Julius Baer

Wealth Report: Asia

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Macro Landscape

Consumption and growth – reciprocal determination

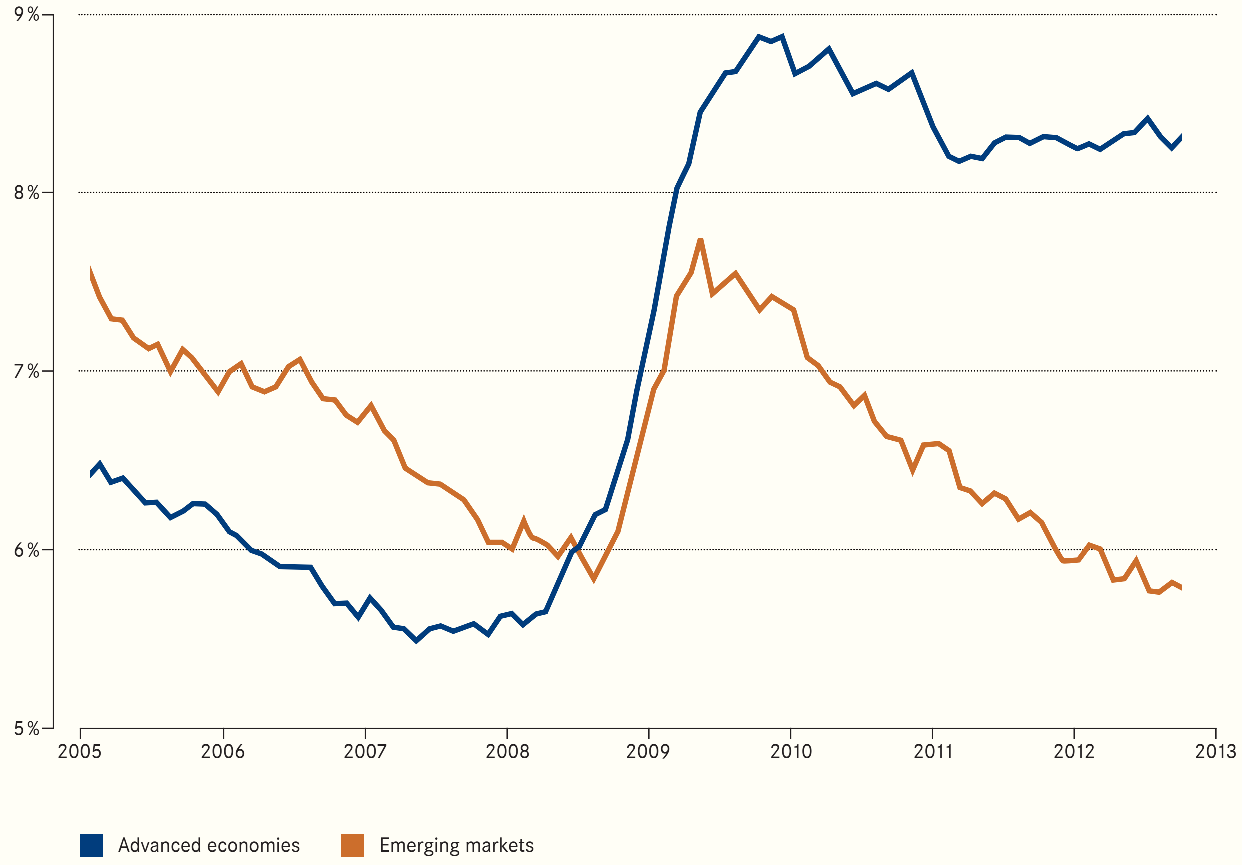
The increased role of consumption in developing economies has been the focus of financial market participants and academic research for several years, but with the memory of the global financial crisis and Great Recession still vivid in our minds, the time is right to examine the role of consumption and ask what is the way forward for Asia's economies.

The question of decoupling

As a starting point, we look back on the recent economic performance of Asia and consider the evidence for arguing that Asia has managed to decouple from mature economies. If a case for macroeconomic decoupling cannot be made, then it makes little sense to consider Asian consumption trends in great detail, as any conclusions may well be offset by trends in mature economies. We then compare how mature economies, namely the United States, grew to become predominantly consumption-oriented and ask whether Asia, in particular China, is on the same path.

When addressing the question whether Asia has decoupled from mature economies, we need to draw a distinction between macroeconomic performance and asset price movements. In terms of the latter, it is very clear that Asian assets, to varying degrees, still hinge upon international investors and capital market trends. Indeed, over the past few years, the correlations between Asian and mature market assets have actually increased. This is in part due to the globalisation of investing. As financial markets become increasingly integrated and capital flows more fluid, local factors tend to have less of an impact. Macroeconomic correlation, however, has decreased and there is mounting evidence that Asia is becoming ever more resilient in the face of economic shocks. Investors need not look any farther than aggregate unemployment levels in developed and emerging markets to see how fundamentals have diverged.

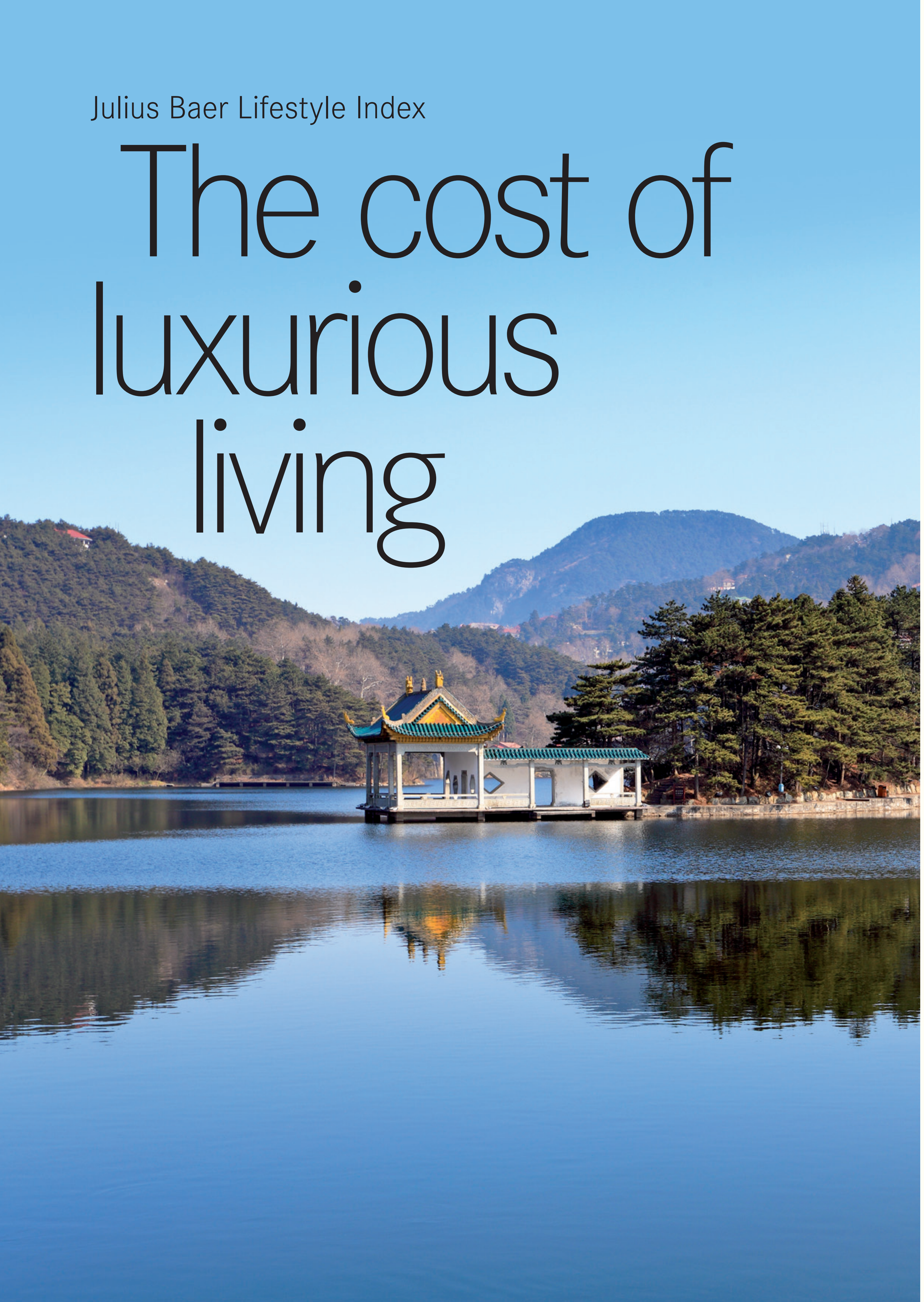
Chart 1
Unemployment rate



Source: JP Morgan, Julius Baer

Julius Baer Lifestyle Index

The cost of luxurious living



The Julius Baer Lifestyle Index, now in its third year, tracks the price of a basket of luxury goods and services, indicating the true cost of living in luxury. The frequently cited index has, this year, been expanded to cover eleven key Asian economic centres, as well as continue to track the essential luxury basket across our original cities of Hong Kong, Singapore, Shanghai and Mumbai. In the following section, we compare the data across the full set of cities, setting the stage for the expanded index in the years to come.

Pressure on the luxury basket

The Julius Baer Lifestyle Index for 2013 has risen 8.0% in US dollar terms, slightly lower than last year's result. At the same time, across Hong Kong, Singapore, Shanghai and Mumbai, the corresponding mainstream inflation indicators have risen approximately 5.3% over the measurement period. This outcome also corresponds to what we learned in 2012, which is that Asia's high net worth individuals continue to face an increase in the cost of living that outstrips the conventional consumption basket. As before, the index covers twenty goods and services, the prices of which are driven primarily by global factors (such as international education costs) while the bulk of the prices reflect local supply and demand.

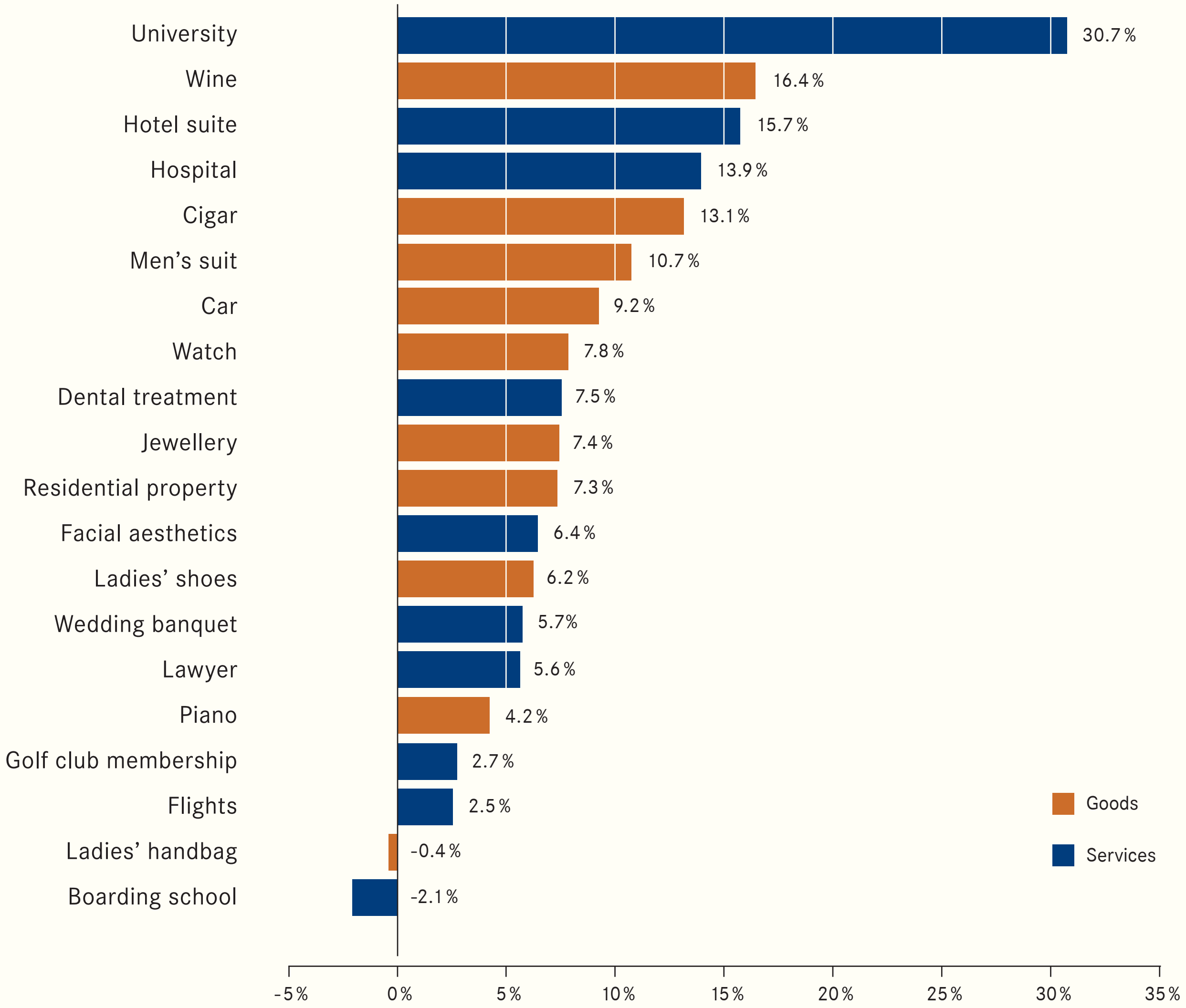
The single largest increase is in the area of education. While fees at prestigious boarding schools have remained largely unchanged, the cost of attending Oxford and Harvard univerities have risen by 30% on average. This increase is more than double the surge of the next highest increase categories, namely wine, hotel stays and cigars. It is also notable that higher education saw the largest price rise in 2011, at 18%. Hence given these significant price trends in education, we have dedicated a section of this year's Wealth Report to examine some of the other issues that Asia's high net worth individuals may wish to consider in this area.

Moderating property prices in China

Currency fluctuations have played less of a role in 2013 relative to the outcome last year. By definition, the Hong Kong dollar and US dollar outcomes are essentially identical, while the Chinese yuan has gently appreciated, resulting in the cost of luxury items US dollar in China to outpace the local currency price rises. Similarly to the 2012 outcome, India stands out for having the largest local currency price movements. The unweighted average of the Mumbai sub-index is 18%, double the outcome of Shanghai. Also in US dollar terms, Mumbai saw the highest jump in the index. While almost every item in Mumbai rose, the 20% increase in high-end property explains the bulk of the move, given the dominant weight that this constituent has. The slight moderation in Shanghai property prices is what has held back this sub-index, as the average price increase of luxury items in this city has been around 10%. Other notable items in the 2013 Julius Baer Lifestyle Index include hotel stays, jewellery and watch prices, which rose consistently across all cities. Wine and cigar prices see the biggest changes relative to 2012, followed by men's tailoring and business-class air travel. The latter is inherently very volatile, hence we have taken averages over multiple time periods to obtain a better gauge of the developments in luxury travel costs across Asia.

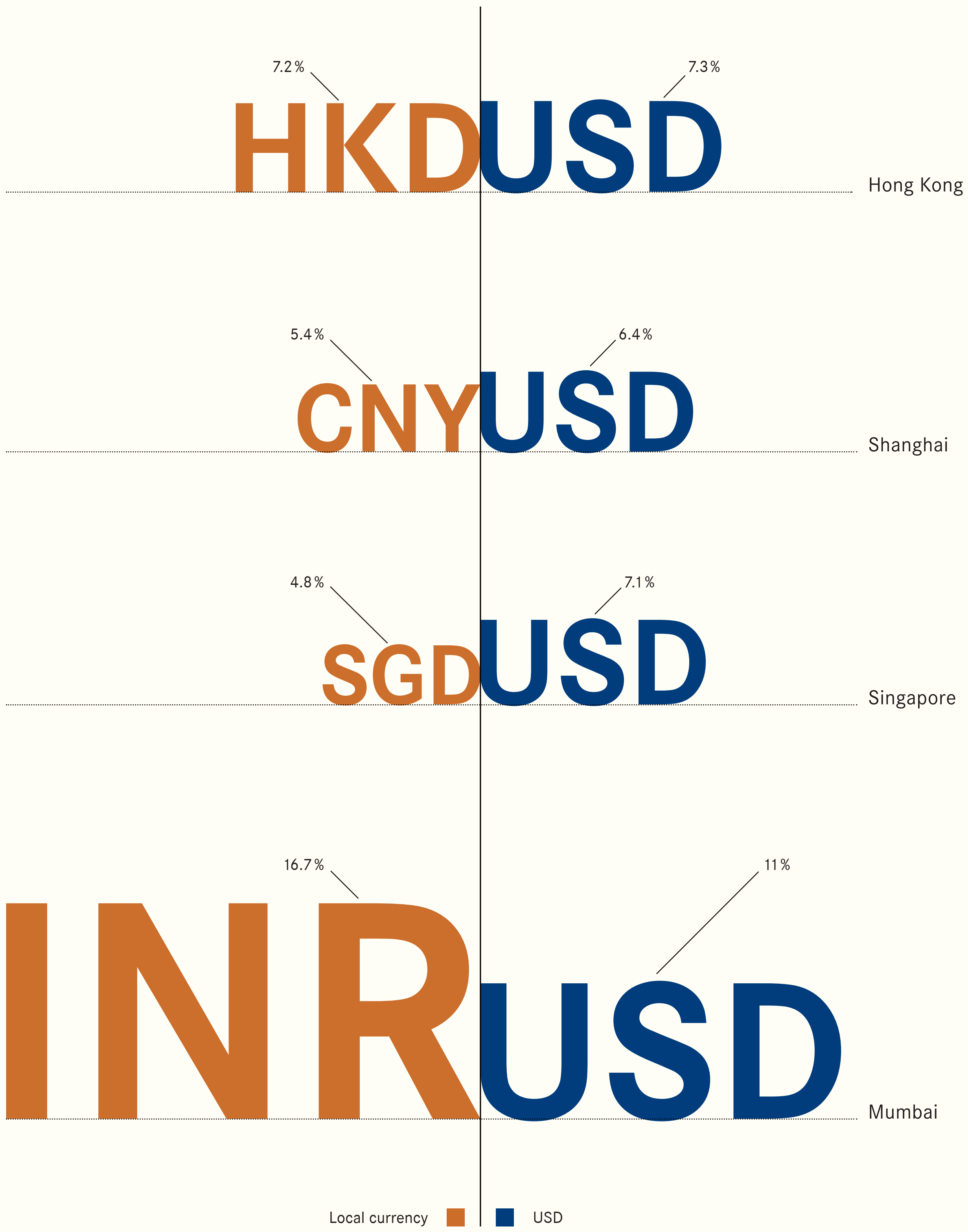
In the following sections, we take a closer look at the variability of prices in Hong Kong, Shanghai, Singapore, Mumbai, Jakarta, Kuala Lumpur, Taipei, Bangkok, Manila, Seoul and Tokyo.

Chart 10
Price increases of Julius Baer Lifestyle items, y/y USD terms



Source: Ipsos Loyalty, Julius Baer

Chart 11
Aggregate Lifestyle Index inflation - local currency vs. USD over measurement period

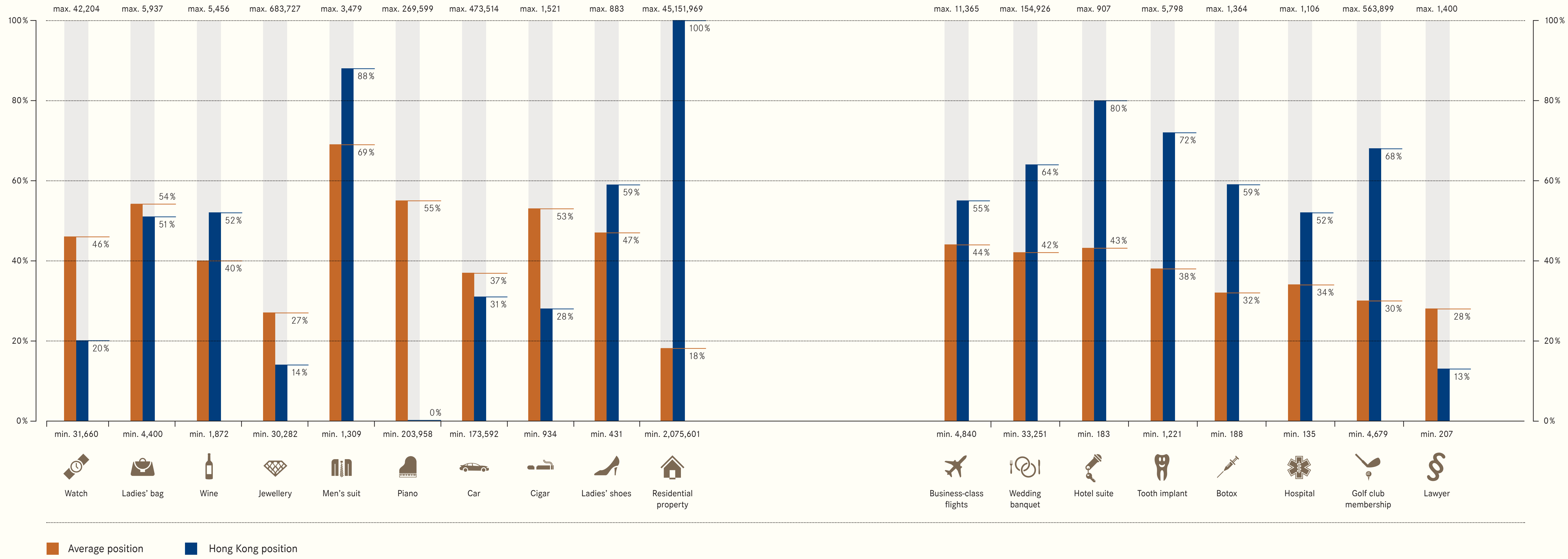


Source: Ipsos Loyalty, Julius Baer

Hong Kong – property fever pitch

Chart 12
Hong Kong – Goods

Hong Kong – Services



Source: Ipsos Loyalty, Julius Baer

The dominant feature over the Hong Kong data set is the high-end property sector. Prices in Hong Kong are the highest in the whole data set. Comparing property across cities represents unique challenges, as the search for similarly sized homes in a premium location is surprisingly difficult. In addition, some properties will command an extra premium given their prestige and significant local supply constraints. In Hong Kong, strong demand from international and local buyers has reached fever pitch and the jury is still out whether government measures to introduce restraint into the property market will have a meaningful impact – but it seems safe to assume that the highest segment will remain largely untouched.

For similar reasons of limited supply, golf club membership in Hong Kong is among the most expensive. At USD 387,000 per year for the most prestigious clubs, this is only dwarfed by the Tokyo data point. Indeed, excluding these two, the average luxury golf club membership in Asia drops to USD 102,060 in this year's data set, with access to golf clubs in Jakarta, Manila and Bangkok costing a fraction of this. At the other end of the scale, Hong Kong is an opportunistic location to buy diamond jewellery. Jewellers will make the case that every item for sale is unique and hence, as with property, strict comparisons are complicated and open to much debate.

On the other hand, with reportedly more jewellery stores per square kilometre than any other city in the world, it must follow that investing time and effort to find the right diamond for you makes more sense in Hong Kong than anywhere else.

On the services side, Hong Kong is relatively expensive when it comes to hosting a 500-person wedding banquet and the corollary item of high-end hotel suites. Hotels offer multiple packages for different budgets, but our best effort to find similar wedding experiences still puts Hong Kong at the top end.

As with property and golf clubs, the limited supply of land is likely to be a driver in keeping banquet costs in this segment high. At the other end of the spectrum, legal fees (defined as a one-hour consultation for a simple will) in Hong Kong are relatively affordable. According to the Hong Kong Bar Association, there are over 9,000 practicing solicitors and barristers in the city from over 800 firms. This reflects Hong Kong's position as a key financial hub in Asia and the thriving legal profession is an important element of that result.

Redefining Japan's place in a globalised world

Japan's stuttering growth as well as several misconceptions have led to the view that the third-largest economy is unable to meet the challenges of a globalised world. On the other hand, Japan remains a key source of demand for luxury goods. A more in-depth analysis, however, reveals that Japan is anything but stagnant. The launch of 'Abenomics' could speed up the pace of change even further.

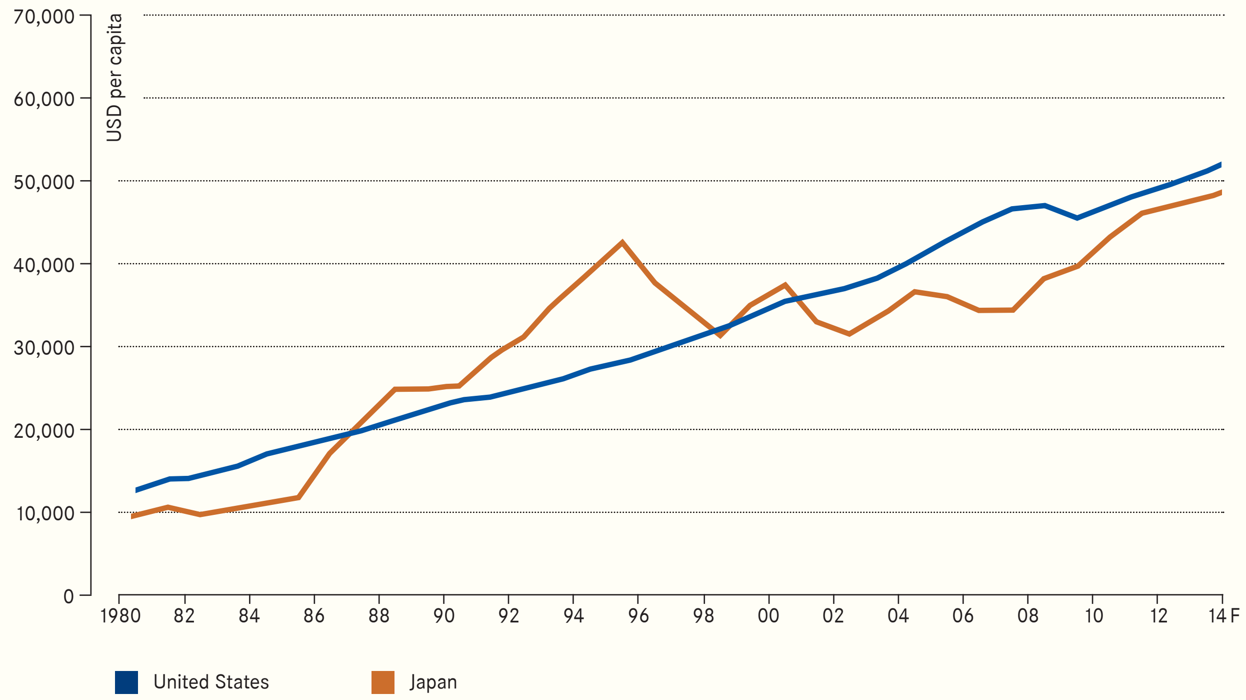
Slipping from view

In addition, IMF data shows that the last two decades have seen Japanese GDP growth average only 0.8%, well below that of other large economies such as the United States (2.6%) and Germany (1.3%), coupled with persistent bouts of deflation. For many investors, Japan has increasingly fallen out of view especially since the local equity market has failed to keep pace in relative terms and it now only represents 7% of the global total capitalisation of stocks, on a MSCI basis. Worse still, economic stagnation has given rise to the idea that Japan has stood still while its neighbours, notably China, are undergoing structural transformations that propel per capita income to new heights. As other parts of this report demonstrate, Japan is a key source of global consumption, in particular of luxury goods. How do we reconcile these seemingly contradictory outcomes?

Misconception of Japan

While some of the mentioned arguments are undoubtedly true, there are also a number of significant misconceptions. Most importantly, there is the erroneous idea that Japan has not adapted itself to face the challenges and opportunities of a globalised economy. In part, low economic growth is a consequence of a rapidly ageing population and limited immigration. Deflation, however, increases the purchasing power of accumulated savings in real terms. Hence while deflation is bad for growth, the approximate USD 12 trillion in savings owned by Japanese households, according to Bank of Japan data, have maintained their value over the longer term. Indeed, adjusted for changes in the Japanese yen, per capita income has largely kept pace with that in the United States, which has a GDP per capita of USD 50,000.

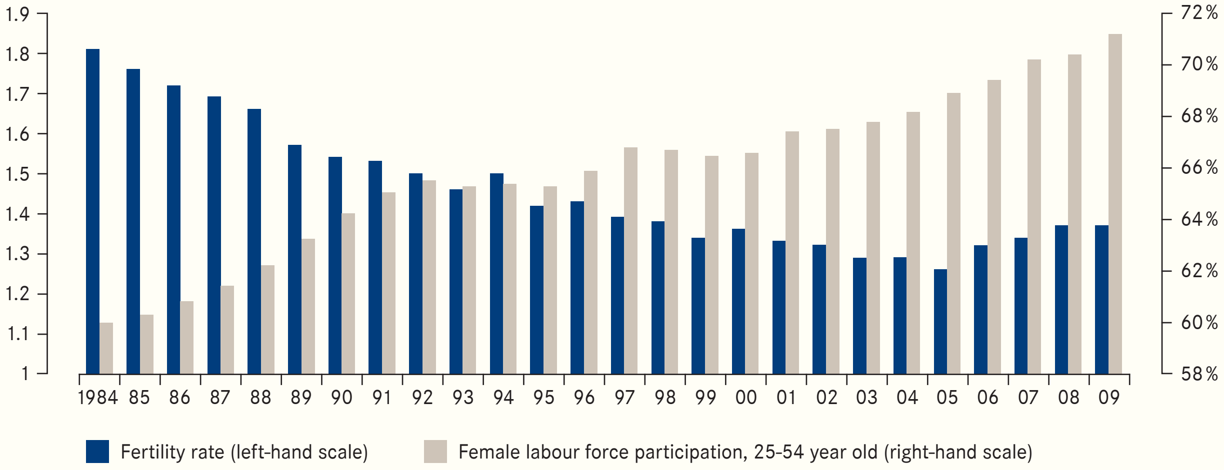
Chart 23
Japan's per capita income has kept pace with the USA



Source: International Monetary Fund, Julius Baer

Some of the counter-arguments are based on currency movements and, critics may charge, are not meaningful or active signals of social or economic change. In response to an ageing population and declining birth rate, Japanese women have increasingly joined the labour force. In the face of labour cost competition, Japanese companies have switched to contract work, which has improved the flexibility of the job market, but in turn has seen companies invest less in their workers, according to the OECD. Hence it is too soon to say that the longer-term impacts of maintaining competiveness in the shorter term will be unambiguously positive.

Chart 24
Japanese women entering the workforce, gradually but persistently

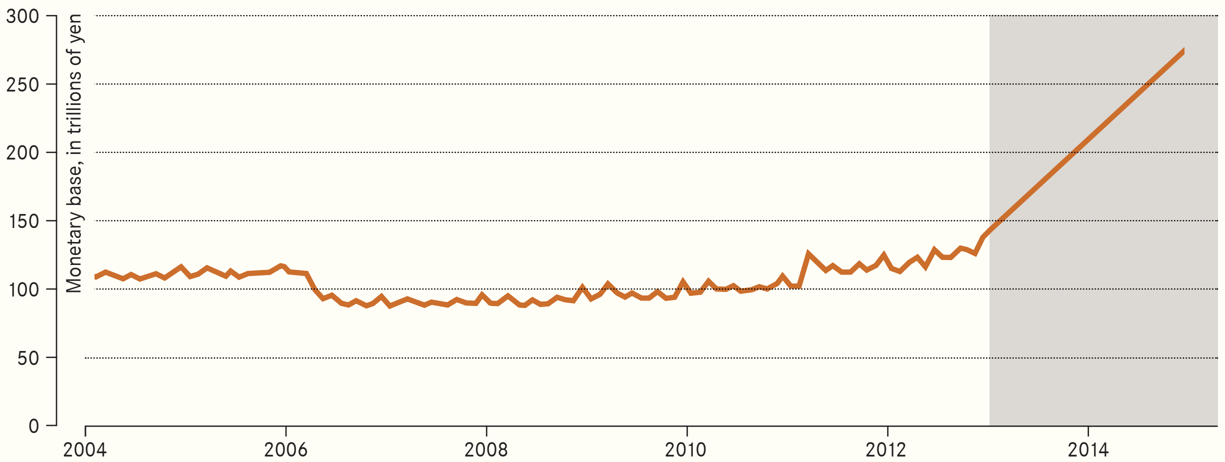


Source: OECD, Julius Baer

Understanding 'Abenomics'

Addressing Japan's legacy of deflation goes to the heart of the policies set out by Prime Minister Shinzo Abe's government, installed in December 2012. The policy programme has three main pillars: a shorter-term boost in government spending to kick-start growth, a major shift in stance at the Bank of Japan and third, a longer-term drive for growth via deep structural change. The first two steps have been accomplished. The supplemental budget passed in February includes spending increases, setting aside concerns over the government's large debt stock. At the Bank of Japan, the new governor Haruhiko Kuroda has launched massive monetary easing, effectively promising to deliver a 2% inflation outcome in two years. These actions have not gone unnoticed by financial markets, resulting in a significant weakening of the Japanese yen. In the longer term, whether 'Abenomics' will be successful in terms of defeating deflation will hinge upon the last pillar of structural reform. For example, further increases in youth and female labour participation will help ease demographic challenges. Harnessing Japan's strengths more effectively in the area of technology and innovation, in addition to new regional trade initiatives, is planned as well. It is still early days for 'Abenomics', but such measures could lay the foundation for a post-deflationary Japan.

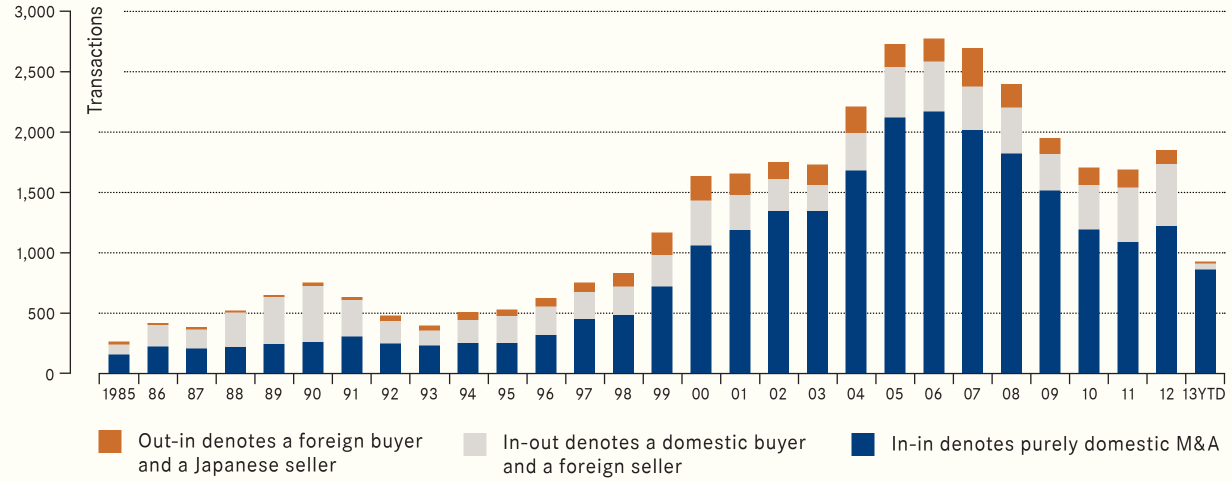
Chart 25
Bank of Japan has launched a major monetary expansion



Source: JP Morgan, Julius Baer

Most striking of all is the misconception that Japan has retreated from the outside world. Japanese corporate activity has progressively internationalised over many years, first in terms of production, as of 2010 approximately 30% stems from overseas operations, according to UBS Investment Bank. Looking only at the subsidiaries of Japanese companies, they generated USD 130 billion of profits for their parent firms in 2010, according to Macquarie data, reaching the previous 2007 peak. This is important as it demonstrates another facet of modern globalisation: today about one-third of all trade actually comprises the movement of goods between subsidiaries of the same companies, located in different parts of the world. Japan is a key exponent of this trend of corporate globalisation. Another barometer of Japan's advanced globalisation can be seen in the mergers and acquisitions (M&A) records. While M&A between domestic firms remains the dominant variety, so-called 'in-out' M&A, in which Japanese firms merge with or acquire foreign companies, has increased notably. The fact that domestic M&A surged over the past decade also argues that Japan is anything but stagnant. In addition to ongoing restructurings at home, the internationalisation of corporate revenue streams means that Japan can 'import' growth, in particular from other countries in Asia.

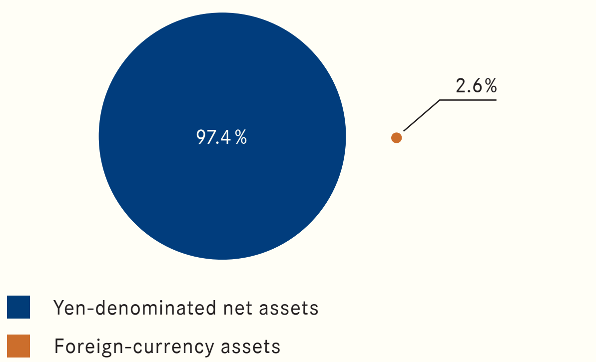
Chart 26
Japan's dynamic mergers & acquisitions landscape



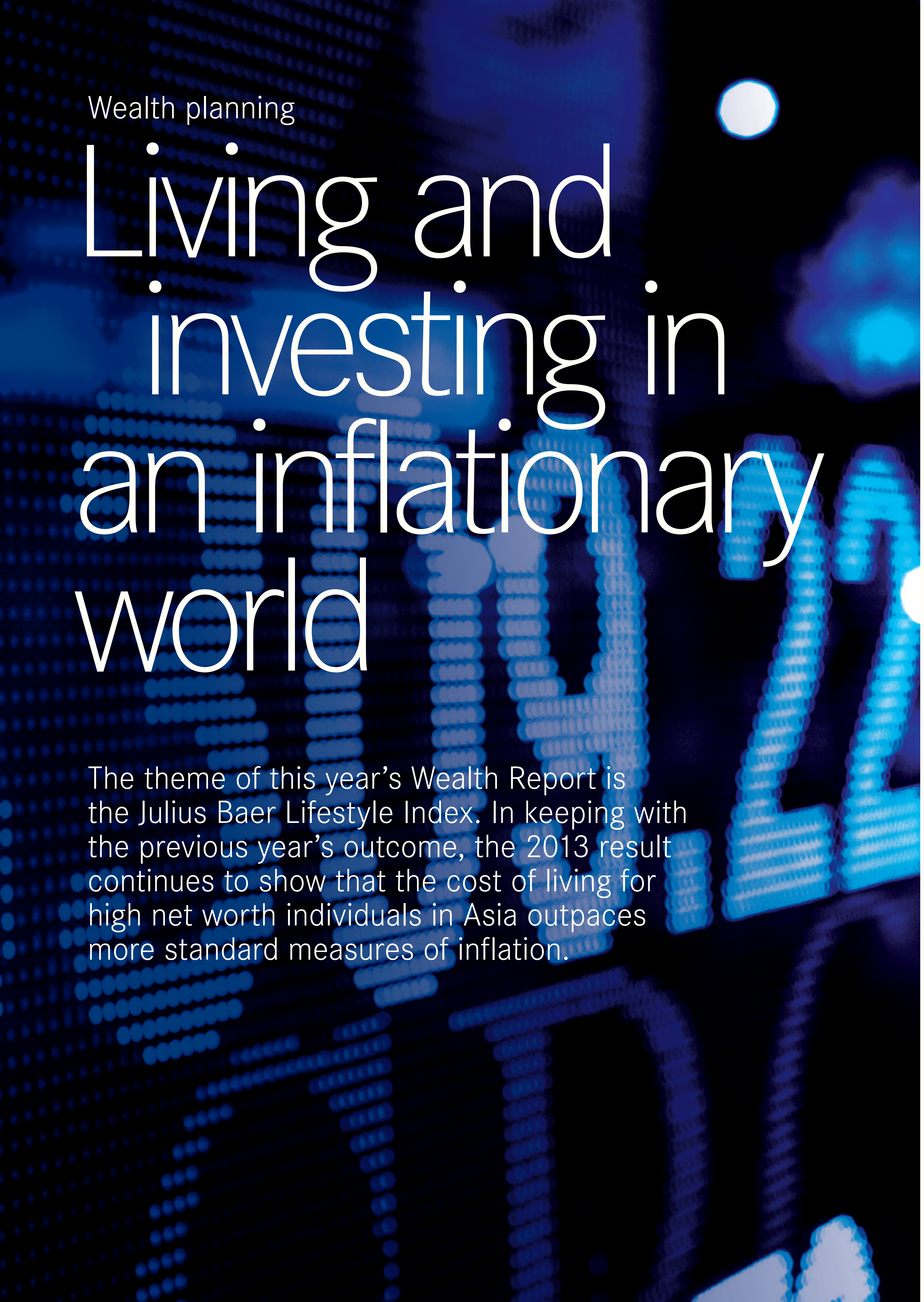
Source: Macquarie, Julius Baer

The final area where we see considerable room for change is the globalisation of household assets. While as an overall economy, Japan holds significant assets abroad, the breakdown of household portfolios is very different: according to the Bank of Japan, only 2.6% of Japanese savings are in non-Japanese assets. In line with trends seen in the corporate landscape, we expect this to change over the longer term as Japanese investors seek returns from a more international set of options. After all, relying on deflation to generate real returns cannot be seen as a viable longer-term strategy. As Japan is challenging the perception that it is immune to change, international investments may prove to be a new and future source of wealth.

Chart 27
Households have very few non-yen assets



Source: Bank of Japan, JP Morgan, Julius Baer



Wealth planning

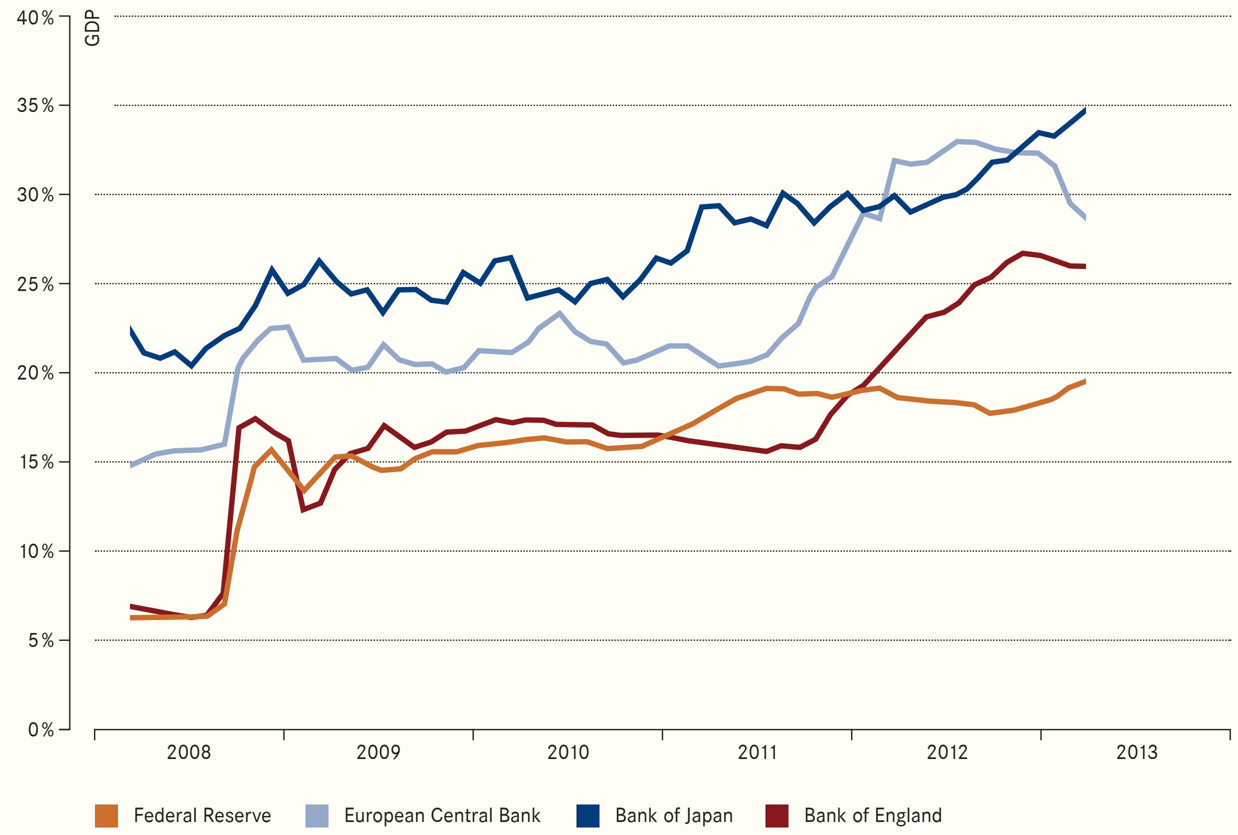
Living and investing in an inflationary world

The theme of this year's Wealth Report is the Julius Baer Lifestyle Index. In keeping with the previous year's outcome, the 2013 result continues to show that the cost of living for high net worth individuals in Asia outpaces more standard measures of inflation.

There have been some profound differences since Julius Baer launched the Lifestyle Index. Namely, the number of central banks engaged in actively expanding their balance sheets has reached an unprecedented scale, raising the spectre of inflation in a serious way. If Milton Friedman is right that "Inflation is always and everywhere a monetary phenomenon," investors are rightly worried about inflation. For high net worth individuals, having access to a portfolio of financial and/or real assets means that possibilities exist to protect against inflation risk. The recent financial crisis has prompted central banks in major economies to use unconventional monetary policies to avert a sustained economic downturn. While both the magnitude and method differ from one central bank to another, the common denominator is a significant surge in liquidity globally. Excess liquidity affects all asset classes from equities, bonds, commodities and not least currencies. It also raises questions about, and fears of, inflation.

How can investors protect themselves against inflation risk and can hedge funds help to hedge inflation? While measured inflation in developed economies is still relatively modest, the 'expectation' of future inflation is being shaped by central banks' higher tolerance for elevated inflation levels as long as it remains under control. Faced with such unconventional action, should investors turn to unconventional solutions, such as hedge funds?

Chart 29
Central banks' balance sheets have expanded significantly



Source: Datastream, Julius Baer

Conclusion

Exciting times ahead

Surveying Asia's leading economies over the past year, there are mounting arguments that the importance of the old business model of being reliant on producing exports for mature markets is fading. In the medium term, global private consumption will still be driven by the United States, but the increasing role of services in Asia bodes very well for a sustainable increase in wages and thereby establishes a new platform for growth and wealth creation in Asia for Asia. When more of this decoupling is completed, the future of Asia will look very different from today.

Over the shorter term, the Julius Baer Lifestyle Index tells us that the spread between standard inflation measures and the cost of living for high net worth individuals remains significant this year although there has been a positive correction of this spread so that the two types of inflation are more aligned. Nevertheless, maintaining a luxurious lifestyle over the longer term continues to have significant implications in terms of the need for appropriate financial advice.

The Julius Baer investment approach is geared to protecting investors' assets while taking opportunistic positions to deliver the desired performance, taking account of the 'real cost' of being wealthy. An investment approach, which is flexible and challenges the conventions of financial markets in the post global financial crisis world, is key in this approach.

In the coming years, the expanded Julius Baer Lifestyle Index will fully cover the eleven key cities in Asia, enabling a more complete picture of the dynamics in the luxury lifestyles in the region. Asian economies are integrating rapidly and the centre of gravity in the global context continues to move to the East. At Julius Baer we remain committed to being at the forefront of understanding these developments and sharing them with our clients.