April 27, 2012

"We can actually manufacture as cheaply or cheaper here in the US than we can in China."
-DAVID ROBERTS, CEO OF INDUSTRIAL CONGLOMERATE, CARLYLE, REFERRING TO ITS TIRE OPERATION

"The discovery and development of North America's shale resources has the potential to be the most remarkable source of economic growth and prosperity that any of us are likely to encounter in our lifetimes."
-US STEEL CEO, JOHN SURMA

POINTS TO PONDER

Brother, can you paradigm? "Mega-trend," "paradigm shift," and "game changing" are a few of those terms that are prone to make people cringe, the syntax equivalent of fingernails on a chalkboard. Yet, occasionally, such trendy buzzwords are the best way to describe a series of events that are truly momentous. In the case of the three major transformations that are the subject of this EVA, I think these somewhat hyperbolic and often over-used word pairings are actually justified.

Over the years, our big picture, or macro, research helped us identify significant trends and trend changes well in advance of the crowd. For instance, our forebodings about both the tech and real estate manias allowed us to preserve our client's capital during the implosions that followed both of those bubbles, hugely benefiting our long-term performance. Thus, we've come to believe that getting the major calls roughly correct is worth the time and effort.

Of course, it's impossible to anticipate all the squiggles and jiggles along the way, as no trend is smoothly up or down. But as John Maynard Keynes once said, it's better to be approximately right than precisely wrong.

In my case, the perpetual pursuit of being approximately right entails a weekly diet of extensive reading and, frankly, heavy reliance on those investment professionals whom I hold in high regard. On that score, a recent visitor to Bellevue both gave me insights on a new uber-trend (note, I avoided "mega") and reinforced a couple of key themes I've been developing.

Some of you might remember the April 6th EVA in which I briefly discussed Louis Gave's visit to our offices. In that issue, I promised to provide more details about the key messages he shared with the Evergreen team as well as with some of our existing and potential clients.

One of the reasons I am enthused to be working closely with Louis and his firm, GaveKal Research and Capital, is that they believe, as Evergreen does, that the world we live in isn't just a jumble of random outcomes. Amid the short-term noise, there are dominant currents that are possible to identify, hopefully while they remain in their early stages.

During his short stay in the Seattle area, Louis pointed out that three trends emerged 10 years ago as among the most significant: the introduction of the euro currency, America's "guns and butter" response to the 9/11 tragedy, and China's inclusion in the World Trade Organization (WTO). Certainly, there were others such as the Fed's panicky response to the bursting of the tech bubble, which ultimately enabled the next speculative frenzy involving houses and credit. But the three developments that Louis highlighted did have huge reverberations. His main point on these prior seminal events is that the various forces they unleashed have run their course.

China's new syndrome. In their place, he sees three new emerging paradigms (buzzword warning!), the first being China's next growth driver. Living and working in Hong Kong, as well as having offices in Beijing, Louis and his company obviously have some insights into the dilemma China now faces. The days of relying on 30% annual export growth have come to an end with a paltry 3% to 4% looking like the new (sub) normal. With millions of rural workers migrating to China's teeming cities, the country's leaders don't have the luxury of sticking with the status quo.

They also don't have the option of launching another debt-fueled spending spree such as the stimulus program that helped pull the world out of the 2008/2009 economic free fall. Loan growth literally went vertical during that phase and there are very legitimate concerns about how wisely that money was spent. Regardless, China is highly unlikely to go deeper into hock for questionable long-term benefits. In fact, loan growth is already flattening out, though it remains at high levels.

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Nor can China rely on cheap labor to continue propelling its industrial juggernaut. The supply of young workers is forecast to fall by one-third over the next decade. Moreover, an increasingly restive population is successfully militating for better pay, causing wages to rise at a 15% to 20% annual clip. This reality is actually a prime factor in Louis' other two—brace yourself—megatrends, to be discussed shortly, both of which I've been highlighting for some time. But China's urgent question is how to maintain the growth needed to satisfy its populace given the twin realities of flattening exports and a disappearing labor cost advantage.

In Louis' view, the answer is financial deregulation. While this can seem like a vague concept, I'm convinced he's right. Hardly a day goes by without an article in the *Wall Street Journal* or *Financial Times* about the latest relaxation of previously rigid financial rules. For example, China is now not only allowing but actively encouraging the trading of its government debt in Hong Kong by foreign investors.

China is also, and very much related to that development, positioning its currency, the renminbi

(RMB), as an alternative to the US dollar with its fellow emerging market trading partners. It is GaveKal's contention that China is setting up the RMB to be the equivalent of Germany's deutsche mark back in the 1970s when the US dollar was under siege and the D-mark became widely used to settle trade within Europe.

This is also consistent with reports I've seen that China is systematically accumulating gold, with one theory being that it plans to make it partially convertible into bullion thereby further burnishing its backup reserve currency status.

Such moves also fit within China's long-range plans to become an exporter of much higher value items such as machine tools and earthmoving equipment. The Middle Kingdom no longer wants to be merely a low-margin assembler of iPads; it wants to sell sophisticated industrial products to countries like Brazil. In return, it will buy the essential commodities it needs with any difference settled in RMB. However, countries like Brazil and Indonesia need to be able to invest their RMB earnings, which is why the Hong Kong—aka "dim sum"—bond market is so important.

China's citizens also require a reasonable outlet for their enormous savings. Presently, they have little choice but to deposit their funds in bank accounts with low rates, providing negative yields after inflation. Allowing interest rates to float at market levels and recycling this massive pool of savings into an unfettered private sector, versus the bloated state-owned enterprises, has the potential to rev up China's growth engine.

Additionally, China's infrastructure needs have largely been satisfied, meaning the country will soon arrive at the "Bridge to Nowhere" point if it continues to head down this road. The end of this trend has immense implications for companies that have feasted on China's voracious appetite for equipment, not to mention commodities. Essentially, the winners of the last 10 years, both inside and outside of China, are likely to be replaced by a much different cohort in the coming decade.

While China is a fascinating topic, the next two trends are likely to be of even more interest to Americans.

From iPad to iRobot. In various conversations with Chinese manufacturers, GaveKal is hearing that the cost between workers and robots is rapidly converging. Underscoring this, Apple's largest Chinese component supplier, Foxconn, has announced that it plans to add one million industrial robots in the next three years. Considering that the planet's total population of industrial robots right now is around one million, this is definitely an eye-opener.

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Obviously, industrial robots have been around for a long time. The difference now is the aforementioned convergence with what has long been the world's rock bottom production cost Chinese labor and a new development with robots themselves: their growing flexibility.

Previously, robots were largely utilized for a specific function such as drilling a hole or welding a given part. There was limited ability to adapt them in the field to different tasks. Now, however, flexible design and enhanced software is allowing them to be "reprogrammed" to fulfill a variety of production needs. Naturally, such adaptability implies lower costs and greater market penetration.

One implication of this is that high-wage countries like the US are no longer at a disadvantage versus emerging markets. It's my belief, as well as GaveKal's, that the US is particularly well positioned in this regard, partially due to a third new super-trend (that I'll cover at the close of this issue) and also because America has had to cope with brutal foreign competition for years. Consequently, US companies have learned to become exceptionally efficient and are already very comfortable with advanced automation.

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As with China's growing financial deregulation, there's nearly an article a day on this movement toward what has become known as "re-shoring." In fact, we began picking up on this last year and the momentum behind it has accelerated. Companies such as GE, Otis, Ford, Michelin, BMW, NCR, and Caterpillar, just to name a few, all have recently announced plans to return production to the US or expand existing facilities. The southeastern states, due to their low labor costs and pro-business climate, tend to be the primary beneficiary of this shift. Moreover,

land costs in South Carolina, for example, are now dramatically cheaper than in China's major industrial cities.

Further catalyzing this trend is the growing use of another fairly new automation technique: 3D printing. If you haven't heard of this, also known as direct digital manufacturing, trust me you will. It has the potential to dramatically cut production costs for items as diverse as hip implants and airplane parts. 3D printers combine computational power and lasers with the basic building blocks of industrial products, such as powdered metals and plastics, to make finished goods with breathtaking efficiency.

It's reasonable to wonder what this new era of automation means for workers. It certainly promises to be a daunting challenge for countries like China that have thrived due to their cheap labor advantage. This is one reason why it is now essential for China to deregulate its financial sector and build a service-based economy. But for the US, which has seen such a large portion of its manufacturing base move offshore, even robot-filled plants will bring new jobs. This is especially true when you think of all the ancillary positions that will need to be filled, such as with suppliers and transportation providers.

Of course, these highly automated facilities will consume a lot of power, and this brings us to the next profound change that also benefits the US.

Advantage America. If the premise is accepted that the era of cheap labor as a country's main attraction is winding down, a relevant question is what replaces it? In the GaveKal view, it is energy. A key reason why GE might want to make appliances in South Carolina rather than Shanghai is that the expense of shipping heavy goods is already a key factor.

Now, however, thanks to immense natural gas finds in the US, manufacturers relocating here can rationally expect far lower costs not only for transportation but also for actual production. For example, natural gas in the US is one-fifth to one-seventh its cost in most of the rest of the world. Vividly illustrating this comparative advantage, Louis recently returned from Germany where he heard repeatedly that, given the present natural gas price differential, the German chemical industry will continue to cede huge market share to their US competitors.

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Regular EVA readers know that I've been on this kick about the importance of abundant and low-cost natural gas for a couple of years, partially thanks to the research my team and I have done on master limited partnerships (MLPs). Many of these entities are essential participants in the gathering, transmission, storage, and processing of natural gas and have been exceptionally rewarding investments for our clients over the years. Listening to their management teams at various conferences several years ago, it became apparent to me that shale gas was truly a game-changer. Yet, for a considerable time, it remained a stealth boom. Now, however, the shale gas boom is about as clandestine as the sex-capades of the Secret (Escort) Service down in Cartagena.

Nonetheless, the numbers are still staggering. The federal government's Energy Information Agency estimates that America's technically recoverable reserves of shale gas have more than doubled from its last tally. This has led to an increase of overall US natural gas reserves of almost 40%. Plausible projections are for the US to be a net exporter of 13 billion cubic feet of gas per day by 2017, equal to about 20% of total current output, reducing our trade deficit by around $45 billion per year.

And that's not all. As I've touched on before, there is another breakthrough underway, in this case "tight oil." Like shale gas, it has been trapped in what had been economically unfeasible shale and sand formations, and while it's still early days for this process it's nonetheless making a material impact. US tight oil production is already equal to Libya's output and is projected later this decade to hit three million barrels per day. Based on the trend we've seen with shale gas, it's reasonable to expect these estimates to be on the low side as technology improves even further and additional formations are identified.

For aging baby boomers like me, who can barely remember a time when there was positive news about the US energy situation, this falls under the too good to be true category. But true it is and it will continue to make the US a more alluring venue for locating—or re-locating—manufacturing operations.

Philip Verleger, former director of the federal government's Office of Energy Policy, noted in an April 24th *Financial Times* article that access to gas far below world prices gives US manufacturers a 60% to 80% energy cost advantage versus Chinese and South Korean companies. He also wrote: "In short, low cost energy provided primarily by shale gas production advances will almost certainly contribute to an investment boom across the US economy."

It's time to close this EVA but let's do so with some thoughts on the direct investment implications of these three increasingly dominant trends.

So what's an investor to do? Regarding Chinese financial deregulation, including the emergence of China's bonds and currency as compelling financial vehicles, this means US investors may want to have some exposure to China's nascent government debt market. While it's possible that robotics and the US energy bonanza might bring about a flattening out of the RMB's long but gradual appreciation against the dollar, its ascension as the number two reserve currency should drive demand for it much higher.

In fact, the RMB may be one of the few currencies that might continue to rise against a resurgent greenback. It's also a nice hedge in case US monetary and fiscal policies continue to lead us down the slippery slope to national insolvency. Despite the justifiable euphoria over our energy good fortune, let's not lose sight of the fact that our government's financial condition is much like Europe's. This is one of the reasons that Evergreen and our new partners at GaveKal intend to bring out an Asian income fund later this year (God, and the SEC, willing), which is highly likely to include Chinese government bonds.

As far as what the re-shoring theme means to investors, it certainly makes sense to have some exposure to those companies that are leaders in industrial automation. Evergreen clients are likely to own one of the best positioned robotics producers in the very near future. Further, US and multinational capital equipment manufacturers in general should enjoy a major tailwind for years to come. Given that the gap between lush cash flow and depressed capital spending is wider than it has been in decades, future demand should be particularly robust.

Finally, relative to the massive discount in price compared to the rest of the world, US companies utilizing natural gas as a feedstock should have material and enduring leverage against their overseas rivals. Additionally, those entities, like MLPs, that are the toll collectors along the nation's energy highway system should continue to prosper as they have in recent years.

Another fairly new message I've been conveying in EVAs of late is that the economic systems that have been in place for Europe, the US, Japan, and China over the last 30 years are no longer viable. As someone once said, the world doesn't come to an end very often; therefore, investing as if it will is, in the long run, a fool's errand. Yet, that's not to say there won't be serious upheavals and convulsions as old ways of doing business, and running countries, hit the wall. There will be winners, many of them, but they are most assuredly going to be among those companies and nations that adapt best to a radically different world order—or, if you will, an entirely new paradigm.

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