insights

Think globally, invest globally

"Economic and political tectonic plates are shifting. We can shift with them, or we can continue to see a new world through the prism of the old. We must recognize new realities. Our world will look very different in 10 years, with demand coming not just from the United States but from around the globe. We cannot predict the future with assurance. But we can anticipate directions – and one is that the age of a multi-polar global economy is coming into view."

Robert B. Zoellick, President, The World Bank, April 14, 2010

As Mr. Zoellick notes, the world economy is in the midst of profound change. Markets are increasingly global in scope, and competition shows lessening respect for national boundaries. Changing demographics are impacting all countries, presenting tremendous challenges for some and vast opportunities for others. Developing countries continue to grow in economic strength and are demanding - and getting - a seat at the global policy table.

Investors today must take a far closer look at overseas investment opportunities - not as a cyclical or tactical event - but rather as part of a diversified strategy that recognizes long-term trends. While domestic equities will continue to be a major part of a well-diversified portfolio, an increased allocation to international equities can offer substantial benefits and return potential.

investing in a global economy

Throughout the post-World War II era, the United States possessed an extraordinary combination of features conducive to superior economic growth, including robust productivity, efficient financial markets, an established legal framework, a stable political environment and acceptance of the dollar as a reserve currency. American investors focused on U.S. stocks, and for good reason.

In recent decades, a number of compelling reasons to increase international allocations have surfaced. First, consider scale: Foreign countries account for about 55% of the world's equity market capitalization and about 50% of the world's outstanding fixed income obligations. Investors limiting themselves to securities available in the domestic markets are neglecting at least half of the world's existing opportunities. Investing globally means broader horizons, which offers the opportunity for a richer set of investment possibilities.

But expanded horizons alone aren't enough: Successful investing is the result of the fulfillment of strong realized return potential. Our view is that international equities offer an excellent return opportunity over the long term for two broad-based reasons:

- **Growth** – Expectations for growth in many advanced and developing foreign economies exceed those projected for the United States, and capitalizing on that potential may be a fruitful source of improved returns.
- **Inflation hedging** – The United States will be increasingly subject to long-term inflation pressures that could weaken the dollar. Since relative currency moves often account for about half of the returns from overseas investments, dollar weakness would be a significant positive for international holdings.

We see four major developments impacting growth expectations and inflation prospects that favor foreign investments over U.S. equities.

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These are:

1. Price competition and profit margins
2. Rising cost of commodities
3. Swelling U.S. public debt
4. Growth in foreign economies

1. Price competition and profit margins

Increased global competition is altering the environment in which most companies operate today. As trade barriers fall and borders open, new global competitors are entering markets that were once dominated by U.S. companies. As a result, American businesses are confronting heightened pressure on sales, pricing and profitability.

To maintain profit margins in the face of heavy price competition, U.S. corporations are attempting to slash production costs. And, since labor is often the largest component of expenses, they seek cheaper labor in overseas markets.Economic theory tells us the market ultimately adjusts and wages shift to reflect global supply and demand. But the United States will lose jobs during the transition, and the outcome is higher unemployment and dampened economic growth.

2. Rising cost of commodities

As the world economy grows, economic progress is creating increased demand for commodities and raw materials. This is especially the case in developing economies, where increased manufacturing, a rising class of consumers and a substantially greater integration into the world economy is placing steady upward pressure on commodity prices. As a result, real economic growth has accelerated across the resource-based world and in mature economies like Australia that are proximate to resource-exporting nations.

Rising commodity prices, however, have negative implications for economic growth in the United States. As demand for raw materials increases over time, the profitability of American companies will be adversely affected, placing further limitations on our country's economic outlook.

3. Swelling U.S. public debt

U.S. government debt held by the public has swollen over the last few years to the point that, compared with the gross domestic product (GDP) of the economy, it is now higher than it has ever been except during the period around World War II. Further increases in federal debt relative to GDP almost certainly lie ahead: Rising health care costs and an aging population will push federal spending as a percentage of GDP well above the levels experienced in the recent past. In fact, according to a projection by the Congressional Budget Office (CBO) this year, public debt will exceed its historical peak of about 110 percent of GDP by 2025 and reach about 180 percent of GDP in 2035. In addition, the recent tax relief act passed December 17, 2010 is estimated to add $858 billion to the national debt.

Large deficits and a mounting debt burden carry a heavy economic cost and could potentially lead to financial burdens and lower living standards in the U.S. The CBO projects that GDP per capita could stop growing in 2022. The impact of growing debt levels on the U.S. standard of living would lead to crowding out private investment in productive capital and other economic consequences that would hamper growth.

Inflation pressures add to the adverse effects on growth of the U.S. economy. Democracies are subject to the temptation to inflate away the real value of debt, and inflation would weaken the U.S dollar relative to other currencies

4. Growth in foreign economies

There was a time in the not-so-distant past that you'd never have expected to see these pronouncements from The World Bank (June 2010):

- Almost half of the rise in global demand in 2010-2012 will come from developing countries.
- Developing economies are expected to grow between 5.7 and 6.2 percent each year from 2010-2012. High-income countries, however, are projected to grow by between 2.1 and 2.3 percent in 2010—not enough to undo the 3.3 percent contraction in 2009—followed by between 1.9 and 2.4 percent growth in 2011.
- The projected growth rate of the U.S. economy is about half that of developing countries over the same time period.

These are projections covering only the intermediate term, and there are many things that may upset these forecasts. But it's clear that a shift in global economic activity from advanced economies to emerging markets is taking place. Developing economies with young and growing populations will increasingly become the focus of rising consumption and production and, ultimately, capital.

Like many Western economies, the United States will struggle with a graying workforce and slow population growth. Unless we achieve major gains in productivity, it will be difficult to attain strong economic growth.

taking a long-term global view

Given the size of the non-domestic capital market, the higher potential for growth overseas and the prospects of a weaker dollar in light of mounting debt and inflation, there's a strong case for increasing the overseas portion of your investment portfolio.

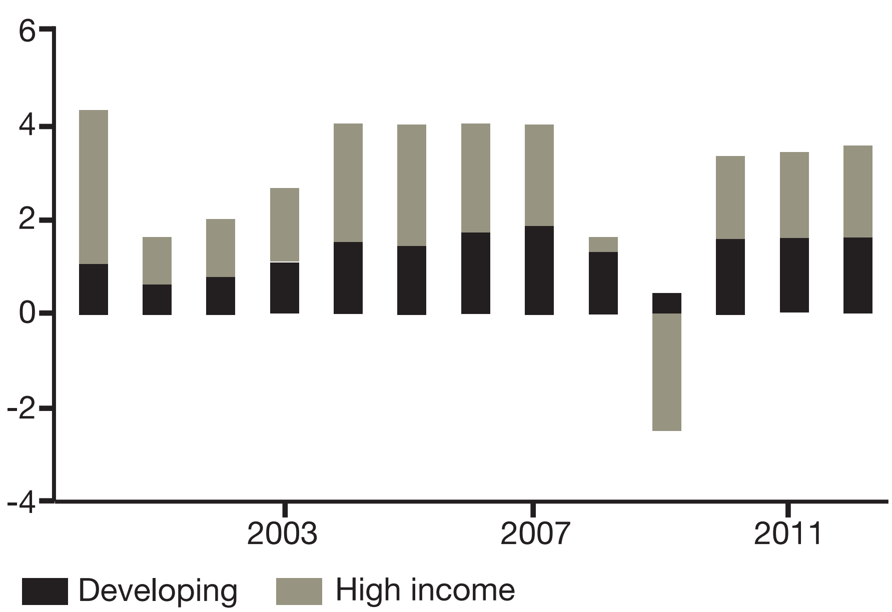
This doesn't mean there aren't international landmines to avoid. Some countries are confronting the same public debt and aging population problems as the United States, and several nations continue to grapple with political instability, weak financial markets, undeveloped infrastructure and suspect accounting practices.

Despite the potential challenges of foreign markets, however, overseas investing can help you benefit from higher growth rates and favorable currency trends being realized by many countries outside the United States.

Now is an especially good time to review your portfolio with your Key Private Bank Relationship Manager to discuss the opportunities of international investing. In today's market, it's absolutely essential that you have a trusted advisor who can offer insight and expertise to your investment planning.

Contributions to world GDP growth

Almost half of global growth is due to increased demand in developing countries.



Source: The World Bank

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