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Cambiar Investors: The Great Rebalancing

Cambiar Investors

Introduction

While there is no shortage of challenges facing the U.S. economy and stock market, we are fairly constructive on the outlook for equities for two key reasons. First, risk premiums, which rose to extreme levels during the crisis, are now falling and can continue to decline to more normal levels (driving valuations higher in the process). Second, the U.S. and global economies are on the mend. Whether one examines leading economic indicators, purchasing manager surveys or steepened yield curves, the signs suggest that the trough in activity is behind us. Together, falling risk premiums and improving economic activity provide a supportive backdrop for stock prices.

However, while it makes perfect sense to anticipate the benefits of cyclical recovery, we believe the global economy is undergoing a number of significant structural changes that must be contemplated in the context of longer-term investment strategies. The global economy that will emerge at the far end of this cyclical recovery will be considerably different in structure from the one that entered the crisis. In a nutshell, one can consider this process to be a "rebalancing of global growth."

In our view, two critical changes are likely to define this period of rebalancing, each reflecting the correction of weaknesses brought to light by the global financial crisis and recession. In a nutshell, the U.S. will consume less (and save more), while China and other emerging markets will consume more (and save less). Heading into the crisis, the United States engaged in too much debt-fueled consumption and had too little savings—the "sub-prime" debt crisis was simply one notable component of this bigger problem. In contrast, China and much of the emerging world saved too much and relied excessively on export-led industrialization. In this sense, they became overly dependent on pumped-up demand in the U.S. and paid too little attention to the development of their own sources of internal demand.

The crisis is forcing a series of changes to these generalized patterns. Thus, while the U.S. will experience a cyclical recovery, we will almost certainly face a multi-year period of "balance sheet repair" as well in which U.S. households boost their savings and companies adjust to the new credit-constrained, lower-demand environment. Growth headwinds in the U.S. (and much of the G7) will contrast sharply with a period of more robust growth in China and many emerging markets. Over time, growth of internal demand in these countries will compensate for weak demand in the wealthier nations. In the process, faster-growing emerging markets should exhibit falling savings rates as well as a rise in consumption as a percentage of GDP.

The Rebalancing of Global Growth

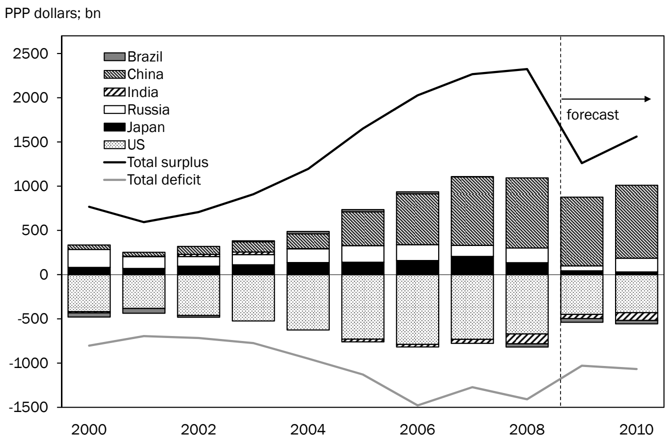
Many of the key global imbalances being discussed originated in, or were exacerbated by, the Asian Crisis of 1997-98. This crisis started in Thailand, but quickly spread throughout the region to countries such as South Korea, Malaysia and Indonesia. From Asia the contagion then spread globally to countries such as Russia and Brazil. While an analysis of the causes of the Asian Crisis is beyond the scope of this piece, the countries that succumbed to the contagion suffered severe currency devaluations, massive capital flight, widespread corporate bankruptcies and deep recessions.

Likewise, given the sharp decline in capital available to emerging markets as a group that resulted from the Asian crisis, developing countries around the world were forced to run current account surpluses (in which exports exceed imports). In this process the developing countries as a group became net creditors to the more developed world. At the same time, a number of wealthy countries, most importantly the United States, began to run larger and larger current account deficits (in which imports exceed exports and the gap is financed by external credit), largely a reflection of growing surpluses in the emerging world.

It is in this sense, then, that the United States became the world's "consumer of last resort" in the years after the Asian Crisis, while surplus countries ramped up their export-driven growth models and stockpiled foreign currency reserves. The export-led surplus countries were presumably pleased with this new relationship after the traumas of the Asian Crisis, and helped perpetuate the new global division of labor by recycling their export earnings back to the deficit countries, thereby contributing to easy credit conditions and robust demand in the U.S. in the process.

There are some exceptions to this general pattern, especially the fact that two of the most important developed economies, Japan and Germany, have run and continue to run huge current account surpluses (and therefore act as net creditors to the world's deficit nations). But in general terms the relationship holds, and is represented currently by two extremes: the United States as the biggest external deficit country and China as the world's largest surplus country. The basic relationship can be seen in a simple graph—which also illustrates the beginning of "rebalancing" as these imbalances revert back to more "normal" levels.

External Imbalances Improving



Source: IMF, GS Global ECS Research
Definition: Purchasing power parity (PPP) calculates exchange rates between countries based on the local costs of equivalent baskets of goods

The patterns that exist at the global level reflect simple but powerful imbalances existing within the key countries—namely between savings and investment. These imbalances get at the heart of the reasons we think global rebalancing will endure as a material driver of returns in the future. As we know very well, one of the basic causes of the U.S. crisis was the lack of domestic savings—or better said, the excess of debt-driven spending by U.S. households. The U.S. personal savings rate actually turned negative for a period of time, not surprisingly about the time the current account deficit peaked at around 6 percent of GDP in 2006. The U.S. personal savings rate has risen sharply in the months since the crisis began, most recently to 6.9% percent. It is unclear how high the savings rate will go, but a level of 8-10 percent is certainly conceivable. The rise in U.S. savings, and the repair of household balance sheets it implies, constitutes an important constraint to domestic demand growth in the future—it is also a key driver of the declining U.S. current account deficit.

This rise in U.S. savings rates is to us one of the most impressive improvements in economic imbalances seen so far. On this point, it is interesting to note that the decline in private borrowing so far has been greater than the increase in public sector borrowing. As a result aggregate U.S. borrowing is falling, contributing to the narrowing in the current account deficit. In our view, these trends should continue, not least due to tighter credit conditions and the need for further balance sheet repair. The housing sector illustrates this point—the end of subprime means the return of the old-fashioned down payment and underscores the need for higher levels of household savings. The need to boost retirement savings, which have been hit hard by falling home prices and the stock market crash, is another example.

In contrast to the U.S. situation, China's current account surplus is likely to narrow over time, as domestic savings fall and consumption's importance to GDP rises. China's current account surplus peaked at around 11 percent of GDP in 2007; this surplus is almost certainly going to fall. Like predicting a "normal" U.S. savings rate, it is hard to say just how far China's economy will move in the direction of "balance." But the signals are encouraging. Chinese officials are pushing the growth envelope, with one of the most aggressive fiscal stimulus programs in the world. They have also made it very clear that boosting the role of internally-driven growth is a major policy goal. Likewise, lending growth in China continues to surprise nearly everyone by its strength. This combination of aggressive fiscal spending and robust bank lending is contributing to extremely strong fixed asset investment, which rose 32.9 percent y/y in the first five months of 2009, well above expectations. This heightened investment is being led by domestic infrastructure investment—not by adding to export capacity.

China's surprisingly robust domestic economic activity contrasts with very weak activity on the external front—in particular weak export activity. For example, May exports from China dropped 26.4 percent compared to May 2008. These numbers should come as no surprise: given the weak global economy, demand for Chinese exports has fallen off a cliff. Imports have been falling as well, albeit at a slower pace. Given the very robust activity data coming out of the domestic economy, not to mention the abundance of cash-rich Chinese importers, it seems clear that imports should rebound sooner, or at least more robustly, than exports. Some of this is already taking place but hidden by the dollar-denominated value of imports—in fact, volume data show much more robust import activity. For example, on a volume basis, unwrought aluminum, copper and iron ore imports rose 1,299 percent, 326 percent and 37 percent in May, after increasing 1,235 percent, 141 percent and 37 percent in April.

BRIC Growth to Lead Global Recovery

Source: IMF & Banc of America Securities-Merrill Lynch
Definitions: BRIC Countries represent Brazil, Russia, India and China; G5 represents the U.S., Japan, United Kingdom, Canada, and Euro Area

Most importantly, the global recession has underscored the inadequacy of China's export-led growth model, as it depends excessively on demand conditions in other countries. This is ironic, since the lesson that many developing countries took from the Asian crisis was that they needed to pursue aggressively export-oriented growth strategies, maintain highly competitive currencies and build up large foreign currency reserves. Yet when taken to extreme levels, this model left these same countries quite vulnerable to fluctuations in external demand—a vulnerability that has hit home in the current crisis. It seems very clear from China's words and actions that its growth model in the future will depend much more on the development of internal demand. Still, China is quite reluctant to allow its currency to appreciate quickly; this reluctance, if combined with a relatively robust economic recovery in the rest of the world, could slow the downward adjustment in China's massive current account surplus.

Caveats aside, we think the global financial crisis and recession represent watershed events—in essence strong catalysts in a dramatic shift in the global division of labor. In the aftermath of the Asian Crisis, the U.S. became the "consumer of last resort" for goods produced in the rest of the world, particularly the developing world. As this relationship matured, it contributed to growing macroeconomic imbalances, both for producing nations and consuming nations. These imbalances (especially the excess debt and insufficient savings in the U.S.) ultimately led to the financial crash. As such, we believe the move back towards balance implies more healthy economic fundamentals in the future. The driving forces of this shift will be increased levels of savings in the world's principal debtor nation—the United States—and sustained, robust growth in domestic demand in many of the world's surplus nations—especially China.

We understand the arguments of skeptics—for example that U.S. deficits are structural and that China's high savings rates are cultural. However, the developments of the last 10 years have been equally implausible. In fact, textbook economics suggests that developing economies more typically run external *deficits*, and that those *deficits* are funded by inflows of capital from richer, more developed countries, whose savings can earn higher rates of return in more capital-constrained emerging economies. The oddity, then, was really the relationship of the last 10 years or so, when the poorer developing world loaned large sums of money to the consumers of the rich world (to buy, of course, goods that the developing world produced). We think the future will look more like textbook economics, and that the global financial crisis and current global recession represent important catalysts in this rebalancing process. We also believe that the rapid growth of internal demand in emerging economies, led by such Asian giants as China and India, will be an investable theme for years to come.

Investing Implications of Global Rebalancing

As suggested, we think the U.S. can look forward to a cyclical recovery in 2010, with signs of improvement becoming increasingly visible in the second half of 2009. However, after the initial recovery in activity, the U.S. faces a few years of modest and probably below-trend growth. This somewhat muted growth outlook reflects the considerable headwinds facing the U.S. economy, such as the need for consumers to repair their balance sheets by boosting long term savings, more restrictive credit conditions, structurally higher levels of unemployment, and potentially higher longer-term interest rates (as higher deficits and national debt generate competition for savings when the economy recovers).

Global rebalancing also implies dramatic changes in the countries that have depended on high savings and exports to drive their economic growth models. The crisis has exposed the soft underbelly of this path to development, underscoring the need for much more robust levels of internal demand. As such, we think it is nearly inevitable that consumption as a percentage of GDP will rise among the larger emerging economies (and probably in the more abstemious G7 savers, like Japan and Germany, as well).

These broad structural shifts in the global economy constitute macro anchors to our longer term investment strategies. A few final ideas and examples help illustrate this point. First, in several aspects the current environment is reminiscent of the early 1990s, when the U.S. faced a weak domestic economy and an extended period of low interest rates as we climbed out of a recession and the savings-and-loan crisis. The economy eventually recovered, but concerns about the strength and durability of the recovery persisted for some time. These conditions, combined with more attractive rates of growth outside the U.S., contributed to a surge in capital flows to foreign economies and stock markets. Not surprisingly, many foreign stock markets outperformed the S&P during this time by a considerable margin.

An analogous situation is taking place today. In the first half of 2009, BRIC stock markets gained an average of 61 percent while the S&P has gained just 2 percent. This discrepancy reflects many of the same factors we saw in play during the early 90's. Most importantly, risk appetite has returned, and investors are looking for returns in an exceedingly low interest rate environment. As discussed, developed countries are likely to produce sub-trend growth for some time. Yet the global economic recovery is likely to be significantly more robust, led by large developing countries like China and India. In this environment it is logical to expect continued heightened flows of capital to these more robust economies and markets, leading to large discrepancies in relative performance.

Thus, from an asset allocation perspective, it makes more sense than ever for investors to revisit their commitment to international equities. If we are correct, the pace of capital formation in many countries should greatly exceed the capital "recovery" in the U.S., as internal demand grows rapidly from a low base. In this sense, insufficient exposure to markets outside of the U.S. could prove to be a costly mistake. It is likewise more important than ever to make sure one has sufficient exposure to the sectors and stocks that will benefit from these structural changes taking place in the global economy. There is probably no greater example of our commitment to this idea than our exposure to energy—seen in both our domestic and international portfolios.

While commodity prices, and especially oil, dropped precipitously last year, the underlying problems constraining supply have not been removed. In fact these supply-side issues may be getting worse as investment projects are cut around the world. To illustrate, consider that globally the energy sector is operating at some 90 percent capacity utilization—during the worst economic slowdown since the Great Depression (and in which our own industrial capacity utilization is around 66 percent).

The point of course is that with these supply dynamics, it will take considerably less demand growth to support higher prices. We think this demand growth will be largely in place in 2010. As Tony Hayward, the CEO of BP puts it: "the center of gravity of the global energy market has tilted sharply and irreversibly towards the emerging nations of the world, especially China. This is not a temporary phenomenon but one that will only increase over time."

In conclusion, we are constructive on the return outlook for equities, based on expectations for economic recovery and the prospects for further declines in risk premiums. Yet in addition to the prototypical cyclical recovery, our analysis leads us to believe that there are a number of more powerful structural changes taking place in the global economic landscape. The dynamics of this process, such as balance sheet repair the U.S. and the rapid growth of internal demand in China and other emerging markets, will constitute important drivers of returns through the next global cycle. The subsequent "rebalancing of global growth" is likely to last for years. Given the magnitude of these shifts, these trends should be taken into account in determining appropriate allocations (domestic vs. international, emerging markets vs. developed markets), as well as sector and stock selection at the portfolio level.

The information included is for informational purposes only and is not a solicitation or offer to participate in any particular investment product.

About the Author

Todd Edwards is an International Investment Analyst, with coverage in the financial services and consumer sectors. Prior to joining Cambiar in 2007, Mr. Edwards was a Director in the Global Emerging Markets Group at Citigroup. Todd also served as Director of Research and Equity Strategist at BBVA Securities in New York. An accomplished author, Mr. Edwards has written books on Brazil and Argentina. Todd received a PhD and MA from Tulane University and BA from The Colorado College.

Cambiar Investors

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