Are Your Guns Facing the Wrong Way? Positioning Portfolios for Future Trends

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"Just like the British guns in Singapore, investors whose portfolios still reflect the 2001 trends are facing the wrong way." So says Hamid Hamirani of the Oman Ministry of Finance.

- **In this illuminating exploration of the key events which have shaped the past decade – and the events which may shape the next – Hamirani enjoins investors to look to the future rather than the past.**
- **Major trends which spurred the post-2001 boom have stalled. The next decade may be defined by factors such as the internationalization of the RMB, energy independence in the US and the rise of automation. Investors who find some way to "catch an early train" on these key issues may well find themselves in a better position than those who are still looking backwards.**

Hamid Hamirani, Senior Economist, Ministry of Finance Oman

To quote Lenin: "There are decades when nothing happens and there are weeks when decades happen."

Think of the last quarter of 2001. Three major events took place: 9/11, China joining the World Trade Organization and the introduction of the Euro.

Together, these three events defined the next decade: they were the catalyst of the economic boom in the years which followed.

9/11 resulted in war spending and a structurally weak dollar. China's entry into the WTO led to their emergence as a major exporter and the recycling of those exports into US treasuries, which resulted in the mother of all investment booms. The introduction of the Euro meant that German balance sheet strength was used to get credit for countries like Greece and Ireland, producing a major economic boom.

Yet if you look at the picture today, all of the above have stalled. US guns are silent, China's spending is slowing down and European consumption is finished.

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So what are the key trends of the future? I believe the three major ones are the introduction of RMB, automation and cheap energy for the USA.

Let's look at the internationalization of the RMB first. Dollar financing is dying, western bank ability to lend is seeing serious capital erosion, exports of cheap goods are declining thanks to recession in the developed world and Chinese wage inflation. Whatever your views on global growth (2.5%? 2.6%?) the truth is that China export model cannot be sustained. This is an important observation. Look at what China is doing: they are dealing with emerging markets, they are arranging swap agreements with Brazil, Argentina, Turkey and Belarus and they are creating an offshore RMB market in Hong Kong. This is an important trend: investors should look at it and catch an early train. Yesterday, China's trade was oriented towards developed markets and was comprised of low value-added goods priced in dollars; tomorrow's China trade will be oriented towards emerging markets, involve higher value-added goods and priced in RMB.

The second major trend is the rise of automation and the change from fixed automation to flexible automation. We will see the move of factories back to the developed world. In addition, we will see Chinese factories becoming more automated, which will pose a challenge to the Chinese authorities since employment will have to shift from labour-intensive factories to the service industry.

Take note: this second trend is also likely to help foster the internationalization of the RMB. The significance of the creation of the RMB bond market is still being widely under-acknowledged at the moment, in my opinion.

The discovery of cheap energy in the US is the third major trend I would focus on. The discovery of Shale Gas could lead to energy independence, assuming that the investment is forthcoming. The return of manufacturing and energy independence in US should produce a significant improvement in that country's trade deficit. Think about the implication of that change for global markets. At the moment, the US trade deficit causes USD500 billion to be sent every year to the rest of the world: their deficit provides the lubricant for global trade. At the moment, nearly 75 percent of global trade is denominated in USD. Reduction in that deficit would result in dollar scarcity.

This may be happening already. This would partly explain why the growth of central bank reserves held at the fed has been a negative priority for the past year and why the Fed has been exceptionally generous granting swap lines to foreign central banks over the past two quarters.

The most important message is this: just like the British guns in Singapore, investors whose portfolios still reflect the 2001 trends are facing the wrong way.

Instead of lamenting over the past, we should be coming to grips with the trends of the future.

Hamid Hamirani delivered a presentation on these issues at the Global Sovereign Funds Roundtable, May 2-3 2012. This article is based on his remarks.

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