SMILE ON THE FACE OF THE TIGERS
US, THEN JAPAN – NOW WATCH THE OTHERS

for half of us here, the aim of this conference is to learn about the Asian economies and stockmarkets and, in particular, about Korea, which is probably the most exciting and fastest developing of all. For the other half actually living here in Korea, the aim must be to learn how foreigners perceive this market and therefore work out what will happen when it is finally opened to them. You need to learn, for example, why overseas markets crashed in October 1987 and why Korea’s stockmarket kept on rising.

For all of us, one of the toughest problems, in an increasingly global financial industry, is to understand why individual markets work so differently from each other. Why does the Japanese market sit on a P/E ratio of 60x whereas the US market sits on a P/E of 12x? Why does trading volume on the Taiwan market now regularly exceed that of the US market? Why is it that there are 22 listed companies in Korea for every securities company whereas in Hong Kong there are three securities companies for every listed company?

At my company, Thornton Management, we have two golden rules of investment. The first is that it is always essential to clearly define your investment philosophy. The second is always to learn from the lessons of history. For us, philosophy and history often end up being combined and the result has been three key philosophies which now guide the company.

The first one, which has guided the company from inception, we call “Supremacy Trends”. It is by no means a proprietary concept. What it says basically is that the Asian economies, led by Japan, are overtaking the US economy as the leading economic engine of the world and, in doing so, will repeat what the US did to Great Britain and its empire towards the end of the nineteenth century. In other words, there is a long 55 or 60-year cycle.

The inevitable conclusion is that the Japanese yen is eventually going to replace the US dollar as the international unit of account in the same way as the US dollar superseded sterling around the turn of the century. It is a very long-term case and although it does not really give you much guide to stockmarkets in the short term, it does say that Asia is the place where you should concentrate your investments.

Our second philosophy covers a period of 20 years running from the early 1980s past the turn of the century. During this period we expect to see most world stockmarkets in an almost continuous bull market. By implication I suggest that the 1987 crash was just an easily explainable short-term correction in this longer-term “20-year bull market”. In particular I expect to see the US Dow Jones Index well past the 10,000 level before the twentieth century ends in just over 10 years. If this is even half-correct,
then can you imagine how much money will be made in more exciting stockmarkets such as we have here in Asia.

The third philosophy we came up with is a more short-term philosophy covering the next 10 years and this was what we called our “Tiger Case”. Basically South-East Asia, or the Tiger countries as they are now known, are enjoying the strongest and longest economic boom that they have seen in over 20 years at a time when, until recently, their stockmarkets had done nothing for, in most cases, at least five years and in some cases as much as eight years. These countries today sit where Japan sat 10 years ago. So if you would like to be able to buy the Nikkei Index once again at a level of 6,000, then all you need to do is buy a portfolio of these South-East Asian “Tiger” stockmarkets.

No story about Asia is complete without addressing the so-called cultural advantages that Asians are meant to enjoy. The region's economies are said to be blessed with hard-working people who are very money-oriented, the governments of these countries are very pro-business, the savings rates are very high and, of course, the people are well educated. Now that is of course true, but I do not think that those factors which prevail in Asia today are much different from the factors that prevailed in Britain if you look back one hundred years. I am sure that in the Victorian era people in Great Britain were every bit as hard-working, every bit as money-oriented and no doubt it was probably a great thing to be rich in those days. The government probably worked closely with business and people saved a lot of money and I am sure that there was a tremendous demand for education.

Of course, it was a different era, a different stage along the road, but exactly the same driving forces existed.

In truth, the most compelling force for all of this is that in Asia today if you lose your job, if you are sick, if you die, all you have got going for you is what you have saved and your family; nothing else – there is no social security, no other insurance. So you have to save all your money, you have to work hard. In Western countries, for good or bad reasons, we have a social security net that guarantees to look after us in adverse circumstances. And, we believe in the safety net – probably stupidly, given the fact that the social security systems of the West are actually totally bankrupt. However, we do believe in it and that is why we do not save so much money. That is why we enjoy life now rather than save for the future.

The economic history of Asia, in simple form, is that high savings are creating a pool of cash which goes to finance a very high level of investment and this, in turn, generates high growth. It is a simple process and the result is that Japan has averaged 6.8 per cent compound growth and the Tiger countries have grown faster than 8.5 per cent a year for 25 years. In the US, on the other hand, you have the reverse process – you have low savings and therefore low investment and, as a result, low growth, which in America has averaged only 2.7 per cent for 25 years. If the savings rates in Asia remain high, which of course we expect them to do, then the growth rates will also remain high.

In Asia, the savings rates of Japan and the four Tigers range between 25 per cent and 40 per cent of GDP, which is a pretty fantastic rate. In America the savings rate is 12 per cent of GDP. The savings rate in America is remarkably constant; the low economic growth rate is also remarkably constant.

For America, total savings add up to $US550 billion a year, a big figure, hard to imagine, but for Japan the figure is $910 billion. The Japanese are already, on an annual basis, saving twice as much as the Americans and on this scale I am afraid that most other countries just do not even feature.

Foreign investors have tended to focus on Japan but it is the whole Asia-Pacific region that is becoming number one. Japan is at the top. Underneath Japan you have the four Tigers of Hong Kong, Singapore, South Korea and Taiwan; and underneath those four Tigers you have the four emerging “Little Dragons” of Thailand, the Philippines, Malaysia and Indonesia; and right at the bottom you have China. China is effectively the infinite supply of cheap labour to the whole region, and if you wrap the whole lot together you have one powerful economic machine – all integrated.

In the long-term history of the world, in terms of economic trade, running from 1960 to the present, the Atlantic basin has accounted for a fairly constant 11 per cent of world trade. The Pacific basin, on the other hand, has been growing very rapidly. In 1960 it had 4 per cent of world trade. Now it is somewhere between 14 per cent and 15 per cent and the fastest growing part of that is the trade between the Asian “newly industrial economies” and Japan.

In the 1950s the first industries Japan dominated were shipbuilding and steel. In the 1960s they started to dominate the automobile sector, in the 1970s they moved into consumer electronics, in the 1980s to computers and semi-conductors, and into the 1990s the Japanese are going to move into, and dominate, the service sector. That is why eight of the ten biggest banks in the world today are Japanese banks. The Tiger countries, Hong Kong, Singapore, South Korea and Taiwan, are in the consumer electronics phase of their growth and they are about to shift into computers and semi-conductors as Japan steadily vacates that field. In fact, all the countries in Asia are following the same path of industrialisation although they are at different points along the way.

The Tiger economies today are where Japan was 10 years ago. The Tiger stockmarkets today, in loose terms, are where the Japanese stockmarket was 10 years ago. The Nikkei Index 10 years ago was at 6,000 but today it is at 34,000 and that is what we are aiming for in the Tigers.

I will go one step further and suggest that if you do not like Japan on a P/E ratio of
60 times earnings, which many believe to be expensive, then the most exciting, the most dynamic slice of Japan is available at only 15 times earnings, because that is what these Tigers are: they are equivalent to the most dynamic slice of Japan available today and they are selling on a fraction of the price levels that the rest of the Japanese market sells at.

Steadily into the future you are going to see the Straits Times index, the Korean Composite index and all the rest emerge as the most exciting subsectors of the greater Asian stockmarket. Of course it is not going to be as simple as that, it is not going to be a straight line, but what the Nikkei has done in the past 10 years is a blueprint for the Tigers in the 10 years ahead.

Another way of looking at this process is in terms of life cycles. Companies and even countries have life cycles just as people do, and these go through four phases from infancy, to adolescence, to maturity and finally, to old age. Japan has in effect been in the second phase of its development for the past 20 years, but when the yen went through the roof in 1985/6 the Japanese were forced into the centre of the world economic scene. Japan has been forced up into the mature phase of its development in doing so it has pushed America over the top. America is now going into the early stages of decline.

The Tiger economies, on the other hand, have been dragged up from their infancy into the second stage of their development. That is very very important because it means that while the growth rates will remain high, the risks and volatility are now going to diminish substantially. In the past 20 years you could have made a fortune out of these Tiger stockmarkets, but you would have found it very difficult to sleep at night. Into the future that is going to change.

These markets and these economies are going to become much more stable, and as they do so, the valuations that we attribute to them will rise. The method by which they are going to become more stable is by moving away from dependence on America, and the vagaries of American monetary and economic policies, towards Japan. Increasingly the Tigers will benefit from the great strength and stability of the Japanese economic system. Indeed, in two years Japan will be a bigger trade partner for all of these countries than America. In five years, people will not even be discussing America any more in some of these countries.

I said we have three philosophies. The most controversial one says that Wall Street entered a bull market in 1982 that is going to run to the turn of the century — a 20-year bull market. The crash was just a blip along the way. The analysis by which we reached that conclusion is important.

Wall Street in 1946 started at about 100 on the Dow Jones Index and went into a bull market that lasted for 17 years to 1965, when it reached 1,000, a tenfold increase. This was America in its heyday. That bull market was known as the “nifty-fifties”. The nifty-fifties were 50 companies which epitomised free-enterprise America. Those companies, IBM, Xerox, Eastman-Kodak, 3M, General Electric, Westinghouse and all the rest, all names that are familiar to you today, these companies had come to dominate the commercial scene within America, and then they began to move offshore. It was the age of the emerging multinational. Because they had come to dominate the American scene, the theory was that those companies were going to go overseas and rule the world. Wall Street loved the concept, and by 1965 had traded up to a P/E of 24-times earnings, as an average, and IBM stood at 36-times earnings.

Most of those nifty-fifties continued to be extremely successful. They grew and grew, and yet IBM, for example, stood at a P/E of 36-times earnings in 1965 and 17 years later, in 1982, it had fallen to 8-times earnings. This was America in its heyday, those companies were going to dominate the world and because they were going to grow forever they justified what were very high P/E valuations for those days. Doesn’t that sound very similar to Japan today? The numbers are a bit different but didn’t we say that eight of the world’s top 10 banks today are Japanese? Japan is in its own heyday. It is out there dominating the world, and yet we do not understand those P/E ratios. We find 60-times earnings in Japan confusing but we accept the price because we believe these companies will continue to grow indefinitely.

I do not know where the Japanese bull market ends. I do not know whether it ends at 35,000, 65,000 or 100,000; what I do know is that, from our analysis of the savings process of the Japanese economy, there is a strong likelihood that the bull market will continue for at least six years. So the Japanese stockmarket is at an equivalent phase of its development to the US at the time of nifty-fifties. Of course it is going to see volatility along the way, but when the Japanese bull market ends, the lesson of history is that it is not going to crash; it is just going to stand still for an extended period while the rest of the economy catches up.

China’s role

China in 1978 began to open up to the West. The policy of the “four modernisations” introduced by Deng Xiaoping in 1978 has had tremendous implications for the world since that time and, of course, right now the whole process appears to be in doubt as a result of the recent turmoil. We are 11 years into the process, a lot of work has been done, but will the reform continue? In Hong Kong everyone is busy analysing in minute detail every statement that comes out of Beijing for some clue as to what is going on.

Maybe we are so busy scrutinising every detail that we are missing what has really been going on, because it was not just China that opened up in 1978. Shortly after that time Russia started to open to the West. Perestroika or Glasnost are simply the names for Russia going down the same path and, not surprisingly, now Czechoslovakia, Hungary and Poland are all going the same way. Who would have dreamed a few years ago that recent elections in Poland would ever occur? And even back here in the East, Vietnam, Laos and Cambodia now look set to begin opening up. If you do not believe it, ask why in the next three months you cannot get a flight to Vietnam: all the flights are full of Thai businessmen busy looking for opportunities.

So much for the communist world.
Yet if we look at many Western countries we see similar changes taking place. In 1979 Margaret Thatcher introduced the new "Thatcherist" economic policies. In 1979 Ronald Reagan started a similar shift. Indeed, around the late 1970s we had many similar political shifts throughout the whole of the OECD. From around the same time many of these countries have been moving away from socialism and towards capitalism - a parallel to the shifts that are now occurring in the communist system - and all of these changes began coincidentally in the late 1970s.

One single event underlies this common economic change and that is the Second World War. In the war the workforces of all these countries were decimated, and following it we saw a tremendous phenomenon known as the "post-war baby boom". The post-war baby boom was a population explosion that lasted for 10 years to 1955. The population explosion was so big that it has caused tremendous demographic distortions ever since. Now, babies, as nice as they might be, are not much practical use in the early years of their life. They cannot be put to work really for about 20 years. So 20 years after the start of this phenomenon, all these baby boomers started to feed into the workforce. The workforce, from 1965 to 1975, started to expand very rapidly and the growth was exacerbated by the fact that many women started to work at the same time.

This tremendous surge of supply into the labour force meant that by the end of the 1970s we were all facing huge unemployment. In England, unemployment rose to 13 per cent, in America 9 per cent, in Germany 7 per cent, Australia 8 per cent and presumably in China exactly the same process was under way. The statistics on unemployment in China were not available until recently, when the authorities finally admitted to having 27 million unemployed. The post-war baby boom effect was nowhere bigger than in China and a result of this was that, by the end of the 1970s, China's workforce was growing very rapidly and the economy was having problems absorbing all that labour. That is why China had to liberalise its economy.

Up to the 1970s, in England and America and the "rest of the west", we were, broadly speaking, running our economic systems on the so-called "Keynesian" model. The main aim of this model was to sustain a permanent situation of full employment. It all worked quite well until the 1970s when suddenly all these people came into the workforce and unemployment exploded. As the Keynesian system began to fail under the weight of the post-war baby boom, many countries abandoned the system and replaced it with the new system of monetarism.

We are now 10 years into the monetarist experiment in the West. In China exactly the same forces prevailed. What is driving China's open-door policy is not altruism or ideology. We get confused because we look at Deng Xiaoping, we look at Gorbachev and we see communists that have suddenly recognised that their system is flawed and they are increasingly turning towards our system. That is all rubbish. It has nothing to do with that at all. It has everything to do with the most basic of human instincts; it is all about greed, fear and megalomania.

The communist party in the late 1970s recognised that if it did not adjust the communist economic system then it, the party, would not survive. So that is exactly what it did. It adjusted the system purely for survival, and introduced economic reform. Today, in China, we are witnessing the fact that you cannot have economic reform without political reform. Although it appears to create uncertainty, it is not going to stop the reform. The "economic imperative" is driving all the communist countries in the same way as it is driving our countries. The process of reform in China will continue. If you believe that China will come good in the end, as I do, then on a long-term basis, the Hong Kong stockmarket at its currently depressed levels is very attractive although it would be wrong to expect instant returns.

This shift in favour of capitalism is likely to last at least until the turn of the century. That is certainly the lesson of history. If such a benevolent environment exists world-wide, where are the best gains to be made? The answer is clear: here in South-East Asia, where the Japanese financial miracle of the past is now in the process of being repeated. As Japan shifts much of its manufacturing facilities offshore, South-East Asia is enjoying the strongest economic boom in 20 years. This comes at a time when the markets are relatively cheap and a re-rating is occurring as they emerge as developed markets in their own right.

One hundred years ago, the British capital markets were 75 per cent of the world and now they are only 8 per cent. Ten years ago, the Japanese stockmarket was only 12 per cent of the world and now it is 40 per cent, the biggest. Yet the Tiger stockmarkets are still only 5.6 per cent of the world. How far will that percentage grow in the next 10 years?