CABOT MONEY MANAGEMENT
216 Essex Street, Salem, MA 01970
(978) 745-9233 | (800) 888-MGMT
www.ecabot.com | info@ecabot.com

Middle Class Expansion of the Emerging Markets

Not just a "Made in China" Economy Anymore…

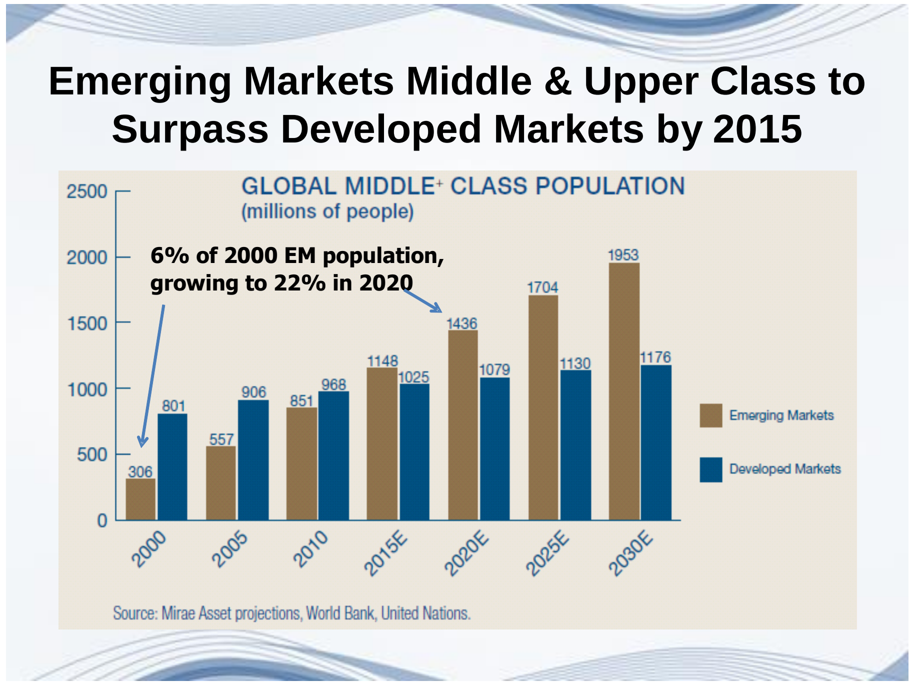
Written by: Dennis Wassung, Jr., CFA
Portfolio Manager

Introduction

At Cabot Money Management, we have long discussed the growth and investment opportunities in the Emerging Markets. Specifically, we have often pointed to Brazil, Russia, India, and China – known as the "BRIC" countries (using their initials) – as these are the larger players in the broader emerging markets. One of the traditional myths or viewpoints on the emerging markets is that these are countries where large, global companies manufacture their goods to sell in the developed economies like the U.S., Europe, and Japan. In fact, this used to be the case, for the most part. However, with the significant economic growth that the emerging markets have experienced over the last ten years (and longer), there is a fast-growing middle class in many of these countries – a growing population of people who now have the financial strength to consume goods and services, and spend on discretionary goods – in some cases, for the first time. China, the bellwether emerging markets country, is the poster child for this transition. With these trends in place, China is not just a "Made in China" economy anymore…

The Expanding Emerging Markets Middle Class

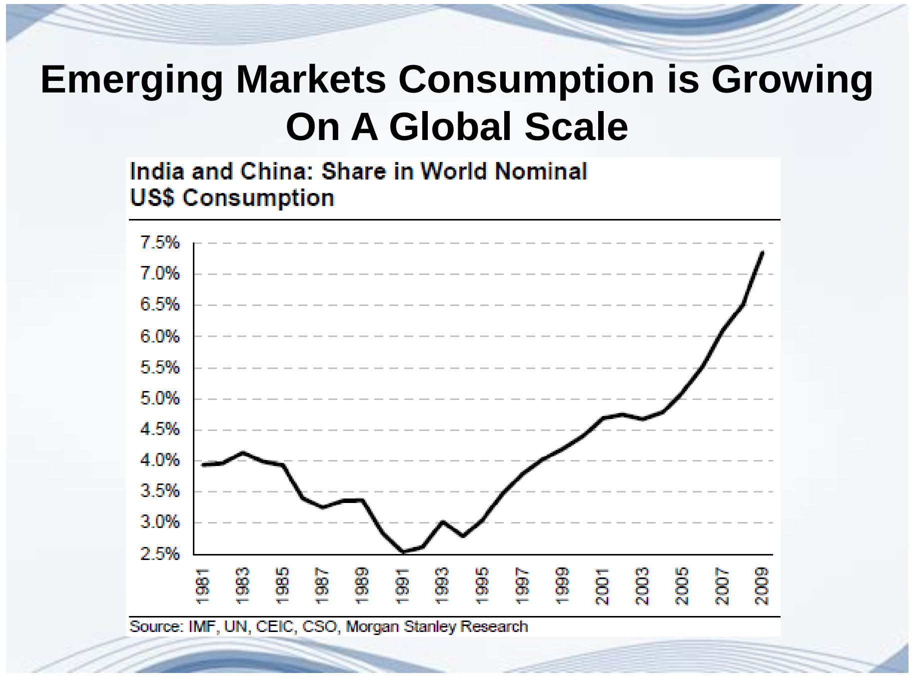
There is no doubt that the middle and upper classes (called the "Middle+" class in the chart below) in the emerging markets are growing rapidly – and are becoming a much more significant portion of the overall population in the emerging countries. Looking to the chart below, estimates (from Mirae Asset, World Bank, and United Nations) point to a 2010 "Middle+" class population of about 850 million people. This compares to the middle+ class of 968 million people in the developed markets – fairly similar numbers. The impressive fact is that the middle+ class population in the emerging markets has grown by over 175% since 2000 – rising from 306 million people, which represented 6% of the EM population. As the chart shows, the emerging markets middle+ class is set to surpass the developed markets middle+ class by 2015, and is expected to reach 22% of the total EM population by 2020 – an astonishing percentage when looking at the 6% number from 2000.



The point of all of this, of course, is the realization that there are now more than 500 million NEW middle and upper class CONSUMERS in the emerging markets since 2000. This points to a growing market opportunity for both multinational companies that are selling to global consumers, as well as local companies in the emerging markets that are taking advantage of these explosive growth markets.

From "Made in China" to "Consumed in China"…

Many people think (or thought…) of China and the broader emerging markets as simply countries that had cheap labor, low-cost manufacturing, and were places where global companies were increasingly making their goods. This is effectively, a "Made in China" economy, where goods are manufactured in China (or other emerging markets countries), and then exported to the developed world. While this was more often than not correct in the past, things have changed. With the rising wealth and population growth in the middle and upper classes, China is transitioning to a "Consumed in China" economy. This transition is also occurring in countries like India and Brazil, as well as others. Looking at the chart below, the emerging markets (China and India, specifically, in the chart) are becoming a larger portion of global consumption. China and India together have increased from representing only 2.5% of global consumption in 1991 – to nearly 7.5% of global consumption in 2009 – and the trajectory seems to point to higher percentages in the future.



Looking to an economic snapshot in 2009, consumption represented nearly 50% of the Chinese economy, and about 70% of the Indian economy. Worth noting, exports have declined as a percentage of the Chinese economy – from about 40% in 2006, to about 30% in 2010, per World Bank estimates – not because exports are declining, but rather consumption is growing faster.

Consumption: Basic Facts

As of 2009/F2010	China	India
GDP (Nominal US$bn)	**5000**	**1314**
Consumption (Nominal US$bn)	**2432**	**915**
---Private consumption	1782	753
---Government consumption	650	162
Consumption (as % of GDP)	**48.7%**	**69.6%**
---Private consumption	35.6%	57.3%
---Government consumption	13.0%	12.3%
Consumption per capita (US$)	**1822**	**782**
---Private consumption	1335	644
---Government consumption	487	138

Source: CEIC, Morgan Stanley Research

When you look at what people are consuming, you can see (in the table below) that the core spending areas remain food, beverages, tobacco, transportation, communication, and housing. Many of these are basic necessity categories, as you would expect in an emerging economy. However, you can also see that leisure, education (a top priority in China), clothing and footwear, and hotels are meaningful portions of the consumption total in China (as of 2009).

As the emerging market economies grow, and the middle class grows in importance, we expect many of these more discretionary spending categories – such as leisure, clothing, hotels, and others – will continue to grow in importance and in their proportion of the total.

Consumption Basket Components

As of 2009	China	India
Food, beverages and tobacco	25%	38%
Transport & Communications	11%	18%
Housing	15%	12%
Leisure and education	10%	5%
Clothing and footwear	8%	4%
Household goods and services	5%	4%
Health	7%	4%
Hotels and catering	8%	3%
Miscellaneous goods and services	11%	11%

Source: Euromonitor, Morgan Stanley Research

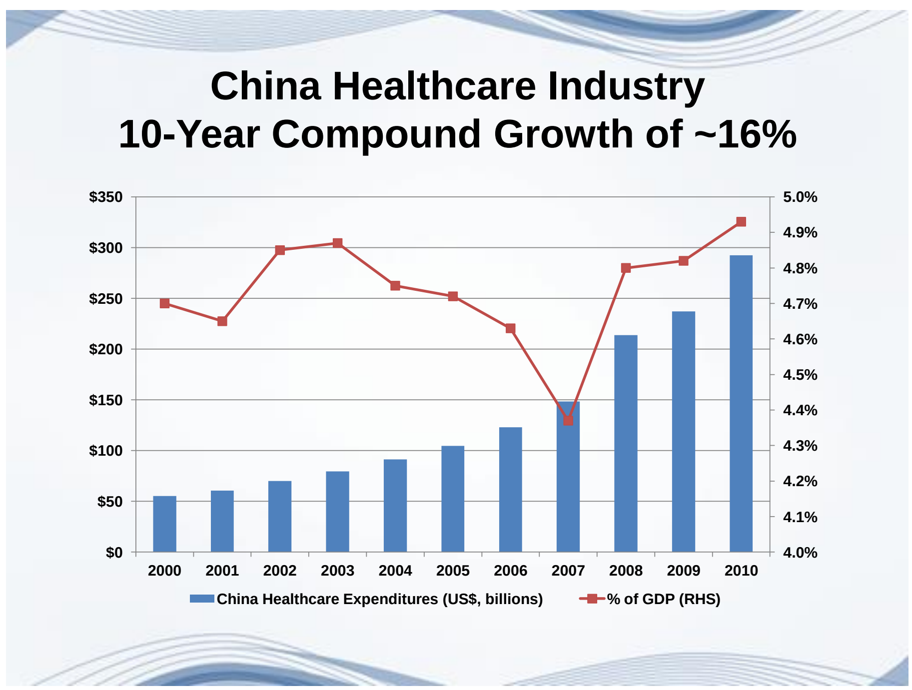
Some Real Examples –
China Is Becoming A Leading Global Consumer

Beyond looking at the big picture data, some of China's industries are becoming substantial markets on a global basis – and illustrate that there is a substantial opportunity for global companies to sell to the Chinese consumer.

The first example, charted above, is the automobile market in China.

For the longest time, the U.S. has been the world's largest car market. In 2010, that changed. At 18 million units sold in 2010, China became the world's largest car market – after experiencing a 10-year compound growth rate of an impressive 24%, where the number of cars sold in China grew from about two million units in 2000, to last year's 18 million. Interestingly, roughly 80% of car sales in China have been to first-time car buyers, and the majority of buyers use very little financing. Most people buy with cash. While the 2011 car market is taking a bit of a pause, growing in the single-digit percentage range, the longer-term growth outlook for auto sales remains strong, and China is likely to remain at the top of the global rankings going forward.

Looking to the healthcare industry, the growth story is similar. As the middle and upper classes expand and have attained the financial resources, the population is increasingly demanding access to services that we, in the developed world, often take for granted. The healthcare industry in China grew 16% compounded over the last ten years, and now approaches $300 billion (US dollars) in size, growing nearly six fold since 2000. The markets for drugs, medical devices, hospital services, cancer treatments, orthopedic treatments, and a host of other healthcare segments, are all growing as the technology is becoming available in China, and the government supports the growth of the industry. Healthcare in China and in the broader emerging markets is likely to be an attractive growth opportunity for investors over the next five and ten years.



In addition to the Auto and Healthcare industries, China's consumers are making their mark on other global consumer markets.

For example, China surpassed Japan in 2010 as the world's largest consumer of luxury goods – demonstrating that China's growing consumer population has the means and is willing to buy luxury goods from the world's leading brands. This fact points to growing wealth and an expanding set of consumers with real spending power – and willingness to use it. Broadly, retail sales in China are growing at about 17%, versus the country's broader GDP growth of about 9% – again illustrating that consumer spending is on the rise, and is growing as a portion of China's economy.

Lastly, looking toward technology and the Internet, China has the world's largest Internet user population, surpassing the U.S. in the 2008 time frame. This growing user base will increasingly utilize technology as the developed world has, and will likely become an eCommerce powerhouse – driving online retail spending and other online consumer activities – furthering the notion that consumption will continue to grow in importance in the Chinese economy.

Conclusion

We see the rapidly expanding middle class representing a range of interesting investment opportunities in the coming years. While the equity markets in emerging market countries have had a tough year, given current global macroeconomic concerns, many of the industries and trends discussed in this report may represent high-growth, long-term investment opportunities. We look for potential investment opportunities in a number of areas:

- Healthcare – Many people in the emerging markets are just beginning to get access to a range of healthcare products and services. As more of the population gets healthcare coverage and access to advanced treatments and services, the healthcare industry is ripe for growth
- Autos – Many people are buying cars for the first time in the emerging markets. With China becoming the largest market and other countries representing growth opportunities, the auto industry could be an interesting opportunity
- Retail – With retail sales growing 17% in China, nearly twice as fast as GDP growth, the consumer is buying retail goods at a rapid rate. This represents opportunity across a range of the retail industry – including apparel, food, consumer electronics, among others
- Financial Services & Banking – As part of the growing population that has financial means for the first time, many people are beginning to utilize traditional banking services for the first time – depositing funds, taking out auto and home loans, utilizing investment services, etc.

- <u>Technology</u> – Technology enables many of the goods and services that the expanding middle class will consume – from online retail, to online travel, smartphones and computers/tablets, Internet services, etc.
- <u>Energy</u> – As the population buys cars and becomes more urban, more energy will be consumed – both traditional and alternative energy sources. The emerging markets will likely grow in importance in energy consumption in the coming years, potentially driving investment opportunities.

Cabot Money Management, Inc. is a wealth management firm based in Salem, MA, with additional office space in Boston. As a firm with more than 25 years of experience, Cabot has a national clientele and is a frequent contributor to CNBC, Bloomberg, *The Wall Street Journal*, *The New York Times*, and other local, national and international media. Cabot provides highly customized global investment management services coupled with tax, estate and financial advice for individuals and their families.

Contact us at (978) 745-9233 or send your email to info@eCabot.com if you have any questions regarding this white paper.