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# Monthly Investment Commentary – March 2014

As the bull market which began in March 2009 reaches five years of age, there are questions about its continuing strength and sustainability. The US stock market is no longer so cheap relative to earnings and, although Asian and Emerging Markets have had some sharp corrections, they will take their lead from Wall Street (US$30bn was withdrawn from Global Emerging Markets in January alone).

Now, moreover, there are several new factors, including the situation in the Ukraine, especially the Crimea, which has historical resonances. Russia will not give up its ancient territorial claims and the West is powerless to prevent them. Will this increase energy prices and result in more currency and market volatility? It is possible.

In addition, China, through the PBOC, has unexpectedly begun to devalue the RMB against the dollar after allowing it to appreciate in the past four years. This may be partly in response to the dramatic devaluation of the Japanese Yen and some other Asian currencies and to the growing pressure on Chinese exporters as their labour costs rise.

What will happen next in China? It is, as always, unpredictable. There are however, growing social and political tensions, although Xi Jin Ping's government has started to stamp out corruption and exert control. China will undoubtedly slow but it will not crash. Consumer spending will grow rapidly: there are plenty of investment opportunities in the internet space as well as consumer durables and staples, many of which are Hong Kong-listed businesses with good accounting standards. (The State-Owned Enterprises are still generally unattractive in our view).

We believe that China and Hong Kong property values are one of the major global "bubbles" and likely to correct in the next 2 to 3 years. It is, by definition, impossible to anticipate the timing of this correction but among the unforeseen consequences would be losses for Chinese and Hong Kong banks (already the problems of "wealth management products" or domestic mutual funds in China are having an impact) and perhaps a slowdown in the massive flow of Chinese capital to foreign destinations, much also directed to real estate.

One key question in 2014 will be the direction of the oil price. While it has been strengthened in the short term by Russia/Ukraine tensions, we anticipate that supply will increase in the spring and summer. In the United States, oil production is expected to rise to 10 million barrels a day within a few years with the rapid growth of shale. It is estimated that, with imports from Mexico and Canada offsetting demand for 19 million barrels a day and with potential energy conservation of nearly 5 million barrels from improved M.P.G or fuel efficiency, by 2020/2025 North America (not the United States) will be energy self-sufficient. This is already having repercussions on US foreign policy in the Middle East and the rapid reduction of US military power (with defence expenditure falling from 4.6% to 2% of GDP eventually).

Recently, we visited Saudi Arabia where the Royal Treasury needs about $75/barrel to meet its budget requirements. Much of the infrastructure build-out has been completed (as in China) and the overriding social problem is to provide enough employment for the growing young population. Among the Saudi companies we have invested in for our Frontier Fund are Mobily (telecom), Herfy (fast food), Jarir (bookstore) and Sadafco (Dairy) - none of them in the energy sector.

In a meeting with His Excellency Dr. Muhammad Al-Jasser, Minister of Economy and Planning, he explained that the Kingdom of Saudi Arabia has made great progress both in economic growth (around 4% per annum) and in balancing their fiscal deficit. The kingdom has one of the largest trade surpluses in the world $140 billion p.a., or 13% of GDP. There are 185,000 Saudi students studying overseas. There is no sign apparently of the "Arab Spring" spreading into the Gulf or Arabia, as the awful catastrophe of Syria, and the instability of Egypt under the brief rule of the Muslim Brotherhood, has focussed attention on the stability of the traditional Arab Monarchies. The rapprochement of the United States and Iran is also contributing to a better climate in the Middle East, despite the long term intractability of the Sunni-Shia divide (since before AD 700).

The final theme which we outlined at the Riyadh conference was the investment theme of water as being the key resource (as well as the source of life) over the next decade. This will include hydro-electric power, water utilities and water treatment, water sports, tourism and resources of the oceans. One of our investors commented that it is still a difficult area to find good listed investments but we are convinced that it is timely and profitable, and we will continue to explore and visit companies in this sector, from Chile to China and the Philippines.

Our final comment is really about the longer term impact of the internet, which is now just 20 years old, and why it is important for investors. Although we foresaw the economic rise of China, one thing that nobody predicted was the deflating consequences and social impact of the worldwide web. As Eric Schmidt recently remarked, it will eventually be like electricity in 1900 – invisible, because everyone lives by it, without thinking of it.

Voice recognition devices, friendly humanised $10,000 robots, instant access to all knowledge and all people globally in a "flat world" (in the telling phrase of Tom Friedman): these are some of the immediate facets. But longer term perhaps, the business model of banking and finance will be completely changed; and the temporary problems of the "bitcoin" will be forgotten as virtual currencies and virtual banking become the global norm. Perhaps many traditional banks in the west have too much "bricks and mortar" and too many staff to be competitive when we look at cost/income ratios compared to those in developing countries. Our experience with banks in emerging markets, nevertheless, is that the best investments are those national retail banks which know the local customers well, collect deposits, and make loans: we own a number of banks in emerging and frontier markets which adhere to this conservative and traditional business model, with excellent results for shareholders.

This is my penultimate monthly commentary, and I hope in April to cover some of our new Frontier holdings in South America, as well commenting on changes in the investment management scene since I began as an analyst in the 1970s (and also what does not change). I would be grateful for any feedback from my readers about what they find useful or stimulating.

R. Lloyd George

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