

THE NEXT BIG INVESTMENT THEME? THINK...



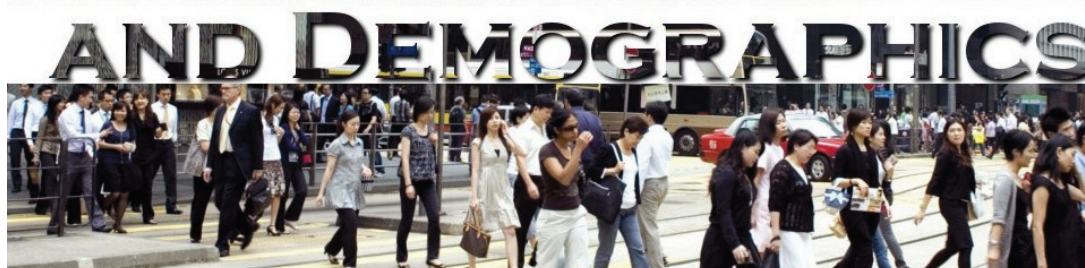
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LIQUIDITY



COMMODITIES



AND DEMOGRAPHICS

Over the past 25 years, we have experienced a series of major bubbles form across the globe.

The Japanese economic bubble (see *Graph 1* on the following page) took place in the late 1980s as the Nikkei almost quadrupled in value over a 6-year period between 1984 and 1989. That bubble burst in late 1989.

Almost immediately, it was replaced by a new one involving the Newly Industrialised Economies of Hong Kong, Singapore, Taiwan and South Korea. The rapid growth and development of these countries and those surrounding them gave rise to the term “Asian Miracle”. It certainly seemed to be one, with the Hang Seng rising by about 700% over an 8-year period (*Graph 2*). However, like all other bubbles, this one burst eventually in 1997.

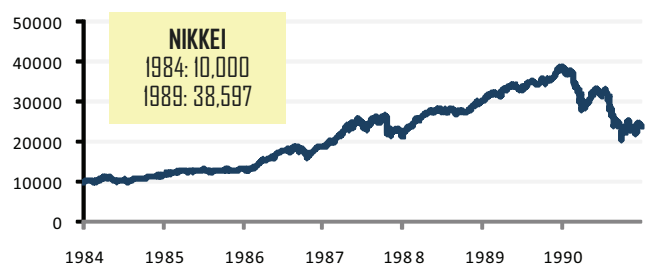
Like the one before, the Asian bubble was followed almost immediately by yet another bubble: the Dot Com mania (*Graph 3*). This bubble was instrumental to the NASDAQ gaining some 400% over a short 3-year time span.

After the Dot Com bubble burst at the start of the new millennium, a short lull followed before the next bubble emerged, and this one turned out to be the biggest of them all.

Between 2003 and 2008, world equity markets gained sharply but the mania was epitomised best by the frenzy over the BRIC (Brazil, Russia, India and China) story. For example, India’s SENSEX index itself gained more than 600% between 2003 and 2008 (*Graph 4*).

First it was Japan...

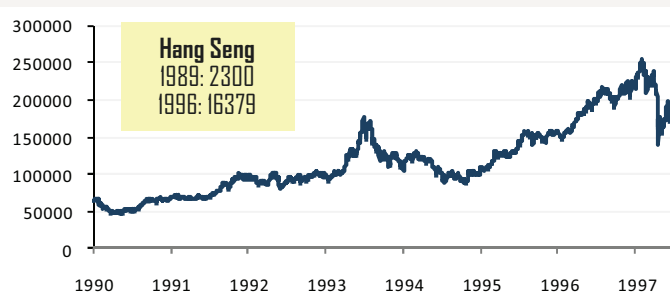
Graph 1: Japan Bubble Economy (1984 to 1989)



Source: Bloomberg

... then almost immediately after came the NIEs...

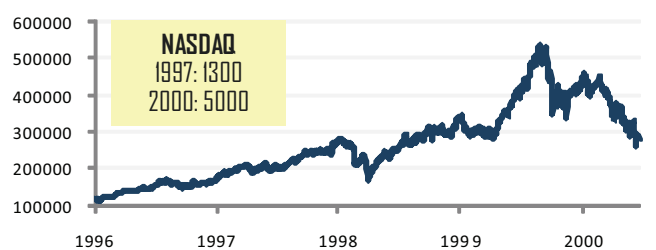
Graph 2: 1991 - 1997 Newly Industrialised Economies (Taiwan, Singapore, Hong Kong and South Korea)



Source: Bloomberg

...then Dot Com mania...

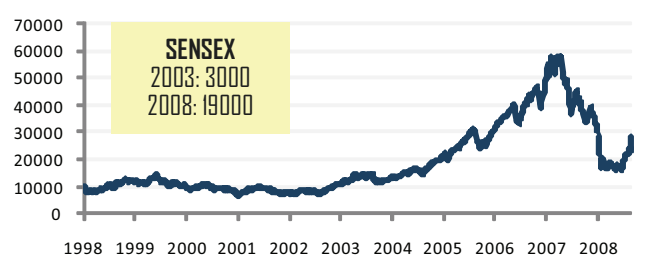
Graph 3: The Dot Com Bubble (1997 - 2000)



Source: Bloomberg

..and finally the "Mother of all bubbles", one on a global scale.

Graph 4: 2000s BRIC (Brazil, Russia, India and China)



Source: Bloomberg



The Common Denominator

What was the reason behind all these bubbles?

In a word, **liquidity**.

Ever since the collapse of the Bretton Woods Monetary System in 1971, the world has seen an increasing amount of liquidity getting created in the global system.

The ability of central banks to "print money" whenever the need arises, the multiplication of this money supply by the fractional reserve banking system and a further leveraging effect by the explosive growth of derivatives have all combined to practically drown the world in liquidity.

“In the light of this, what is likely to be the next major export item to act as a transfer channel for global liquidity?”

The ANSWER lies in COMMODITIES.



Graph 5 shows the history of U.S. Monetary Base growth. Monetary base, or better known as high powered money, is the primary or original source of liquidity from the Federal Reserve. These primal funds are then multiplied by the banking system and derivatives to create liquidity many folds over.

The chart clearly shows the acceleration in monetary base after the collapse of the Bretton Woods System. This reflects how the Federal Reserve has increasingly used the printing presses as a means to pump-prime the economy, especially during recessions and periods of weakness.

On the other hand, Graph 6 shows the strong correlation that the stock market has with the monetary base as this excess liquidity makes its way into assets like equities and real estate.

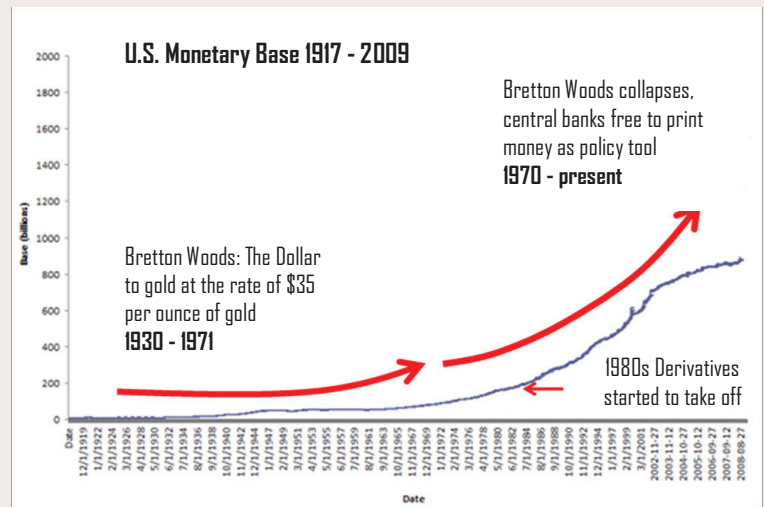
Where Is The Present Global Liquidity Headed To?

In the 1990s, the Asian Miracle, which attracted liquidity into the region, was a foreign direct investment-cum-export story.

Separately, the massive flow of liquidity into Asia in the mid-2000s was also an export story, this time a result of China’s position as the factory of the world.

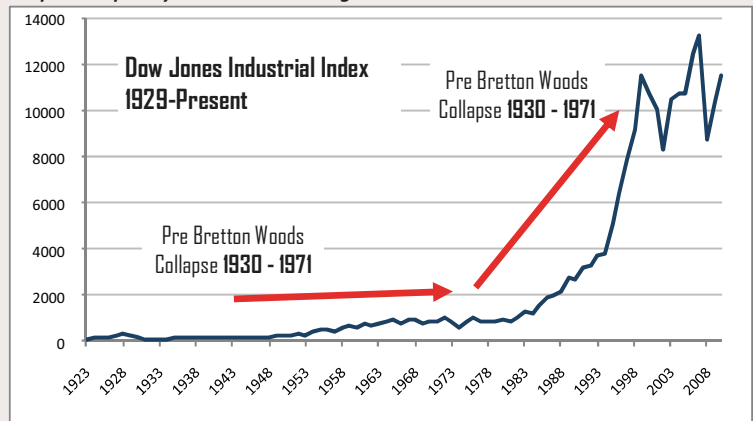
In essence, liquidity from the U.S. and other developed countries were channeled to China as payments for Chinese-made goods. And in return, a large part of that money made its way to the rest of Asia-Pacific as China had to pay for raw materials for both its domestic consumption and export-oriented goods.

Graph 5: US Monetary Base 1917 - 2009



Source: Federal Reserve; FA Wealth Management

Graph 6: Liquidity makes the world go around



Source: Bloomberg

In all the above examples, the key transfer medium for the liquidity was exports. Electronics exports were a key factor leading to the Asian Miracle, while consumption goods were key to China’s success story.

In the light of this, what is likely to be the next major export item to act as a transfer channel for global liquidity?

“Countries which have large domestic populations and economies are likely to benefit more because of the fact that the liquidity which flows in will be recycled in the domestic economy.”

The answer lies in **commodities**.

In a nutshell, commodities have a strong demand story and an equally strong supply story over a multi-year period.

On the demand side, one can only imagine in the next upcycle of the global economy that both the increasing middle class in countries like India and China will exert strong pressure on prices. Put another way, the total population of 2.3 billion people in both China and India will be demanding commodities and paying more and more for them.

On the supply side, structural issues remain with respect to many commodities such as years of underinvestment (e.g., oil and gold) or the continued destruction of supply (certain grains or farmland being used towards the production of renewable energy vis-à-vis food production). The weather also continues to play havoc on the supply of many agricultural products.

Who Will Benefit?

The key beneficiaries will of course be the countries which are net exporters of commodities.

However, countries which have large domestic populations and economies are likely to benefit more because of the fact that the liquidity which flows in will be recycled in the domestic economy whereas countries with small populations and economies will see such liquidity quickly recycled out to say, U.S. treasuries.

Based on this measure, countries that fit both the net commodity exporters and large population categories are Indonesia (population 242 million), Brazil (188 million), Russia (143 million) and collectively, the Middle East and North Africa region (476 million).

In the months ahead, we will look to introduce a portfolio to play this particular theme of liquidity, commodities and demographics. The high concentration into commodities make this trade high risk but one which we believe will be rewarding for the investor who can take a 3-5 year investment horizon and a large degree of volatility. ♦

