THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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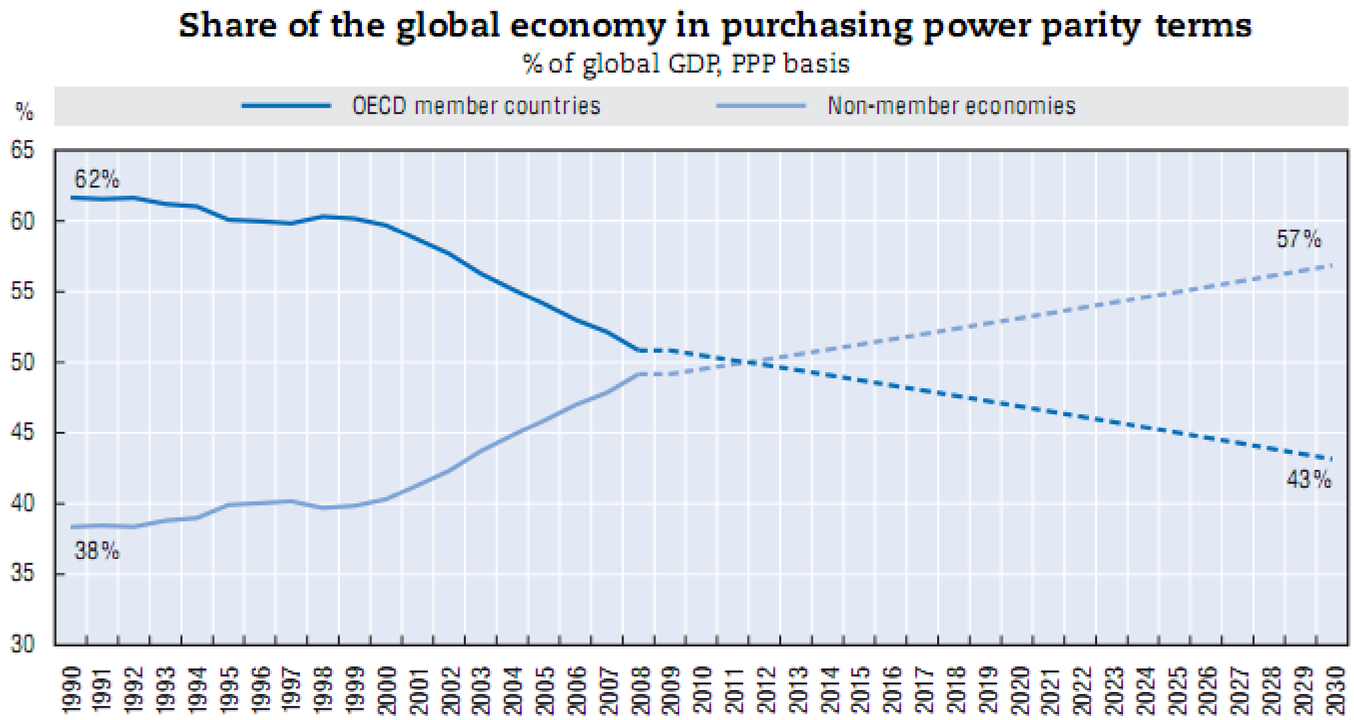
July 12, 2010

Positioning for a Tripolar World: The Good, the Not So Bad and the Ugly

- We increasingly view the economic and investment landscape in three parts — a 'Tripolar World' — that is split between emerging markets (the good), the US (not so bad) and Europe and Japan (the ugly). Whereas emerging economies are likely to grow in the mid-to-high single digits this year and next, developed world growth should be anemic, with US growth in the low single digits while Europe and Japan flirt with dipping back into recession. This perspective drives our strategic and tactical positioning, which favors emerging markets and developed world companies able to take advantage of emerging world growth.
- **The Good:** The emerging market story is well known. Led by rapid development in China and India, emerging market economies' share of global output is slated to overtake developed world economies by 2013 (see Weekly Chart). However, we believe a fundamental shift is beginning to take place in the composition of emerging market growth. Export-led growth has been the primary driver for emerging markets over the last decade — primarily commodities for Latin America and Southeast Asia, outsourcing and business services for India and manufacturing for China (following the successful development models of post-war Japan and the 'Asian Tigers' of Hong Kong, Singapore, Taiwan and South Korea). While exports will continue to play an important role in emerging market economies, as capital and wealth has accumulated, workers there are increasingly entering into the middle class with higher disposable incomes and a desire for better standards of living. In short, emerging economies are gradually becoming consumer societies as they transition from export-led to consumption-led growth.
- As this transition occurs, we believe that emerging economies must become less dependent upon exports to indebted developed economies that can no longer afford systemic trade deficits. Instead, emerging market growth will increasingly depend upon domestic consumption, and increasing domestic consumption will provide more trade opportunities *between* emerging markets (in 2009 China became the leading trade partner of Brazil, India and Africa). So whereas the emerging market story has been mostly about how well its countries and companies could fulfill consumer demands in the developed world, we think the opportunity now lies with how well countries and companies *anywhere* are able to meet the demands of burgeoning middle class emerging market consumers.
- Mired in debt, dysfunctional government, and poor demographics, the developed world's growth prospects are dimming and, if not careful, it risks slipping into irrelevance. Led by Japan, which began exhibiting signs of malaise two decades ago, we think the developed world's vitality is being surpassed by younger, more numerous, and increasingly productive and competitive emerging market upstarts. We view this as a natural progression, but one that does not necessarily have to come at the expense of economic growth in the developed world. In our view, maintaining dynamism in the developed world will require gradually reducing the size of long-term government spending, growing wages through higher productivity, and maintaining leading edges in technology, innovation, marketing and finance. With these competitive advantages, rising wealth in emerging markets can create new customers as well as new competitors. While easier said than done, we believe successful implementation of these measures will characterize those developed world countries able to maintain economic growth and relevance. The alternatives — ignoring the changing world, failing to tackle structural spending issues, falling behind in technology, closing off trade and becoming protectionist — are a recipe for economic decline, in our opinion.
- **The Not So Bad:** We believe that US corporations have generally been 'early adopters' in recognizing emerging markets' challenges and opportunities (we would also include the markets of Canada, Australia, the UK, and Sweden in this group). Hence we believe they are broadly positioned to benefit from the Tripolar World.

- **The Ugly:** Europe and Japan have been reluctant to restructure their economies, so after years of complacency they now have to make wrenching changes that are likely to keep them near, or even put them back in, recession over the next year. Furthermore, there is no guarantee that restructuring efforts will be enough to overcome entrenched interests, political sclerosis, cultural biases and relentless demographics, as Japan has amply demonstrated over the past two decades. However, to the extent that Europe and Japan *are* able to restructure, valuations are currently attractive and may present selective investment opportunities. Notably, Germany appears to be making the necessary adjustments to remain competitive in a Tripolar World. We are also watching for signs of structural change from Japan's political and corporate establishment, if only because China's rise can no longer be ignored or dismissed.

The Weekly Chart: Perspectives on Global Development



The chart above is from the Organization for Economic Cooperation and Development (OECD), whose 31-country membership is comprised mostly of developed market economies. The OECD's publication *The 2010 Perspectives on Global Development: Shifting Wealth* describes a world in which "OECD non-member economies have markedly increased their share of global output since the 2000s, and projections predict that this trend will continue. This re-alignment of the world economy is not a transitory phenomenon, but represents a structural change of historical significance." As may be seen, the OECD expects this transition to occur by 2012 (in terms of purchasing power parity, which adjusts for exchange rate discrepancies for identical goods and services).

The OECD concludes: "Rather than see the 'rise of the rest' in terms of the 'decline of the west,' policy makers should recognize that the net gains from increased prosperity in the developing world can benefit both rich and poor countries alike. Improvements in the range and quality of exports, greater technological dynamism, better prospects for doing business, a larger consumption base — all these factors can create substantial welfare benefits for the whole world." We agree and would expand policy makers to corporate leaders and investors. We believe that countries and companies that can facilitate this transition stand to benefit, whereas those standing in the way of, or trying to impede, global development are likely to see their wealth shifting away from them.

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