Globalised markets: a force for good or evil?

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Philippe Geijsels:

Before coming here, I did some research on Mr. Gave who has a long and distinguished career in global market analysis, and his works. His company GaveKal is based in Hong Kong, with offices in New York, London, Paris and Stockholm. He has a most impressive CV, but I usually try to introduce somebody by quoting what others say about him. There are a number of endorsements on the company website; I wouldn't like to indulge in names-dropping, but there were congratulations on a piece by Mr. Gave, *An Intellectual Regression*, which said: "It is one of the more insightful pieces I have read in a long time." And this is not a small compliment when it comes from Milton Friedman.

There are also quotes from Bill Gross (Pimco) and Marc Faber, and as you may know Mr. Faber is known as "Mr. Doom" because of his very negative views on markets, especially western markets. But he still reads everything that Mr. Gave writes, which is interesting since [Mr Gave] is very optimistic about the future. He also says that "this time, things are different" which is a very dangerous statement in the financial world, but he makes a good point.

Mr. Gave will speak about this very important issue for the EU and whether Europe will lose its competitive advantage.

Charles Gave:
There are two important mistakes which you must never make when advising people on financial markets, or when you manage money yourself (which I did in a previous life). The first is to say "this time, things are different"; and for the past two or three years, we have been doing exactly that. And I will explain why. The second thing, as Galbraith (a lousy economist but a very good writer) said: as an economist, you should never be bullish. An optimistic economist is an idiot. And I will be optimistic, and tell you two things I should never tell you as a reasonable man. In my career of 40 years, I have found that a reasonable man never makes any money: this is why the Brits are very good investors, whereas the Germans are not. The Brits are full of fantasy, and the Germans know how to organise things. You don't make money in the financial markets by being organised.

Things are different this time
We are moving at full speed from an industrial economy to a knowledge-based economy, and this is changing all the rules. What does this mean? We have all been taught that when the marginal cost of a good goes beyond the marginal return of producing it, you should stop investing. If we are moving into a knowledge-based economy, we should realise that knowledge has a marginal cost of zero. If you are using Windows software, this doesn't take it away from the person next door. The largest factor of production – knowledge – has zero marginal cost. I find this absolutely mind-boggling: our economy, our political and legal institutions are not organised to deal with this. Moreover, certain sectors in society are adapting very quickly to this new paradigm (e.g the computer industry) and others adapt very slowly (e.g. politics). And this creates incredible social tensions.

The knowledge-based economy is brand new animal, and we haven't understood a tenth of what it means. How can we know that this is real? If you look at Western companies, we can see the emergence of a massive new business model. A company does three things: it designs, produces and sells products. Increasingly, companies are discovering that the production part of the business is a mug's game, which they shouldn't get into. Take Apple: it has realised that building computers is the safest way of losing money. Instead, they design an iPod in a studio in California with 30 or 40 engineers.

Then they find a victim in Taiwan which produces the iPod at a margin of 2 per cent. And finally they slap their logo on the product just before delivery and sell it with a 98 per cent margin all over the world. This means that companies are doing research, development and marketing, but no production. And they move to massive positive cash-flows: they don't have factories or thousands of employees. Suddenly, the act of creating wealth is becoming independent of geography. What matters is where the idea takes place and where the products are sold. This has huge investment implications, in particular for the EU governments.

We call this new business model the 'platform company'. But this also means that the entire macroeconomic apparatus which we use to measure the economies is hopelessly obsolete. Let me give you two or three examples.

The trade balance: everybody 'knows' that the dollar is going to collapse because the United States has a large trade deficit: you just need to read the *Financial Times*, the Economist or Marc Faber who have been waiting for this for the past 35 years. The only problem is that in the new business model, the US exports have a margin of 90 per cent, and the imports a margin of 2 per cent. If you calculated the US trade balance with profits instead of sales, you would see that in fact it has a massive surplus! So why should the currency of an economy where the world's profits are concentrating, collapse? I don't know.

The new growth sectors
In the world of knowledge which we are entering, the four growth sectors in the world in the foreseeable future are research & development, education, health care and finance. But in terms of national accounting, R&D and education are regarded as a form of consumption. A country spending a lot of money on this will have a very high "consumption" and maybe – horror of horrors – a negative savings ratio. Italy, which does very little of this, will have a very high savings ratio.

R&D and education will be high growth sectors; but we simply don't know how to measure the return by using national accounting. What is the return of Harvard University? Of Stanford? Or the Mayo Clinic? Nobody knows. But out of Stanford in the last ten years came Yahoo, Google and Sun Microsystems; that is in my view a lot of wealth creation, but nobody knows how to measure it.

The second growth sector will be health and quality of life. Take the French health care system: the Social Security insurance has as much to do with the market as did the Soviet Union. The system has a massive deficit; but this means nothing. If we have a massive deficit (i.e. we are investing a lot in health), this is considered an expenditure in national accounts. I'm 63; if I stay in good health for the next 20 years, that will be a good investment! If you consider spending money on health a waste of money, there is something wrong with you.

The third growth sector will be logistics: for the new business model which I described, logistics will only work if Apple can know, at any given point in time, where the iPods (which are being built as we speak) are, and get them to consumers around the world. Therefore, logistics technologies (e.g. UPS, FedEx, DHL) will become a major growth sector. An example: Wal-Mart, the world's largest retailer, has a computing capacity which is second only to that of NASA.

Asset liquidity is increasing
The fourth growth sector is finance. Some of you may have read "The Mystery of Capital: Why Capitalism Works in the West and Fails Everywhere Else" by Hernando de Soto. He makes the point that the difference between capitalism and the rest of the world is that, if I own my house, I can sell it, rent it, mortgage it. It's mine because there are property rights. 90 per cent of the capital accumulated by most people during their lives will be in their house. But in the past, housing was extremely illiquid: before, you bought a house and lived in it for 30 years, and it was liquid only for a very short time.

Today, houses are becoming a very liquid asset: in Canada, the Netherlands, Australia, the UK, the US and Spain you can borrow freely on your house, i.e. extract equity from it if you need it. This is part and parcel of the information revolution. When a previously illiquid asset becomes liquid, its risk premium goes down, which is a complicated way of saying that the price goes up. There is a massive rise in real estate all over the world because of this. If you own a house which was worth €2 million, it suddenly is worth 4 million: you can extract some money and buy shares in the US or Asia. All these dormant savings suddenly flow back into the system through a financial transformation which wasn't available to previous generations: we are basically tapping into the savings of our fathers and grandfathers.

These four revolutions are gigantic. Capitalism, if you will, is going into full speed. Take a company like the car-maker Peugeot. It was producing wheels, but losing money on it. They analysed their production processes and decided to outsource the wheel production to somebody for whom it would be a marginal cost, instead of a fixed cost to Peugeot. The capital spent on producing wheels at a loss, then flows back into the system, enabling Peugeot to spend it elsewhere. For the first time ever in economic history, both capital and labour are being managed at the margin. This of course leads to much higher growth rates and much lower interest rates, as pockets of unused, dead capital are now injected into the economy. So no wonder I'm bullish.

What are the risks?
What are the risks involved? In the system I'm describing, you have those who know and those who don't (either because they don't want to know, or because they are unable to understand). There is a massive increase in the spread between salaries which could lead to backfiring in public opinion. Imagine that you are making a lot of money living in a country not far from here where being wealthy is considered a sin, and being successful a disaster. Your money will be taken away by taxes. But since making money is no longer a matter of geography with needs for employees, factories or office buildings, you can live and work anywhere. Consider the founders of Skype: they were a Swede and a Dane, but they chose Estonia where there is no capital gains tax. So when they sold Skype to eBay, neither Sweden nor Denmark saw a cent of tax money. In this new world of knowledge, taxation is becoming voluntary: wealth creators will pay tax only if they get a return on their contributions. In other words, governments are now competing. Badly run states will be killed. Capitalism destroyed communism, and it will destroy social democracy.

And the Euro?
In Europe, some states (Sweden, Finland) have seen the light and reformed to a large extent. But if some countries are reforming whereas others aren't (because the government or the population opposes it), how do you maintain a monetary union? For the countries which refuse to reform, budget deficits and unemployment become the variables of adjustment. After a while, the financial markets won't lend them any more money.

The knowledge-based economy is not only the death of social democracy, but also of the Euro. There is no way the Euro can survive with half of the member countries reforming and the other half opposing it; the tensions will be too big. If you are an investor (and this is what I tell our clients), buy shares all over the world, buy US bonds or Asian bonds (where the currency is undervalued), buy shares in Europe; whatever you do, don't touch the European bond market. It is a disaster waiting to happen. If you buy it, you are essentially buying the Argentine bond market in 1999: by 2001, you had lost 70 per cent of your money. Had you bought Argentine shares, there was a bit of a hiccup during the crisis, but three years later shares were going through the roof. The point is: never lend money to people who need it. Every banker knows this rule. Don't lend money to France or Italy: by not doing so, you will also help them to reform.

What are we going to sell to the people where the world's industrial base is being built? Knowledge, which can be found, for instance, in our banking system. These people have no idea about banks, nor about how to manage, apportion and cover risks. The growth of the Asian financial markets will be colossal and we will provide the knowledge.

All over the world, shares have never been so cheap. Logicians use the term "non sequitur" to describe two propositions being linked but which have nothing to do with each other. A typical example is: "The stock market is going up", therefore "The market is more dangerous". No; they can be more or less dangerous, but one doesn't follow from the other. Stock markets have increased a lot less than earnings in the past five years. Today, stock markets are less dangerous than five years ago. If you bought Japanese shares in 1995, assuming that after a fifty per cent decline it would be less dangerous, you were proven wrong. If you bought and sold US shares in 1995-96 after it doubled, assuming it couldn't get any higher, you missed out on the tripling!

The earnings yield in the US is 7 per cent, the cash flow yield is 9 per cent and the double A bond rate is 6 per cent. The largest private equity firms in the world can borrow at 6 per cent and invest in the best companies, yielding 9 per cent immediately; it's a license to steal! Our companies are being given away in the street, as people have not understood what is happening in the knowledge economy. This is not being priced by the market, and that's why I remain an optimist.

Philippe Geijsels:
I tend to agree with most of what you said, so I could actually stop here. But a few remarks.

The banking sector, where I work, has an added value, and put into perspective, everybody is trying to consolidate stock markets (NASDAQ etc) creating a platform which will be impossible to compete with in the next 50 years. Companies are selling at a price/earnings ratio of 50 to 60 per cent, which most people think ridiculous, but if you can incorporate Asia and the emerging economies into this platform, you make money. It's the eBay business model: nobody can compete with eBay which has the volume. This is also the case for companies like Continental or Adidas.

From an investment point of view, the platform companies are very interesting (e.g. Intel) as they have huge return on equity and large margins so investors are willing to pay a lot for them. The only problem I see with the platform company approach (which you also mention in your publications) is that it requires a certain number of factors. You need free trade to enable profits to move around; technological progress, especially in communications to do the scaling; recurrent overcapacities in the system to enable companies to buy the goods they need; infrastructure, such as ports and airports.

Technological progress is not a problem; in ten years, we'll be doing things a lot faster than today. But free trade might be a problem (e.g. the United States). Also current overcapacities: if commodity prices were to continue going up, this will squeeze the middle man and the production capacities in the emerging markets which will make it more difficult to compete for the platform companies. Today, they can choose their suppliers; if after a crisis there are only a few of them left, this could be problematic in terms of pricing. Right now we see tremendous development, but we are still running political risks. After having done away with agriculture, we are getting rid of manufacturing. But what happens if all companies are platform companies? How is the legal system and society at large adapting to this?

This process is very hard to reverse, once set in motion. I can follow the argument that if you make all the profits, your currency shouldn't collapse; but some people are pushing hard for protectionism against China for instance. China is also building knowledge very fast: they have more engineers and MBAs than anywhere else, and the knowledge gap is closing. I'm not Mr. Doom, but I see real risks which could be very destructive.

Charles Gave:
You ask the right questions. The only real danger for the time being is protectionism. Look at what happened at the end of the 19th century when the first wave of globalisation, by the sheer stupidity of politicians, was turned into the carnage of the first World War and protectionism for the next fifty years. Yes, protectionism is a massive possibility. And I don't mean simply protectionism against goods. Something very nasty is happening in the United States, and in many other countries, which has a lot to do with racism. The Americans don't mind if the Brits or even the French buy assets in the United States. But if the buyer is Asian or Arab, they suddenly don't like it: the Chinese shouldn't buy oil companies and Arabs shouldn't buy ports, for instance. Protectionism against foreigners holding assets is as stupid as protectionism against goods.

Moreover, every time foreigners were prevented from buying US assets, the dollar took a bashing afterwards. If you have a lot of dollars, US assets are attractive; but if you're not allowed to buy them, you'll go elsewhere. You will sell your dollars to buy euros or another currency. Every time there is a protectionist measure, the dollar declines and this impoverishes the US citizen.

Let me be clear: I'm describing a structural bull market, because capital and labour are managed at the margin. This is the natural state of capitalism. We have had structural bear markets in history: the 1930s; Japan in the 1990s; Europe and the US in the 1970s. What were the common characteristics of these periods of declining growth and falling asset values? Always the same: a war, tax and regulatory increases, monetary policy mistakes and of course protectionism. Each of these five factors leads to a lower return on invested capital, and lower economic growth, higher inflation/deflation and misery. I certainly hope that nothing like this will happen. I'm 100 per cent convinced that this will not happen in Asia: these people are signing free trade agreements between themselves as fast as they can. I hope that the US will not fall into the protectionist trap, but you have to understand that the Democrats are the party of protectionism which is something very new. Historically, the Republicans were protectionist and Democrats for free trade. If the Democrats win the presidency and Congress in two years, you cannot exclude that they will shoot themselves in the foot. Never invest on the idea that politicians that will do anything intelligent for you.

Second risk: commodities. These have been in a bear market since Hammurabi, some 5,000 years. Commodity prices go down structurally and that's what capitalism is all about. Since 1800, the world population has grown from 1 to 6 billion; the commodity price index in real terms has declined by 75 per cent. So somebody in 1800 who thought there would be too many Chinese and not enough toothbrushes and decided to invest in that would have been killed! In terms of commodities, what is always underestimated is productivity gains and substitution. The commodities market works in a very simple way: it goes down all the time and nobody invests because nobody makes any money. After 20 years of no investment, you get bottlenecks and the price of commodities triples in two years and everybody invests like crazy, then the bear market resumes because of overcapacity. If you look at commodities over the past 500 years, this is what has happened every time. The price of oil will return to $ 30 a barrel within five years, because it always returns to the marginal cost of production. That is why we remain bullish on Asia. So I don't perceive an imminent threat on commodities.

On adaptability of the system: provided governments don't interfere, there is no reason why it shouldn't adapt. Theoretically, nothing so promotes adaptation as the risk of receiving a kick in the behind. If you cannot ask for protection or subsidies, capital will move. It's true that these people are gaining knowledge. What they don't have – and it will take them a lot of time to get it – are two things: the ability to fail and creative destruction. Our bankruptcy laws in the West enable us to redeploy capital at 10 cents to the dollar. The Asian countries do not have bankruptcy laws: they don't know how to redistribute capital once it has been wasted. An old joke in the financial world is that a bear market occurs when capital returns to its legitimate owner. The fellow who has leverage goes bust, the ones who don't arrive with cash and buy assets worth 50 cents at 10 cents, because there are no other buyers. A firesale: capitalism is about transferring assets to those who know how to manage them from those who don't.

There are two kinds of societies: those built on guilt and those built on shame. Our society is built on guilt: if you make a mistake, you apologise and are allowed to start again. The Asian societies are built on shame: once you have lost face, you're finished! To them, the beauty of the American system is that you may fail once, twice or three times and continue; in Asia, you fail once, then commit suicide…

Creative destruction is about creation, but also about destruction; strangely enough, nobody ever says that this is a big comparative advantage, but it is. Creation implies disrespect: you may think your boss is an idiot, then create a new firm which will beat the one you just left. This is prevalent in what we may call Caucasian societies. In the rest of the world, you don't go very far with disrespect. In most societies, people will try very hard to prevent innovation. You have to remember that China had created many inventions long before other civilisations: paper, the printing press, the compass … But this was so disruptive that the rulers decided that this was no good, and innovators were basically killed. It requires a very strange society to uphold the belief that change is good; most societies believe in stability!

This is why I don't buy the idea that Western societies will stop inventing, and that Asian countries will innovate in our stead. This has nothing to do with genes: the Koreans, the Chinese and the Indians who come to the United States are innovators.

Shane Frith (Stockholm Network):
How do you see the difference between China and India in terms of performance in the future?

Charles Gave:
We have done some work on this, along with friends in these countries. I'm very suspicious of India, for you cannot sustain 9 per cent annual growth without infrastructure: roads, power plants, ports and airports. The models are very different: India has moved into businesses which don't require infrastructure, like computer programming. When you go to China, you see the colossal developments in infrastructure. An industry will go to China to put up its plants, not to India where it takes 3 hours to cross Bombay in a taxi. The train system has not had any investments since the Brits built it, more or less.

Another disturbing thing in India is the 300 million population which is illiterate. You cannot claim to be a dominant force in a knowledge-based economy where a third of the population cannot read and write. In China, it is almost impossible to find an illiterate person, as they have made huge investments in education. On the positive side, India has a much better demographic situation. The Chinese population will age very quickly in the next 20 years, because of the one-child policy. But China has put the infrastructure in place and companies will be reaping the rewards of these positive externalities.

India has a large current account deficit, which nobody talks about, a budget deficit of 9 per cent of GDP, the money supply is exploding and inflation is accelerating. There may be balance of payment crisis in India one of these days; you will not have it in China.

The other day, I was with my publisher in Paris: as you know, the French are all leftists, and publishers are even worse! He asked me about China. I said : "It used to be Stalin, now it's Pinochet", i.e. there is improvement. Not to say that it's very nice, but if you consider the change rather than what you have, I still prefer Pinochet to Stalin. But the next step after Pinochet is some kind of democratic elections, which is more or less what Singapore has done.

The Chinese have just recapitalised their banking system to the tune of 70 billion dollars, with one directive to the banks: lend money to consumers and to housing, not to industry. Thus a 40 billion dollar lending boom will be spent on housing, because Lee Huan Kew of Singapore has told the Chinese government that a society where people own their house instead of renting it, is a lot more stable. So, before organising elections, make sure people own their house, and then when they organise free elections in 10 or 15 years, the Communist party will get 85 per cent of the vote!

Question:
What do you see emerging in the place of collapsing social democracy in the context of globalisation?

Charles Gave:
A very interesting question; I must admit I have no clue! If I look at what people should do if they want things to work, out of the 10 highest standards of living in the world, 9 exist in countries with a population of less than 10 million people. It would seem that the optimum level of administration exists in countries of 7-10 million people. Above that level, it stops working, i.e. the "European state" is not going to work.

What could work in Europe is for instance our old provinces: Catalonia, Pays basque, Britanny, etc. could be autonomous, with their own governments and education systems. We could break the Nation State which has produced little more than murder and genocide. The sooner the nation state disappears, the happier I will be; only, the nation state will fight back of course. And Belgium will split in two …

Question:
Following your argument on the knowledge economy, will this further consolidation of markets (mergers, concentrations, etc)?

Charles Gave:
To make a long story short: looking at the West today, we need markets like we need a hole in the head. Last year, US companies bought back 500 billion dollars of their own shares. My platform companies have a constant positive cashflow; their balance sheets are becoming lighter all the time. They don't need huge assets. This means that the centre of gravity of financial markets in terms of market capitalisation is moving away from us, towards those who need to raise a lot of money to finance the building of infrastructure. Our markets will shrink: there is no need for Dell or IBM to be quoted. But there is plenty of reasons for the Chinese railways or road system to be quoted; whereas our markets are past the point where we need infrastructure investment. Today, the West represents 80 or 90 per cent of the world stock market; in 20 years, we will represent 50 per cent, and Asia the other 50; and that's a good thing.

Question:
You are very critical about the EU bureaucracy; what about the Chinese government? What about the Taiwan issue?

Charles Gave:
A couple of years ago, I had a conversation with the acting foreign minister of Taiwan (although that was not his official title). He told me that there were two things that Beijing would never accept from Taipei: any attempt to go nuclear would mean a strike before it happened. Second, any attempt to proclaim official independence from mainland China would meet with immediate military action. Apart from that, Beijing has made them understand that they could do whatever they like. The real issue for the Taiwan president is going on about independence, which gets on the nerves on the government in mainland China.

On the other hand, the US has told Taiwan that they will be on their own, should they decide to declare independence unilaterally. But if the Chinese attack Taiwan without being defied, the Americans will come.

Bureaucracy: take France after the Second World War. There were highly qualified people in the French civil service who were very able when it came to reconstruction of the electricity networks, the transport system and the inner cities.

Having competent civil servants need not be a bad thing when it comes to building infrastructure. The problem is containing bureaucracy once this phase is over.

Question:
You criticise protectionism and the nation state: but if you had a multitude of smaller units, I think there would be more room for protectionism.

Charles Gave:
There was a lot of free trade in the 19th century: smaller countries historically have generally been much more open to the outside world than the large nation states.

Question:
What would be an alternative to the EU, for instance for defending its interests in international negotiations, e.g. Kyoto?

Charles Gave:
The largest free trade area currently in the world is the one linking Canada, the USA and Mexico (NAFTA). There is not, like in the EU, a bunch of bureaucrats producing 80,000 pieces of regulation every year, there is just one treaty. Free trade does not imply "management" of free trade; either trade is free or it is managed. Look at the tragedy of the Bolkestein directive: 70 per cent of trade today in Europe is in services. Yet we don't have free trade in services, because of the bureaucrats in Brussels.

On Kyoto, I listened to one of the greatest scientists in the US at a conference recently. He said that Earth is probably getting warmer. It is not the first time: in the 12th century, the planet was a lot warmer than today. There were vineyards in Sweden, agriculture in Greenland. Second, the link between human activity and global warming has not been proven. There is not a single model of atmospheric activity which could have predicted the weather we had last week or next week; yet they are claiming to predict the climate in the next 50 years. That requires a lot of gusto! If all my models had been wrong for the past 30 years, I would be doing something else. And to conclude, the measures in the Kyoto Protocol are not going to work; we are just doing it to pacify the population, he said. In other words, we are going to spend hundreds of billions of dollars on something completely useless. So, when 99 per cent of the US Senate refuses to sign this, I'm happy to see that there is still a democracy left in the world.

What's the point of having the EU sign it? Also, France has signed Kyoto: CO2 emissions have since increased. The United States, sensibly, refused to sign: there, emissions have decreased. What we need in a democratic system is the ability to make the polluter pay, or put him into bankruptcy if he doesn't stop polluting. The problem in China is that you cannot sue the people who are polluting! It is not government that creates clean air; it is the ability of suing the polluters.

Is there such a thing as a "European" interest which needs a centralised European organisation to be defended? I doubt it: both France and Germany are big enough to discuss with the US. We have no European defence, for instance. What would be useful on the other hand is a European network of air traffic control: after 50 years of European integration, this is still a national affair. This is more important for European growth than speaking with one voice to the US.