**Aureus Asset Management**
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# Investment Impacts of a Bifurcating World

## Introduction

Today's investors must recognize two key developments: first, the growing economic extremes between the world's wealthiest people and the poorest (particularly in the U.S.); second, the differing prospects of the middle class in the emerging versus developed world. This paper examines the investment implications of these contrasting profiles and discusses some of the opportunities and risks that they represent.

## Social Wealth and Income Gap

A recent study indicates the wealthiest 0.9% of global households control 39% of the world's wealth – up from 37% in 2009 – while the wealthiest 0.1% of households control an amazing 22% of global wealth[1].

This socio-economic movement has been underway for years in the U.S. The top 10% income-earning households in the U.S. control 45% of all income earned, up sharply from 33% in 1980. The top 0.5% earners have experienced the biggest increase over this time, with their share rising from 5.5% of total income in 1980 to roughly 14% today[2]. However, average weekly earnings for the typical private household inched up only slightly from $290.86 in 1980 to $297.31 in 2010, a total gain of only 2% over 30 years[3]. Finally, since the millennium, many middle class Americans dramatically increased mortgage and home equity loans. This proved to be a serious mistake as the events from 2007 to today have demonstrated. Now the U.S. middle class must retrench, to reduce over-inflated debt levels.

Wealth in the emerging world is also very concentrated. However, in contrast to developed nations, faster growth rates have resulted in significant income gains flowing through to the middle and lower classes. Wage increases across all emerging markets are clear indicators of this trend, as real incomes have been rising faster than price inflation.

For example, over the past several years wages in China have increased by an average of 12-17% per year in contrast to consumer price inflation in the range of 4-6%. In India, a recent announcement by Tata Consultancy, a provider of outsourced technology consulting services, to hire 60,000 new employees and increase wages by 12% is a micro indicator of a broader local trend. Although poverty is still widespread, tens of millions of workers in the emerging world are finding solid jobs offering upward mobility and higher living standards.

Today, the middle class in developed nations is hurt by stagnating incomes, debt repayment obligations, and rising costs of food, gas, education, and healthcare. Meanwhile, the middle class in most emerging markets has little debt, is gaining access to credit, is able to keep pace with rising costs as wages increase, and is able to better afford modest housing and other consumer goods. The contrast is stark.

## Sovereign Countries Fiscal Condition

A strong economy means better prospects for that country's middle class. Net debt as a percent of gross domestic product ("GDP") provides a good measure of sovereign fiscal strength: The lower the percentage, the better a country's fiscal condition and ability to borrow at reasonable interest rates. The following table summarizes global net debt as a percent of GDP by major country grouping:

**Net Debt as a % of GDP** [4]

| *(%)* | **2010** |
|---|---|
| United States | 65 |
| Euro Area | 67 |
| Emerging Markets | 27 |

Because of unprecedented recent borrowing by the U.S. and Western Europe, both areas of the world are facing fiscal pressures, which are especially acute in certain southern European countries. Most projections indicate the U.S., on its current track, will break the higher end of sustainable net debt levels before 2020, unless deficit reduction measures are addressed relatively soon. At that point, the reaction from our bond market might force the U.S. to implement abrupt and considerable austerity measures (e.g., the situation of Greece today). Growth prospects would be reduced, and pressure on middle class incomes would rise even further.

The emerging markets have financed much of their growth through exports to the developed world, have borrowed less, and are in better relative and absolute fiscal shape. Exploitation of abundant natural resources (such as in Latin America), large pools of educated nationals (as in India), efficient and low-cost manufacturing (as in China), as well as improved transportation and communication have played important roles in wealth creation from Brazil to Botswana. As prosperity ensues, the local economy demands more goods and services for its own consumption. Since these countries have ample additional capacity to borrow, they can finance key physical infrastructure projects even as exports to the developed world stagnate. These improvements should enable the continuation of relatively rapid growth, particularly for their middle classes.

## Conclusion

Economic extremes in the developed world involve wealth that is concentrated among fewer and fewer people. Extremes between the developed and emerging markets are both balance sheet and income related, with emerging nations doing better in both categories. Current tensions in Europe and the U.S. about debt levels reflect the uncertainty created by these polarities, with consequent effects on the volatility of financial markets.

We conclude that: intelligent investors must continue to take advantage of the growing power of the developing world; and, we must also exploit those opportunities in the developed world which arise from the concentration of wealth. Specifically, companies providing goods and services to wealthier consumers globally as well as those catering to the middle class in much of the emerging world have the wind at their back; suppliers of infrastructure development from raw materials to technical expertise also appear to have positive growth prospects; suppliers of productivity enhancements for the developed world's best exporters and high-tech industries will benefit; commodity demand in the developing world will remain rapid; and, improved emerging country risk profiles and growth prospects suggest that both fixed income and equities denominated in non-traditional currencies have good long-term prospects. To offset the risk of rising volatility, broad diversification by asset class and by industry is a necessity.

Aureus is constantly analyzing key worldwide trends and adjusting client portfolios accordingly. A diversified and global approach, which reflects fundamental trends, should continue to benefit our clients.

Footnotes

1. "The Boston Consulting Group: Global Wealth 2011."
2. "The World Top Incomes Database." – figures expressed in 1982 dollars.
3. Obama. "The Economic Report of the President: 2010."
4. Gagnon, Joseph E., and Marc Hinterschweiger. The Global Outlook for Government Debt over the next 25 Years: Implications for the Economy and Public Policy. Washington, DC: Peter G. Peterson Institute for International Economics, 2011.