“Invest Now and Wait 20 Years ….
Follow Emerging Demographics”

By Robert Okada, CFA

Over the holidays I was asked the following question: “Where would you invest monies now if you had to place a bet and open your eyes in 20 years?”

Before I answer this question, let me provide a bit of context, and assess the value of bonds and stocks at this point in time. (For sake of simplicity, let’s assume the monies are strictly for investment purposes, invested either in stocks or bonds, the degree of risk is unlimited, and funds are not required for living or health care expenses.)

Bonds:

Bond yields remain highly compressed after several years of central bank bond buying following the financial crisis in 2008. For example, a 20-year U.S. Treasury bond currently yields 2.70%, and a Triple-A rated corporate bond currently yields 3.63%, respectively.[1] After inflation, the "real yield" of the U.S. Treasury bond is near zero, and the Triple-A rated corporate bond is less than one percent. These types of numbers provide little to no opportunity for growth, so bonds are not a smart option for these set of circumstances.

Stocks:

According to Blackrock Group, U.S. large cap stocks are forecast to return 4% over the next five years.[2] (Beyond that time period, is anybody's guess.) So, the expected return is less than half the historical average, of about 10%, for the S&P 500 over the last ninety years. 4% vs 10% suggests U.S. equity prices are currently elevated.

With a bit of creativity, I can do better elsewhere.

Risk "Buckets" and Return:

I typically think of return as being driven by a set of "risk factors" or "buckets", the larger the number, the greater the opportunity to enhance return. Keep in mind, it can work both ways, each factor helping to add or detract from total return. For example, in my previous article *"Cambio, Change, Wechsel"*,[3] I discussed the power of currencies (or currency risk) that can add to, or detract from, total return of a global stock/bond portfolio. In the article, I highlighted that currency risk explained over half the total return of emerging market local currency bonds (which had returned 17.41%, at the time of the article.)

So, as a U.S. dollar based investor, I want to buy a cheap currency that provides an opportunity to boost return of the asset I'm targeting.

Big Macs reveal value:

In 1986, The Economist magazine invented a "Big Mac Index" as a way to measure the "correct' value of a currency. The index is based on purchasing-power parity (PPP), and measures the price of one identical product (a Big Mac) that is available almost anywhere in the world. What a clever idea. I find the index useful and a good gauge of whether a currency is cheap or expensive vis-à-vis the U.S. dollar. For example, in July 2016, the average price of a Big Mac in the U.S. was $5.04 while in India it was only $2.41 (based on market exchange rates at the time.)[4] So, the index suggests the rupee is undervalued by 52%, and in the long run exchange rates should move toward a rate where the price of a Big Mac is equal in each respective country.

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[1] Source: Treasury.gov, Yahoo Finance
[2] Source: Blackrock.com "Capital Market Assumptions", October 2016.
[3] Source: "Cambio, Change, Wechsel", Robert Okada, CFA – November 21, 2016
[4] Data: as of July 2016. Source: Economist.com, Statista.com

Of note, the price of a Big Mac in the U.S. is fifth highest among the fifty-six currencies within the index, suggesting the dollar is relatively expensive on a PPP basis.

Chart 1: Big Mac Index – Under/Over Valuation vs U.S. dollar – Global Price for a Big Mac, select countries (in U.S. dollars)

Currency	Rank	Under/Over Valuation vs USD	Price of Big Mac (USD)
Switzerland	#1	+30.8%	$6.59
United States	#5	-	$5.04
Vietnam	#45	-46.6%	$2.69
India	#49	-52.2%	$2.41
Mexico	#50	-52.9%	$2.37
Indonesia	#51	-53.1%	$2.36

Data: Economist.com, Statista.com (July 2016)

"The safest and most potentially profitable thing is to buy something when no one likes it" -

Howard Marks, CFA - Co-Chairman, Oaktree Capital

Since the election of Donald Trump and his staunch message of protectionism, the U.S. dollar index has broken out to new multi-year highs, while the consensus view among Wall Street analysts has moved overwhelmingly bullish toward the U.S. dollar. Subsequently, most international stock and bond markets have underperformed domestic markets. If you combine Mr. Mark's message (noted above) with the Big Mac indicator suggesting that many foreign countries have severely cheap currencies, you have the ingredients for a potentially profitable investment.

So, my answer to the question at the beginning of this article would be to look globally at countries where growth and demographics are favorable combined with both a rising working-age population and expanding middle class.

India and Vietnam for example, have some of the highest GDP growth rates in the world. The IMF forecasts in 2017 that each country will grow by 7.6% and 6.2%, respectively.[5] Both countries have booming populations, of 1.266 billion and 95 million, ranking as #2 and #14 most populous countries in the world. Perhaps the most intriguing demographic is that 65% and 70% of the population is below the age of 35, with a projected average age, in 2020, of 29 and 27 years.

Indonesia, according to PwC, is projected to be the fourth biggest economy (GDP in PPP terms) by 2050, while rising to fifth largest by 2030. In comparison, the Indonesian economy will likely be larger than Germany and France combined. GDP is forecast at 5.3% in 2017, and increases to 6% in 2021.[6]

[5] Data: IMF.org

[6] Data: IMF.org – World Economic Outlook, October 2016

In summary, when investing with a longer term time horizon, it often pays to look at the most out of favor sectors. By doing so, while targeting both strong fundamentals and a cheap currency, can often lead to a potentially profitable investment.

As famed-investor George Soros once said *“markets are constantly in a state of uncertainty and flux and money is made by discounting the obvious and betting on the unexpected”*.

The obvious in regard to Vietnam, Indonesia and India is the dramatic transformation from agrarian society to one that embraces technology, tourism, manufacturing and consumerism. The unexpected is whether these countries can deliver reforms and policies that support a period of sustainable earnings growth in a low inflation fast (GDP) growth environment. At such currently depressed prices, I’m willing to make that bet.

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