# Equity portfolios and globalisation

EQUITY INVESTORS ARE RESPONDING TO THE GLOBALISATION TREND BY CHANGING THEIR INVESTMENT PORTFOLIOS TO A GLOBAL RATHER THAN A REGIONAL APPROACH. BUT WHEN YOU TAKE AWAY THE COMFORT BLANKET OF REGIONAL LABELS AND TOP-DOWN COUNTRY ALLOCATION, HOW DO YOU CONSTRUCT A PORTFOLIO THAT COVERS A UNIVERSE OF THOUSANDS OF MULTI-NATIONAL COMPANIES?

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Sarasin & Partners was one of the pioneers in tackling this issue 15 years ago through the adoption of a global 'thematic' approach. This means picking out the trends that run through the world of business and focusing on those with the most enduring long-term momentum. These trends are often very different from the regional macro-economic indicators studied by fund managers. Even when the economic climate is poor, there are always trends to be found with strong fundamental dynamics.

Take for instance the growing influence of the government in most economies. Most of us think of this as a negative trend but there is a move to direct national savings toward national projects and national champions. Nurtured by the government, and given preferential access to capital, these companies will be seen as the instruments of job creation and the development of new national core skills (names such as Petrobras in Brazil, Gazprom in Russia or EDF and AREVA in France stand out). The trick is to find companies, favoured by government, that also have the strength and freedom to price their business correctly.

A different but equally compelling theme seeks to benefit from the lip-smacking opportunities in the global agricultural economy. With the world population growing, there is an inevitable need to raise agricultural yields per hectare, a powerful trend that seems inexorable over the medium to long term. The agricultural yield enhancers such as fertiliser company Potash of Saskatchewen and tractor maker John Deere are clear beneficiaries of the theme.

The more you look, the more you find interesting developing themes. There are even some positive investment trends in the more negative results of human development including the monetisation of carbon emissions and of scarce fresh water. Consider also the unfortunate side effect of improved diets in emerging markets, which is that the spread of obesity appears to be inevitable with all its unfortunate consequences. We know from studies of developed markets what this involves, and also understand that once underway, this trend has strong momentum which will not be slowed. In Mexico soft drink consumption weighs in at 380 calories per day, outstripping the US on a mere 300! It appears that humans are not accustomed to year-round abundance and are genetically coded to lay down fat during the feast, in preparation for the anticipated famine that never arrives. The investment implications lie in the companies that provide treatment for the medical consequences which include insulin for diabetes and kidney dialysis.

## What effect has the financial crisis had on the outlook for global equities?

After unprecedented moves by central banks to flood the world economy with global liquidity, the first, albeit tentative signs of a reversal of economic policy are starting to be felt. But the process is certainly not going to be one recognisable to investors who remember previous tightening cycles. This time round the largest industrialised economies will be among the last, not the first to move, as they cope with enormous housing- and banking-related problems. In contrast, emerging markets – which are experiencing a colossal rebound in industrial production – need to raise rates more rapidly. Yet, because many of these economies keep their currencies tightly linked to the US dollar, they will be unable to move independently of the Federal Reserve. The result is likely to be rampant global liquidity and even faster emerging market economic growth.

Unconditional policy support in the G4 developed economies (US, UK, Europe and Japan) will exact a heavy toll on economic growth. In the G4, the long-term costs of last year's credit and banking crisis are staggering. Guarantees for bank debt, capital injections into failing banks and intervention in frozen capital markets have furiously expanded the public sector's footprint. The costs of these programmes will weigh heavily on medium-term growth. Debt-to-GDP ratios in advanced economies are already a sky-high 70%, and are projected to rise to 115% by 2014. Such vast public sector debt accumulation can only constrain future growth.

The implication for monetary policy in these countries is stark. Fiscal retrenchment means that monetary policy will need to do a disproportionate share of the economic heavy lifting in the quarters ahead. Interest rates will need to remain at historic lows, and even when they start to rise, their trajectory will fall far short of previous peaks.

So, with dollar pegs transmitting near-zero G4 interest rates to faster-growing emerging markets, the global economy that is rising from the ashes of the crisis is gradually bifurcating. Much of Europe, the US and Japan are increasingly defined by excess capacity and wide output gaps that dictate low interest rates, while most emerging markets and some advanced economies like Australia and Norway, which boast lower leverage ratios and sounder, simpler banking systems, face a more urgent need to normalise monetary and fiscal policy.

Such a two-tiered world economy, bound together by low interest rates in the G4 and undervalued pegs in the emerging markets, will continue to direct global capital to emerging markets in an effort to bring about an economic convergence. The process will reflate domestic emerging market asset prices potentially to bubble levels. In countries with exchange rate flexibility, currencies will continue to climb as interest rates normalise. In the absence of a revaluation of emerging market currencies or a more rapid normalisation of G4 interest rates, global economic recovery is likely to be a two-speed affair with gathering currency and interest rate tensions.

However, life is never simple for investors and, after the recent rallies and their multi-year outperformance of western markets, the valuations on emerging market equities are challenging. Capital controls, particularly in India and China, risk creating local asset bubbles, rising currencies will challenge earnings, and the rush of possibly quite ill-disciplined spending from recent stimulus programmes carries risks. By contrast western markets are cheaper but the growth rates seem less alluring.

So there seem to be no quick wins from regional asset allocation. The winners in materials and energy that so dominated returns over the past decade will now be vulnerable to new technologies, the highly successful green agenda and demand in the West that will stay sluggish. Many western financial stocks will find rising provisions, regulation and poor loan growth in the developed world cannot easily be mitigated by selling consumer banking services in the emerging economies. Similarly, local tastes, cultural barriers and brand will be a challenge to many global consumer stocks.

The winners will need to have flexible global supply chains, global brand value, local distribution capabilities and robust intellectual property. They will likely be geared to many of the 'new requirements' of the growing emerging consumer, namely healthcare (China has today 2% of world health spend for 20% of the global population), education, entertainment, travel and old age provision. They will also need to be able to arbitrage local currency differences, funding and labour costs across the global economy. This is ideal territory for thematic equity processes and argues for a continuation in the trend towards truly global equity portfolios.

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