# *The Multicultural Advantage of Nations Determine Their Prosperity*

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## Downturns, Recoveries and Markets

The lost decade has passed. It was the best of times and the worst of times. And in searching for a new theme in writing this letter, I have taken the liberty to review previous EDM investor letters and found myself uniquely perplexed at how eerily salient last January's letter (January 8, 2009) is to this one. So much so that I have sought and been granted permission (from myself?) to reproduce its first passage:

> *"So here we are. 2009. Is it all over? Will the new administration save us? Is there light at the end of the tunnel? Some say yes, others no.*
>
> *The truth is no one really knows. An economic and financial crystal ball does not exist. Oracles, sages, empirically-sophisticated prognosticators with Ph.D.'s in Finance do not know either. Even Warren Buffet does not know.*
>
> *This is a brave new world. The US will remain the most powerful country, but will not retain the position of self-proclaimed tutor. The entire global financial architecture and apparatus is getting a facelift and upgrade with new rules, regulations and a shot in the arm of new cash liquidity. The patient (global financial system) is on the gurney and receiving a blood transfusion (new cash liquidity), while removing the toxins (distressed assets and leveraged instruments) from its system. Capitalism is not dead, but it will certainly not look nor feel the same in financial markets. It will take time before the global financial players – new and old – adjust to this new, emerging global environment.*
>
> *Although we've been living on thirty years of borrowed money and borrowed time and the piper has finally arrived to get paid, there are promising signs. Good will surface*

*from this chapter in economic and financial history: I am certain of it. What good might you ask?*

*A restoration of frugality, humility and pragmatism is in the offing. There is preliminary empirical and anecdotal evidence of a rise in American savings, which is long overdue; while other countries, like China, are developing their middle class with consumers spending from their savings glut. The U.S. government is not repeating past mistakes and has used all its available tools and measures to flood the market with much needed capital from its relevant agencies: the US Treasury, the Federal Reserve System, and Congress. Global governments and central banks have followed suit, to the chagrin of some (Germany). Sure inflationary threats abound; but the risks of inaction and lack of capital are far greater.*

*Indeed, global financial markets will surely recover before the US and global economy does."*

Well, global financial markets did recover and true to economic form the US and global economies are showing signs of life one year later, albeit at a sputtering pace. As the patient is still on the gurney and the blood transfusion is near complete; it is, however, far too soon to pop open the Champaign bottles (Sparkling Wine for you petulant Californians); in fact, too soon to even put them on ice. Anxiety looms throughout the US and global economies as job creation remains stale, and the threat of sovereign debt defaults hamper a fully restored sense of confidence in global financial markets. Risk taking in debt markets remains a drip in comparison to the floodgates of recent decades and rightfully so as the majority of the developed world has been living on borrowed money and borrowed time for three decades and counting. The abuse and misuse of leverage was the ultimate culprit of this global financial malaise, not to mention the greed that underlined it. A tightening of the belt is in order and it would be prudent to let the recent past serve as the ultimate prologue.

Mere mortals, no matter how civilized, are doomed to repeat past mistakes. Greece – that foundation of western civilization and arguably the ancient home of democratic political thought – finds itself assuming the forsaken role of the recently lit financial fuse that will potentially ignite a time-bomb of sovereign debt defaults across Europe. Can the Germans in concert with other EU nations save them? For global debt markets sake (and possibly ours), let's hope so. Faith, I do have. Trust is another matter. Since 1800, Greece has been in default or has been rescheduling its debt 50.6% of the time, per academic economists Carmen Reinhart and Ken Rogoff[1].

[1] *This Time is Different: Eight Centuries of Financial Folly* by Carmen Reinhart and Kenneth Rogoff (Princeton University Press 2009).

So as not to appear disproportionately biased towards the Greeks: France has had 15 banking crises since 1800; the United States, 13; the United Kingdom, 12; Italy and Brazil, 11; Belgium, China and Denmark, 10; and Argentina, 9[2].

A reading of economic and financial history teaches us many things about global banking financial, and sovereign debt crises. Namely: we've been here before! Now is not the time to panic or hideaway in the sidelines from continual and sustained global capital flow. The spigot should remain on and flowing. As they have diligently scrubbed over eight centuries of financial and economic data, Reinhart and Rogoff[3] have persuasively shown that such crises can not only be averted but also are endemic to the natural progression in the evolution of financial markets and banking systems across all nations – poor and rich. In fact, banking crises are not particularly prone to the distinction between developing and developed economies. The more "sophisticated" and developed the financial system, the more prone it is to banking crises. Why is this so?

Developing economies and their "underdeveloped" banking systems fare far better than advanced nations and sophisticated banking systems simply because the use – nay, overuse – of leverage is averted, disallowing the tentacles of financial weapons of mass destruction and of shadow banking from extending their poisonous reach to "underdeveloped" financial markets. Little wonder that the promising areas of the global economy today hail from many emerging nations – Global Economies of Color (more on this later).

When banking and financial crises have arisen over the centuries, economic and financial history has taught us that:

- Financial crises are like viruses; sovereign (government) public debt crises, bacteria. One (bacteria) is easier to isolate, manage and remedy than the other (virus). Private capital flow is always less regulated and harder to contain than public flow of government monies.
- The value of government debt tends to explode 86% immediately after a crisis, particularly during the post-World War II period. Keynesian injections of capital will always do this but save us from financial calamity.
- Asset market (in this case, both real estate and stock markets) collapses are deep and long. Declines in real housing prices average 35%, stretched out over 6 years; whereas equity (stock) price collapses average 56% over a downturn of nearly 3.5 years. We are almost half-way through both. Patience is also an investment virtue.
- The aftermath of banking crises is associated with profound declines in industrial output and in employment. Industrial output falls (from peak to trough) more than 9% on average, although the duration, averaging roughly two years, is considerably shorter than

[2] Ibid.
[3] Ibid.

that of unemployment. In early 2010, we are seeing early signs of a return to rising industrial production. In the past seven months, it has increased 9.7%, well above the rate of increase in the first seven months of the past four recessions.

- The unemployment rate (# of unemployed persons / total labor force) increases (from its base level) an average of 7% during the down phase of the cycle, which lasts on average more than 4, almost 5 years. While the # of unemployed persons is decreasing, we are still waiting for the return of material employment gains – perhaps late 2010.
- Whereas the main cause of debt explosions is not necessarily the widely cited costs of bailing out and recapitalizing the banking system, the biggest driver of debt increases is the inevitable collapse in tax revenues that governments suffer in the wake of deep and prolonged industrial output contractions. Bailouts are politically unpopular but sometimes necessary. The real threat is the decline in public tax revenue from both companies and workers as a result of weaning industrial production.

Global financial crises tend to have a life-cycle, or sequencing of events, of their own as they take time to heal, and economies return to normalcy. They also tend to occur in periodic clusters with more than one institution or country suffering from similar ailments roughly at the same time or over the same block of time. Over eight centuries, financial crises follow a similar pattern. Reinhart and Rogoff also teach us that:

1. Financial liberalization is usually the catalyst that creates the incentives for financial innovation and the use of the least understood of financial instruments (derivatives, leveraged assets), most recently leading to global "shadow banking systems."
2. Hysteria and asset bubbles usually follow in stock and real estate markets, leading to eventual crashes in both.
3. A crisis unfolds from the overuse of leverage and an economic slowdown begins.
4. Dislocation in economic fundamentals in the banking sector leads to a currency crash.
5. Governments usually respond with Keynesian economic stimulus packages, utilizing all available monetary policy levers to introduce new money in the economic system (a process otherwise known as "printing money," a necessary but potentially risky tactic. Standard macroeconomic theory teaches that this will lead to bouts with inflation.
6. If government default is averted, then the financial crisis has run its course and the Keynesians are off to the local pub for a celebratory toast.
7. If government default is not averted, a banking crisis usually peaks simultaneously when government defaults (either domestic or external, in no particular order) begin. (Note: Keep an eye on the vulnerable sovereign, public sector debts of California, France, Greece, Ireland, Italy, Japan, New York, Spain, the United Kingdom, and the United States.)
8. If government defaults continue, crisis in public financing leads to further erosion of investor confidence, thereby worsening inflationary forces.

9. Real and nominal interest rates are substantially increased so as to fight runaway inflationary pressures.
10. Economic and financial history teaches us that runaway inflation can substantially eat away at middle-class savings and buying power, bi-furcating and widening the caverns between upper and lower income classes even further.

While there is very little evidence of an imminent short-term inflationary threat, we are presently at a critical juncture in this episode in the long history of global financial crises. If sovereign government defaults can be averted, then a restoration of global economic growth can reemerge. If not, the global economy will continue sputtering, struggling to get out of first or second gear with pockets performing at higher RPMs (China, Brazil, Turkey, etc.). As the U.S. is still the largest economy in the world, much will depend on the jobs creation legislation that will come out of Washington this year, politics notwithstanding.

## Mid-Term Elections and Market Performance

Mid-term elections always present unique moments of tactical shifts for the United States. These shifts may be cultural, political, social (Remember Newt Gingrich's *Contract with America* in 1994?) as well as, more importantly, shifts in the realm of economics and stock market performance. Typically after a president wins the election the first two years are spent pushing through as much policy as possible (unless, of course, it is the behemoth health care reform).

Conversely, as presidents and their parties get anxious about holding on to power after mid-term elections, they begin to prime to the pump in the third year, fostering bull markets, prosperity and peace. Among the two branches of government (Executive and Legislative) charged with short-term economic diagnosis and prescription, six possible political alignments exist in Washington at any given time:

1. Democratic President with a Republican Congress;
2. Democratic President with a Democratic Congress;
3. Democratic President with a Split Congress;
4. Republican President with a Republican Congress;
5. Republican President with a Democratic Congress;
6. Republican President with a Split Congress.

Market performance under the six scenarios above provides insightful results counter to conventional wisdom and political polemics. For example, analyzing historical performance data of the Dow Jones Industrial Average Index ("DJIA") from 1949 to 2007 reveals that:

- Under Democratic Presidents the stock market historically returned 9.8% versus 8% under Republican Presidents;

- Republican Congresses have yielded 16.8% gain in the DJIA compared to 6.7% return when Democrats have controlled the Hill;
- When Republicans control both the White House and the Hill, the DJIA gains 14.1%;
- When Democrats control both the White House and the Hill, the DJIA gains 6.7%;
- When power is split, with a Republican President and a Democratic Congress or a split Congress, the DJIA gains 6.7%;
- When power is split, with a Democratic President and a Republican Congress, the DJIA gains 19.5%;
- There has never been a Democratic President with a split Congress.

The best possible alignment for EDM investors (your political inclination notwithstanding), in a post November 2010-world would be with *Democratic President Obama still residing in the White House and Republicans ruling the Hill*. This scenario yields the best possible empirical result: Nearly 20% in annual stock market return since 1949.

## Economic and Market Outlook for 2010

So where does one park their money today for when the myopic ebb and flow of politics and distant laws of supply and demand catch up to our financial expectations and investment desires?

During the early stage of a bull market (like now), the majority of investable assets should be in: equity (stocks), fixed income (preferably tax-free municipal bonds), commodities (especially gold), real estate, and cash.

The relative weightings of each asset class will coincide with investment policy statements and long-term plans of individual and institutional investors. This is a prudent overall asset allocation strategy for these trying times while investors should snoop around for opportunities.

During times of economic uncertainty, certain sectors tend to outperform. EDM investors should consider:

- Defensive sectors, such as health care and consumer staples, that help mitigate extreme economic uncertainty and for the more aggressive investor, information technology offers unique opportunities for rewards.
- Alternative energy and emerging green businesses offer promising investment prospects but have yet to prove worthy of long-term value creation or market success. While sexy, investors should beware of branding schemes to traditional business lines that genuinely are neither alternative nor green in spirit or practice.
- EDM investors may want to consider investments in the following health care, consumer staples, and information technology sector companies when share prices are attractive relative to intrinsic value: Johnson & Johnson (JNJ), Novartis (NVS), Baxter

International (BAX), Clorox (CLX), Kroger (KR), Sysco (SYY), Colgate-Palmolive (CL), Microsoft (MSFT), Automatic Data Processing (ADP), and China Mobile (CHL).

More importantly, EDM investors should maintain disciplined, value-based investment principles:

1. Companies with strong dividend and dividend growth policies
2. Attractive pricing relative to company intrinsic value
3. Impressive free cash flow, earnings growth and, more importantly,
4. Strong balance sheets with very little or no debt.

Companies with little debt, solid earnings growth, healthy (real) profit margins and free cash flow to spare, could offer comfort and upside to EDM investors during this period of economic uncertainty.

The following companies hold less than 10% long-term debt as a percentage of their total capital and EDM investors may want to consider investments in them when share prices are attractive relative to intrinsic value: Apple (AAPL), Applied Materials (AMAT), Automatic Data Processing (ADP), CME Group (CME), Intel (INTC), Microsoft (MSFT), Stryker (SYK) and T. Rowe Price (TROW).

Some, like Johnson & Johnson (JNJ) and Intel (INTC), also offer an attractive dividend policy, complementing their strong balance sheets. (See: previous November 2008 letter for the virtue of value and dividend-based investing.)

Winds of Demographic Change on the Shores of Global Economies of Color

According to UN population division estimates, global population growth will stabilize at 9.15 billion by 2050. Today's global population: 6.83 billion. Over the next four decades there will be 1.2 billion people entering the global middle class. This massive – four times the size of the American population – emerging consumer force wants to live, to buy, and to act American. But let's be clear: They do not want to be Americans! They are fine in their own homeland, thank you. However, they certainly want to emulate American standard of living, quality of life, and absorb, mainly, aspects of American popular culture that suit their needs. (Isn't the internet grand?)

Free markets and democratic institutions sanctioning the rule of law, protection of property rights, while promoting individual liberty can help lubricate this process but each nation will do so at its own pace, on its own terms, and certainly, with its own flavor. Autonomy, cultural integrity, self-determination, and national sovereignty are paramount. Such nations hail from Africa, Asia, Latin America, the Middle East, and former communist regimes. I term these nations: Global Economies of Color. This is beyond mere semantics as some may opine that

Global Economies of Color are the traditional BRIC, Emerging, or now, Frontier Markets. I beg to differ. There is a common experience unique to Global Economies of Color in that the role of ethnicity, gender, race and culture has historically been the demarcating attitude, attribute or characteristic, differentiating progress and prosperity from the white, western ways of economically advanced nations. Not so anymore.

Does the advanced, industrialized world have the market cornered on capitalism in the 21$^{st}$ century? The most recent global financial crisis introduces undeniable doubt. Perhaps now is the time to not look for a supplanting underlying economic philosophy, replacing capitalism as we know it; but, rather, look to nations and economies where the next phase of capitalism will further evolve and progress. As all great lasting ideas, capitalism is not static. It is a work in progress. It is evolving, morphing, internally mutating in the Schumpterian mold, always in flux and always seeking greater efficiencies with which to allocate capital, labor and natural resources.

For more than three decades, the advanced, industrialized world has been selling the virtues of market-based economics (the recent global financial malaise, notwithstanding), while vehemently opposing the vast inefficiencies and inequities of communist central planning. While this may be well and good and the fall of communism twenty years ago may have signaled the ideological triumph of free markets over repressive regimes, those in the emerging, developing world bought the capitalism commercial and are competing better than many advanced nations today. Why is this so? As Capitalism has extended its reach to the developing world, its replication will not be in the traditional American or British mold - no “Washington Consensus” cookie cutter capitalism going forward. Global Economies of Color will exert greater influence over the terms with which they compete and trade on a global scale, as well as redefine capitalism for themselves, taking on bits and morsels to suit their competitive needs. It is no wonder that the fastest growing area in global finance is not financial engineering or risk management but Islamic – or Sharia-compliant – finance. A theoretical victory for the west is one thing; practice in the developing world is another. The home of “Capitalism Version 3.0” in the 21$^{st}$ century will rest solely and squarely in multi-cultural, multi-colorful, multi-flavorful nations: Global Economies of Color. Let’s look at the empirical evidence.

Never since 1800 has a majority of the world’s population and economic growth occurred outside of Europe, the United States, and Canada – and never so many people in those regions been over 60 years old. Advanced, industrialized nations are aging at a faster clip than many realize, while populations from low-income, economies of color are catapulting, and becoming increasingly young and more urbanized, more market-oriented, and more culturally relevant.

Workers from such nations will form the backbone of the global labor supply and will be the source of future equity and income, while markets expand, in purchasing retiree assets from advanced, aging nations. Such will be the world’s demographic state of affairs in the 21$^{st}$

century: *aging, white, economically advanced nations will assuage economic might to younger, growing, multicultural, industrially-nascent, global economies of color*.

According to UN population estimates coupled with economic fundamentals, two overarching demographic forces will shape the distribution of labor, capital and production across the globe over the next four decades:

1) Advanced nations are getting older with increasing debt burdens unable to meet private and public pension obligations, as well as their share of global economic pie is gradually decreasing.
2) Youthful, emerging economies of color will hold larger shares of equity, labor and capital surpluses, largely financing the production and retirement needs of the aging, industrially-advanced nations.

As to the first force, the relative demographic weight of the advanced, developed world will drop by nearly 25%, shifting economic power to developing, economies of color.

- In 2050, 88.4% of the world's population will reside in Global Economies of Color. Today: 85.2%
- Europe is expected to lose 24% of its prime working age (16-64) population (about 120 million workers) by 2050, and its 60+ population is expected to increase by 47%.

Labor forces from developed nations will substantially age and decline, constraining economic growth in the advanced world and raising the demand for immigrant workers from economies of color. For example, the United States, where higher fertility and more immigration are expected than Europe, the working age population will grow by 15% over the next four decades – a steep decline from its growth of 62% between 1950 and 2010. This unmet labor demand can only come from two sources: an increase in domestic American fertility growth or increased immigration from economies of color. (The latter will hold the key to America's public finance woes for they will provide the added public tax revenue needed to offset public deficits and debts.)

As to the second force, UN population estimates also show:

- Roughly nine out of ten children under the age of 15 live in Global Economies of Color. These countries will continue to have the highest birthrates over the next four decades.
- Over 70 percent of the world's population growth between now and 2050 will occur in 24 countries the World Bank classifies as low-income or lower-middle income, with an average per capita income of under $3,855 in 2008. These are Global Economies of Color.
- The combined GDP of Europe, the United States, and Canada will roughly double by 2050, whereas the GDP of Global Economies of Color will grow by a factor of five.

- The portion of global GDP produced by Europe, the United States, and Canada in 2050 will then be less than 30%, substantially smaller than it was in 1820, and Global Economies of Color will account for more than 73%.
- In 2050, 64.4% of the world equity will come from economies of color. Today: 6.6%

Investors, policymakers and strategists must therefore make adapt today's new global governance institutions to the new realities of the aging of the industrialized world, the concentration of the world's economic and population growth in economies of color, and the increase in international immigration.

Current levels of immigration from developing to developed countries are paltry compared to those that the forces of supply and demand might soon create across the world. For example, occupations in local industry clusters of advanced nations have traditionally been filled by skilled workers arriving from developing economies. (Think: south Asian engineers arriving en masse to Silicon Valley and its neighboring technology firms, venture capital funds, and universities in the 1990s.) This long-held trend may very well cease to exist, or reverse, as developing economies deepen their own industrial portfolio and conditions for job creation and prosperity so long as the movement of capital, knowledge and business expertise transcends borders.

The strategic trade-off must be one of Pax Americana versus a multicultural, multi-polar world, while the economic policies and their respective institutions of the 20$^{th}$ century are proving obsolete. It is time to find new ones based on economic multiculturalism, creativity, innovation, and linking Global Economies of Color with blossoming, entrepreneurially mature communities of color in advanced nations. Markets do not care for nationalist sensibilities or patriotic pride or even dogmatic bickering among competing schools of economic thought (Free market, neo-liberals versus New Keynesians). Markets will always seek more efficient use of capital, labor and natural resources, irrespective of politically-defined geographic boundaries.

Perhaps Capitalism version 3.0 in the 21$^{st}$ century will provide us with a new operating system for a more just, equitable allocation of its riches and its spoils. This is, after all, its 234 year-old promise. Economic and financial history, along with changing demographic and economic facts, should serve as a guide.

As the multicultural advantage of nations will determine their future prosperity, I am reminded of the oft-used quote from John Maynard Keynes: *"When the facts change, I change my mind. What do you do?"*

In the next EDM investor letter:

- **Investment performance in Global Economies of Color**
- **Ethnic Enclave Economies, Industrial Clusters and Job Creation in the U.S.**

*For more information, contact EDM Investments at (510) 836-0260 or www.edmcapitalpartners.com.*

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