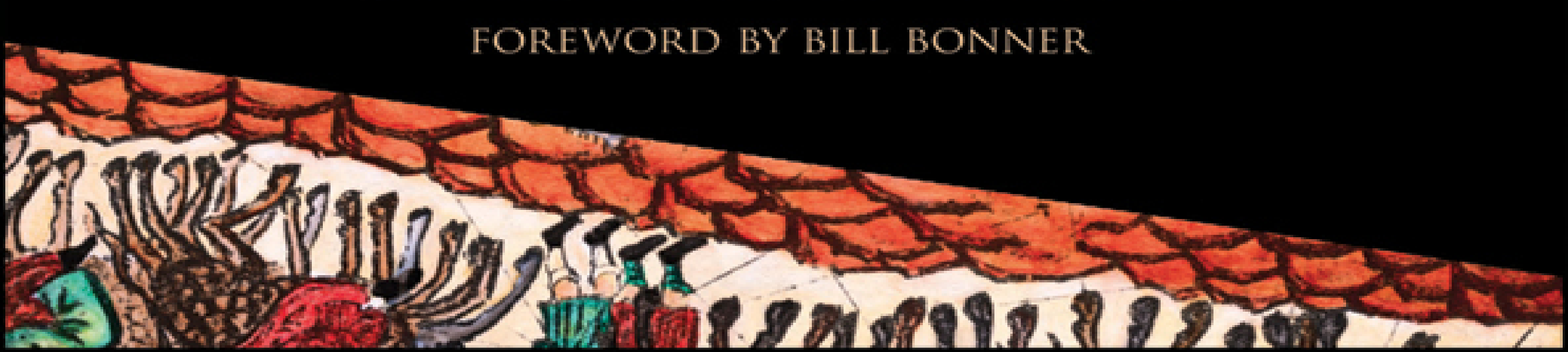
WORLD RIGHT SIDE UP

Investing Across Six Continents

Christopher Mayer

Foreword by Bill Bonner



Contents

World Right Side Up

Investing Across Six Continents

CHRISTOPHER MAYER

WILEY
John Wiley & Sons, Inc.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

For general information on our other products and services or for technical support, please contact our Customer Care Department within the United States at (800) 762–2974, outside the United States at (317) 572–3993 or fax (317) 572–4002.

Wiley also publishes its books in a variety of electronic formats. Some content that appears in print may not be available in electronic books. For more information about Wiley products, visit our website at www.wiley.com.

Library of Congress Cataloging-in-Publication Data:

Mayer, Christopher W., 1972-

World right side up: investing across six continents / Christopher W. Mayer.

1 online resource.

Includes index.

Description based on print version record and CIP data provided by publisher;

resource not viewed.

ISBN 978-1-118-17140-0 (cloth); ISBN 978-1-118-22679-7 (ebk);

ISBN 978-1-118-23978-0 (ebk); ISBN 978-1-118-26450-8 (ebk)

1. Investments, Foreign. 2. Investments. 3. International finance. I. Title.

HG4538

332.67 03–dc23

2012006627

Foreword: Sometimes It's Different

The material progress in the developed world over the past 300 years is undeniable. But the closer you examine it, the less it appears as a tribute to how clever the human race is, and the more it seems to be an illustration of how lucky Europeans have been.

Europeans embraced the Industrial Revolution. Others did not or could not. Thus, the world turned against the non-Western countries, relatively, at the beginning of the Industrial Revolution. But if the world turns long enough, it comes back to where it began. And such is the case today.

Over the past 10 years, the real, private-sector economies of the developed world have grown at medieval rates. Meanwhile, the emerging markets have enjoyed a growth spurt. They are catching up breathtakingly fast.

When I was a student in 1969, I visited Paris. I went back to live in Paris in 1999, 30 years later. Almost nothing had changed. Same buildings. Same people. Except for the automobiles people drove and the clothes they wore, you would barely know that it had changed at all.

In the early 1980s, I went to China. I was taken to a barren track of dirt and dust and told that a new city, Shenzhen, would be built there. It was hard to believe. The whole country seemed desolate, gritty, and poor. When I returned in 2010, it was not the same country. There are believed to be three times as many people living in Shenzhen as in the whole Paris metropolitan area, and it is only one of dozens of new cities. Beijing, which used to be such a gray, empty, and lifeless place, is a city of gleaming towers, luxury automobiles, and traffic jams that can stretch for a hundred miles.

There is a lesson in all of this.

Most people see material progress as a result of continual innovation, investment, and technical achievement. We have come to see it that way because that is how it has appeared for generations. Once the enlightenment was reached, we thought continued material progress was guaranteed. The scientific method made improvements routine, examing new ideas and re-examined old ones, systematically rejecting what was unsound and adding to the accumulated knowledge of the human race. Freed from the limitations of the past, we could look forward to more wealth and knowledge, forever.

But the world doesn't work that way. No one stays on top for long. Competitors are everywhere.

For example, agriculture seems to have begun in the fertile crescent of Mesopotamia and the Valley of the Nile long before elsewhere. But the richness created by sedentary farming proved a lure for the steppe tribes, who seemed to have had an edge of their own. They had learned how to use the horse, to hunt, and to fight. Mounted warriors raided and later conquered the farmers.

Likewise, the tribes who invented the bow and arrow must have played hell with those who had not.

Technological progress did not bless all of the world's people evenly or at the same time. In the jungles of South America, Southeast Asia, and Africa, as recently as a few years ago, there were people who still lived as they had 10,000 or 20,000 years earlier.

In Europe, Asia, and America at the time of America's discovery, there were advanced civilizations of roughly similar standards of living. (I am probably being a little generous to the Americans of the fifteenth century.) Neither Inca nor Aztec civilizations could rival those of Europe or Asia. The Americans didn't even use the wheel. Still, in 1600, there was probably not much difference between the living standard of a serf in Europe, a slave in China, or a field hand in the Andes.

It is no surprise that those who took up the use of fossil fuels first and most aggressively, backed by institutions and customs that had evolved to suit the new technology, stole a march on their competitors.

Europe, and its colonies, raced ahead on coal-fired trains and oil-fired battleships until it had destroyed the civilizations of the New World and tamed those of Asia. India was host to the French and the Portuguese, before being taken over completely by the English. Japan was forced to open its doors to foreign trade and became a rapid, gifted imitator. China was besieged then battered by Western warships.

The world is different now. It's changing all the time, taking surprising twists and turns that create opportunities for venturesome investors. You'll read about many in this book.

Chris Mayer has traveled around the world looking for these opportunities. Together, we've been to China, attended conferences in France, and dined in Nicaragua. He keeps his eyes and ears open. You'll enjoy reading about, and perhaps profiting from, what he has uncovered.

—Bill Bonner

Acknowledgments

Author Albert Jay Nock (1870–1945) once said, “You don't try to repay the help that is given you. You pass it along to others.” This book is an effort in that direction, because I can never repay all the help given to me in putting it together.

I want to thank Addison Wiggin, my publisher at Agora Financial, friend and long-time booster of my work. We were bouncing around in a cab in Bogotá one day when he said to me, “I think you have another book in you.” The result you hold in your hands would have been impossible without his support.

A special thanks to Samantha Buker, my associate editor at Agora, who was an enormous help in organizing and editing the mass of material into a coherent form. The book is much improved because of her efforts.

Thanks to Susi Clark for the wonderful cover and for all the charts, and to the unsung efforts of Erik Kestler, our diligent copyeditor. Thanks to all my friends at Agora Financial for their support and good cheer, especially Bill Bonner, Joe Schriefer, Eric Fry, Greg Grillot, Jack Forde, Joel Bowman, Bruce Robertson, and Mark O'Dell. Thanks to Deb Englander and Kimberly Bernard at John Wiley & Sons. And to Eric Winig, for all those conversations at HQ and the ideas they inspired. And thanks to all the people I met along the way who took time out of their busy lives to show me around. I must also thank my loyal readers who make it all possible.

Finally, thanks to my family, especially my wife Carol, who put up with my sometimes hectic travel schedule and late night and weekend writing as deadlines loomed.

Travel, its very motion, ought to suggest hope. Despair is the armchair; it is indifference and glazed, incurious eyes. I think travelers are essentially optimists, or else they would never go anywhere.

—Paul Theroux, The Tao of Travel

Preface: Notes before We Go

I want to say a few things about what you are about to read. . .

Please remember this book is written from the perspective of an investor—a great enthusiast of all the world's charms but still an investor searching for ideas. I'm not writing a piece of social commentary or proclaiming deep knowledge about the nature of a place or its people. My aim is to find investment opportunities and trends.

In my travels, I've met a lot of new people and gained valuable contacts. But the fact of the matter is that the spadework of successful investing is mostly done from afar. In fact, many of my most successful investments came from companies I never met in places I've never been. That is as it should be.

A great investment idea should be plain, clear, and nearly obvious. I say "should" because many times they are, but there are always exceptions. The idea of investors harboring secrets and holding insider knowledge is something drummed up by people as a way to explain something they don't understand. It's propagated by many people in the business to whom such ideas are self-serving.

Most investing insights come from unglamorous trolling of publicly available data, mixed with some creative foresight and a good stomach not afraid to stand against a crowd. Conviction, patience, diligence: These are more important than secrets (or travel, for that matter).

I'm a big believer in history as a teacher. Sometimes, the best history books don't come from the desks of historians. They come from the works of inquisitive and observant scribblers at the scene, suffused with the immediacy of the moment and of what they see and hear. The insights are fresh when recorded, unspoiled by the editing of long memory looking back over many years.

You'll see I often refer to the works of travelers. On a trip to China, I picked up a used copy of *Shark's Fins and Millet*, written by Ilona Ralf Sues, a journalist who traveled to China in the late 1930s. Sues' book is a personal look at China as she traveled it: Canton (now Guangzhou), Shanghai, Nanjing, Hankou, Shanxi, and Yan'an. In her words, the book:

> *. . .is neither a study, nor a travelogue, nor a political treatise. It is a medley of everything, as unorthodox as life itself—an unconventional set of stories and anecdotes—a series of big and small events, of great and little people observed, not through a high-powered microscope, but with the imperfect, naked, sympathetic, twinkling human eye.*

I write this book in that spirit.

What does all this have to do with the stock market and investing? A good investor is a worldly investor who has an understanding and appreciation of how the world works and how it came to be. Reading old (and new) travel books has given me a glimpse of such things. It teaches me how to ask better questions of my hosts: traders, fund managers, bartenders and cabbies alike.

I've been lucky to be able to see the world. They say travel broadens the mind. Maybe it does. Or maybe they have it backward. Maybe it's the broad-minded people who travel. When I think of all the wonderful, well-traveled people I've met out there on the road, I can't help but believe that's the right way to put it. It's a memorable experience to bump into another American in a bar in a small town somewhere in southern Brazil. Odds are he's worth chatting with, a curious mind with good stories to tell about his own small discoveries.

For me, a place is always about the people I've met and, especially, those who took some time from their own busy lives to show around a curious traveler. You'll meet more than a few of them in the pages that follow.

—Chris Mayer

Chapter 1

The World Right Side Up

One thought always strikes me in my travels. I'll be sitting in a comfortable bistro in Medellín with its doors open to the warm night air wafting in gently from a quiet street, in a restaurant on a man-made island gazing up at the tallest tower in the world twinkling on a starless night in Dubai, at a bar in Cape Town, in a noodle shop in Beijing, or countless other places around this ever-fascinating planet of ours. And the thought will hit me.

If I close my eyes, I could easily imagine myself in New York, Washington, D.C., or any number of American cities. Of course, each of these places is different from each other in many ways, and yet they are much the same.

People are people around the world. They like many of the same things. They want to have a better life. They want to have a safe home, wear clothes they like, and have friends. They want to have leisure time and eat well. They all want something.

They share all the same traits that make us human. People everywhere are humble and vain, generous and greedy, wise and foolish, and many other qualities besides. They've made mistakes. They have hopes and dreams.

Yet great disparities and differences exist, too. Since the Industrial Revolution, the Western world—mainly the United States and Western Europe—has vaulted well ahead of everyone else. Traditionally wealthy economies, such as China and India and parts of the Middle East, were left far behind. The Western world dominated—in manufacturing might and in military power, especially.

This gap probably reached its apex sometime in the 1950s. According to *Power and Plenty*, a good reference book on trade, the Western world (excluding Japan) represented 90 percent of the world's manufacturing output as late as 1953. The United States bestrode the globe as Tiger Woods once lorded it over golf's majors. America's economy alone was nearly half of the world's industrial output.

But things started to change in the late twentieth century. The gaps narrowed. And these trends continue to unfold in the present. My thesis is that such narrowing of the gaps will continue for decades. This will be the most important long-term investment theme of the twenty-first century.

I call it “the world right side up” because it is, in my mind, a more natural world, more the way the world ought to be. It's a Western conceit to think that the current technical, economic, and military superiority of the West is normal. When you look at the history of our planet over a longer time frame, the dominance of the West is a relatively recent affair.

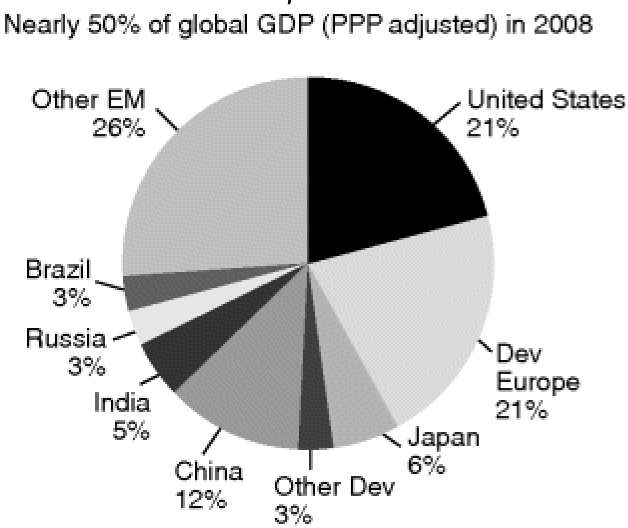
The Polynesians had prosperous farming villages across a great swathe of the South Pacific while Europeans were still living in caves. In double canoes, using only the stars and their wits, Polynesians crossed distances as great as those of Columbus thousands of years before Christ was born. And of course, you surely already know the long list of inventions first made by people in China or Arabia.

The distinctions between “emerging markets” and “developed markets” are starting to disappear. Indeed, the term may already be obsolete. Such is the thesis of Everest Capital, which made the case in a white paper called “The End of Emerging Markets.”

First, in terms of size, these emerging markets make up about half of the global economy. Take a look at Figure 1.1. GDP, or gross domestic product, is a flawed statistic, but it serves as a rough guess of economic size. “Purchasing power parity” (PPP) aims to take out the distorting effect of different currencies.

Figure 1.1 Let's Call It Even

Source: Everest Capital.



This is astonishing, but the comparisons get more interesting by country. Emerging markets make up 10 of the 20 largest economies in the world. India is bigger than Germany. Russia is bigger than the United Kingdom. Mexico is bigger than Canada. Turkey is bigger than Australia. These are things that I think would surprise the casual observer of markets, rooted in a Western view of the world as it was.

These trends will become more pronounced over time. The creation of new markets, the influx of hundreds of millions of people who will want cell phones and air conditioners and water filters, who will want to eat a more varied diet of meats and fruits and vegetables, among many other things, will have a tremendous impact on world markets. In fact, we've felt the impact in many areas, as we'll see.

In these pages, I'll focus on where these markets have been, where they are, and where they're headed. It is, necessarily, an eclectic and idiosyncratic look at the world. The world is still a big place. There are many patches of Earth and stretches of sea where I've never set foot. They are many places I don't write about here. This is not a comprehensive guide to global markets. It is one curious investor's sampling of that world.

That world is always changing. I first visited Dubai in 2007, when it was a boomtown. Buildings were going up everywhere. Trucks filled the highways. Cranes crowded the skyline. I learned later that two-thirds of the world's cranes were in Dubai back then. It had all the buzz and confidence of boomtowns I've seen in many other places.

My second trip was in October 2009, when everything was bust. It was a completely different place. There were still cranes, but they weren't moving. The many construction sites were still there, but there was no activity on most of them. The place was dead. The third palm island dredged out of the Arabian Gulf—it's never the Persian Gulf in that part of the world—wasted away in the waves and wind.

That's part of the business. Just when you think you've got a bead on a place, something happens that forces you to revisit all you thought you knew.

But the broader narrative never changes. The rest of world is catching up. That's the overwhelming tidal force in markets, and one that will continue to surge on its shores well into the twenty-first century. (Dubai is coming back, slowly, but surely. It's not going away; we'll take a look in Chapter 7).

The evidence is all around us, as you'll see in these pages. Every day, I find new snippets of it as I peruse the *Wall Street Journal* and the *Financial Times.* As I travel and meet people and research new investment ideas, I am confronted with this narrowing gap again and again. These experiences inspired this book.

The key idea is simply that the Industrial Revolution set off a yawning gap between the "West" and the "rest of the world." That gap is shrinking and will continue to shrink. Don't be afraid of this change. All is as it should be. The aberration was the last 200 years. The anomaly was that China, in 1970, had an economy smaller than that of Belgium. For hundreds of years before that, it was the world's largest economy.

It may already be on top again.

Arvind Subramanian, a senior fellow at the Peterson Institute, makes the case that China's economy is already the largest in the world, passing the United States in 2010. "On this basis," he writes, "the average American is 'only' four times as wealthy as the average Chinese, not 11 times as rich, as the conventional numbers suggest."

It might seem funny to you that we can't to seem agree on how big economies are. But it is not easy to estimate the size of something that doesn't sit still—so you can count it—and that consists of billions of transactions. All of these things are estimates, but the impact China's had on the global economy is real and not in doubt. We'll take a look at China in Chapter 5.

I stay away from statistical abstractions like GDP. What is GDP, or gross domestic product, exactly? What does it mean, and why should we care? The truth is there is an awful lot of guesswork in such figures, and they are not practical. You could lead a very successful and rich life as an investor and never know a thing about GDP figures.

In this book, I will stay away from such economic monstrosities as much as possible. This book is a boots-on-the-ground view, a first-hand look. It's more practical, and the aim is to stay close to what is happening and what we can understand in more tangible ways.

For instance, we may debate the size of China's economy—as many people spend an inordinate time doing—but don't doubt its impact. Take a look at Figure 1.2 to see the tangible impact of the growth of China on commodities.

Figure 1.2 China: Hungry Dragon

Source: Barclays Capital, Credit Suisse, Goldman Sachs, U.S. Geological Survey, BP Statistical Review of World Energy, Food and Agriculture Organization of the United Nations, IMF.

China's consumption of select commodities, as a percentage of world consumption

Commodity	China % of World
Cement	53.2%
Iron Ore	47.7%
Coal	46.9%
Pigs	46.4%
Steel	45.4%
Lead	44.6%
Zinc	41.3%
Aluminum	40.6%
Copper	38.9%
Eggs	37.2%
Nickel	36.3%
Rice	28.1%
Soybeans	24.6%
Wheat	16.6%
Chickens	15.6%
Oil	10.3%
Cattle	9.5%

So it is impossible to be an investor in iron ore, coal, or wheat without considering what's happening in China.

In any event, my view here is that we are headed back to a world more in line with a “normal” historical perspective. It is a world right side up.

The work of Angus Maddison, the late British economist, offers this helpful illustration. Again, I am skeptical of the ability to measure economic size in general—much less for, say, 1600—but I think Figure 1.3 makes intuitive sense.

Figure 1.3 Shifting Mix of Global GDP

Source: Morgan Stanley Research.

	Western Europe	Former Soviet Union	United States	Japan	China	India
1500	17.9%	3.4%	0.3%	3.1%	25.0%	24.5%
1600	20.0	3.5	0.2	2.9	29.1	22.5
1700	22.5	4.4	0.1	4.1	22.3	24.4
1820	23.6	5.4	1.8	3.0	32.9	16.0
1870	33.6	7.6	8.9	2.3	17.2	12.2
1913	33.5	8.6	19.1	2.6	8.9	7.6
1950	26.3	9.6	27.3	3.0	4.5	4.1
1973	25.7	9.4	22.0	7.7	4.6	3.1
1998	20.6	3.4	21.9	7.6	11.5	5.0
2008	17.1	4.4	18.6	5.7	17.5	6.7

During the Song Dynasty (960–1279), for instance, the capital city of Hangzhou had a population over a million people. It was one of the world's most advanced cities. Lars Tvede describes it in *Supertrends*:

> *Here you could find hundreds of restaurants, hotels, and theaters. There were tea houses with landscaped gardens, large colored lamps, fine porcelain, and calligraphy and paintings by famous artists. The nightlife was rich and varied, and there were professional puppeteers, sword swallowers, theater actors, acrobats, musicians, snake charmers, storytellers, and whatnot. People with special interest could join exotic food clubs, antiquarian and art collector clubs, music clubs, horse-loving clubs, and poetry clubs. All of that about 1,000 years ago.*

So, in some ways, the seemingly sudden and unprecedented boom in China is more a return to what was, when Chinese cities were among the largest and most advanced in the world. It's not there yet, but to anyone who's walked the Bund in Shanghai or seen the gleaming new airport terminal in Beijing or even visited the modern fashion shops in today's Hangzhou, you see the trend unfolding.

I mentioned Everest Capital's white paper earlier. It points to a few more ways in which you see how the gaps are closing.

One is to look at simple liquidity. Not that long ago, the value of IBM shares changing hands in a single day in New York were worth more than all the shares that traded hands in Shanghai or Bombay on a given day. No more.

Today's emerging markets are large and liquid. As Everest Capital pointed out at the time of its report, “Chinese markets (granted, there is a lot of retail turnover there) traded more than the NYSE; Hong Kong and Korea traded more than Germany; India traded more than France; and Taiwan traded more than Italy, Australia, or Canada.”

Others see shifting changes in the world's financial markets. My colleague and friend, Eric Fry, at *The Daily Reckoning*, pointed out a few in a piece titled “A Shrinking Distinction.”

“The First might become last . . . and the Last, first” Fry wrote. “Generally speaking, the mature economies of the West are slipping, relative to many emerging economies around the globe. The First have not become last just yet, but they are working on it.”

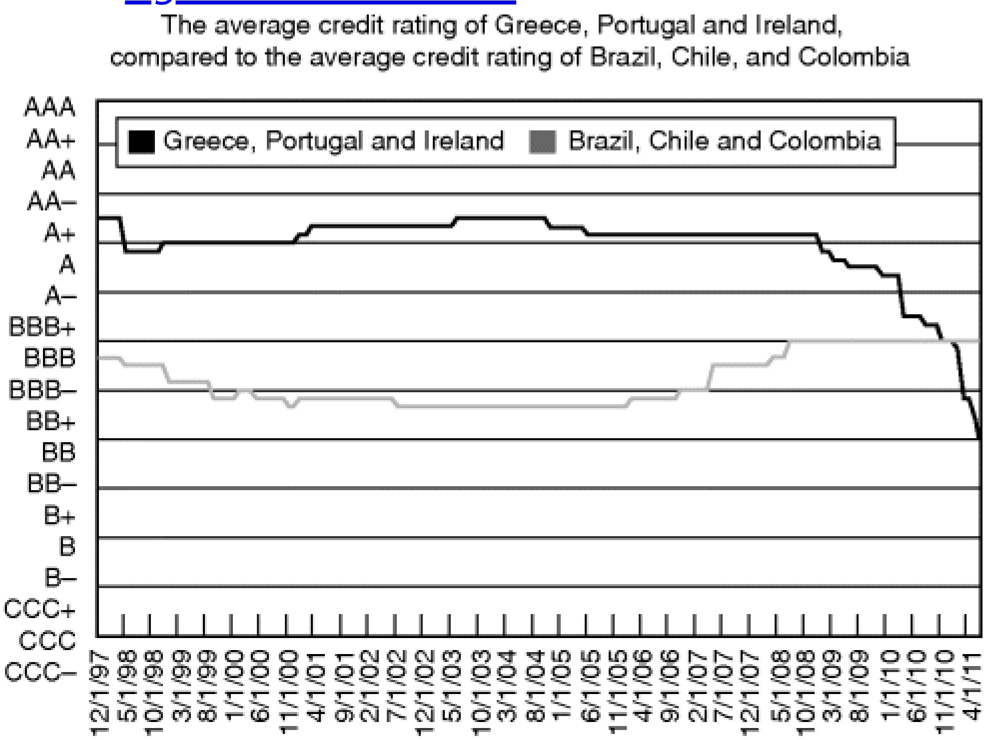
He pointed to the five-year credit default swap (CDS) on AAA-rated French government debt as compared to that of Chile's AA-rated debt. (A CDS is a kind of insurance against default. The higher the risk, the higher the price of the CDS.) Remarkably, Chile's CDS rate was lower.

This is not an isolated event; it is of a piece of what's going on all over. The CDS rate on French debt was higher than Brazilian, Peruvian, and Colombian debt. That would've been unimaginable 10 years ago! All three of the latter countries carry BBB-ratings, too, one notch above junk. But the market renders its own judgments, ahead of and more accurately than ratings agencies.

"Ten years ago," Fry continues, "Portugal, Ireland, and Greece were highly rated sovereign borrowers. Ireland was AAA. Meanwhile, Brazil, Peru, and Colombia were all 'junk credits.' Figure 1.4 below shows what has happened since. Today, Brazil, Peru, and Colombia are all investment grade, while Portugal, Ireland, and Greece are all junk credits."

Figure 1.4 Submerging Markets

Source: AgoraFinancial.com.

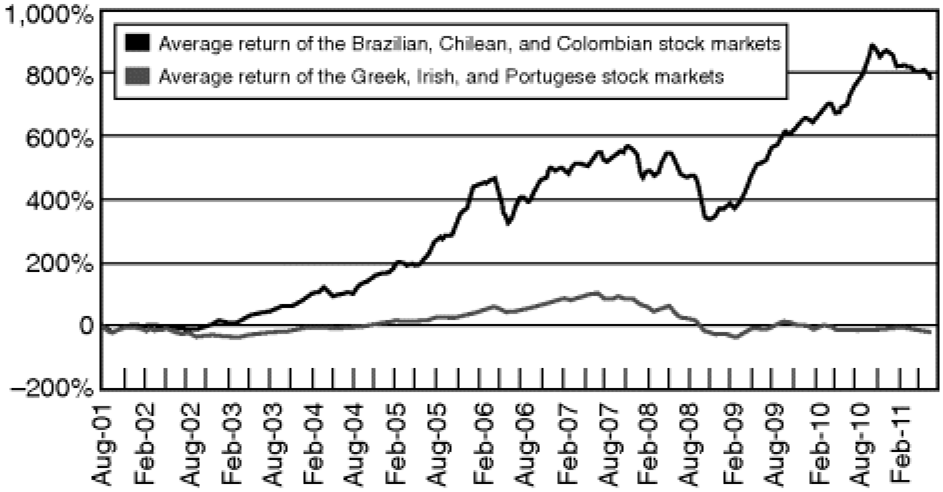


And over this time frame, the stock markets of Brazil, Chile, and Colombia trounced the Europeans' as you can see in Figure 1.5.

Figure 1.5 World Markets Turn Right Side Up

Source: AgoraFinancial.com.

The very strong performance of three Latin American stock markets during the last decade, compared to the very weak performance of three European stock markets



"This glimpse into the past," Fry offered, "will also be a glimpse into the future. Capital flees from abusive relationships and seeks out environments where it can be fruitful and multiply."

That is a core truth of wealth creation. That truth drives the world's financial markets to turn right side up.

Everest Capital's exhibits should shake off doubt from even the most moss-backed investor. The brontosaurus's lagoon is no longer his alone. His world has changed. He must compete with new furry and nimble animals.

Beyond this, Everest continues to clear away old attitudes as a man with a broom sweeps away cobwebs. For instance, "The belief that companies in the United States, Western Europe, or Japan are better managed than in emerging markets is also no longer valid. We meet a large number of managements in emerging market countries, and it is impressive to see how quickly they have adopted the best practices in terms of disclosure, governance, and creating shareholder value."

Supercycles: Where We Are Today?

I am not the only one who has picked up on this idea, which is broadly applicable to many areas of investing. For instance, in early 2011, I attended the 49 North Resources conference in Manhattan, meeting with mining companies and gathering intelligence. I heard mining strategist Christopher Ecclestone give a talk titled “A Mining Supercycle?”

I thought to myself: “Of course, he'll say we're in a mining supercycle and how wonderful mining is. I'm at a mining conference, for crying out loud, surrounded by mining companies and geologists. To expect otherwise is like walking into a Star Trek convention expecting to hear a guy talk about how dumb the whole show was.”

Yet he surprised me. He said no, this isn't a mining supercycle. In fact, he turned the idea on its head. What he said folds neatly into our world right side up idea.

As you know, commodities have been going up in recent years, everything from copper to coal. It's getting harder to find big deposits of some of this stuff, and what we find is more expensive to dig out.

The Chinese get what's going on. They are securing supplies of those key resources of which they consume so much. So they're making deals with Brazil, all over Africa, and in a bunch of other places.

Ecclestone had a good line about the Chinese. He said they are more interested in natural resources than they are in intellectual property “because they know they can rip those off. It's harder to rip off a coal mine.”

But Ecclestone's main point is that what we're seeing isn't anything new. It's not a new supercycle for mining. It's a return to normal. The aberration, he said, was the