

Power-shift

AT A GLANCE

- We are moving from a uni-polar to a multi-polar world
- China could be the biggest economy in the world as early as 2027
- The dollar is vulnerable as international reserve currency as US power diminishes
- Increased interdependence will mean greater international cooperation
- Emerging market consumption will be a key driver of future global growth
- BRICs are united in vision, divided in practice
- Investors should position their portfolios to benefit from an epochal shift in power from the West to East

'China may overtake the US as soon as 2027'

A very different -looking top 10 economies by 2050

The defining theme over the next decade and beyond is almost certainly going to be the shifting balance of power in the global economy. This is not simply an emerging market story - after all, new markets have always emerged over time, with the likes of Japan, Korea and Taiwan joining the elite 'developed' nations club over the last fifty years. This is a story of the resurgence of sleeping giants, of economic and industrial catch up, of a historic shift in wealth from West to East that will change the economic and investment landscape forever.

In the first of our series on '21st Century Investment Themes', we take a step back and a leap forward in time to look at the long-term outlook for the balance of global economic power. Forget the short-term considerations of whether some emerging markets, such as China, might be over-bought and make sure you are on the right side of a secular shift in power that has the potential to define the shape of the 21st century.

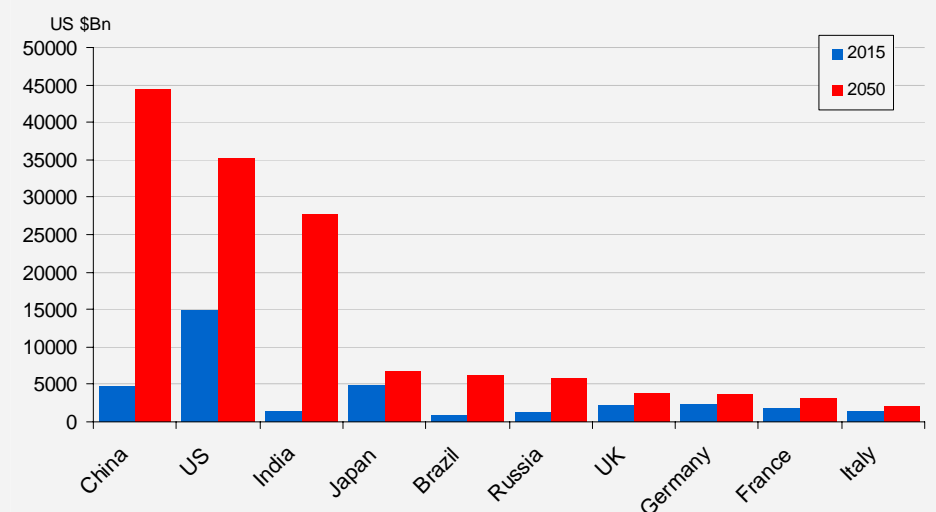
THE SHAPE OF THINGS TO COME

The global economy that we know today will be virtually unrecognisable by 2050. The rise of emerging powers, the impact of globalisation and a historic transfer of wealth, predominantly from western developed nations to eastern developing nations, will transform the familiar economic, political and investment landscape.

For much of the 20th century, the US provided the world with economic and political leadership. After the Cold War receded and capitalism was seen to win out over communist ideologies, we entered a relatively stable, uni-polar world where the US was the undisputed economic and military heavyweight. Expect this to change as the world becomes multi-polar.

The growth of emerging powers, principally Brazil, Russia, India and China (the BRICs), is increasingly challenging the uni-polar model. In 2050, we are likely to have a very different-looking economic 'top 10' (see the chart below). China is almost certain to be the largest economy in the world; indeed, the very latest figures from Goldman Sachs suggest that after the asymmetric impact of the western-inspired financial crisis, China may overtake the US as soon as 2027*. India will not be far behind the US, while Brazil and Russia will demote the major Western European powers into the lower echelons of the top 10. It is clear that the world is becoming increasingly multi-polar as gaps in national power narrow between developed and developing countries.

THE PREDICTED SHIFT IN THE ECONOMIC BALANCE OF POWER



Source: Goldman Sachs BRICs Model Projections, 'Dreaming with the BRICs' (2003)

*Source: Goldman Sachs, Global Economics Paper 192, 'The long-term outlook for the BRICs and N-11 post crisis' (December 2009).

MOVING TOWARDS A MULTI-POLAR WORLD

One of the most natural consequences of moving to a multi-polar world in which US power is diminished is that emerging countries will consider alternative models of development. Specifically, instead of emulating the established western model of political and economic progress, more countries may be attracted to China's centrally-driven economic model. This may be particularly true for African nations, where China has already forged some strong ties after investing significant sums to secure access to commodities.

Non-state entities are likely to become more influential. This includes companies. In fact, powerful international companies with global brands may increasingly gain influence at state level. The senior managers of leading financials, commodity producers and other strategic industrials may be found treading the corridors of power almost as much as our elected parliamentarians.

Political forums and trade organisations are likely to replace posturing with more substantive power and influence in an interdependent world and increasingly become used in negotiations between trading blocs. Traditional forums and alliances will weaken; the G8 (America, Japan, Germany, Britain, France, Italy, Canada and Russia) is almost defunct already, having been recently overshadowed by the enlarged G20 summit. These major power-broking events are likely to set the tone for a plethora of underlying multi-lateral and bi-lateral negotiations between regions and individual states.

THE SCOPE FOR DISCORD; THE NECESSITY FOR PROGRESS

While the move to a multi-polar world is a relative certainty, there are a number of uncertain outcomes that need to be addressed. In a multi-polar world, there is greater potential for discord but also greater necessity for cooperation and technical progress to solve widely-recognised problems. Continued economic and population growth will put increasing pressure on geographically-constrained energy, food, and water resources and raise the prospect of resource nationalism. Worryingly, the World Bank predicts the demand for food will rise by 50% by 2030.

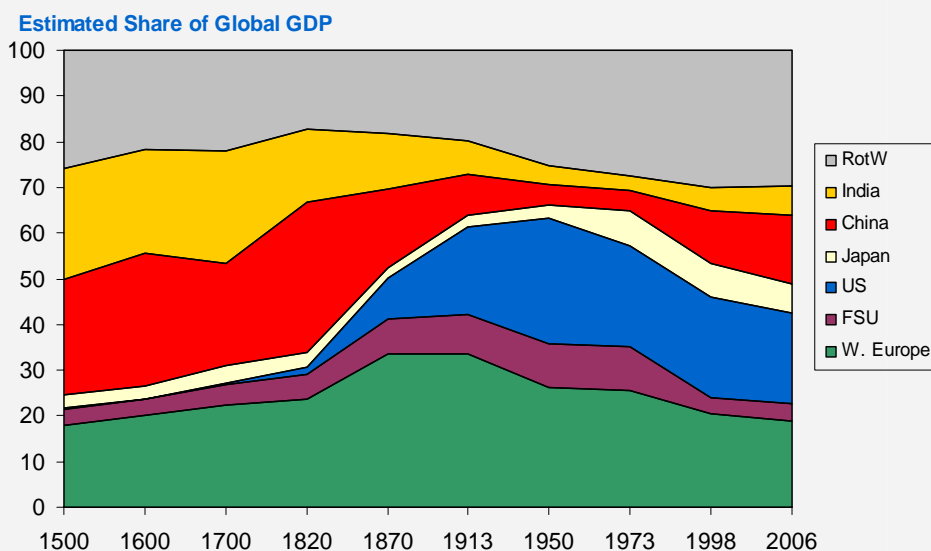
In particular, the need to move away from the current nexus of constrained energy sources, such as oil, is something that is recognised by all governments but, as yet, has no wholly satisfactory solution. In the short-to-medium-term, oil and gas producing countries could increase their economic and political power. In the longer-term, they could lose out as alternative energies are found. Green and renewable energies will slowly increase their share, but further technological advances are likely to be required to fulfil the global economy's burgeoning energy needs.

The US dollar's position as global reserve currency within the financial system has already been questioned in the fall-out from the credit crisis and the resultant surge in US government debt. Whispered calls for a new international reserve currency gained little more than newspaper inches, but how this story develops could have significant implications for financial markets.

'Strong, strategic companies with global brands and loyal consumers will be more influential at state level'

'Economic and population growth will put increasing pressure on constrained resources'

THE SHIFTING BALANCE OF ECONOMIC POWER THROUGHOUT HISTORY



Source: Angus Maddison, The World Economy: A Millennial Perspective, OECD (2001); IMF. Based on 1990 International (PPP) Dollars; FSU is Former Soviet Union.

WHEN SLEEPING GIANTS WAKE...

The long-term view is compelling and, in fact, it is also supported by historical precedent. History not only shows us that power-shifts are nothing new, it can also be instructive in telling us the conditions that typically accompany them.

Looking back through history, this comes with the caveat that it is more difficult to separate military and economic power as the two went more firmly hand in hand in the past, but even accounting for that we can make some insightful conclusions.

In the 1500s and 1600s, China and India were responsible for huge chunks of the global economy and international trade as it was then, much more so than is the case today. They then entered a period of international isolation and self-sufficiency in the 1800s which began to reverse in the two decades following the Second World War. The resurgence is overdue. They are, after all, the two most populous nations on earth. The difference now is that their governments and entrepreneurs are firmly embracing economic and industrial progress.

'Emerging markets export, developed markets consume'

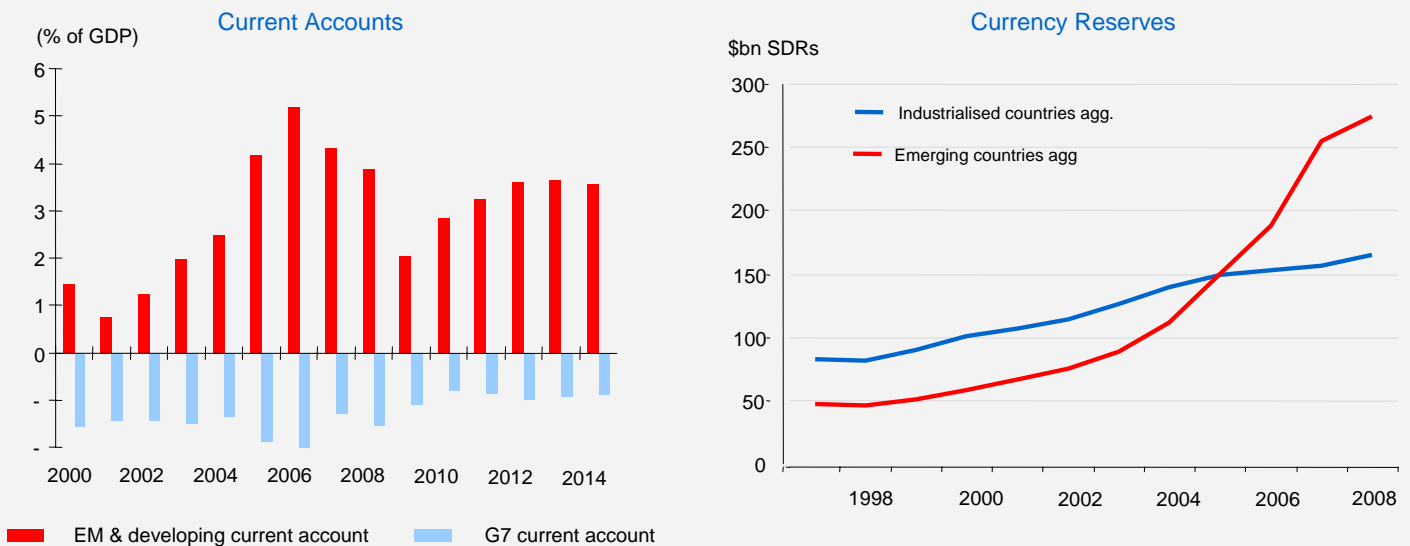
THE ASCENT OF EMERGING MARKETS

The rise of emerging markets in the last ten years has been extraordinary. As the panel below shows, emerging markets have improved their current account positions immeasurably in recent years through the export of commodities and manufactures, while consumption-hungry western nations have largely provided the demand side of the equation, resulting in a consistent current account deficit for the G7 since 2000.

The turnaround in the fortunes of many emerging economies has been dramatic, given that only 12 years ago Russia suffered a debt default and Brazil a major currency crisis. The current account surpluses and consequently healthy foreign reserves have been driven by increases in oil and commodity prices, which have generated windfall profits for the Gulf states, Russia and Brazil. Meanwhile, the competitive advantage of low cost labour has seen Asia establish itself as the world's manufacturing powerhouse.

These excess foreign reserves have been invested in US financial assets such as Treasury Bonds and have led to the establishment of sovereign wealth funds that have been active in the equity investment and corporate finance arena. After a flurry of activity at the start of the credit crisis, they have been a little quieter recently, but are sure to play a significant role going forward.

POWER SHIFT – BETTER CURRENT ACCOUNTS, BURGEONING FOREIGN RESERVES...



Source: IMF, World Economic Outlook Database, October 2009

'The credit crisis has clarified a secular shift in power from West to East in the minds of investors'

THE CREDIT CRISIS AS A DEFINING MOMENT...

The recent financial crisis was different from previous crises in many ways. In terms of its ferocity, it was the most gut-wrenching event for investors in living memory. But, perhaps even more uniquely, it was the first widespread credit crisis to have its epicentre in the west. Such crises used to happen in Russia, Latin America and Asia, with only the ripples affecting western economic shores. This time the shoe was on the other foot as the crisis took root in the US. Not only that, its impact was also most firmly felt in the US and Europe. Asian economies saw limited impact and the growing consensus view is that they have emerged relatively stronger than before.

The 1997-98 Asian currency crisis was, in retrospect, an important watershed, as governments vowed to learn from their mistakes. The Asian economies have since built up significant currency reserves to avoid the need for IMF help. Time will tell if the recent financial crisis is also looked back on as a transformational moment when the centre of gravity in the global economy decisively shifted. What is certain is that it has clarified and accelerated an ongoing shift in investors' minds.

POWER RESTS WITH THE CREDITOR NATIONS

History also demonstrates that economic and geopolitical power has tended to rest with the largest creditor nations. In broad-brush terms, this saw Spain dominate the 1500s thanks to a richness of South American gold, Holland gain influence in the 1600s on the back of emergent capitalism and seafaring trade, and France hold sway in the 1700s. Great Britain powered its way to economic hegemony in the 1800s on a combination of industrialisation and imperialism, before the US took on the mantle of largest creditor and geopolitical leader in the 1900s. Clearly, Asia regionally, and China specifically, are going to be the next names on that list.

China is now the largest creditor to the US

As recently as the 1980s, the US was still the world's largest creditor nation. Since then a burgeoning trade deficit has been funded by foreign investment in the US. China is now the largest creditor of the United States. Figures from the US Treasury Department show that China currently holds around \$740 billion in US debt, which is equal to around 60% of US national debt.

THE 800 POUND PANDA IN THE POWER-BROKING ROOM

China, China, China. Its omnipresence as an economic and investment news story is so complete that investors risk becoming completely lost in a rapidly proliferating forest of hyperbole. For once, however, the superlatives are justified. China is much bigger and growing much faster than any other emerging market or, indeed, any other country, period. China recently overtook Germany as the largest exporter in the world.

China has increasingly begun to wield its economic power on the political stage, though not always successfully. Attempts to swing the negotiations at the Copenhagen climate change conference in its favour were met with intransigence by western nations. More recently, strong global brands such as Google have effectively called China's bluff over alleged political interference.

The Chinese government previously backed down from its assertion that all computers shipped to China should have a Chinese-produced web filter. We are likely to see more of these kinds of stories in the near future as an ideological, economically powerful, China finds its way on the world stage. However, China already seems to be finding out that economic power is one thing, getting others to do whatever it wants is another.

TOWARDS A MORE BALANCED WORLD ECONOMY?

Let's go back to the fact that China recently overtook Germany as the world's largest exporter. This is, in itself, an interesting point because it reflects the huge industrial progress China has made, but also disguises the unbalanced nature of China's externally-facing economy.

The undisputed "workshop of the world", China is the king of exports but, in absolute terms, its level of consumption is weak relative to its western peers. Although consumer spending is growing strongly (and western firms are scrambling to get access to the Chinese consumer), it is doing so from a low base and the transition is complicated by China's preference for saving. As the chart below shows, the consumption share of GDP has been falling steadily in developing Asia as exports have risen.

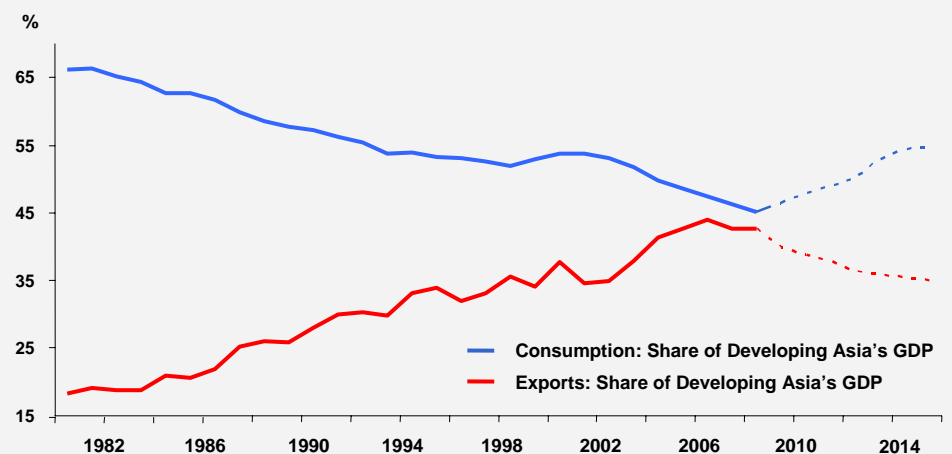
One western concept that China has rapidly embraced is inequality of income. Despite pockets of profligacy among the very rich, however, China has become less rather than more of a consumer economy in the past decade. The high savings rate in the household sector in China, India and developing Asia generally, can be partly explained by the lack of a social safety net. If governments begin to tackle this issue, Asian domestic consumption looks likely to be a dominant growth driver over the next few decades.

Until now, Asian governments have done little to generate more balanced growth in demand across the global economy. Japanese governments, for instance, have been happy to see a strong export sector and a strong yen compensate for weak domestic consumption. Discontent over growing deficits in the west, and growing demand for the trappings of western lifestyles from surging middle class populations at home, should make emerging market consumerism and the rebalancing of global demand an over-arching theme of the next several decades.

Emerging market consumption needs to grow to rebalance global demand.

The economy of developing Asia has become increasingly geared towards exports, while consumption's share of GDP has declined due to a high propensity to save earned income.

WE KNOW ABOUT EXPORTS, WHAT ABOUT CONSUMPTION?



Source: National Sources, IMF, UN, Morgan Stanley Research.

THE DEMOGRAPHICS OF POWER

Demographics has an important part to play in power shifts in combination with other political and economic factors. China is the most populous country on earth with around 1.3 billion people, while India is a firm second with around 1.2 billion. The next largest country is the US with just over 300 million.

While the sheer number of people can give an economy obvious labour market advantages, the composition of populations can also have a significant impact on economic power and stability. One of the challenges that Japan and many Western European countries face is the ageing of their populations, which is putting increasing pressure on the state and working populations. Due to its 'one child' policy, China will also have to face this problem in the next 30 years, at a much earlier stage of its economic development.

Another interesting strand of population theory that affects the balance of economic power and world stability, and which has also been a significant influence on recent US foreign policy, is the subject of 'youth bulge' demographics.

Many developing countries have a prominent youth bulge; these often tend to correlate well with increased geopolitical tension. For instance, parts of the Middle East and North Africa are currently experiencing prominent youth bulges (Libya, Iran and Yemen on the chart below, which shows the proportion of various populations in the critical 15-24 demographic grouping since 1950).

Improvements in health care, beginning in the 1960s, created the conditions for a population surge which has meant that many developing countries are today overwhelmingly made up of younger people. Proponents of the 'youth bulge' theory, such as political economists Gary Fuller and Gunnar Heinsohn, argue that this excess of young adult males often leads to social unrest and, in certain cases, war and terrorism, partly because the third and fourth sons in families find a lack of prestigious positions in their existing societies.

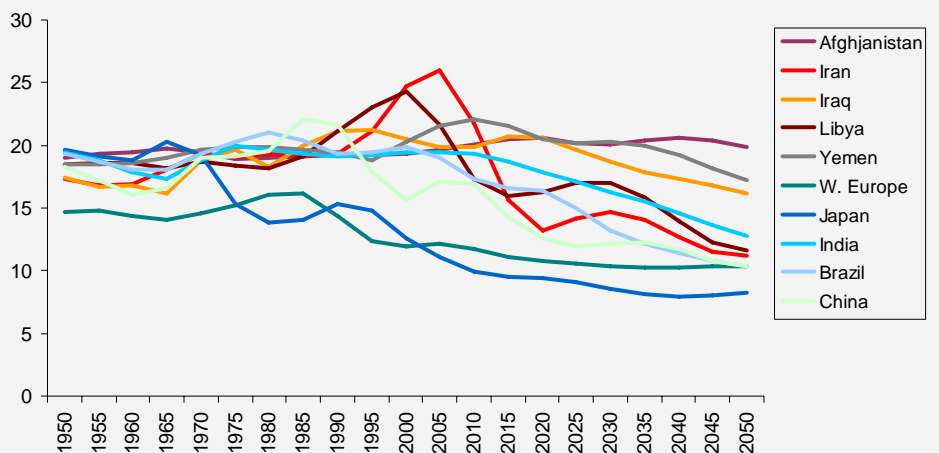
It is a contentious theory that tends to ignore a myriad of other social, political, and cultural factors, not least the consequences of poverty and unemployment. In isolation, it is certainly not an accurate predictor of social unrest or conflict. However, the theory has garnered interest because, even when there are a number of factors behind unrest, a 'youth bulge' is invariably one of them.

The chart also indicates that, with a few exceptions, youth bulges are projected to diminish in the next 30 years, which could bode well for greater geopolitical stability. We will be analysing demographics in more detail later in the '21st Century Investment Themes' series.

The demographics of 'youth bulges' have been influential in US foreign policy.

'YOUTH BULGE' DEMOGRAPHICS: IMPROVING OUTLOOK

Proportion of population aged 15-24



Source: United Nations, 2009, 'World Population Prospects: The 2008 Population Database'

BRICs AS POWER SHIFT LEADERS: UNITED IN VISION, DIVIDED IN PRACTICE

One of the interesting aspects of the power-shift is that loose affiliations, such as the BRICs, have actually bonded, finding common ground in their pursuit of national power and economic progress. All the BRICs have large populations, underdeveloped economies and governments that are willing, to varying degrees, to embrace global markets.

However, the similarities begin to end there; these are very different countries. China is now an acquisitive, high-investment economy with a powerful competitive position in low-cost manufacturing. India's economy is more closed and insular, with the jewels being a globally competitive software industry and a large outsourcing sector. The Brazilian economy is dominated by agro-exporters, while Russia is overwhelmingly biased to oil and gas. Given that the growth of the BRICs has been built on differences, we should not assume they will behave as a group going forward. In future, they may find they have as much to quarrel about as to celebrate.

CONCLUSION: SHORT-TERM RISKS, LONG TERM REWARDS

For every prediction, there is a naysayer and for every projection, there are myriad alternatives. Some commentators think that the growth we have seen in emerging markets is unlikely to continue at the same high level.

True, a decade of rapid growth in itself is not enough for the BRICs to completely wrestle the baton of global economic leadership from the US and western Europe. And, we may see bouts of volatility in emerging markets going forward. However, if things continue to develop in the same vein and we move towards the kind of global economy in 2050 that we discussed on the first page, then this historic shift in power could become the kind of epochal investment story that dwarfs even the recent heightened interest in emerging market equities and debt.

There are some short-term risks...

There are short-term worries that China, especially, is in a bubble, as many investors question its ability to create self-sustaining growth without significantly increasing domestic consumption. The Chinese government introduced a \$585bn stimulus package in November 2008 and loosened bank credit. All the economic figures subsequently suggested that it worked like a dream. However, much of the funds were channelled to favoured strategic export industries and public works, which has raised the risk of overcapacity in these areas.

...but the long-term story is compelling.

Nevertheless, although investors should be careful when extrapolating the recent past into the future, the long-term story is compelling as the BRICs and other emerging markets are expected to deliver growth numbers that simply overshadow mature, credit-crunched western economies.

With new drivers of growth expected to come from increasing emerging market consumption, we can be very positive about the medium-to-long-term outlook. Investors must make sure they have exposure to the beneficiaries of the historic shift in power that is expected to play out over the next few decades. Identifying the beneficiaries will mean not just having the foresight to select the right countries in which to invest but, just as important, being able to undertake the fundamental research to identify the companies which have the ability to succeed in what is certain to be a more competitive world.



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