Caldwell Investment Management Ltd.

Independent Investment Managers

The Unexpected Global Outlook
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What centrally planned, one party state promoted rapid industrialization by relocating workers from agricultural areas located inland, to coastal urban areas?

The government welcomed foreign direct investments, spent little on social programs, and controlled the banking sector. Furthermore, 75% of the top domestic firm assets belonged to the state sector. The economic miracle that followed took the global economy by storm; its GDP grew at almost 11% for approximately 10 years.

What country are we referring to? The answer is Brazil, from 1965 to 1974, not China. Few today remember the “junta rule” and the growth miracle Brazil experienced. Few also remember that Brazil was unable to adapt to the change macro environment.

China is a dynamic and severely unbalanced economy that is entering into a natural adjustment phase, with an aging population, high levels of debt and over

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$4 trillion dollars in Foreign Exchange reserves. Investors, before the events of this summer, place a high degree of certainty that policy makers have the ability to navigate through a difficult road without hitting any potholes. This view is somewhat misplaced. It is true that potholes where hit this summer, this was to be expected and will happen again. But to come to the conclusion that President Xi and his team will fail at the task at hand are incorrect. The journey will take longer than many forecast, but as Confucius said “a journey of a thousand miles begins with one step”.

China’s current journey stared in 1978, its economy has gone through two transformations, from a rural, agricultural society to an urban, industrial society. In 1978, Deng Xiaoping introduced reforms, to start the economy on its journey. As recently as 2007, Wen Jiabao, at a press conference to mark the end of the fifth secession of the tenth national people’s congress stated: “China’s economy has maintained fast yet steady growth in recent years. However, this gives no cause for complacency, neither in the past, nor now, nor in the future. My mind is focused on the pressing challenges…..there are structural problems in China’s economy, which cause unsteady, unbalanced, uncoordinated and unsustainable development”.

The evolution of how an economy grows has been extensively researched by academia. In 1993, Paul Krugman's paper entitled "The Asian Growth Myth" built on the earlier work of Sir Arthur Lewis. Krugman correctly points out that economic growth, based on transfer low cost manual agricultural labour into low value added manufacturing jobs, will increase economic growth for only so long. Eventually the economy will need to enter into a new growth phase where growth is based on consumption, services, higher valued manufacturing and innovation. Russia in the 1950's, Brazil in the 1960's and Japan in the 1970's have all preceded China in taking this path. President Xi, is slowly navigating China through this adjustment process. Unfortunately, investors want this process to be complete in quarters, and without any increase in volatility.

The last phase of growth China experienced was commodity intensive. Capital markets evolved to allocate resources to benefit from this growth, and from the fact that there were decades of under investment in the commodity space. The commodity super cycle was supposed to last for decades, the investment phase motivated investor, companies and capital markets to pour billions of dollars into the emerging market and commodity exporting economies. This spurred a period

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of economic growth in the emerging market unparalleled in modern history, motivating investors, to turn their back on the U.S. economy. The U.S. dollar experience a period of devaluation, and with the financial crisis of 2008, further anchored investor's belief that global growth for this century was to be generated by China, it was their century. The Institute of International Finance's October 2015 report on capital flows highlights the fact that capital flows are just now beginning to flow out of the emerging market, the tide has turned. Growth concerns about companies such as Caterpillar and Glencore, with the memory of 2008 as the fallback narrative, whenever the market hits a period of turbulence, has over shadowed the fact that NIKE posted a 30% increase in growth in the most recent quarter.

In addition, the industrial internet and internet of things: robots, self-driving cars, wearables, machines talking to other machines and internet TV will change the way we live, work, manufacture, and play. As seen in the commodity complex, when the Chinese economy evolves, its demand for products that helps facilitate the evolutionary process and will experience strong growth. The International Federation of Robotics ("IFR") reports that the fastest growth market for robots is China, with growth over 40% in 2014.

With China's manufacturing robot density is below the global average, the IFR 2015 report suggests that China will be the main driver of this industries growth for many years. There are pockets of growth in China, at the present time they are not large enough to over compensate for the declines in other sectors.

The United States economy is far along in adapting to this new environment. The U.S. economy is not that dependent on export lead growth, and over 60% of the Gross Domestic Product ("GDP") is consumption. The U.S. consumer has repaired their balance sheet, and declining commodity prices should help support steady growth. We expect global growth, specifically growth in the emerging market to continue to slow. The market is also about to lap the decline in commodities and strong increase in the U.S. dollar. What were head winds for the market now become neutral. Our work suggest that interest rates in the United States will be lower for longer, as growth slows in the rest of the world, central banks will continue to cut interest rates and use foreign exchange reserves to help stimulate domestic economic growth. We are modeling the Federal Reserve to be on hold until late 2015, with the increasing probability of rate rises being pushed out until 2016.

As for Canada, as the global economy continues to evolve it's becoming evident that Canada's economy will need to adjust. Mexico is now stealing market share from traditional Canadian manufactures that export to the U.S.A. Mexico is now more cost efficient than China in many manufacturing enterprises, and the Mexican Peso is twice as cheap as it was in the early part of the last decade.

Our Strategy for our clients is to invest in companies focused on the U.S. economy, especially the U.S. consumer. Look for Canadian companies exporting to the U.S.A. that do not compete with Mexico, and recognize that we are in a new regime. China's adjustment process is the part of the normal evolutionary process of the global economy.

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