those leveraged cashequivalent promises like Auction Rate Notes that turned out to be anything but – will rule the day. That implies a geographic shift in the epicenter of global finance: from the traditional nexus of New York and London to the Liquidity Triangle: three points bounded roughly by the Gulf Cooperation Council (GCC) states in the Middle East, to Northern Asia's hubs of Shanghai and Tokyo, to the southern Asia Pacific Region including Malaysia, Singapore, Brunei and surrounding countries. The actual identity of liquidity providers will likely include the central banks of the region with their substantial capital reserves surpluses, regional sovereign wealth funds and a growing number of private funds, foundations, trusts and other investment structures. And despite the chronic troubles of Japan and its slow, painful fall from economic dynamo to also-ran, the country remains cash-rich with persistently high individual savings rates. In Asian circles the phrase *Mrs. Watanabe* conjures up the image of the stereotypical Japanese mega-saver – the frugal and usually conservative housewife who controls the family finances (and every now and then dabbles in something exotic like the hedge carry trade that was so popular 2-3 years ago).

The second key market is that for the production of goods and services, and here it seems clear that Asia possesses a dynamic global advantage. China and India are, respectively, the manufacturing and services centers of the world. Malaysia, Hong Kong and Singapore are smaller but not far behind. These sectors have become increasingly more value-added over the 20-odd years since globalization took root as a dominant trend. Sometimes this trend hits too close to home – as a holder of the CFA® designation I am all too well aware that the fastest-growing part of the world for the minting of new financial analysts with this coveted designation is in Asia – and in many markets the professionals offering investment advice and other sundry professional services like accounting, financial planning, creative design or advertising are simply far more cost-competitive than we are in the US. We call this the Bangalore-Boston nexus: look at the current average wage for any given profession in Boston and that prevailing in Bangalore, India for corresponding services, and watch those relative rates converge over the coming years. What that implies is a massive income shift – again, from West to East. It also sets the stage for the third leg of the three-market foundation…

…that of the consumer. Here again the sight of crowded shopping malls with expensive, high quality products is a telling sign. In aggregate terms Asian consumption is a fraction of that in the US – but the relative growth trend is clear. Consumption as a percentage of GDP rose to 72% in the US, while in Malaysia it is still at 45%. Chances are it will never reach 70% here – Asian households are thrifty in a way that ours in the US simply are not. What is more likely, however, is that consumption here may rise to around 55% (a level that would put it on par with France) while ours in the US will fall back to 65%, a level that prevailed for just about every year from 1946 to the start of the Great Leverage Boom in 1982. That's a significant net shift.

The other thing about these three markets is that their growth is self-reinforcing: a virtuous spiral where the growth in one market feeds into and compounds the growth in the other two. After all, the common bond between finance, production and consumption is *income*, and as income grows incrementally these components can grow exponentially.

What could the world look like when the dust has settled, markets have stopped crashing and our economies have stopped having cardiac arrests? In times past there was a clear mantle passed from one Great Power to another – from the Italian merchant states of the 15th century to 17th century Holland, 18th century England and most recently the United States. One could even go further back to the fall of the Byzantine Empire and the rise of the Ottomans with advancements in economics, mathematics and science. Each progression offered something more than economics – there was advancement in social, scientific and cultural fields as well.

This time it is not so clear – in the US we may have stumbled badly but there is no clear claimant out there to take the mantle of world leader from us. In many ways the world is and will continue to look to our leadership example, and hopefully we can live up to it. But when it comes to economics we are going to share the stage. That has all sorts of implications. It need not be a bad thing – we Americans are famously adaptable. In the meantime, Asian exposure is something we feel should not be overlooked in portfolio construction. As we navigate the tempests of the present cataclysm we cannot take our eye off what lies beyond – what is next. Rest assured, we are not only keeping our eye on it but we are reaching out and touching it where it lives – in these noisy, vibrant cities of Asia Pacific with their full malls, crowded highways and gainfully employed bankers.

With warm regards,

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MVCM 2009
DOFU: March 2009

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