Our Brave New World

History never repeats itself, but it often rhymes.

This simple fact explains why so many financial analysts, market strategists and portfolio managers like to study past economic cycles and market reactions before taking investment decisions. By studying financial and economic history, market participants are able to anchor beliefs on solid facts.

For over ten years now, a wide majority of market strategists and economists from famous investment banks, a large number of upscale financial publications, highly respected consulting have drawn on historical parallels to warn us that the expansion of the past decade in US consumption was both unsustainable and likely to end in tears. Real estate all over the Christian civilised world was bound to collapse, along with global equity markets. The world would then enter into an 'ice age'...

So far, and despite the strength of the above thought process, and the numerous historical parallels, the dreaded meltdown has completely failed to materialize.

When a thought process fails, i.e., when History fails to rhyme, money managers and analysts can typically respond in one of four ways:

1) Shut up and crawl under the carpet. This is usually an expensive proposition.
2) Pretend that the numbers are wrong and that, despite all the signs, they are right (i.e., enter into denial). This too, is an expensive proposition.
3) Hope that one is simply ‘early’ and that one’s scenario is about to unfold. This can sometimes work, but more often than not proves costly.
4) Admit that one has been wrong, and try to find out where the mistakes lie. This is the most intellectually honest stance to take and the one that we wish to adopt in the following pages. After all, as Churchill once said, ‘an economist needs to be able to forecast what is going to happen in a week, a month and a year, and then be able to explain why it did not’.

The reason so many analysts drag their feet in admitting that History has failed to rhyme this time around is that it would lead one to the dreaded conclusion that ‘things are different this time’.

But why is this a dreaded conclusion? Because anyone who has spent ten minutes on a trading floor knows that saying that ‘things are different this time’ is:

1) the easiest way to get laughed out of a room,
2) the most expensive words ever pronounced,
3) the surest way to lose any kind of credibility.

And yet, this is exactly what we aim to argue in this book.

The first thing that has changed is what companies in the Western World do for a living. Instead of producing goods, they now merely design and sell them while the production has been outsourced elsewhere. The birth of this new business model, the "platform company" model, has already had very important macro-economic, political and financial implications.

In Our Brave New World, we aim to review how, in recent years, our world has changed; and what this means for our investments.
"Tim, I don't read your emails every day, but I do my best to read them as often as possible and I enjoy them most of the time when I do read them."

I found myself at the other end of the email correspondence this week as Tim Price sent out an email waving goodbye to all his loyal readers.

Tim is Chief Investment Officer for wealth manager Ansbacher & Co in London. Or he was, because if I read his last email correctly he will be moving to a new position at Union Bancaire Privee, though that won't happen until June, so I guess he will have some transition time at home, on the couch.

It must have been a little over a year ago that I came across one of Tim's regular emails and I liked it. So I simply contacted him and asked if I could be added to his distribution list. Tim was happy to add me. And I have been a happy reader until yesterday.

It's not that he's such an inspiring writer. Most of the time his writings consist of large quotations from things he read elsewhere, and this doesn't always guarantee fluent reading. On occasion he refers to some particular in-crowd discussion which is apparently taking place in the Big City's finance circles, which doesn't interest me in particular either.

But Tim is also a thinker. As you all may know by now I like to be inspired by new ideas, new approaches, or simply the same old thing but looked upon from a different point of view.

Tim also has been around for a while, I can tell from his writings and comments. A free thinker, working in the finance industry, who has been around for a while, and who hasn't fallen for the temptation to go full force in his attacks on the ruling system (unlike many gold bugs), that is something to cherish, I think.

It was Tim who first pointed me at a book that was making waves within global financial circles. Soon after I was made aware of its publication, and its impact, I ordered a copy over the internet. It took a few days for the hard copy to end up in my mail box.

I remember starting to read it in the late afternoon on the very same day it had arrived. I couldn't stop reading. I had to finish it. And I did, in the middle of the night, feeling inspired and enlightened, and sad there were no pages left anymore.

Two weeks later I handed it to Greg, saying I had lots of ideas about how to approach its content and some of the points made, but time simply was not on my side. Having been around himself for a while, Greg was rather skeptical at first. After all, how good could it be if I was passing it on to him?
It did not take long before he got back to me admitting he too had been truly inspired. I asked a few of my overseas contacts. They all had already read it too: they thought it was fantastic.

The book I am talking about is Our Brave New World, published by independent researchers GaveKal. Simply Google the title and its publisher and you will find we are far from the only ones who have been inspired by the book's free thinking spirit.

I have no commercial interest in doing this, but if you are looking for the ideal birthday present, or simply for the next best book to read yourself, this one has to be on top of your list - because it truly wipes away the mind of its readers.

The book only costs US$20 when ordered directly from the GaveKal website (like I did). And that includes shipping costs.

In case you don't want to spend the money, or cannot, we plan to offer you a series of smaller feature stories on the basis of this book. We published our first one today. Greg is having a helluva task to try to match the inspiration that comes from the original. But he's been around for a while; his shoulders can carry the extra burden.

I take the liberty to end this week's editorial with the quote Tim Price used to open his final email: "Good Night, and Good Luck." - US broadcaster and journalist Edward R. Murrow.

May you all find inspiration and enlightenment!

Till next week.

Your still inspired editor,

Rudi Filapek-Vandyck

(supported by the Magnificent Three)

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Feature Series: Brave New World Part I
19 April 2006

By Greg Peel

GaveKal Research is an independent economic research house and consultancy created in 1999 in the US by Charles Gave and partners. GaveKal has a reputation for "original thinking". The following feature series is drawn from a GaveKal publication of 2005 entitled: Our Brave New World.

For over ten years a wide majority of market strategists and economists from respected investment banks, a large number of respected financial publications, and a number of highly respected consulting firms have turned to history to suggest that rampant expansion in US consumption in the past decade was doomed to end in tears. Real estate markets would collapse, stock markets would collapse, and the world would enter an economic "ice age".

It hasn't happened.

Some observers have not changed their view – they've just extended the time frame. Others have tempered their view, and still others have thrown their text books out the window and gone fishing. GaveKal is one organisation that has been prepared to say "things are different this time". This is a big call, as those who utter these immortal words in the world of financial markets tend to become mortal pretty quickly.

It was Alvin Toffler who coined the first, second and third wave phenomena. The shift from hunter-gathering to agriculture and the formation of the civilised society was the first wave. The invention of the steam engine brought us the massive boom that was the industrial revolution which became the second wave. Toffler suggested the third wave would see information substituting for material resources, and the gap between producer and consumer bridged by technology. This is pretty impressive when you consider Toffler predicted the third wave in his publication of 1980.

There are not many economists who have adjusted to the third wave. Their worlds are still all about industrial production, inventory levels, trade balances and so forth. In the third wave, these measures become increasingly irrelevant.

The first economists appeared in the late 1900s. Their recommendation for value-adding was all about efficient agriculture. Unfortunately they refused to take notice of the industrial explosion going on around them at the time. History repeats.

While economists are slow to wake up, successful companies are no longer operating on business models of a generation ago. Relationships between countries have evolved. Social structures have been transformed. We have entered a brave new world, and that world has given birth to a new phenomenon – the platform company.
Traditionally, a company has followed a long-standing, straightforward process: design a product; manufacture the product; sell the product. To use a US example: Ford designs a car; it is manufactured in Detroit; it is sold through dealerships all over the country. This model has been in place for about fifty years. Global expansion has been added, for example: Toyota designs a car in Japan; it is manufactured in Australia; it is sold through Australian dealerships.

This is yesterday's business model.

The new business model is to produce nowhere, but sell everywhere. This is how a platform company operates. It simply stamps its logo on a product someone else has actually produced.

Platform companies keep the high value-add parts of research and development, treasury and marketing in house, and farm out everything else. Out of the three steps of designing, producing and selling, producing is a mug's game.

Producing is capital intensive, often labour intensive, and requires one to keep expensive inventories. It is a volatile business. Manufacturing businesses usually trade at a discount to non-manufacturing businesses on the stock market because returns are volatile, and generally lower. Cut out the middle, and a platform company can concentrate on designing and selling while keeping a nice lean balance sheet.

And the model can extend well beyond the manufacture of widgets. For example, many global hotel chains have sold off their hotels, but have kept the branding and simply operate now as managers. This "light balance sheet" concept allows companies to change and adapt quickly and efficiently. It could be compared to travelling with a small backpack as opposed to a trolley load of suitcases.

When executed properly, the platform company business model makes for very high, and stable, returns on invested capital. With that in mind, can we safely say the platform company is here to stay?

Of all the examples and anecdotes in GaveKal's treatise, this one is a cracker: The laptop on which the treatise was typed was made in China. The PCB was made in Singapore and the motherboard in Malaysia. The flat screen was made in South Korea. The semis were made in Taiwan, on a US design patent. Some of the software was compiled in the US, some in India, some in Sweden and some in Russia. The design was created in Texas, and the laptop was assembled in China. On the bottom, it says "Made in China". On the top, it's stamped Dell. And who do you think makes the real profit?

Consider two very strong forces which have contributed to growth in the capitalist world - growth that has led to the concept of the platform company. Firstly, growth can come from the rational organisation of talents.
If a surgeon can type faster than his secretary, should he do the typing? No - that would only take up his time, and he earns a helluva lot more slicing and dicing. He'll stick with a secretary. The benefits derived from this example are enhanced in the global marketplace by free trade. France makes great wine and Senegal produces great football players. So the Senegalese should stick to French wine, but their footballers should play in France.

The second growth force is invention. (The mother of all growth forces?) Build a better mouse trap and the world will beat a path to your door. A new invention can trigger demand, lead to new products, new management techniques and new markets. Since faxes, emails and broadband, who would invest in telex? (Younger readers may need to ask me what "telex" is at the end of the lecture).

Growth through the rational organisation of talent requires low trade barriers. Growth through invention requires low regulation, tax incentives, easy access to capital and, most importantly, the ability, and the right, to fail. This is a pretty good summation of most of the Western world, so what's the big deal about the brave new world?

The Dell example shows that free trade opens up the potential for countries to be economically integrated with one another. Not only does this help in promoting peace, it promotes faster economic growth. The more countries that join economic forces in a global network, the greater the economic benefits. And the benefits can be exponential.

A world with two centres requires one line of communication. Add a third and you need three lines. Add a fourth and you get six lines. Keeping going and you get what is known in mathematical parlance as "lots".

Every day, some new pole is added to the global economy. Yesterday it was China, today its India. Tomorrow it could be Vietnam, the Ukraine or Egypt. With each new addition the lines of communication grow exponentially. And shortly following, in order to cement the opportunity, comes massive spending on telecoms, aircraft, roads, ships, tourism – everything needed to be part of the global society.

The exponential growth in communication lines sets in train other possibilities. The exchange of ideas leads to more new inventions. Suddenly the lines of communication that kick-started the relationship may spawn new ideas, for example, in communication (Skype?).

Within the brave new world it quickly becomes apparent that econometric models, based on second wave principles rather than third, will struggle to quantify such inherent possibilities and potential outcomes of the new system. Each time a new player enters the game the whole game is enriched. For emerging economies, even the impetus and wherewithal to build something as simple as a road can take food and other goods to subsistence peasants, while sending labour back in the other direction. But this inherent opportunity has never been accurately forecast. (Who really saw the ramifications of China, not five years ago?)
Technology, free trade and infrastructure are three of four pillars on which the platform company business model rests. The fourth is overcapacity. Rome wasn't built in a day, and in Aldous Huxley's Brave New World there were alphas and there were epsilons. But more on that later.

**Feature Series: Brave New World Part II**
24 April 2006

Three of the pillars upon which the platform company business model rests are technology, which allows the rapid exchange of information and ideas; free trade, which allows for economic integration across borders; and infrastructure spending, which provides for the benefits of the first two to be efficiently exploited.

The final pillar, or requirement, of the model is prevalent overcapacity. Overcapacity is an inherent part of capitalism which ensures competition and the lowering of prices through efficiency. One problem with overcapacity is it means there must be successes and failures, winners and losers along the way. But that is capitalism.

Overcapacity leads to falling prices. The concept that prices must fall is something Marx took as a reason why capitalism must ultimately destroy itself. However, falling prices also affect greater sales and greater disposable income which then flows back through the system. It might become cutthroat but the system will not destroy itself simply on falling prices.

While acting with the best intentions, it is unlikely Marx would have ever envisaged what his doctrine would lead to – particularly the cold war. But communism was never really communism anyway (a fact which George Orwell was quick to point out), and even well-meaning hippies eventually bowed to the inevitable.

Overcapacity is inherent in the capitalist world, and it has become particularly prevalent in the twenty-first century. Enter China. China's excess savings have been used in a rush to exploit the country's inclusion in the capitalist world by building ridiculously excessive manufacturing capacity.

In China today, for example, there are reputedly 3000 ball-bearing manufacturers. The market can probably support ten. The Chinese government has been moving to place some controls over capacity madness, and prevent the collapse of markets and subsequent ramifications. It seems a bit like shutting the gate after the horse but again, no one was quite ready for what was about to happen.

What China has slowly succeeded in doing is evolving a manufacturing industry which is not only competitive on price, but also on quality. It is shaking off the "Made in China" joke. Recent years of capacity overspending can be utilised by aggressive exporting of competitive products which will then challenge producers elsewhere.
To do this China needs to be able to move goods around, to source production anywhere, and to create producer competition. The Chinese have begun to buy outside China – facilities, mines, oil wells – and boy doesn't this scare a few people.

However, this is the goal and not yet the reality. China is still in the midst of a capacity bubble. This bubble has provided impetus for the platform company business model to develop and thrive as established industries in the Western world remove the low return business of production from their balance sheets and shift the risks elsewhere. But were this bubble to burst, would the whole model implode?

To discuss this point consider that there are two types of bubbles – those that take place on non-productive assets such as land, gold or tulips (the "rarity" factor), and those that take place on productive assets such as canals, railroads or telecom lines.

In the first case, if the bubble bursts well, prices fall, but we still have the same assets as we started with. In the second case, prices will fall, but only until such time as the assets come to be more efficiently utilised by someone else. In the case of an overcapacity bubble, assets ultimately move "from weak hands to strong hands".

Then there is the finance issue. Bubbles financed by banks have widespread ramifications that upset the banking system and can cause collapses. Bubbles financed by the financial markets (stocks and bonds) are not as destructive as only the investors lose out. An example of a "bad" bubble is the Japanese real estate boom of the 1980s which was financed largely by banks. An example of a "good" bubble is the tech boom of the 1990s which was financed by stocks and bonds.

For a productive asset market to be revived after the bursting of the bubble, the assets must move from weak to strong hands. For this to occur, companies must be allowed to go bankrupt, assets redistributed, and efficiencies sought. If this is not allowed then the deflationary effects will linger as the vain support of excess capacity will continue to keep prices low.

Japan attempted to prop up its system for decades. That is why it is only now looking at some light at the end of the tunnel. The UK and Europe have a history of not allowing iconic companies, such as car manufacturers, to die. This has contributed to economic sluggishness. The US, on the other hand, let everyone do their dough on the tech boom, shrugged, and moved on.

China's system equates to that of Japan, and not to the US. The country's bubble in infrastructure, factories and construction has been financed either by retained earnings, by foreign investment, or by banks. In China's case, the banks are merely an extension of the government. Thus the government is the ultimate owner of failed enterprises, and it is unlikely it will sell off the ranch for a loss. Instead, it will keep unproductive companies on life support. Overcapacity will linger.
As commodity prices have soared, the world has been waiting for the subsequent inflation wave to hit (particularly with regards to the oil price). It hasn't. What we have is a "things are different this time" scenario. The combination of globalisation, industry deregulation, technological progress, the internet, and the platform company have moved the economic world close to the concepts of perfect information and perfect competition. Prices are made at the margin, and no longer on average.

Overcapacity leads to lower prices, but shortages and supply disruptions still lead to price spikes. A global platform company is a deflationary force. Take a company like Wal-Mart in the US. It has a computer system reputedly second only to the Pentagon. Wal-Mart can rapidly identify excess capacity somewhere in the world and exploit it at the optimal price. Thus prices will tend to be kept low.

As much as the platform company is a deflationary force, it still can't prevent supply shortages or infrastructure disruptions. However, China and other emerging markets ensure a massive amount of labour and manufacturing capacity, and with equally massive amounts of savings it can be guaranteed that the cost of capital in China, for example, will remain low for some time and that excessive investment will continue.

This explains why global inflation has not reared its ugly head. The expression "China has exported deflation to the world" is often used. Whereas in the past increases in inputs – oil, copper, labour etc – have been passed through to the consumer, resulting in a fall in disposable income, in today's world price increases lead to a fall in the profits of the companies that cannot increase productivity fast enough and who, because of the internet-connected world, have no pricing power.

Commodity price increases have not hit the Western consumer, they have hit the Chinese corporation.

If ever one needed evidence of this just look at the Chinese stock market. The country is undergoing unprecedented economic growth, a percentage of its population is a lot wealthier than it used to be, and yet its stock market is at five-year lows. Chinese companies have not been able to make money in the boom because they are unable to raise prices.

The platform company model has opened the way to a world in which inflation is totally discontinuous. Instead of hurting the consumer, inflation wipes out the most marginal producer. China has been growing at a colossal pace in economic terms as it rushes to become part of the mature capitalist world. Unfortunately for the Chinese, the mature world has been able to benefit from a world containing globalised, integrated networks and rapid information exchange. China has been unwittingly exploited. Capitalism is returning to its deflationary roots.

Coming up: The rich get richer, the poor get the picture, and is this a problem?
The twenty-first century has brought the rise of the platform company. A platform company is one which retains the high-margin design, marketing and sales elements of a product while outsourcing the low-margin, labour and capital intensive manufacturing process. In so doing the platform company makes the bulk of the profits (and these are within the "Western" industrialised nations), while the outsourced manufacturers receive very low reward for risk (emerging markets such as China).

Overcapacity in emerging markets has ensured that platform companies can quickly switch their manufacturing contracts to wherever the best price is offered, leaving competing manufacturers to fight over what little margin there may be. The whole process is deflationary, as prices are kept to a bare minimum.

As the platform company model becomes more prevalent, it is probably more correct to suggest that "Western industrialised nations" are no longer so, but more "Western post-industrialised nations" or perhaps "Western service nations". The emerging economies, such as China, India or Brazil, are becoming the new "industrialised nations". The West has outsourced its industry.

Because the West is making all the profits, while the emerging markets take all the risk, it follows that the rich are getting richer. But strangely, it's also getting a lot more expensive to be rich.

If Western economies have been making all the money then one would expect this to result in inflation, as wealthier consumers can pay more for whatever they might want. However, inflation globally has struggled to breach a 2-3% level, even despite a significantly higher oil price.

The reason inflation hasn't bitten is due to the deflationary effect of the great capacity boom in emerging markets, and the subsequent fall in price of manufactured goods. In Britain for example (as measured to 2005), clothing prices have fallen 42% in a decade, shoes are down 31% and consumer electronics are down 63%.

With such falls in these everyday items you would think we would actually have negative inflation, not low positive inflation. So using Britain as the example again, anyone who's been to London knows it is one of the costliest cities in the world. Australians used to cheap-and-cheerful Thai meals for example, have heart attacks when trying to eat out – even simply – in London. The reality is, not everything has fallen in price.

The offset to the fall in price of manufactured goods is the equivalent rise in price of those goods or services that the emerging markets cannot deliver. Financial services, for
example. Insurance, education, real estate. And any service industry such as holidays, hairdressing and indeed, restaurants.

In Britain over the past decade prices of such services have increased 30-60%. It is such services or goods, some of which might be called "luxury", that are making it a lot more expensive to be rich. But within those countries that can provide such goods and services – the post-industrial West – the providers are benefiting from the higher prices and thus getting richer. An upward spiral of sorts.

In the meantime, the booming emerging industrial countries such as China are producing goods at lower and lower prices and lower and lower margins which means less pay for workers. The wedge between the global "haves" and "have-nots" is getting wider. Surely there are ramifications of such a trend?

Let us consider firstly that there are more effects leading from the platform company model than just lower prices. The blue collar worker in previously industrialised nations such as the US is disappearing. This is not good news if you are a blue collar worker, or unionist, or political champion of the "working man". But either way there is a generational shift from a blue collar to a service industry workforce.

The industrial part of the production process – that which the platform company has outsourced elsewhere – is by far the most cyclical of the design, produce, sell process of industry. Something is invented or improved upon, it is highly sought after and attracts a high price, everyone opens factories or tailors factories to jump on the bandwagon, prices collapse. Workers are laid off.

The cyclicality of the process ensures volatility within the system – boom, bust, boom, bust. But under a platform company model, that volatility has been outsourced along with the production process.

If a company such as Ikea finds a particular line of furniture is no longer popular, it can contact its outsourced producer and say "I don't need so many of those anymore". But the producer might say "But I've ordered all the wood and set up my factory to make them". To which Ikea can say "Well then you should be able to give me a good price on the smaller order then." In the meantime, Ikea develops a newer model that becomes popular, and so never suffers from overproduction and subsequent loss on inventory.

The producer, however, does suffer.

The volatility of production ensures volatility of wages, employment and profits. Over the past decade volatility in the US of these three elements has fallen substantially (and no doubt the same has occurred in Sweden, home of Ikea). This fall in volatility has an important flow-through effect.

If the employment market and wages are stable, an individual can be more confident in spending money, rather than feeling the need to save it just in case. To take it to the next
level, an individual can be more confident in borrowing money to finance a new house or car, for example. The same is true at the corporate level. With a stable flow of profits, a corporation can more confidently leverage for the purpose of expansion.

Is it any great surprise then that the US has become the great consumer nation, running up vast amounts of debt? While wages, employment and profits have reduced in volatility, volatility of imports has greatly increased. In the meantime, the US has exported its volatility to the emerging world.

Many economists have despaired at the size of US debt, and its lack of savings, but strangely delinquency rates on loans in the US have also fallen – quite substantially compared to the booming 1980s. In past times an event such as 9/11 should have brought the US economy to its knees, but that has not been the case. The US economy has motored along, and the US consumer has been the "bedrock of the world economy".

It is in to the US and other long established economies that China has sold. Vast amounts of liquidity in China have encouraged productive capacity to provide goods for Westerners to lap up as they go further into debt. Many an economist has been expecting the big crunch, a natural outcome of the growing global imbalance, but to date it hasn't eventuated. A lot of those economists are now tempering their views. The platform company model, it would seem, has contributed to the stability of a system which might previously have been unsustainable.

But while China can keep producing goods and the US can keep buying them the fact remains that Western economies have exported their volatility to emerging economies. It is the likes of China, India, Mexico and Brazil that will suffer booms and busts in specific products, collapsing profits and laid-off workers. The stability of Western economies may have supported the growth of emerging economies, and allowed many a Chinese or Indian to become far better off than they were previously, but at the street level there is plenty of room for poverty and unrest.

It is interesting to note that resources analysts are looking with some trepidation towards an upcoming round of mine-worker contract renegotiations across the globe. A lot of the current massive bull run in the copper price, for example, has been caused by supply disruptions due to industrial action in nations such as Mexico.

If further supply disruptions occur, then prices will only continue to skyrocket. This is all well and good for mining companies, but at some point price levels must have a dampening effect on demand. No one is sure at what point this will happen, as everyone has been surprised that demand, particularly in China, has held up this far. When it does happen there will be quite a shake out.

Perhaps the humble worker still holds the power. More in Part IV.
Two facets of the US economy have been very much under the microscope of late. Recent years have seen a boom in housing prices and an unprecedented blow-out in the current account deficit. The bears would tell you both are a recipe for disaster as far as sustained US economic growth is concerned.

Australia has seen a similar transformation. Not only have Australian house prices surged but the deficit has also begun to worry many observers. But while Australia has experienced a quietening of the housing market, it has not been devastating, and despite a growing deficit the Australian economy rolls relentlessly forward.

The bears have begun to either temper, or question their views. Why have there been no disasters to date? The US housing market may have eased, but it hasn't collapsed, and the US economy continues to be strong in the face of record after record in the current account deficit. The answer is that the bears' predictions are based on an economic world that has now passed. The platform company model has heralded a new paradigm.

Australia's housing price surge actually led that of the US, and it's a bit unusual that Australia should lead the US in anything much. One possible explanation is that because of the Sydney Olympics in 2000, the rest of the world found out just how great a place Australia is and hence foreign interest sparked a scramble for real estate.

There might well be truth in this, but the reality is that housing prices rose because interest rates fell, inflation was low, and disposable incomes increased. Throw all this together and it makes sense that the average Joe would aspire to own a better house, and had the wherewithal to pay for it. Result: real estate surge.

As discussed in Part III, the platform company model has led to a fall in volatility of corporate profits and worker incomes in "Western" countries. This has allowed both companies and individuals to feel far more secure about the future. In the meantime, the Chinese story has led to downward pressure on the real prices of many goods, and the platform company model has ensured that while margins have fallen in the emerging world, margins have increased in the Western world. That is why Westerners have more disposable income, and why they've had no qualms in spending it.

The surge in real estate pricing has not, thus, been a bubble at all, but a secular price adjustment under the new paradigm. That is why we've have seen the heat come off the market from the last great burst, but have only experienced a benign southward drift of prices to a new, higher average.

And have houses really become overpriced at all? Prices should realistically reflect the price of a mortgage, as that's the way average Joe will finance his purchase. Leave the
super-rich out of the equation for a moment (and besides, Sydney waterfront prices have hardly faltered). The best measure of mortgage prices in the US is the thirty-year mortgage zero coupon bond.

US figures suggest that the housing prices and the price of the bond have risen in close correlation for the last fifteen years. This means prices have only adjusted dollar-for-dollar with the decline in long term interest rates. Not a bubble at all.

Okay, so housing prices can be explained. But surely a massive US current account deficit (which reflects the amount of money borrowed by US corporations and individuals to finance ongoing consumption) is a dangerous beast?

To address this, let's go back to the Dell computer of Part I. The flat screen, built in Taiwan, costs (all figures are in USD) $300. The Taiwanese manufacturer's margin is $30. The mechanical part and the box it sits in are made in China and cost $100, with a margin of $5. The Intel chip, designed in the US but made in Taiwan, costs $70 with the margin split $35 to Intel and $5 to Taiwan. The Microsoft software costs $200 with a margin of $180. Dell takes a sales margin of $30 when it sells the completed PC.

If you crunch the numbers from an accounting perspective, US companies pick up a total margin of $35 + $180 + $30 = $245. Foreign companies earn $30 + $5 + $5 = $40. On the sale of the computer, the US is $205 ahead.

An economist, on the other hand, would look at it a different way. Leaving out the Microsoft software and the Dell mark-up, the PC sold in the US equates to a $470 import. Nothing is exported, thus the trade deficit is $470.

Between them Dell, Intel and Microsoft make a profit of $245 which adds to the US GDP. The economy thus suffers a net "loss" of $470 - $245 = $225.

The economist sees this result as unsustainable. The US moves further into debt and the risk is the US dollar will collapse if foreigners decide to stop selling into the US. But if the exporters to the US are making an average margin of 1%, and US exporters make an average of 20%, which economy would you prefer to own?

As far as economists are concerned, a country's imports and exports need to balance over time otherwise debt continues to build until the whole system collapses. But trade balances are calculated on the value of sales, not on the sales margin.

Mature economies, those who have moved to a platform company model, enjoy stable incomes for workers who thus feel no need to save. Companies have a positive cash flow with high returns so they don't need to retain large amounts of precautionary capital. Emerging market economies suffer unstable incomes for workers who must save to avoid a crisis. Companies work with negative cash flows and low returns and need to retain capital to avoid going bust.
Where do those savings go?

Into an investment that provides security of return – that's where. So emerging market savings are fed back into mature market assets and the circle becomes complete. Hence the US has become part of what is called a "global trade imbalance". But what has really happened is that goods have been exchanged for assets.

In 1991, foreigners owned 11% of the stock market. In 2005, with a burgeoning current account deficit, the figure was 17% - a 50% increase. That goes some way to explaining why the US stock market has quadrupled over that time. Prices are made at the margin. And at the end of the day everyone is richer – the US consumer, US companies, Chinese companies and Chinese workers.

There can be no reason to worry as long as the US has assets to sell.

The US trade deficit does not exist because China has a comparative advantage in being able to save instead of borrow. It exists because under the platform company model the US can outsource its production to wherever it can get the best price. The deficit is offset by a colossal increase in earnings, and foreign investors also gain a benefit from that increase.

Economists will suggest if you have the advantage, this should manifest itself as a trade surplus. But the new reality is that the advantage has manifested itself as a higher standard of living. From 2000 to 2005, US profits have increased by US$500 billion, and the US current account deficit has increased by US$250 billion. If you apply a 20x multiplier to the value of US assets, this suggests the deficit could blow out to US$10,000 billion before there is a problem. In 2005 it was US$1,200 billion.

As long as corporate profits rise more than the deficit deteriorates, the imbalance is viable. It does not seem from these numbers that "unsustainable" is a word that can be applied yet.

The US has been balancing its current account deficit not with its GDP, but with the value of its assets, which foreigners are happy to buy as they provide security and healthy returns. Even buying a house in Miami represents value to a foreigner who is not used to a relatively stable and safe society. The deficit should not be measured as a proportion of GDP, but as a proportion of the value of US assets.

Coming up in Part V: how can this system continue to grow?
Under the platform company model, the labour and capital intensive and low-margin step in the economic process – production – has been outsourced to emerging economies in order to exploit low cost opportunities. This has allowed companies in the Western world to reap most of the profits while reducing a lot of the risk.

But the practise of outsourcing has not ended with factory workers in China. It has also seen the emergence of the Indian call centre. Thousands of low-paid Indians now sit in call centres in Mumbai or Bangalore either receiving call for the likes of phone directories to insurance claims to help desks, or ringing out with sales pitches of every kind. The outsourcing process has taken a further step – from blue collar worker to service sector worker. Where will it end?

The Australian government has recently shocked its electorate by on the one hand providing airline route protection to Qantas, which blocks competition and allows ticket prices to remain high, while at the same time making no moves to prevent Qantas’ plans to move maintenance of aircraft offshore.

While the former is frustrating, the latter cuts to the heart of the Australian people. Qantas has the best safety record of any airline, and yet both Qantas and the government are prepared to compromise that record for the sake of lower costs. The safety record was established by good, honest, hard-working Aussies who had pride in their job and their reputation. Now those people will be forced to look for work.

Taken to the nth degree, one presumes eventually all jobs that can be filled for less wages outside a mature economy will eventually go, leaving less and less traditional jobs available for the average worker. Can this be sustained, or will there ultimately be a revolution as unemployment reaches desperate levels?

While traditional economists see this evolution as unsustainable, platform model economists do not. If government's move to stifle the natural redistribution of labour, they will only end up shooting themselves in the foot.

Adam Smith proved that the capitalist system is one that works because it is based on inherent human nature that every participant in the market place aims to maximise profit. Marx argued that rising profits is representative of the exploitation of the humble worker.

Some 60% of Americans now own shares, either directly or through pension plans, and US corporate profits keep rising steadily under the platform model. In Australia, a country with compulsory superannuation, that figure would be higher still. This means that the majority of wage or salary earners are also shareholders, and thus they also benefit from increased profits.
The number of blue-collar workers in the US has fallen from around 40% to around 25% in the last 30 years. While this upsets many hard-working traditionalists from factories around the country, there has been an offsetting gain in service workers, administrative support, sales jobs, technical, professional and management roles. Tradition aside, does it really matter what form of employment is on offer, particularly at the low end of the market? Is a sales job less respected than a factory job?

The Industrial Revolution ushered in the Second Wave of the economic model that provided the great factories of the mature economic world. While emerging economies are catching up to the Second Wave phase, mature economies have moved on to the Third Wave. As Alvin Toffler predicted, in the third wave the source of all wealth is knowledge – this is the information age.

In the period 1973-2001 the average real wage (inflation adjusted) of male college graduates in the US grew by US$5/hour. The real wage of high school graduates remained stable, and the real wage of non-high school graduates fell by US$3/hour. It then may be surprising to note that the number of male college graduates (and this is before one even considers the entrance of women into the equation) grew much faster than either the high school graduates or non-graduates.

This implies that the Third Wave is creating an economy where the vast majority of Americans are better off. Only the high school "drop-outs" have suffered, but such is their lot. In Australia, too, university and high school graduation has grown tremendously as fewer young people aspire simply to be a factory worker like Dad, leaving school at fifteen, but to embrace the new age of information technology and service by spending the time to educate themselves and provide a life better than Dad's was.

But coming back to offshore outsourcing, Indians can graduate university too, so isn't there still a risk that there will be fewer jobs available for US or Australian graduates?

To answer this it is necessary to understand that outsourcing is not a zero-sum game. In other words, it does not represent a loss of wages available to locals but is mutually beneficial to the people of both countries. The Milken Institute conducted a study in 2004.

The Institute found that for every US dollar of corporate spending, the receiving economy (ie India in this case) receives 33 cents in the form of wages, profits and taxes. The US company on the other hand, saves 58 cents. With this saving the company can invest in more product development, pay higher dividends to shareholders, or both. The US consumer also wins because lower costs mean lower prices.

The call centre in Bangalore will also need to be fitted out with computer hardware, software, phone systems and so forth. Hence companies like HP, Microsoft and Lucent will benefit, as will service providers such as PriceWaterhouse who will audit the books. At the same time, young Indian workers are receiving wages that allow them, for the first time, to buy mobile phones, computers, iPods, whatever, again providing a beneficial flow back to corporations.
Thus the US corporation experiences savings, increased exports and repatriated profits. All in all a benefit of 67 cents, calculates the Institute, which is twice that of India's gain. Where will that money go? Apart from dividends it will be invested in new businesses which will boost productivity and, more importantly, create new jobs.

On average, the job added as a result of outsourcing will provide more value than the job lost.

US manufacturing employment has shrunk by two million in twenty years, but net employment grew by 43 million, representing jobs in the fields of education and health services, professional and business services, trade and transport, government, leisure and hospitality and financial services. As more jobs are shipped offshore, greater value jobs emerge locally. Hence it is wrong to assume a job lost is a net reduction in the amount of jobs available.

And despite the whinging, the reality is that jobs outsourced tend to be low-satisfaction jobs that Westerns scorn (and a high turnover occurs) but emerging market workers lap up. One British bank's call centre agents in Bangalore process 20% more transactions than their UK counterparts with a 3% higher accuracy level.

The platform company model represents an efficient reorganisation of talents. That is one of its fundamental bases. Another is new inventions.

While new inventions are creative, they can also be destructive, albeit for the ultimate benefit. For example, the fax machine replaced the telex machine, and now faxes have all but been overtaken by email. While the manufacturers of telex machines moved onto new technology, there would have been some in the wash that were forced out due to new technology. Email, for example, requires less use of paper, and global paper manufacturers are struggling.

This brings us to a very important requirement for a successful platform company economy, as was first introduced in Part I of this series, and that is the right, and the ability, to fail. Without failure, an economy cannot evolve efficiently. Propping up antiquated industries or protecting companies from their own inefficiencies in order to save jobs is to dig a deeper and deeper hole.

Japan has done it, Europe has done it, and even the UK has had its moments as it has tried to save, for example, iconic car manufacturers. In the US and Australia, as elsewhere, organised interest groups such as unions have leant on governments to protect jobs in, for example, the steel industry, which is now the domain of rampant Chinese participation. But to a great extent, these governments have let the efficiencies dictate, whether they be right or left wing leaning. The capacity of companies to fail (auto is a good example) or to outsource (call centres) has provided for both countries to experience solid economic growth.
In the meantime, the economies of Japan and Europe have taken a long time to become reinvigorated.

Nationalisation is anathema to a strong capitalist government, which is why countries such as Australia have privatised constantly, from banking to telecommunications, from education to healthcare. In Britain's heyday it boasted thriving nationalised industries in the likes of steel, coal and rail. These industries slowly ran themselves into the ground (remember British Rail jokes) before Thatcher unleashed her unpopular shut-it-down or sell-it-off policies. The UK economy is currently a strong one.

Whether or not Thatcher went about it the right way is a different matter, and any good government will still pay heed to social aspects of economic change, but under the platform model efficiencies dictate that capital should be placed in the strongest hands. We now have debate about whether services such as health, education and childcare should be allowed to be corporatised, and again these are areas that cut into the heart of the people.

In Europe, the trend is to make such areas untouchable. While this is popular in winning votes the reality is these services need to be paid for either through taxes or deficits. To protect any industry is to stifle the creative side of corporatisation, and ultimately use capital inefficiently. This is also true for service industries as well as manufacturing.

The platform model is not one which dwells on social responsibility from a benevolent perspective. From this will flow hardships, until such time as the people speak not through votes, but through their consumption. When the Commonwealth Bank of Australia was privatised, and the banking industry deregulated, there was a slow and steady decline in customer service. Only now have banks woken up to the fact that customers are actually something a company needs, so they have begun to reverse some of their more cost efficient, but less equitable policies. This has resulted in a reversal of market share loss for some, which tends to suggest the search for the greatest efficiency is a bumpy trail, not a smooth transition. But the end result will need to be that which keeps the majority of people happy, not the minority.

Nevertheless, under an economic model in which the prime motivator is the individual pursuit of profit, there must be losers. One of the biggest perceived problems of the Third Wave world is the growth of income disparity.

As addressed in Part IV of this series, Americans and Australian have become big spenders and poor savers largely as a result of the fall in volatility of job security and corporate profits under the platform model. China, on the other hand, faces volatile corporate profits and low job security as the industrial explosion has meant rushing headlong into the next opportunity while it exists, only to find that everyone is doing the same. Profits are low but saving is high in case there is no job tomorrow.

The end effect of the emergence of the likes of China and India has been, however, a more affluent society for many. Chinese are now buying their first mobile phones in their
millions, and are eying off a first car. Those in the more mature economies of the US and Australia have found themselves wealthier as well, through increased property values, corporate profits and stock prices.

But tell that to the laid-off auto worker in South Australia, or the unskilled subsistence farmer in China. It is these people who have effectively become poorer while everyone else has become richer.

However, under the platform model it is necessary to accept such disparities, rather than redistribute through intervention. If capital is taken away from where it can be most efficient, and can generate the highest returns, then this leads to an impoverishment of the entire society, in which those at the bottom will only be even more worse off. That is why socialist societies have failed to survive.

It must also be understood that income disparity is a strong motivational force. Human nature dictates a desire to get on in life, and to succeed at whatever one puts one's mind to. For the average person this means the desire for conspicuous wealth. If there was nothing to strive for, then why go to the effort? There would be little in the way of creativity or economic growth under such a model.

More in Part VI.

**Feature Series: Brave New World Part VI**
20 June 2006

GaveKal Research is an independent economic research house and consultancy created in 1999 in the US by Charles Gave and partners. GaveKal has a reputation for "original thinking". The following feature series is drawn from a GaveKal publication of 2005 entitled: Our Brave New World. This is Part VI.

There is a raging debate at present between the bulls and the bears as to whether financial markets are experiencing a healthy correction in an upward trend or the bursting of bubbles that ushers in a downward trend. One of the bears strongest arguments is that current asset valuations are way out of step (much higher) than historical averages. Bulls favour the notion of a secular shift in pricing.

The platform model takes the bears to task and suggests that things are different this time.

The price/earnings ratios of S&P500 companies are still above historical averages despite a bear market between 2000-2003 and an impressive growth in profits in recent years. The bear would say there must eventually be a reversion to the mean. The platform company model suggests the mean is the past, and the present is different.
Consider two iconic US companies: Caterpillar, which specialises in earth-moving and construction equipment, and Proctor & Gamble, which provides a good deal of the household goods available in supermarkets (both companies are also prevalent in Australia).

Caterpillar's business is highly cyclical, being at the mercy of mining and construction cycles. Consider the resources super cycle we are in now compared to a few years ago when no one would even look at mining companies. Proctor & Gamble's business is non-cyclical, as no matter what the prevailing climate – boom or depression – people still need household items.

If over the long term both companies showed similar growth in earnings, Proctor & Gamble should trade at a premium to Caterpillar for the simple reason that non-cyclical earnings are less volatile and more predictable, providing investor comfort.

The economies of Western countries under a platform model are now far less volatile than they have been in earlier times. Economic growth is less volatile, corporate profits are less volatile, financial markets are less volatile (see Brave New World Part III). Thus it follows that there should be a premium placed on stock valuation – we have taken a step away from the mean.

Platform companies outsource the cyclical part of their procedures, and thus offer high, stable returns on invested capital. This makes them popular with shareholders. The twist is that platform companies actually don't need a lot of capital.

Consider one of the world's most successful companies – IKEA. The ubiquitous Swedish provider of flat-pack furnishings has never sought equity by issuing a share, nor borrowed by issuing a bond. It has only ever funded itself on cashflow. Yet anyone who's ever visited, for example, what I call The Colossus at Rhodes in Sydney's west – IKEA's warehouse/retail outlet - on a weekend can only marvel at what one Swede has achieved.

(It may have helped that the guy is reputedly so tight he will only catch public transport and fly economy and still lives in the same small flat. Folklore? Not sure.)

IKEA never needed capital to take over the world because it started with a handful of furniture designers in an office in Sweden and outsourced everything else from the start.

So if platform companies don't actually need capital, yet they provide high and stable returns, what is the obvious response? Share prices go through the roof.

Today we live in a world with a large pool of disposal capital, but companies don't want it. Two ramifications follow from this. Firstly, company executives pay themselves ridiculous compensation packages that would have been criminal only a few years ago, but this doesn't stop share prices going up. (Australians would be familiar with this concept).
Secondly, with nowhere to allocate capital companies begin to return capital to shareholders in the form of buybacks and special distributions. (Ditto).

A third ramification is that this creates even more excess capital (executives with too much money, shareholders with returned investments) which still has to go somewhere, so it goes back into stock markets (which are now at historically high levels), or bond markets (yields are at historically low levels) or real estate (high) or hedge funds (growing exponentially). Hedge funds then farm their investors' money into stocks and bonds, and other asset classes such as commodities. So here we are.

Money also flows into emerging markets, such as the BRICs (Brazil, Russia, India, China) as that is where the capital is actually needed. However, investment in emerging markets is fraught with danger (because that's where all the Western volatility has been transferred to) thus being a place for only the most risk-thirsty, and besides, financial markets in emerging countries are not yet sufficiently developed to deal with the efficient allocation of capital.

Emerging countries are renowned for the cyclicality of their markets, with extremes of boom and bust. Note that while the Chinese economy is all boom, boom, boom, the Chinese stock market is still one of the scariest rollercoasters ever created. Hence those looking for stable returns will tend to favour mature economies, and hence markets in those economies deserve to be revalued to levels which are above historical means.

The exponential growth of hedge funds is testament to the search for capital returns in a stable economy. In 1998, one of the world's largest hedge funds – Long Term Capital Management – was brought down by gambling in Russian sovereign debt. Russia defaulted, and LTCM nearly brought down the entire Western financial system, but for the intervention of the Fed. Hedge funds became tainted as high-risk dangers that should be banned.

But they weren't, and now hedge funds represent a huge and growing slice of the investment world. There are no longer a handful of large, over-capitalised funds, but rather a plethora of smaller outfits that dart in and out of markets. At any one time there can be hedge funds that are long this and short that, and others which are short this and long that, providing a wealth of trading liquidity in all financial markets. They don't provide the capital, they just make markets more efficient.

The rise of hedge funds is a response to the excess liquidity within today's global economy and a response for the need to direct excess capital into some financial instrument or market that will generate a positive and healthy return in a stable and mature financial market setting. The money must go somewhere.

While the Western world goes on becoming wealthier new problems emerge within the political landscape. Firstly, the power base of traditional left-wing parties has been undermined by the reduction in levels of blue collar workers in the West, as these roles have been outsourced to emerging markets. With fewer members, trade unions become
less potent. This has happened in the US and it is presently a very big issue in Australia. This reorganisation of labour globally also has ramifications that could threaten the existence of the Welfare State.

The Western world might be becoming richer but the emerging world is becoming richer too as new entrepreneurs come to the fore. It then makes sense for the new wealthy to transfer funds out of their own volatile markets into the safer return markets of the West, into the likes of stocks and bonds, and even real estate. In the case of real estate, the new wealthy want to experience all the good times the Western world can offer.

Asset prices in the Western world must thus always remain slightly overvalued. The capital account of Western countries will be positive if financial markets are well developed. The current account, which is the opposite side to the capital account will thus always be in deficit, and massively so.

This capital flow pushes up the value of Western currencies, particularly as the new savers of Asia, Latin America or Eastern Europe replace gold with dollars as their new standard. A high currency and low cost of capital in Western countries means that the production side of any business becomes highly competitive and very low margin. Best to revert to a platform company model and send the production offshore.

While platform companies are making lots of money by only maintaining design and sales areas onshore, they subsequently end up paying a lot of tax. What is the solution to this problem?

Did you know that on any given day, the biggest foreign net buyer or seller of US treasuries is the Caribbean Islands?

As we all know, Caribbean countries are not the world's largest investors. The hedge funds domiciled there, however, are. The efficient capital of the world used to be domiciled in the big investment banks of New York, London, Frankfurt and Tokyo, but now it sits in the world's tropical tax havens. And don't executives just love being given the excuse to visit "head office" occasionally. Some have set themselves up there for good.

And it is not just the preserve of hedge funds. Large companies are now also domiciled in tax havens. One of the world's biggest video game designers, Electronic Arts, is incorporated in the Caymans.

As the world moves towards a platform company model, tax receipts in countries that do not adjust to the model will collapse. Income taxes will also become increasingly more voluntary as platform company employees can choose to domicile themselves elsewhere. It happened with rock stars, it happened with sports stars, why wouldn't it happen with financial stars?
When this occurs, governments will be forced to derive tax income from other sources such as property and consumption taxes. (Australia, again, is a perfect example. Take New South Wales: despite increased wealth in Australia's most populous state, the state is broke and is heavily reliant on the likes of land tax and poker machine tax. The Commonwealth relies on GST).

The likely outcome is a downsizing of government in Western countries to a more efficient level. Without sufficient taxes, the Welfare State is under grave threat.

In the First Wave world (from the first civilisations to the Industrial Revolution), governments provided subjects with basic regalian functions – army, judges, police. In the Second Wave (Industrial Revolution to now) governments also provide income redistribution into education, and welfare – pensions, unemployment benefit, healthcare.

In the Third Wave (that which we are entering) governments will struggle to maintain such services. They will need to compete with each other to attract global platform companies by providing the best services at the lowest possible price. This means the most efficient regalian functions. The city-states of Hong Kong and Singapore are two examples of this reality in practise.

Will other countries go bankrupt?

Coming up: Brave New World wraps up with an analysis of how one should invest one's money in a platform company world.

**Feature Series: Brave New World Part VII**

3 July 2006

The Brave New World – that of The Third Wave, or more specifically the platform company – seems a whole new challenge for investors. If the paradigm has shifted, what use are previously regarded investment criteria? Do we start again?

One possible response is for the unskilled investor to throw their hands up and say: I think I'll just give my money to an index fund and be done with it. That would be a big mistake.

An index fund is one which invests for return on capital based on an index. The most obvious example is an index-tracking stock market fund. These funds merely allocate investor's money based on the capital weighting of the stocks in the index such as, for example, the S&P/ASX 200.
The evidence is actually in favour of index funds. Its shows that, over time, active management (ie stock picking) rarely outperforms the index. It may do so in certain periods, and there will always be the odd genius who gets it right a lot, but the further into time one goes the more active management will be rebalanced back to the index. Eventually everyone will have a bad run.

However, active managers are necessary for the market. If everyone was an index-tracker, then everyone would attempt to hold the same portfolio and the "market" would cease to exist. It is a necessary function of a capitalistic system that there are winners and there are losers.

Over the decades of the 80s and 90s, active management was prevalent, and a failure. The 80s witnessed one of the greatest bull rallies in history only to crash. When a bear market looked like digging in fortunes were revived by the Gulf War. The 90s were a rocky road featuring emerging market booms and busts (eg Asian tigers, Russian debt markets), the fall of Barings, spectacular hedge fund collapses (eg LTCM) and finally a tech boom that ended in tears.

Active managers had a hell of a time.

The result was an enforced move away from active management. Not enforced by managers themselves, but by the accountants and risk managers. Conservatism became fundamental and overnight what were once active funds became "closet" indexers.

Thus a bear market was ushered in. (Note: The US has been in a bear market since the tech boom peak. Australia never experienced much of a tech boom/bust, but still suffered a bear market in 2000-03 before the commodity boom).

The reason a bear market eventuated is because indexing became a victim of its own success. If everyone steers well clear of risk, then no one is going to spark a momentum rally. Furthermore, the fundamental problem with index-tracking is that allocations are made purely on size. This is actually counterproductive.

Think about it. If most of the money goes into the biggest company in the index (eg BHP) then that company's share price will rise which in turn sparks more allocation because capitalisation increases. Thus the price of BHP feeds on itself, at least until some trigger causes a price drop (eg the current correction) and money then has to be removed, which causes the price to fall further. In other words, risk-averse indexation causes volatility – the sort of volatility that hurts because you are always on the wrong side of the market. It's pretty hard to make money that way.

Indexation has its place, but the recent boom in investment has been hedge funds. One of the major reasons so many hedge funds have sprung up lately is not just because of excess global liquidity, but because of all the active managers who vacated their positions when the accountants moved in.
While hedge funds have thrived, large pension funds have faltered. This is not just because hedge funds offer more diversified risk investments. It is because under the platform company model, companies now no longer employ vast numbers of blue-collar workers, nor vast numbers of any lowered paid employees. This has sounded the death knell for large company retirement funds, which have joined the large government employee funds which have become redundant due to privatisation of industry.

More and more workers in the Western world are becoming responsible for their own superannuation. From this has grown a plethora of new-style funds – whether you want to call them hedge funds or not – which offer a balance of indexing and active management. We have seen the birth of such animals as the "individually managed account".

It is important to understand at this point that there are many who do not understand hedge funds. Firstly, the name is a furphy – it arose from the early use of derivative instruments by small funds for the actual purpose of hedging. (One Australian fund manager became a legend overnight because he bought index futures puts ahead of the '87 crash and thus lost no money when everyone else lost 25%. That was a hedge).

Since then some hedge funds (eg again, LTCM) have given the industry a bad name by using derivatives to actually increase risk through leverage and then falling over. This has created the stigma. It is only the feeble-minded who still associate "hedge fund" with imminent danger and "derivative" with risk by default. The reality is that hedge funds provide for all sorts of risk/reward profiles and those who get caught out are only the same gamblers and worshippers of greed that have existed in markets since the beginning of time. Nothing has changed.

It is these feeble-minded who will immediately rail against anything hedge fund just like their ancestors who burned "witches" at the stake. These are sad people who think anything they don't understand must be evil, and the problem is made worse because they will likely never understand. It is perfectly fair to regulate in order to protect investors from "dodgy" practitioners. It is ludicrous to regulate against financial market risk. Risk is fundamental. Those who get burnt are usually burnt not by the instruments they invest in, but by their own greed.

(Take the NAB "rogue" traders as an example. Who are the culprits here? The foreign exchange options market, or a handful of criminals? Actually, the real culprits were NAB management. There are none so blind as those who will not see.)

Having said my piece on hedge funds (that was me, not Gavekal) consider that hedge fund strategies fall under three basic categories.

The first is the "return to mean" strategy, where assets are bought or sold based on perceptions of under- or overvaluation. Warren Buffet is the pin-up boy here.
The second is "momentum-based" strategies. Here you will find the trend-followers and the technical analysts. The idea is to ride the wave while you can but get off before it breaks. This category is based more on human psychology than any fundamental analysis.

The third is the "carry trade", where managers play the yield curve by borrowing at low rates and lending at higher rates, or by investing in assets with higher returns. This category is very much in focus at present, as excess global liquidity has given rise to extensive carry positions but global interest rate rises will likely see them unwound.

Most hedge funds will play any or all of these strategies at any given time. As more and more smaller hedge fund strategies replace cumbersome index strategies the extraordinary return opportunities will become less and less. This is already apparent in financial markets where levels of actual volatility have been dropping for a long time. The less volatility, the less opportunity. This might be comfort for the risk averse, but it makes it hard to make money.

So if index funds are not an option, and hedge fund returns are diminishing, where do we put our money under the platform company model?

First option: give it to the consumer. Under the platform company model outsourcing has grown, leading to higher and more stable returns on invested capital, lower volatility in the economic cycle, higher productivity and higher disposable incomes for consumers. Thus the obvious choice is to overweight consumer plays – retail, consumer finance etc. However, in the more mature platform company economies (US, UK, Australia) the likelihood is that the benefits are already priced in. Hence the trick is to find countries that aren't so mature (Japan, Singapore, Sweden perhaps?).

Second option: Buy scarce assets. Under the platform company model the poor get richer through falling prices, low interest rates and rising disposable incomes. The rich get insanely richer by capturing entire markets with zero marginal cost (Microsoft, E*bay, Google, IKEA). Thus one might turn to real estate, art, wine or anything the rich would covet. Again the problem is how much is already priced in.

Third option: emerging markets. As emerging markets expand and economies grow there are golden opportunities. There is also extreme volatility.

Final option: buy platform companies everywhere. You thought this would be the obvious conclusion, didn't you. Platform companies offer higher more stable returns and thus should outperform over time. But again, how much is priced in already? The trick here is to invest in companies which are in the process of moving towards a platform company model (outsourcing production, maintenance, call centres etc) such that, in due time, their movement from the old business world to the new business world will eventuate in a re-rating.

But remember – platform companies don't need capital. This is evidenced by the spate of capital initiatives, share buybacks, special dividends and so forth. It is actually not too
much of a stretch to think that the days of listing a company for the purpose of raising capital may be numbered. What we might find is that instead of endless IPOs there will be complete management buy-outs. That would rid a company of those pesky shareholders.

It doesn't sound all that inspiring, does it, and there you were expecting a key to the meaning of life in the Brave New World.

The fundamentals of investing have not changed. The trick is still to look for the highest returns but the trap is those returns may already have been priced in by investors ahead of you. Remember, the secret is also as much about avoiding losers as it is about picking winners. And it is still fundamental to hedge against risk.

How to hedge against risk? (1) Diversify – this is a golden rule in any investment model; (2) Insure – if you have a lot of your money in, for example, the stock market, talk to your broker about index put options. These can be employed as a trailing stop-loss that allows you to always sleep at night; (3) Hedge often – when things are going very well then it's a good idea to spend some of that gain by locking in part of it. That doesn't just mean selling, it means investing in other instruments – derivative or otherwise – that will perform well if your star performers falter. The best scenario is that you always lose on your hedge, but at some point a hedge will ultimately come into play.

At the end of the day, investment success is inexorably linked with economic growth. But just because economies are growing, it doesn't have to follow that prices are growing too. Consider that there are four investment scenarios.

The first scenario is the "inflationary boom". This is the scenario that has been most prevalent since the Second World War, and hence the scenario that drives most investment strategies today. In an inflationary boom sales accelerate, prices rise and margins rise as well. Such booms usually occur when central banks pump too much money into the system with the intention of stimulating economic activity.

In this scenario the winners are emerging markets and commodities. Does this sound familiar? Inflation has crept into the system once more and the world has experienced a boom in emerging markets and commodities recently. The problem is that once inflation takes hold there is a chance of...

The second scenario is the "inflationary bust" or "stagflation". This was the theme for the 70s. This scenario is usually triggered by excessive government spending and growth in money supply, and in the case of the 70s an oil price spike. Many economists warn of stagflation right now, because inflation is rising but economies are slowing. Most, however, see inflation abating. In the meantime, the inflationary bust tactic is to buy gold.

The worst scenario of all is the "deflationary bust". This is a scenario in which everything goes down in price, except government bonds. A deflationary bust is born from excessive
government intervention that might involve increased taxation, increased regulation, protectionism, or a war.

By a process of elimination, it follows that the fourth scenario must be the "deflationary boom". The concept of a deflationary boom may seem almost contradictory, but only because there is a misplaced association between the words "deflation" and "depression". Deflation simply means the level of inflation is declining. There is another word, "disinflation" which actually means inflation is negative, and again it is confused with deflation. Depression means negative economic growth, and hence is not associated with a deflationary "boom".

Not only is it quite possible for prices to fall while the economy is booming, there have been many such cycles in history. What is important to a business in a time of falling prices is that sales are increasing. If both are falling then its game over. The reason the oil and metals commodity price spikes have not sparked immediate global inflation nightmares has been because of the deflationary boom going on in China. Exports from China have been growing but prices have been falling (take electronic goods, computers etc as examples).

The consultants at Gavekal believe the deflationary boom is the natural state of capitalism. This state will often be interrupted by any of the other three scenarios over periods of time, but the deflationary boom will prevail.

They believe that after 25 years featuring inflationary bust (1972-1982), inflationary boom (1983-2000) and the occasional deflationary bust (Japan since 1990, Asia 1997 and 2003) we are entering a global phase of deflationary boom. The problem is no one much alive knows how to invest in a deflationary boom.

Evidence from the nineteenth century, and also from the US (and Australian) experience from the mid-90s to 2005 when the Gavekal treatise was written, shows that the winners are the currency, the local consumer, local financial companies (especially banks), real estate (particularly at the high end) and any producer of goods with high elasticity (sees volumes rising faster than prices fall).

At the moment it appears, as suggested, that we may suffer a very brief inflationary burst as current inflation fears are worked through. However, this does not override Gavekal's greater theory.

Gavekal's advice for portfolio selection under a deflationary boom is to invest in platform companies, emerging markets and commodities, and to hedge against the mistakes of governments and central banks by holding gold or cash and high quality government bonds. The consultants suggest one could split between these four and go to the beach, rebalancing once a year, and be surprised how good the longer term performance turns out to be.
For those who back themselves that they can move money around more actively for a better result then portfolio shifts between the four asset classes is the way to go.

Gavekal believes the odds of a real inflationary bust are small, and the odds of a deflationary boom are high. Thus it makes sense that an overweight position in platform companies makes sense in a brave new world.

The ideas and examples put forward in this series are the work of Gave, Kaletsky & Gave: Our Brave New World, self-published, 2005. The writer has added observations as well.

That wraps up FN Arena's Brave New World feature series. The complete series will shortly be made available in a single PDF file. We hope you found the ideas put forward as evocative as we did.

**Piquant Blue: A True Australian Platform Company**

August 2006

“Piquant Blue Ltd (PQB) was established to become a significant player in the marketing of Australian olive oil. It focuses primarily on the marketing end of the olive oil value chain and generally avoids direct involvement in production.”

That is the opening paragraph on Piquant Blue’s website. What it implies rather succinctly sums up the new economy of the twenty-first century – that of the “platform company”. This represents the Third Wave of global economic development.

The First Wave was the move from hunter-gathering to agriculture. The Second Wave was the move from agriculture into the Industrial Revolution, and the Third Wave is that of high-profit, low-risk platform companies operating in the Age of Information.

FN Arena has, since April, published a series called Brave New World which precises the writings of Charles Gave and his associates, leading business consultants and proponents of innovative thinking. That series is now available in PDF format on the FN Arena website.

A quick summary of the platform company model goes like this:

Traditional industry is that of design, production and marketing. Of the three, production is the high cost, high risk element. It also represents the lowest margin. The most commercially sensible thing to do, in an age where the internet connects the world at the click of a mouse, is to outsource production to competing companies in the developing world (say, China).
That way the remaining platform company is able to purchase the products it designs at the lowest possible cost, and sell them at the highest possible margin. The producer takes the risk and makes little profit. The platform company has low overheads and makes significant profit.

There has been an explosion in olive growing and olive oil production in Australia, as multicultural influences and Australia’s passion for cooking has combined to drive demand. Fancy oils from the Mediterranean are expensive, and Australian oils are now world class. The past five years have seen rapid expansion in production capacity.

It takes about seven to eight years before olive trees mature and bear fruit. That represents a significant investment. With a wealth of producers now bringing their oils to the market, competition will be tough domestically and international sales will again require investment in marketing from already stretched small producers.

Piquant Blue has no interest in growing olives, or owning companies that grow olives. Remember, “it focuses primarily on the marketing end of the olive oil value chain and generally avoids direct involvement in production”. It is, however, Australia’s largest listed olive oil marketing company.

Piquant operates under two main brands – redisland and njoi. Redisland is the fastest growing and most successful extra virgin oil supermarket brand in the country, and njoi is Australia’s number one gourmet oil.

There are 1,900 supermarkets in Australia. There are 28,000 supermarkets in the US, and, having conquered Australia, Piquant has already signed up 2,500 of them. Once critical mass is achieved Piquant will move on to Europe and Asia.

If the Australian wine industry is anything to go on, olive oil has a long way to go yet.

Piquant sources its oil from growers around the country, brands it, and markets it to the world. Who do you think makes the margin?

A couple of weeks ago ABN Amro Morgans initiated coverage on Piquant with a Buy recommendation (for absolute performance) and a 12-month target price of $0.48. At the time of writing the stock was trading at $0.39. ABN is predicting this will be the last year of loss-leading for the company. It forecasts an FY06 loss of $2.56m, followed by profits of $2.01m in FY07 and $7.19m in FY08.

For what it’s worth, ABN’s normalised earnings growth estimate for FY08 is 263%. There is no plan to pay dividends at this stage. Agribusiness giant Timbercorp (TIM) has seen fit to buy into 10% of the company.

Just out of interest, while platform companies have been established now for some time, one prediction of the Gave model is that as less capital is required to operate a business without the production costs, public listing becomes less necessary. The flipside is that
existing listed companies may similarly return funds to shareholders (how much of that has been happening in Australia?), be bought out by management, or be bought out by private investment companies.

Coles?

Epilogue
by Chris Lightbound
Head of Sales, Europe, Asia & Middle East GaveKal Research

History never repeats itself; but it often rhymes.

This simple fact explains why so many financial analysts, market strategists and portfolio managers like to study past economic cycles and market reactions before taking investment decisions. By studying financial and economic history, market participants are able to anchor beliefs on solid facts.

For over ten years now, a wide majority of market strategists and economists from respected investment banks, a large number of upscale financial publications, highly respected consulting firms have drawn on historical parallels to warn us that the expansion of the past decade in US consumption was both unsustainable and likely to end in tears. Real estate all over the Christian civilised world was bound to collapse, along with global equity markets. The world would then enter into an 'ice age'. So far, and despite the strength of the above thought process, and the numerous historical parallels, the dreaded meltdown has completely failed to materialise. So what is the next step?

When a thought process fails, i.e., when history fails to rhyme, money managers and analysts can typically respond in one of four ways:

1) Shut up and crawl under the carpet. This is usually an expensive proposition.

2) Pretend that the numbers are wrong and that, despite all the signs, they are right (i.e., enter into denial). This too, is an expensive proposition.

3) Hope that one is simply 'early' and that one's scenario is about to unfold. This can sometimes work, but more often than not, proves costly. Moreover, after ten years of predicting Armageddon, one's credibility tends to melt away.

4) Admit that one has been wrong, and try to find out where the mistakes lie. This is the most intellectually honest stance to take and the one that we wish to adopt in the following pages. After all, as Churchill once said, 'an economist needs to be able to forecast what is going to happen in a week, a month and a year, and then be able to explain why it did not'.
The reason so many analysts drag their feat in admitting that history has failed to rhyme this time around is that it would lead one to the dreaded conclusion that 'things are different this time'. But why is this a dreaded conclusion? Because anyone who has spent ten minutes on a trading floor knows that saying that 'things are different this time' is:

1) the easiest way to get laughed out of a room,

2) the most expensive words ever pronounced,

3) the surest way to lose any kind of credibility,

And yet, this is exactly what we aim to argue in Our Brave New World

Get your own copy at www.GaveKal.com
The Invisible Hand’s Impressive Work

Last summer, we published a small book entitled *Our Brave New World*. In the book (copies can be purchased on [www.amazon.com](http://www.amazon.com) or [www.gavekal.com](http://www.gavekal.com)), we attempted to show that, because of the rapid pace of change our world was experiencing, a number of the relationships which we, and many other economists, had used for decades were badly breaking down. Following the book, and as so often when we publish a “think-piece”, clients were very generous with their feedback. We received hundreds of new ideas, which we plan to organize in a follow-up book in the near future.

In the meantime, life goes on, and markets continue to throw more questions than we could hope to have answers. Of particular concern lately amongst our clients has been the apparent pick-up in inflation. Another worry has been the sustainability of the high profit margins evident in most developed markets. And interestingly, these concerns bring us right back to some of the notions we developed in *Our Brave New World*.

We like to think of financial markets as a massive big puzzle whose pieces are scattered around the table. We also like to think that, if we concentrate hard enough and, more importantly, if we listen to our clients (who work in all different parts of the financial markets and usually hold far more experience than we do), then we should be able to somehow piece this puzzle together.

1– The First Piece of the Puzzle: Very Strong Profit Margins

One of the recurrent questions some of our smartest clients have asked us recently is whether profit margins were not set to come back down very rapidly? After all, profits as a percentage of GDP have historically always returned to the mean (as they should—otherwise, given the laws of compounding, profits would end up being bigger than GDP).

The answer, as far as we are concerned is “yes”. Profit margins as a percentage of GDP should come back down as our economies go through their mid-cycle slowdowns. After all, corporate profits have historically been one of the first variables of adjustments in our economic cycles.

But having said that, the “mean” to which profits revert to may be much higher than some expect. Indeed, while profits as a percentage of GDP cannot rise forever, we might have witnessed a structural shift higher in corporate profitability.

Let us take the US as an example. With ever-growing shareholder activism, and ever-improving management techniques, an increasing number of companies have become parsimonious with their capital spending. Capital is only deployed on projects which are deemed to bring returns over a certain threshold. Functions in which the company does not add value are either shut down, or spun off and sold to other investors better able to generate value. In the US, what matters first is profits and returns on invested capital. Employment then comes as a natural consequence of the companies’ profit seeking activities.

Let us now take China as a second example. Thanks to a low cost of capital and a very low cost of labour, companies have sprung up all around the country and piled into new businesses. Because returns on invested capital are a distant consideration, most sectors are in overcapacity; and yet capital spending continues regardless. The country thus has over over 300 auto producers, 3000 ball bearing manufacturers… **In China, what matters first and foremost is employment; profits are not really even a consideration.**
We live in a world where a major player is saying “we will take all the jobs and you can have all the profits”.

This major player is China.

And this behaviour might help explain why profits have failed to return to the mean.

The US and China could of course each live as islands unto themselves (and if Chuck Schumer had his way, that is probably what would happen). But fortunately, the past twenty years have been characterized by ever greater improvements in communication technologies, port infrastructure, airplanes... Encouragingly, trade barriers and impediments to the movements of goods, and people, have been rapidly collapsing (up until recently).

As a result, we live in a world in which China and the US can increasingly talk to each other. And when they do talk, what do they say? China says “all I want is jobs” and the USA says “all I want is profits”. And in that discussion a deal can rapidly be struck. Is it a coincidence that, just as we saw a widening of the US current account deficit, we also witnessed an explosion in the profitability of US corporations? Readers of Our Brave New World will hopefully argue “no”.

Would it be a stretch to say that the impressive, and unprecedented, growth in US profits of the past few years is directly linked to Chinese companies’ inability to hold on to any recurrent profitability? As the trade between the two economic giants keeps on growing, one question that investors should ask themselves is “who captures the profitability of the trade flows?” Is it Wal-Mart (or some other US distributor)? Or is it the Chinese goods manufacturer?

The answer to that question (i.e.: Wal-Mart), brings us back to the idea that profits need to return to the mean. This is undeniably true of a closed economy. But of course, few economies in the World today could be called “closed economies”; instead, companies are increasingly global, and thus their total profits should probably be compared to global GDP, instead of domestic GDP. Or to stay on the Wal-Mart example, maybe Wal-Mart’s earnings as a percentage of US GDP are at the top of their band... But could the same be said of Wal-Mart’s earnings relative to Chinese and US GDP. Most likely not! In other words, profits probably return to the mean on a global basis; they may no longer return to the mean at a national level?

2– The Second Piece of the Puzzle: Income Disparity

This new world order (in which rich nations get the profits and poor nations get the jobs) immediately creates a quandary: massive income disparity. Indeed, in the “old days”, people sitting at the bottom of the socio-economic ladder could get well-paid manufacturing jobs and ensure decent living standards for themselves and their families. The problem today is that, as the US-China trade of “we take the profits and you take the jobs” gets made, the people who were previously holding those jobs could be seen as losing out.

And, to be fair, one of the more obvious economic developments of the past decade has been the increase in income disparity across much of the Western...
This trade-off between profits and jobs lead to an increase concentration of wealth.

From there, one could draw Marxist theories of coming revolutions etc…

But this would be to give the market little due.

World. The poor have not gotten poorer… but the rich have definitely gotten much wealthier. And for a simple reason; when we say “we will take the profits” the “we” is usually a somewhat concentrated smallish pool of rich people, i.e.: shareholders in Western companies.

This growing income disparity, one could fear, might lead to political problems and tensions. Are our societies sufficiently mature to cope with such income disparities? Some might be (US? Hong Kong? UK?). Others, maybe less so (France? Italy? Germany?).

One might fear that governments might try to redress the balance through taxation (i.e.: France’s wealth tax) or even outright protectionism (with both of these measures, needless to say, doomed to only ensure that both the rich and the poor get poorer… a bad deal for the rich but a truly calamitous proposition for the poor). One could perhaps wish that governments would try to redress the balance by promoting share-ownership throughout the entire structure of society (i.e.: Australia’s super-annuation scheme, or Singapore’s MPF plans…), hereby ensuring that even the workers toiling away at the lowest ranks of the economic ladder benefit from the “we take the profits, they take the jobs” trade. But then again, one might simply hope that the governments will step aside and continue to rely on the good services of Adam Smith’s invisible hand.

3– The Third Piece of the Puzzle: Discontinuous Inflation

The ever-optimists in us want to believe that, for any given problem, the market, when left alone, will typically find a solution. The good news is that the birth of the platform company model, and the trend whereas Western companies say “we take the profits, you can have the jobs” has been so recent, and yet so powerful at the same time, that most governments have not had a chance to react to it (yet?). The market has been left free to do what it does best: adjust to new realities.

Assuming that we are right in our statement above that “the rich keep on getting richer”. Then it follows that whatever the rich buy should be going up in price much more rapidly than what poorer people buy (for there will be more competition for the goods/services that rich people buy). Incidentally, this has been one of the longest running themes of GaveKal Research (Charles first started grumbling in 1999 that “it has never been so expensive to be rich!”).

As Anatole wrote last summer: “At its simplest, therefore, the disagreement over “true” inflation simply reflects people’s tendency to focus on prices that are rising and forget about the ones that are going down. But the extent and persistence of the divergence between service and goods prices in the past decade also suggests a less obvious and more important story in three parts.

The first part of this story relates to China’s entry into the global economy. By becoming the workshop of the world, China has pushed down the prices of all mass-produced manufactured goods. The virtually limitless supply of cheap labour and capital in China, and the chronic mis-allocations of capital will ensure that manufactured goods continue to get cheaper, not only in Britain but around the world.

But the relentless downward pressure on manufactured prices from China has resulted in a second effect which is less widely understood, even among economists: cheap imports from China have actually pushed up the prices of many goods and services which the Chinese cannot or do not produce - either because they lack the resources (for example, oil) or the legal infrastructure (financial services) or simply because some things cannot be traded (for example, housing, healthcare and education).

People who see China purely as a source of downward pressure on prices forget that overall inflation in any economy is essentially determined by the availability of money. If monetary policy is successfully run (as it is in Britain) to produce an overall inflation rate of 2%, while the prices of manufactured goods are persis-
As the rich get richer, being rich gets more expensive by the day!

Meanwhile, “being poor” gets cheaper every day through goods price deflation.

ently falling by 3 or 4%, prices elsewhere in the economy must rise faster to maintain the 2% average inflation rate.

In this sense the ever-cheaper consumer goods from China have created more leeway for other prices in the world economy to go up. This effect has been particularly visible in the prices of goods and services which the Chinese are ravenously consuming but cannot produce themselves – for example oil, financial services and luxury property around the world.

Which brings us to the third, and most surprising, part of the inflation story. As the prices of financial services and luxury goods are driven persistently higher, service-producing countries such as Britain get richer relative to countries which specialize in manufacturing. And within Britain, the rich, who tend to work in high-end service industries which are relatively unaffected by competition from Asia, get richer, while the poor, who tend to work in industries more exposed to cheap-labour competition, get relatively poorer. For the lucky bankers, lawyers and, yes, even economic analysts, who are benefiting from this seismic change in the structure of the global economy, there is, however, a sting in the tail. While we are getting richer, the high-end services, most obviously housing, travel and private education - on which many of us spend a disproportionate share of our incomes are becoming more expensive, because of the very same global trends which are making us relatively rich.

That is why, even as inflation remains almost nonexistent, the talk in London’s bars and restaurants is of galloping prices. As Charles has claimed for years, being rich has never been so expensive. And staying rich is going to get more exorbitant by the day.”

Reading the above, our friend David Scott wrote a great report where he stated that “while it has never been so expensive to be rich”, it has also “never been so cheap to be poor”. And, if we accept the crude simplification that poor people tend to spend more of their revenues on goods (which keep falling in price) while rich people spend more of their income on services (which seem to just keep on rising), then there might be a simple explanation to the impressive discontinuous inflation we have witnessed in recent years and which has baffled us such; the invisible hand is simply doing its work. If the rich people in Western countries are currently capturing an inordinate amount of the World’s profits, then those profits are slowly being taken back from them, either through higher service price inflation (see Why It Has Never Been So Expensive to Be Rich), or through higher asset prices (see Art, Wine & Horses).
4— The Fourth Piece of the Puzzle: A Confused & Confusing Fed

If we were in a mood to be self-righteous, we could try to count the number of times that, since he became Fed Chairman, Ben Bernanke “turned his coat” on the topic of future monetary policy tightening. But then again, we might run out of toes; so we won’t even try.

Having said that, it is hard not to feel some sympathy for Ben Bernanke. After all, how should policy makers react to the odd inflationary environment which they now confront? As Anatole suggested in Why It Has Never Been So Expensive to Be Rich if policy makers take aim at the galloping service price inflation, they risk pushing the entire system into deflation.

However, given the recent tick higher in the inflation data (see our April 2006 piece, Disturbing Inflation Data), the question needs to be asked as to whether we have moved from an environment of: a) falling goods prices which allowed for rising service prices and an overall benign inflationary environment to b) an environment where the price of goods is no longer falling and service prices are still on the rise?

Now, as Churchill once said, most economists use statistics like drunks use lampposts: for support more than for light. And given that there are so many statistics on inflation one might be able to back-up nearly any kind of pre-conceived idea with scientific sounding data.

Unfortunately for the Fed, however, all the inflation data seems to be pointing in the same way (see Median CPI vs Core CPI): prices are creeping higher. The only question is whether this is a new trend? Or whether the rise in prices we have recently experienced is a short term phenomenon which will roll-over with the economic cycle?

In Our Brave New World we wrote that, until the mid 1990s, we lived in a world of oligopolies. When average costs went up, so did average prices. But as the recent spike in oil, copper, transportation prices has shown, this is simply not the case any more. Thanks to the combination of globalization, industry deregulation, technological progress, the spread of the Internet, and the emergence of the ‘platform company model’ (which feeds off all the above trends) we are moving towards a world with perfect information and perfect competition. In such a world, prices are made at the margin, and no longer on average.

The perfect examples of such pricing mechanisms can be found in the commodity markets where the information is at the same time available to most, and widely spread. As we all know, commodity prices are far from stable: if there is a shortage of one barrel of oil, the price shoots up; if we have an overcapacity of one barrel, its price collapses. The same can be said of the freight rate for oil tankers, for copper, or for any well published price determined at the margin.
When looking at inflation, a good place to start might be Hong Kong’s re-export prices.

When re-export prices fall, one year later, deflation starts to show up around the Western World.

And so today, we are in a situation where a growing number of prices are going up (hence the rise in median CPI) while the “heavy” prices (e.g.: rent) are still in check (explaining why the rise in the core CPI is more modest).

5– The Fifth Piece of the Puzzle: China’s Export Prices

In the capitalist world, and barring the emergence of monopolies, competition always leads to the most efficient producer lowering prices in order to drive his output higher. The fall in prices is therefore inherent in capitalism which is why Marx believed capitalism sowed the seeds of its own destruction. A claim to which Bastiat would answer: in economics there is always what you see, and what you don’t see. You see the fall in prices, but you do not see the rise in disposable income, or the increase in sales triggered by the falling prices.

This natural capitalist tendency was interrupted by the emergence of the social-democrat state, the nationalisation of a wide range of industries, and the Cold War of 1946-90. But it was the prevalent trend between 1820 and 1941, and again between 1990 and 2004. But is it still in effect today?

We believe that it is, if only because important parts of the world are clamouring to join the capitalist world, and in so doing, are using their excess savings (which are often large), to build excessive manufacturing capacity. This, of course, is nowhere more true than in China. A quick example will illustrate this.

As mentioned above, in China today, one can reportedly find over 300 car manufacturers. Unfortunately, the Chinese market is probably big enough for ten car manufacturers. This means that 300 car manufacturing company CEOs wake up every morning and wonder: ‘how do I get to be one of the ten survivors? Being the most profitable is good, being technologically advanced is also a plus, as are political connections, but at the end of the day, one gets to survive by being the biggest; by employing so many people that, when the down phase of the cycle occurs, the government can not afford to fire hundreds of thousands of workers. One becomes ‘too big to fail’.

This of course means that, when capital is offered up, all three hundred car manufacturers (following their ‘too big to fail’ business models) will grab it and spend it with both hands. Competing with each other for: a) raw materials, b) labour and c) allocations on the overstretched power and transportation grids.

In previous cycles, Chinese manufacturers would, in this way, end up with excess capacity that no-one would buy from them at any price. Today, the situation is very different. After the recent Chinese capital-spending boom (Chinese capital spending has grown from 32% of GDP to 45% in the past five years), most Chinese manufacturers now produce goods that are competitive on the international market not only on price, but also on quality.

This is a very important change, whose ramifications help explain China’s continuous disinflationary impact. Because of the excess capital spending of recent years, Chinese producers have little choice but to export their overcapacity aggressively (hence the era of the US$5,000 Chinese car… despite rising steel, aluminium, rubber prices…). Chinese goods will attempt to gain market share by undercutting any other producer out there. Which, of course, then explains why goods prices have been under pressure in most economies in the past decade.

With that in mind, measuring China’s propensity to export its excess production and put pressure on the prices of “goods” around the World becomes very important. And fortunately, there is a simple way to do this: studying the changes in Hong Kong’s re-export prices (blue line on chart next page). Indeed, Hong Kong is still an important port of transit for Chinese-made goods; and the data that the Hong Kong government compiles is trustworthy.

And this is where it gets interesting: according to Hong Kong re-export prices, China’s deflationary impact seems to have been the greatest at the end of 2001-beginning of 2002. It then took a little over a year for the world to really start to
A year ago, China was exporting inflation. It is now back to exporting deflation.

Failing intervention from politicians, the “invisible hand” tends to work... and in the past few years, it has provided for higher standard of living in the US, as well as in China.

Then, for the first time in a decade, China’s export prices started to rise meaningfully in 2004 and 2005. For a short while, China was exporting inflation; but once again, it took a year for the world to notice (and now people everywhere seem as concerned about inflation as they were about deflation three years ago). Today, Chinese re-export prices are back into negative territory. In other words, a year ago, Chinese companies had pricing power (which might help explain the great performance of the Chinese equity market... and even the Japanese equity market - see our January 2006 piece, The Japanese Market Sells Off); but this pricing power has now disappeared. China is back to exporting deflation.

6—Conclusion: The “Invisible Hand” at Work

At the risk of sounding Panglossian, we will admit that we are in awe at how Adam Smith’s “invisible hand” works in strange and funny ways. If anyone had told us a decade ago that a “trade” would be put in place whereas China would say “give us all the jobs” and American companies would say “we’ll take all the profits” and that this trade would lead to greater wealth, and greater social harmony in both countries, we most likely would have been very skeptical. Of course, we would have been wrong, for we would have forgotten to put our faith in Adam Smith’s invisible hand which somehow has a way to make things work out in the end.

One interesting factor about the above developments is that they have occurred so quickly that politicians have not really had a chance yet to interfere with the invisible hand and turn gold into lead. However, listening to the rhetoric currently prevalent in the US Congress, some US politicians (Graham, Schumer...) seem very keen to catch up.

To conclude, we would like to leave the reader with the following points:

- Inflation, at this stage, does not seem to us to be a viable threat. The current increase in prices we are witnessing reflects the past years’ easy monetary policies and increases in China’s export prices. These factors are now behind us. In front of us, we have the fact that China is once again exporting deflation (a fact which might help explain Japan’s weak equity market performance) and the tighter monetary policies of recent quarters.

- In a tighter liquidity environment such as the one we are now facing, owning the guy that says “I’ll take all the profits” makes a lot more sense to us than owning the guy that says “I’ll take all the jobs”.

worry about deflation (and the “China price”). Of course, by that point, the deflation that China was exporting was already abating.
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