BlueBay
Asset Management

Are your children learning Mandarin?

In the first of his articles as Strategic Advisor for Emerging Markets, David Dowsett argues that emerging markets are about to assume global leadership politically, economically and financially. The Western world is not prepared. Are you?

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Value in emerging markets

"The old is dying and the new cannot be born; in this interregnum a great variety of morbid symptoms appear". *Antonio Gramsci, Prison Notebooks.*

"Here we are on top of the world. We have arrived at this peak to stay there forever. There is, of course, this thing called history. But history is something unpleasant that happens to other people."
Arnold Toynbee at the Diamond Jubilee of Queen Victoria, 1897.

"There is nothing more difficult to take in hand, more perilous to conduct, or more uncertain in its success, than to take the lead in the introduction of a new order of things." *Niccolo Machiavelli, The Prince.*

Did you know that?

The IMF constitution stipulates that its headquarters must be in the world's largest economy. Therefore the IMF must shift its HQ to Beijing around 2027.

63% of Americans don't have enough savings to meet a USD500 emergency.

The global middle class will rise from 1.6 billion to 4.9 billion by 2030.

In 2015 and 2016, life expectancy in the US declined.

By 2075, the world's largest city is projected to be Kinshasa.

Of the 15 countries in the world with the highest per capita income, 2/3rds are non-democracies.

Between 1995 and 2017, the share of French, Germans and Italians who favoured military rule more than tripled.

By 2020, China's e-tail market will be the same size as the US, Japan, UK, France and Germany combined.

By 2025, there will be more English speakers in India than in the US.

In 2100, there are projected to be 450 million people living in Europe, and 4.5 billion living in Africa.

The traumas of Western democracy

The golden age of Western liberal democracy is over. *Representative* democracy is ill suited to a world of *instant and direct* information provision.

All of the political and social schisms of the past 2 years are symptoms of a broken political system. A global labour market has depressed Western living standards, and a simultaneous information revolution has given people a digital, and global, platform to express their discontent. Brexit, Trump, European populism and #MeToo are all examples of what happens when respect for existing institutions and power structures weaken. Power and influence now travels through networks, not outdated political parties. Such networks require immediate gratification, whereas politicians are used to aiming to achieve results over a four or five-year political cycle. Validation through the ballot box has been substituted for a mutated form of direct democracy on Twitter with The Donald as chief practitioner. He sets the agenda on a daily basis, and the people and traditional media give instant feedback.

Today's successful politicians understand this reality, and so aim to create 'movements' to achieve power. En Marche, Momentum, Five Star and the Tea Party/Trump supporters all define themselves against the traditional party structure. These groups generated political relevance in the same way Facebook generates 'likes'. This may work as a method to achieving power, it doesn't seem a very effective way to govern.

This is not to say that Western democracy is about to die. There will be a 47th President. What it does suggest, however, is that Western liberal democracy will morph into ever more contorted forms as its grapples unsuccessfully with the task of meeting its citizen's needs. In the Western world, we have a set of 19th century institutions, creating 20th century solutions to 21st century problems. We can hope for a wholesale reimagination of government to make it relevant for the digital age, but today's intellectual inertia in the West makes this unlikely. Political dissatisfaction will rise, the population will seek more extreme policy alternatives and external saboteurs will operate in fertile territory. This is not a passing phase. Liberals who think they can hold their breath and wait for Geert Wilders, Marine Le Pen, Alternative fur Deutschland, Trump, Lega Nord and Brexit to burn themselves out are likely to be disappointed. These names are merely today's symptoms of a much deeper malaise. Democracy for ever is not guaranteed. The great Athenian democracy only lasted for 200 years.

An alternative governance model: 'Authoritarian modernity'

At the same time that democracy is losing its allure, a new governance model is arising in the developing world.

Xi, Modi, Putin, Erdogan and Mohamed Bin Salman do have differences but all present themselves as nationalist strongmen who will protect their subjects, strengthen their economies and reclaim their country's rightful place in the world order. The concept of 'authoritarian modernity' is gaining currency throughout the emerging market (EM) landscape. Of course, Putin, Modi and Erdogan have all been elected, but so were Mussolini and Hitler. Respect for institutions and allowing opposition are as much prerequisites for a democracy as how the leader is elected. History suggests that over the long term, the political system that generates most growth is the one that is most popular. Will the urbanising middle class in Asia really see democracy as an attractive prospect if in the West it demonstrates policy gridlock and political infighting? Africa is on the verge of a population explosion. Will young people there see the dysfunction in the US and EU as something to emulate?

For a long time, the standard argument in the Western world has been that demands for political freedom in the developing world will rise along with living standards and education levels. In fact, people may conclude that political freedom is overrated if the end result is Trump. The US is, it is sad to say, squandering the 'soft power' that previously was such an important part of its arsenal. The sense of democracy in retreat will likely be reinforced by major Latin American elections in the second half of 2018. As we have seen in Mexico, and are likely to witness again in Brazil, the electorate has voted in an extremist anti-establishment figure as a result of institutional mistrust. Latin America is likely to join the drift away from liberal democracy.

The big structural issues that the developing world faces over the next 20 years are national security, urbanisation, climate change, inequality, a reduction in energy intensive growth and, in common with the developed world, how to cope with the vulnerabilities and pressures of the internet and cybercrime. It is arguable that messy, short-termist democratic policy making is not the best way to address these structural issues at a time of such profound social change.

The approach of the 'authoritarian modernists' to the internet is an interesting example. As information flows spin out of control in the Western world, China has effectively nationalised its internet commons. International firms are locked out of the space. Alibaba, Tencent and Baidu may not be formal state-owned enterprises, but government interaction with them makes the Chinese Communist Party the master of the data. In the West, we may debate the ethics of this, but maybe it is a more sustainable operating model. The situation creates order and control whereas in the West the internet feels anarchic. On this, and on many other issues, self-righteous liberals love to frame the definitive choice facing nations and societies in the 21st century as 'open' versus 'closed'. This is suggestive and self-serving terminology. On information, as well as on immigration, if we reframe the choice as 'uncontrolled' versus 'controlled', many may choose the latter in the West as well as in the developing world. Once again, we can perceive a reversal of conventional wisdom. It was accepted logic that the increased transparency of the internet would inevitably lead to the fall of closed political regimes. In fact, the opposite is occurring. Those closed regimes seem to be growing stronger, whilst the democracies struggle to adjust.

The foreign policy dynamic

The trials of the West are likely to be exacerbated by the fracturing of NATO. The Western democracies have been bound together in common interest, but the US and Europe now have different strategic challenges. The US's greatest concerns will inevitably revolve around China, the South China Sea and the wider Pacific Ocean. Europe's greatest long-term strategic challenges will be caused by the population explosion in Africa and associated migration flows.

In the East, China will inevitably look to reclaim its historic sphere of influence and reposition itself as a naval power to complement the world's largest standing army. From a US perspective, security flashpoints are far more likely to occur in Taiwan, Korea or the Ryuku Islands than they are in Talinn, Astana or even Kiev. Russia may be a malign actor on the international stage, but given its weak demographics and economic prospects it is simply not a long-term strategic threat to the US.

Europe, by contrast, will see the growth of China as a commercial opportunity but has to address the security risks associated with the fact that by 2100 there will be as many people in Africa as there are today in Asia. The 21st century will assuredly be an African as well as an Asian century. The young population in Africa will contrast with the aging demographic in Europe. How will the rich countries in the North deal with this issue? It seems beyond the reach of today's limited politicians but sustained attention to the economic development of Africa, starting with the countries of the Mahgreb, should be the EU's number one foreign policy priority. This is the only hope of avoiding completely chaotic and destabilising migration.

NATO is already beginning to feel this strategic dissonance. In his unorthodox way, President Trump is simply picking at the scab.

At the same time the post-1945 security framework in the West is under pressure, China is offering an alternative path. This is mostly framed in terms of economic partnership, but the foreign policy leverage is undeniable. The Asian Infrastructure Investment Bank was only inaugurated in 2015, but already has 86 member states. The Boao Forum is now a practical equal to Davos. Between June and December this year, China hosts the Shanghai Cooperation Summit, the Forum on China Africa Cooperation Summit and the China International Import Expo. Of course China soft power seems limited, it will never be the 'shining city on the hill'. What it does have is a lot of cold, hard cash. The centrepiece of this strategy is obviously the One Belt One Road project. It is 12 times the size of the Marshall Plan on an equivalent basis. It has 4.4 billion people in 64 countries within its scope. Money talks, particularly when the democratic model seems to be losing its effectiveness.

The economic centre of gravity shifts East – and it's only just begun

Of course, as noted above, political systems are only as good as their economic outputs. This is where the case for a reordered world becomes much more persuasive. In this section I will concentrate mostly on Asia, as this is where the economic transformation will be the most dramatic. We all know economic power is shifting to the East, but do we really understand its profundity and extent.

The headline statistics may now be quite familiar, but that doesn't make them any less dazzling. As expressed by McKinsey, during the Industrial Revolution Great Britain took 150 years to double output per person. China achieved this feat in 12 years and India in 16. The acceleration, then, occurred 10 times faster in China and India, but on 300 times the scale. This creates an economic force 3,000 times as big. This is why China used as much cement in 2011-3 as the US did in the entire 20th Century. This is how China managed to build the equivalent of Europe's entire housing stock in just 15 years. They say "Rome wasn't built in a day", but in China they were building the square foot equivalent of today's Rome every two weeks.

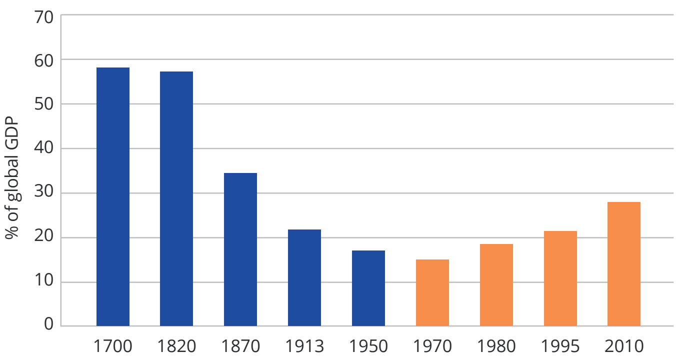
Clearly, when making forward looking projections, assumptions need to be made. If we use Asian Development Bank (ADB) projections of a continuation of current growth trends for the continent as a whole we can reach three basic conclusions about the picture by 2050.

1. Asia's share of global GDP will reach 52%.
2. 3 billion additional Asians will become affluent by current standards.
3. Per capita income will rise sixfold in PPP terms to reach today's European standards.

This economic transformation surely offers the greatest investment opportunity of our lifetimes.

In many ways, this is simply a return to the natural order of things.

FIG 1: ASIA'S SHARE OF GLOBAL GDP 1700-2010



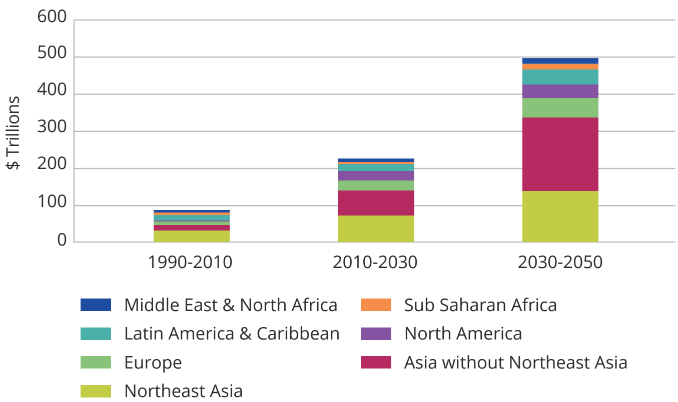
Source: Maddison, Agnus: Contours of the World Economy (1700-1950) via 'Asia 2050: Realizing the Asian Century' by Harinder S. Kohli, Ashok Sharma & Anil Sood. Data for 1700-1950 is in PPP and data for 1951-2010 is in market exchange rates.

What are the practical economic implications behind the headline numbers.

a) An investment boom

Rapidly growing economies become more capital intensive. The rate of obsolescence is also high. Today, 70% of the world's capital stock is in advanced countries and roughly USD5 trillion is added each year. By 2050, expect the capital stock to be increasing by USD20 trillion per year with up to 70% of the net additions coming from Asia.

FIG 2: ASIA WILL ACCOUNT FOR 70% OF THE WORLD'S ADDED CAPITAL STOCK BETWEEN 2030 AND 2050



Source: Centennial Group International projections, 2011 via 'Asia 2050: Realizing the Asian Century' by Harinder S. Kohli, Ashok Sharma & Anil Sood.

In the most simple way, an investment boom creates return seeking opportunities. As discussed later, deepening capital markets will be an essential corollary for a continent that has been hesitant to invest in itself. Where will this investment be directed?

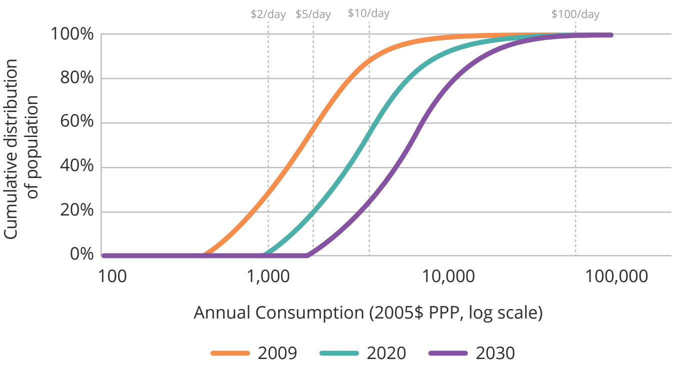
b) Urbanisation

Asia is experiencing an urbanisation avalanche. In 1970 only 400 million Asians lived in cities. Today that number has reached 1.6 billion. By 2050, the urbanised population will rise by another 1.4 billion to 3 billion people in total. The implications of this are mindboggling. The Chinese cluster city based around Shanghai on the Yangzi delta will have 150 millon residents. The one on the Pearl River Delta will have the same footprint as the entire country of the Netherlands. Smaller cities such as Tianjin will grow to produce the same economic output as Sweden. The infrastructure demand this will create is immense. Just in South East Asia alone, infrastructure and housing projects will require USD7 trillion of investment by 2030 – this is roughly double Germany's current GDP. The ADB calculates an annual infrastructure deficit of USD 60 billion per year up to 2050 to achieve relatively manageable, environmentally safe, working cities in Asia. This level of urbanisation implies the third implication: a middle-class explosion.

c) A middle-class explosion

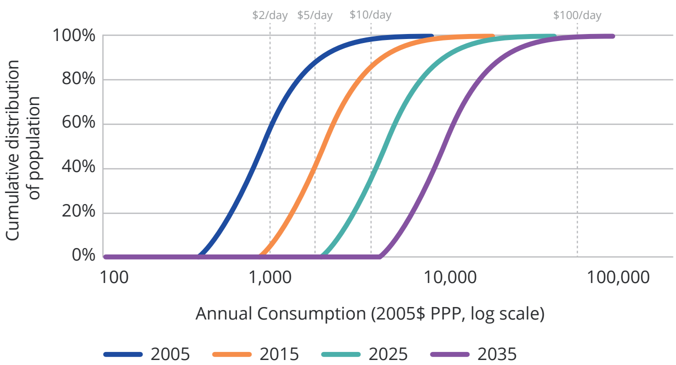
Often commentary suggests the middle class in Asia is mature, in fact the development has only just begun. For instance, we know that China is already the world's largest market for cars and smartphones, but only 12% of Chinese consumers have yet reached middle-class status. Roughly another billion consumers in China and India each should achieve middle-class status by 2050.

FIG 3: CHINA'S MIDDLE CLASS IS POISED TO TAKE-OFF



Source: Centennial Group International calculations via 'Asia 2050: Realizing the Asian Century' by Harinder S. Kohli, Ashok Sharma & Anil Sood.

FIG 4: INDIA'S MIDDLE CLASS DYNAMIC ECHOES CHINA



Source: Centennial Group International calculations via 'Asia 2050: Realizing the Asian Century' by Harinder S. Kohli, Ashok Sharma & Anil Sood.

The above charts show that spending by Chinese and Indian consumers is poised for take off. Spending by the Asian middle class is projected to rise by 9% a year through 2030. Compared with relatively static projections for final demand in the Western world, it seems obvious where the global consumption engine will reside for the foreseeable future.

d) Digital opportunity

Highly urbanised societies with rising living standards will inevitably create demand for high levels of digitalisation. The growth of digital connections over the past decade is remarkable, even if already well known. Indian cell connections went from virtually zero to 700 million within the past decade. WeChat added 400 million users in two years. We discussed the issue of control of the internet commons earlier. Even despite this, the commercial opportunities seem huge. The process is not complete. Another two-to-three billion EM consumers are expected to go online in the next decade. Internet penetration in Africa, for example, is only 16% and the internet's contribution to GDP is only 1%. A digital ecosystem will be created that has only begun to be explored. Most of Asia is a mobile first market. In the words of Flip Kart founder Sachin Busal, "The best thing about India is we didn't have to replace anything". This will create huge opportunities in healthcare, electronic cash, ecommerce and banking as the very basic structure of the economy is reimagined. It is no surprise then that a majority of the world's financial 'unicorns' (privately held start-ups valued at over USD1 billion) are now to be found in Asia, as we will examine later. Those who possess the creativity and imagination to utilise the power of the network in a fast growing , highly urbanised society will surely reap huge rewards. This is the technological opportunity of the next 20 years.

e) Trade flows

Given all of the above dynamics, trade flows will continue to grow. McKinsey estimate that global trade volumes will triple between 2012 and 2025. Much of this will be EM related. Intra EM trade flows are expected to exceed North South trade by 2030. The scope for growth is still huge. Intra-regional trade flows in EM are still surprisingly low. In Western Europe, for example, 58% of cross border flows occur intra regionally. In North Asia this figure is 17%, in Latin America 19% and Africa only 13%. This reflects the previous importance of the developed world as an export destination, but clearly signals the potential for intra EM growth as economies grow. Of course, an upsurge in protectionist rhetoric threatens the outlook for global trade, but it seems perfectly possible that EM centred trade could continue to grow while the West imposes protectionist measures as a flawed response to their inability to reorder themselves to a globalised world. By 2050, six of the largest seven economies in the world will be developing countries who will benefit from increased global trade. For example, China aims to double annual trade with the ASEAN countries over five-years to reach a target of USD1 trillion by 2023. This would be roughly double total trade with the US. It is easy to see how priorities will quickly change.

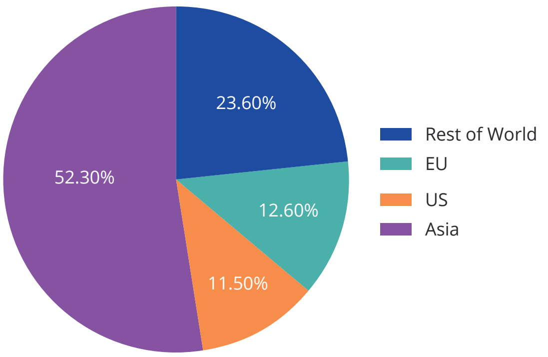
Each one of these areas could clearly be explored in much more detail, and all are subject to risk. The point is, though, that however one might quibble with some of the individual assertions the overall picture is hard to dispute. The centre of gravity is shifting East. For the global economy, and indeed the way we all live our lives, the practical implications of this are only just beginning.

Finance

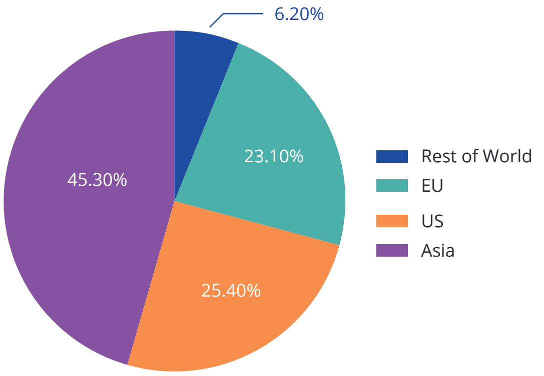
a) A growth opportunity

Such an economic transformation requires an equivalent financial market deepening. Currently Asia accounts for only a quarter of global financial assets. The ADB project that as Asian GDP rises to just over half of global GDP, the size of financial assets will grow accordingly.

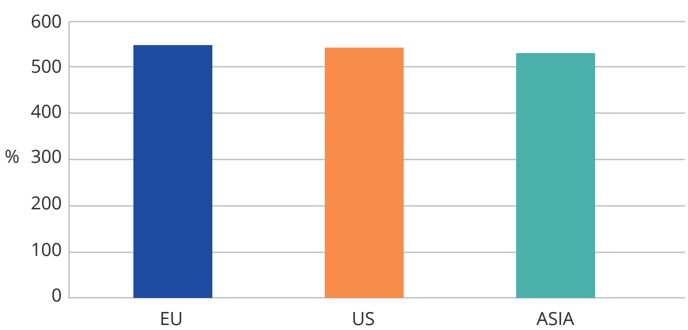
FIG 5: ASIAN CENTURY SCENARIO, 2050
GDP (% OF WORLD GDP)



FINANCIAL ASSETS (% OF WORLD FINANCIAL ASSETS)



RATIO OF FINANCIAL ASSETS TO GDP (%)



Source: IMF Global Financial Stability Report (October 2010), Appendix Table 3, and Centennial Group International estimates via 'Asia 2050: Realizing the Asian Century' by Harinder S. Kohli, Ashok Sharma & Anil Sood.

Emerging Asia has so far largely been a bank-dominated financial market place. The level of debt securities to GDP is only 50%, compared to 177% in the EU and 224% in the US. Debt levels in the developed world may be too high, but this should not stop further growth in EM. The story is simple, strong growth creates further investment opportunity that needs capital. Asia, and indeed EM as a whole have the capital resource to meet the need.

This phenomenon is already beginning to play out. Of the world's ten-largest financial 'unicorns', six are Chinese and one is Indian. In total, China has 164 unicorns, compared to 132 in the US. As well as start-ups looking to take advantage of a dynamic, networked society, established companies in EM also experience explosive growth and establish larger scale than can be achieved in the mature markets. The Chinese smartphone maker Xiaomi was only founded in 2010, and now accounts for one third of all smartphone sales. Bharti in India has three times as many customers as Verizon in the US. A quarter of GE's new healthcare products are now developed in India.

b) A new reserve currency is needed

Since globalisation has taken hold, EM financing has largely occurred in dollars. This is no surprise given previous US economic and financial market hegemony. Forecasting how reserve currency status will change is a tricky business. The US economy surpassed the British economy in size in 1872, and US exports pulled ahead of UK exports in 1915. The US dollar only usurped the pound as the global reserve currency in 1945. The Chinese are clearly resisting a move to a truly open capital account. However, as the world rebalances economically, surely the dollar will lose its overarching primacy as the financing currency for the developing world. It will simply not make sense when the US is generating less than 15% of global GDP.

Should financing arrangements change, one beneficial consequence could be a reduction in the vulnerability of the developing world to the dollar liquidity cycle. Once again in 2018, despite the economic progress that EM countries have made, global liquidity is tightening and EM financial assets are proving to be amongst the most vulnerable. The structure of global capital markets is lagging the structure of the global economy. A solution to this anomaly is at hand.

c) Local debt markets – the structural opportunity

Locally funded finance is clearly the most sustainable source of funds for EM sovereigns, and most particularly corporates, in the future. EM investors have been some of the slowest to deploy capital in their own markets. This should change as the perceived 'safe haven' status of the developed economies begins to wither. The US political posturing over the debt ceiling is probably just an early example of this.

Given the growth outlook, EM corporates should be the most capital needy. The extent of dollar-based financing for EM corporates has been highlighted as a concern at this point in the liquidity cycle but the scope for increased issuance in local currency is huge.

LOCAL CORPORATE DEBT AS A % OF GDP

US	90.72%
India	5.48%
Indonesia	1.14%
Mexico	15.15%
China	24.05%

Source: BlueBay Asset Management, July 2018

This makes particular sense as the next phase of EM growth is internally focused. **The first phase of globalisation (1989-2018) has seen EM countries exporting goods and commodities to the developed world. In the next 30 years the dominant feature will be the domestic growth of the developing economies. Domestic growth requires domestic finance.**

As select EM currencies gain more 'reserve' status and capital markets deepen, so this will also lead to a more broad based financial services industry. EM economies are under insured. Asset management services will be in much greater demand as income standards rise. The regulatory task will be hard to manage. It will be important that Fed inspired volatility is not simply replaced by volatility caused by individual policy mistakes. However, surely the opportunity is great enough to overcome this particular challenge, particularly when contrasted with the hardly spotless regulatory record of the West in the post Bretton Woods era.

If growth continues its upward path we could see up to USD300 trillion of asset creation in Asia in the next 30 years. This should excite us all as investors. It is the opportunity of our lifetime.

Closing thoughts

Often when observing global events, uncertainty and anger seem to be the prevailing sentiments.

Governments in the West struggle to produce a coherent democratic response to a changed world in which their citizens have less bargaining and buying power. Traditional foreign policy considerations are suddenly scrambled by the new world order.

The aim of this article is to illustrate the extent of the rise of the East, and to emphasise that it is not a passing phase. It will continue to be the dominant trend reshaping the global economy and great power politics for the next 30 years. And so in answer to the question posed in the title…'Are your children learning Mandarin?'. If they are, then congratulations to them as they have the chance to participate in the most intensive period of economic development and consequent investment opportunity in the history of our planet. For those of us whose children aren't…maybe they should start.

DISCLAIMER