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Somewhere over Siberia

We don't live in a static planet. Since the human race started in Africa several thousand years ago, it is only natural to assume that the first economic center of gravity our small planet ever had was located in the continent that is exactly the poorest one in the time we write this letter.

That is odd. If a Martian first came to Earth and took a quick look at a map of our planet, he would probably assume that Africa is still the planet's most important place, as it is located exactly in the center of our maps, with a strategic position like no other, unlike fragile Europe or fragmented Asia.

Then, migrations happened. As ancient humans ran away from hunger and poverty, they learned to hunt, to trade, to sow seeds and to make tools. After a few millennia of human migration, the world's economic center of gravity had shifted east, since that was where most of us humans were already living, a fact that continues to be true to this day, and most importantly, that was where earth's most advanced civilizations were located.

By the year 1000 BC, any Europeans that were lucky enough to get to China and not be killed would certainly be amazed: a sophisticated writing alphabet, gunpowder, the compass, great navigators, a civilizations that poor Europeans, stuck in the darkness of the Middle Ages, could only dream off.

But as we said earlier, we don't live in a static planet: at the same time that most Asian civilizations, especially the Chinese, were experiencing a dusk, becoming more xenophobic, more fearful of trade and foreigners, less appreciative of knowledge and new ideas and closed in their own traditions, Europeans were about to experience a giant leap forward.

From the year 1500, when the great navigations started led by Portugal and Spain, Europe slowly but surely became the world's economic center. The points we see in the picture above come from a calculation made by McKinsey global Institute.

In this exercise, they consider the entire world's economic output, weight it by each place's economic size and try to estimate a single point on earth, the point zero of the economic activity, where would it be?

Since 1500, it has clearly moved from east to west and from south to north, as the position of being the economic frontier moved from China to Portugal, then to Spain and Italy, then to the UK and France.

When the First World War broke, Asia was already very distant from the world's economic center, despite the fact that it had the biggest population. The reality was that most Chinese and Indians were simple and living on subsistence.

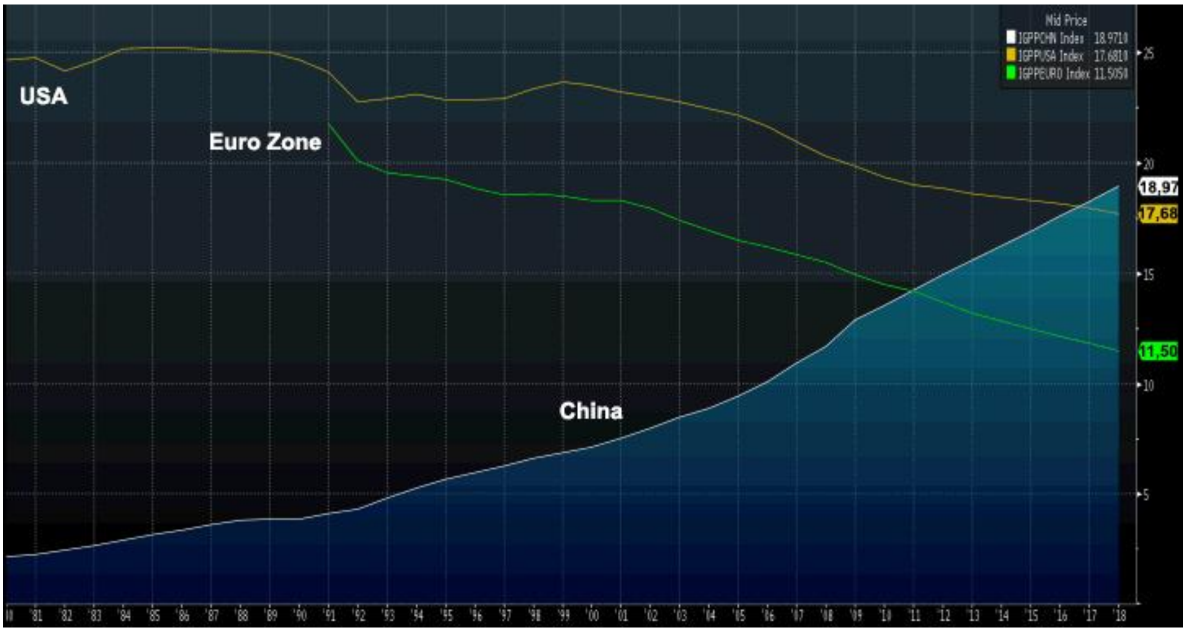
If someone thought things could not get any worse for Asia, they did. The United States of America, a new land discovered only a few centuries earlier became the world's largest economy and economic frontier. In other words, the world's leading economic nation.

This implied a previously unthinkable fact: the world's economic center would not stop in Europe. It started to gravitate towards the Atlantic, heading to America. By 1950, the economic center almost touched the New York City's coast and many people thought it would continue to shift west towards Chicago and California.

Once again, the world is not a static place. During the decades that followed, the huge divergence in productivity that separated the original economic frontiers and America started to slow down a bit. By 1960, the economic center was back in the middle of the Atlantic, thanks to Europe's resurgence, helped by America's Marshal Plan.

By 1980, the point zero had touched Europe once again. And then, our lifetime's most extraordinary fact: Asia's reemergence started to happen, and the economic point continued to shift east.

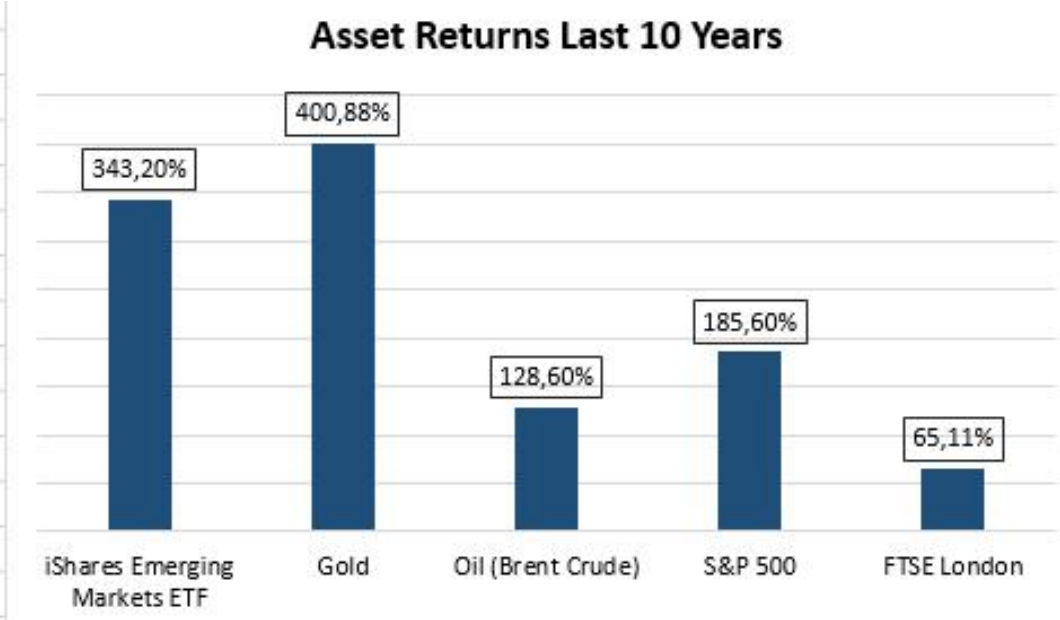
It is somewhere over Siberia now and according to IMF's GDP Growth estimates, it will touch back the west part of China sometime around 2030. Interestingly, the center is moving faster than ever before, at a speed of around 140 km per year.



GDP comparison and world share percentage. Source: Bloomberg

Many consequences of the shifting economic center - first towards west and north, and now back east and south – are only now starting to be felt. Probably the first huge beneficiaries were the so-called cyclical industries, that had in 2001-2010 their best decade ever.

Countries like Brazil, South Africa and Australia, exporters of primary products, saw some companies have unprecedented profits, stock market booms, and a few dozen dollar billionaires, the huge winners of this process. New York's Upper East Side and London's "billionaire row" are full of winners of this decade.



However, the process will not be so smooth and simple. China's economic growth model is changing, and at this house we believe that in the next decade the best industries to be exposed to will mostly likely not be the cyclical ones, but especially the ones tied to the rising east's consumption. Inside Bovespa, we think the main beneficiaries will be the companies that help feed the world. Minerva and Heringer, two positions in our portfolio, quickly come to mind.

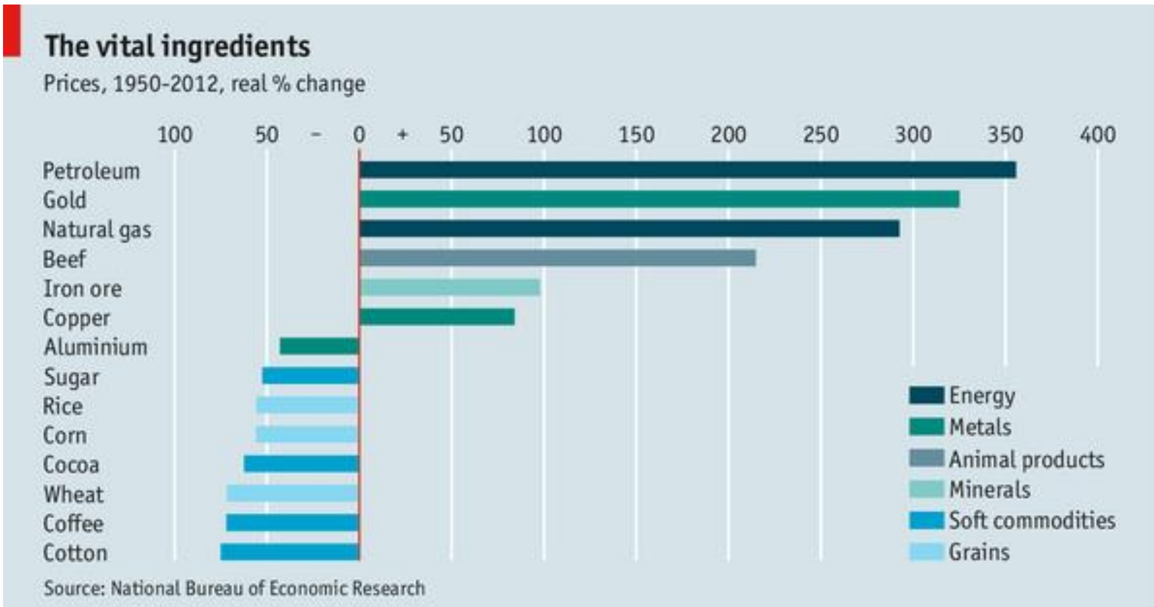
A second consequence comes from where we are located in this picture. We believe in emerging markets not because they will grow faster than advanced economies, but because we love the intersection of high growth and a relatively inefficient market, as it tends to happen in an emerging market like Brazil.

Evolution of stock market capitalization in the last 10 years. Source: Bloomberg

A third consequence of this shift comes from the fact that a lot more people are closer to the economic frontier than before and the planet, as an aggregate, will have a much higher level of total consumption.

This is interesting, because as it turns out, the classic economic theory formulated by Thomas Malthus that we as humanity would inevitably consume Earth's resources, might regain some respect in more than a few circles. Perhaps he was just early by a few centuries.

As our investors know, we like to look for opportunities in places where most people are not looking at. Be they neglected companies or in a longer time frame. Therefore, we found an interesting chart compiled by The Economist magazine that takes the real long-term look at commodity prices, something most investors, worried about next month's movements tend to ignore.



It turns out that over the long term, the commodities from under the ground experienced an appreciation in value. The Economist's article does not go that far, but we speculate that this is because the easier oil and gold have been already extracted by now - the low hang fruit if you will - and the remaining reserves are in more remote places. At the same time, agricultural commodities had a decrease in value, probably because of more advanced techniques, at least in most countries.

We have a reasonable suspicion that in the next decade or two, this chart could revert a bit, since China's most capital intensive phase of its development is ending and agriculture is more overlooked than in the past. Meanwhile, three billion Asians will develop a taste for western food like meat, candies and sodas (again, companies like Minerva, Cosan and Heringer come to mind).

The median age for farmers is 52 in the US, 57 in the UK and 66 in Japan. The planet is becoming more urban and less agrarian. So considering the long term, we think that a new way to play the china story is being born: less industrial (iron ore, steel) and more related to soft commodities.

If history is any guide, new situations lead to new desires and new expectations. Away from the farm, a billion of Chinese will first try to buy a house and then slowly they will form new circles, acquire urban tastes, eat different food and change its habits. We judge that the biggest winners of this next decade will not be the same ones as in the last.

We have said in our past letters that we are not particularly bullish on Brazil. An inept and corrupt government along with distrust on free markets by the population leaves us no other choice. That being said, we are extremely bullish on the Bovespa stock exchange.

As seen above, we have an increasing share of the world's stock market capitalization (a market still far away from the American efficient frontier practically guarantees this), a relatively inefficient market (where it is easier to find price distortions), a high beta play on the world's economic growth and, most importantly, a market that is cheap by historical standards.

	Latest CAPE	Forward PE	Average CAPE	Deviation from avg.	*History*
Mexico	24.9	17.9	19.5	28%	*2001*
USA	23.7	13.3	18.7	27%	*1973*
Japan	21.6	13.6	46.1	-53%	*1975*
Indonesia	19.8	13.9	21.6	-8%	*2001*
India	18.0	14.3	22.0	-18%	*2001*
Australia	17.8	13.6	15.8	13%	*1975*
Canada	17.2	13.2	19.2	-11%	*1975*
China	14.4	10.4	17.3	-17%	*2001*
Germany	14.4	11.0	18.8	-24%	*1976*
Korea	13.7	8.5	16.4	-17%	*2001*
France	12.3	11.3	19.7	-37%	*1975*
Turkey	12.3	11.7	15.1	-19%	*2001*
UK	12.2	11.2	13.7	-11%	*1975*
Brazil	10.8	11.1	15.1	-29%	*2001*
Italy	8.4	10.2	21.8	-61%	*1989*
Spain	7.5	11.2	17.8	-58%	*1985*
Russia	7.2	5.3	13.8	-48%	*2001*

Source: Datastream and GSAM calculations
As of February 2013

We should not overemphasize the readjustment the world is experiencing. Rich pockets and poor pockets will always be a reality in the world. We, as humanity, will continue to put trust on governments, to make economic mistakes, to experience booms and bursts.

Since the good harvests and bad harvests of our forefathers, this has been the case and recessions and economic hardships are a great thing: they purge the inefficiencies. If you do not think there are economic lines dividing us, just look at the video below that shows in accelerated time a 24-hour timeframe of airplane movements across the planet.

Look at South Korea and North Korea: the same language, the same culture, and such an extraordinary difference in economic outcomes. Or the north, led by the US and Europe, with its dazzling movement compared to the south, especially Africa (but compensated in part by Australia's east coast).

We could almost say it is all there and any Martian would certainly be marveled by such amazing differences that are each country's own merits and mistakes. This manager is guilty of having spent more than a few minutes looking carefully at this video. To sum it up, convergence is a good thing and we should take advantage of it.

http://www.youtube.com/watch?v=G1L4GUA8arY&feature=youtu.be&noredirect=1

Our conclusion is that, counterintuitive as it might appear, being exposed to small and mid-cap ideas within the Brazilian stock market, like this house tries to do with the Equities Fund, is a great place to be if we take this longer term view of the world economic picture, its financial markets and the journey of the "economic center" back to Asia, the place where it once, a thousand years ago, belonged.