

The Long View

January 2013

Rise of the global consumer

In Peru and other developing countries around the world, young men and women are doing things their parents never dreamed of. They are buying washing machines, taking their first plane rides and calling home on their smartphones.

Indeed, millions of people around the world are now beginning to have a lifestyle that not so long ago seemed unattainable. The improvement in their standard of living represents a remarkable transformation that could have significant ramifications for the global economy and companies around the world.

“The increasing affluence and the emergence of consumer classes in developing countries is a durable trend that should continue for many decades to come,” says portfolio counselor Rob Lovelace. “It’s a trend that has the potential to be one of the primary engines of economic growth.”

\$30 trillion in buying power

How big is the new wave of global consumers? Researchers at the McKinsey Global Institute estimate that in 2025 there will be about 4.2 billion people in what demographers call the “consuming class,” or those with disposable income. That’s nearly double the number in 2010.

China and India are leading the advance, but countries in Latin America and Africa also have a growing consumer

class. In 2010, the emerging markets accounted for \$12 trillion in spending. In 2025, they are expected to account for about \$30 trillion of spending, or nearly half of global spending.

Rob and other portfolio counselors say the rising purchasing power in much of the developing world points to increasing demand for a variety of consumer products, ranging from smartphones to luxury goods to health care products. Between now and 2017, for example, developing countries are expected to account for about 70% of the

projected increase in pharmaceutical sales.

Portfolio counselor Mark Denning says the trend represents a significant opportunity not only for companies in developing markets, but also companies domiciled in developed countries that have competitive products, enduring franchises and the flexibility to capitalize on potential growth beyond their home borders.

“A number of dynamic companies in the U.S. and Europe that have been confronted with slow growth in their home markets have moved to take advantage of opportunities in Asia and Latin America,” Mark says. “Many of them have been aggressively doing business overseas, and as more people move out of poverty into the middle and upper classes, I think you will see that trend continue.”

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— Rob Lovelace, *portfolio counselor*

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Past results are not predictive of results in future periods.

Emerging entrepreneurs



Gregg Ireland

*Portfolio counselor
40 years of investment experience*

Capitalism worldwide is flourishing. It’s flourishing not only at the global level, but at the individual level.

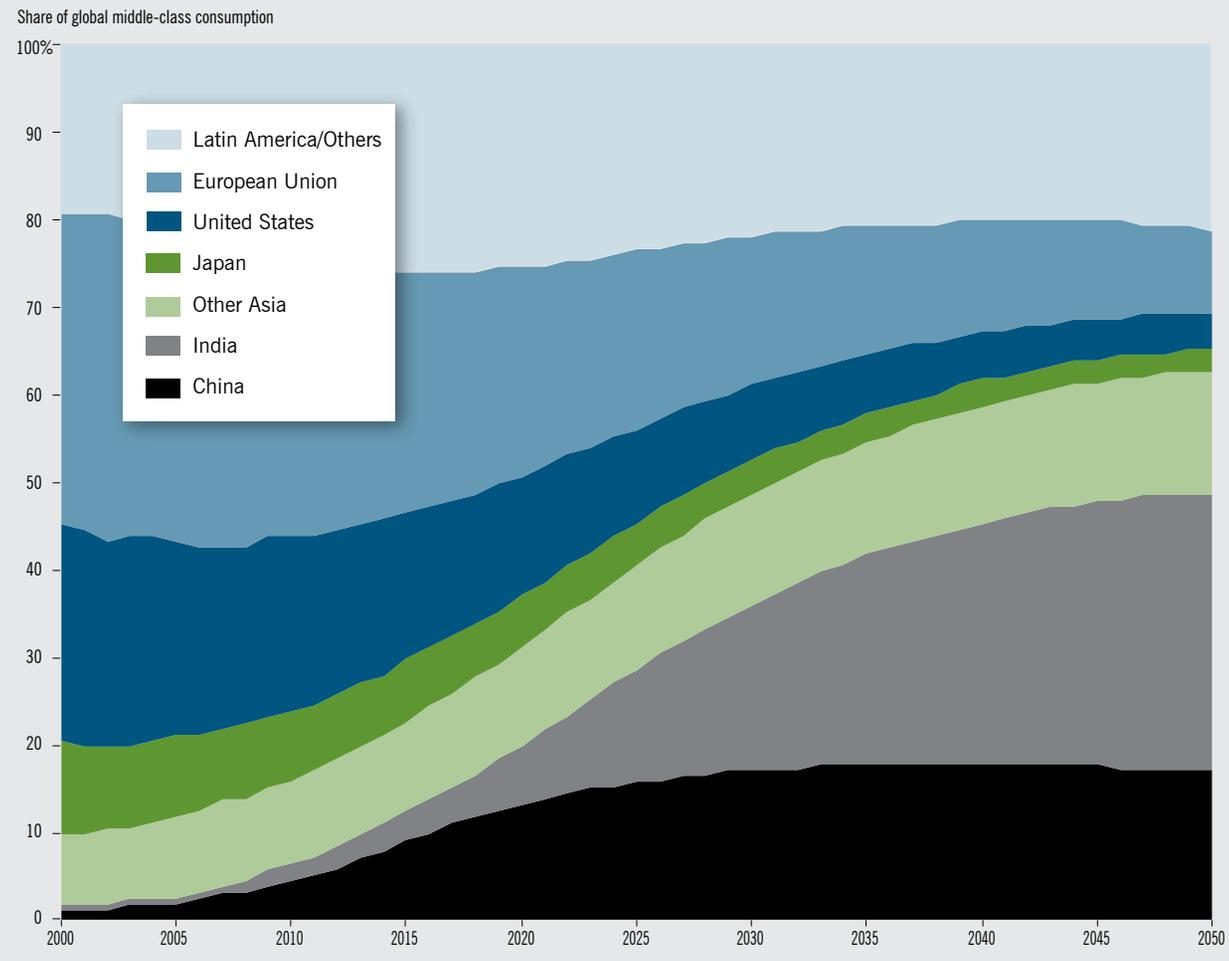
There are millions of people who aren’t waiting for the government to pass some law or for a bank to make them a loan to start a business. They’re not listening to CNBC every day and they’re not waiting for the next election. They are just doing it. These are people that not that long ago had no opportunity, and now they have a small business.

It’s happening around the world — in Vietnam, the western part of China, or Africa. I was in Africa recently and it’s a boom economy. It’s at the ground level. It’s a farmer in Botswana who goes to the city, buys a scooter, starts up a business and suddenly has two or three employees doing really well, serving the local community and supporting a family.

That kind of growth is happening with the help of the Internet and smartphones, or just regular cellphones, everywhere I go. When you multiply that by hundreds of millions of people it’s absolutely amazing. This is bubbling under the surface. It’s massive and it’s probably just going to build and build.

That’s where much of the growth is going to come from in the world economy over the next 20 years.

The next wave of consumption could come from a growing middle class in the developing world



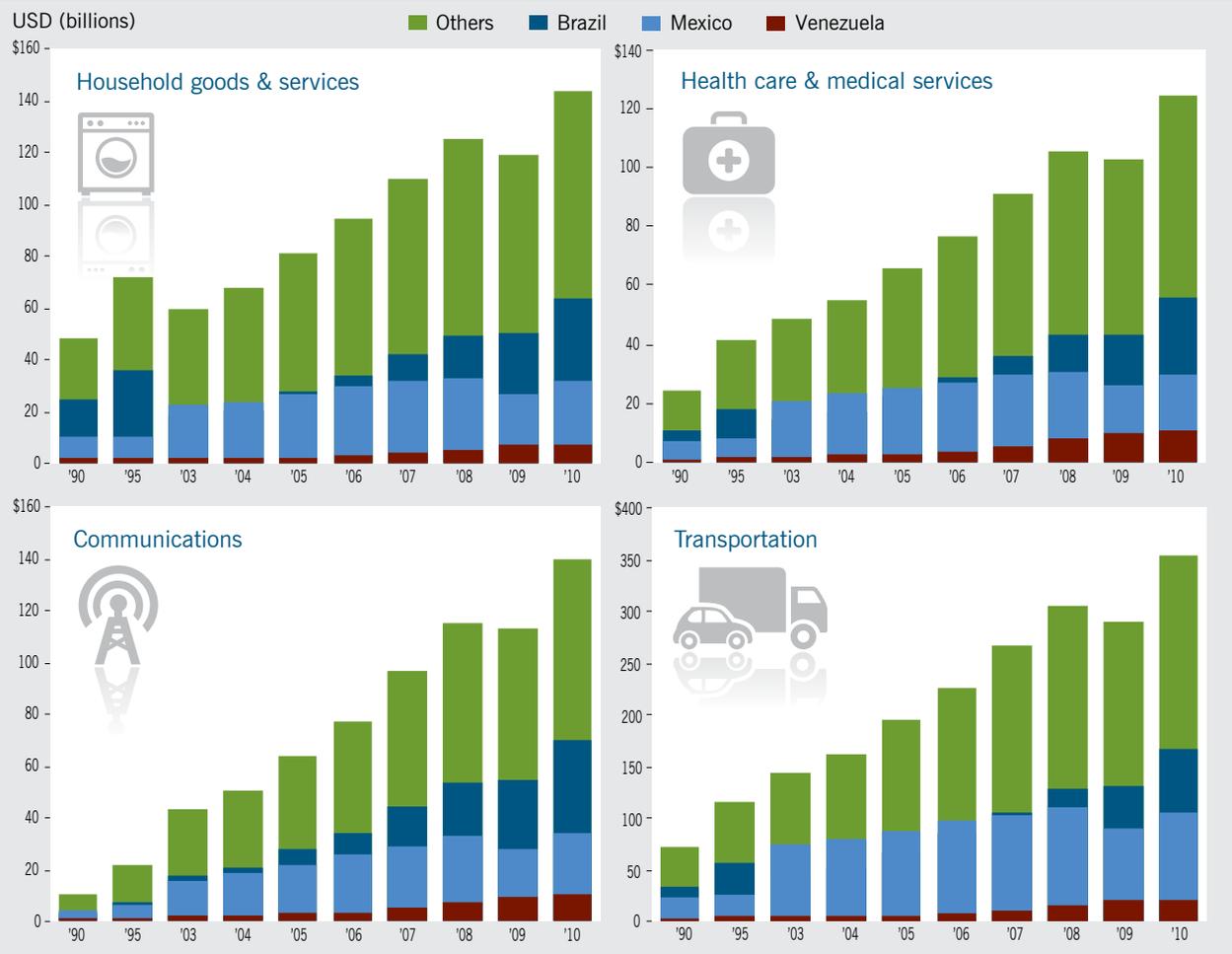
Sources: *The New Global Middle Class: A Cross-Over from West to East*, 2010, Homi Kharas and Geoffrey Gertz; *The Emerging Middle Class in Developing Countries*, 2010, Homi Kharas.

- The world's consumer class may be on the verge of becoming a transformative force for the global economy. From China and India to Peru and Botswana, the number of people expected to join this group over the next decade and beyond already has changed the way many companies do business, and the way investors should look at the world.
- The projections of the size of this demographic wave can vary, but there's little debate about the direction. According to the McKinsey Global Institute, the ranks of the global consuming class will swell from about 2.4 billion today to 4.2 billion by 2025, when the world's population is expected to be about 7.9 billion. In other words, for the first time in history more people will be middle class than poor, according to McKinsey.
- This broad expansion of a consumer class with discretionary income represents a significant opportunity for multinational corporations and local businesses.
- For the last 50 years, the middle class in the United States and other developed nations has been one of the driving forces of the global economy. But when it comes to consumption growth, the consumer class in the developed world may now be in the process of passing the baton to the evolving global consumer in the developing world.

“We are seeing something very exciting happening all around the globe. There are a lot of countries where you have a large, growing population of middle-class people with rising disposable income. This is one of the most significant developments of our time.”

— Gordon Crawford, *portfolio counselor*

Consumer spending has surged across the region since 1990



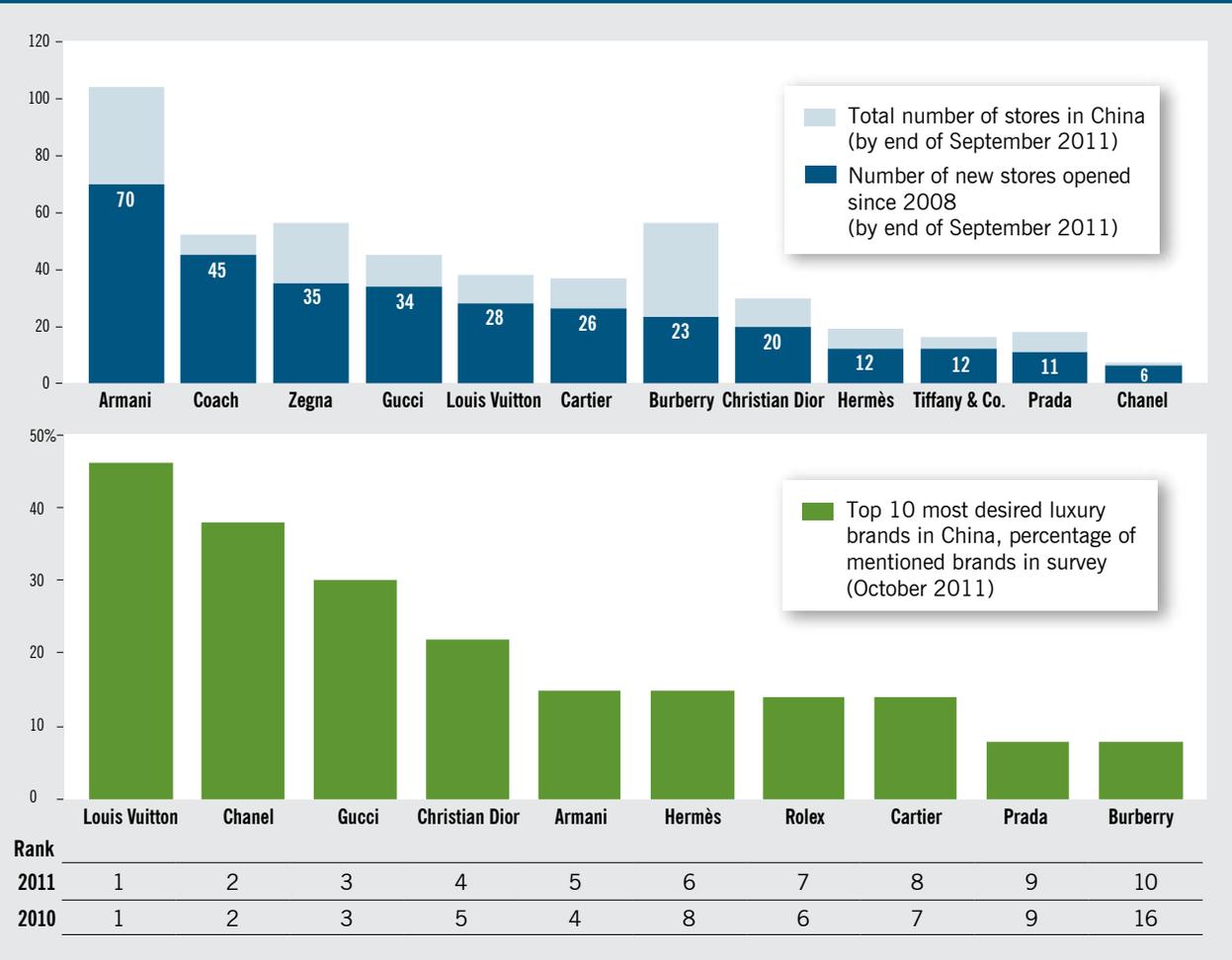
Source: *World Consumer Income and Expenditure Patterns*, 2012, Euromonitor International. "Others" represents the following countries in Latin America: Argentina, Chile, Colombia and Peru. Consumer expenditure data are expressed in USD at current prices.

- For much of its history, Latin America has had some very rich people, lots of poor and not many in the middle. But that's changing. Much of Latin America has been on a journey toward economic and political stability for several decades, and that's meant a better life for millions of people across the region.
- From 1990 to 2007, the number of middle-class households in Latin America has increased from 56 million to 128 million, according to a 2011 analysis by the United Nations Economic Commission for Latin America and the Caribbean. This implies a large expansion of the consumer market.
- The chart shows the increased spending in a variety of sectors. Spending on health care, for example, has increased fivefold since 1990, rising from about \$24 billion to \$124 billion in 2010. Overall, consumer spending has increased from about \$683 billion in 1990 to \$2.7 trillion in 2010.
- The growth of the middle class is largely the result of a relatively robust economic expansion in Latin America. As millions of people join the middle class and make purchases aimed at improving their standard of living, the impact on the global economy could be significant.

"I'm from South America and I'm very bullish on the area. There are a lot of people hitting the middle class, tons of water, commodities, good weather, arable land, the Atlantic and Pacific coasts. I think that market is underappreciated and will become incredibly significant."

— Isaac Sudit, *portfolio counselor*

Objects of desire: The world's top luxury brands have rushed to establish a presence in China



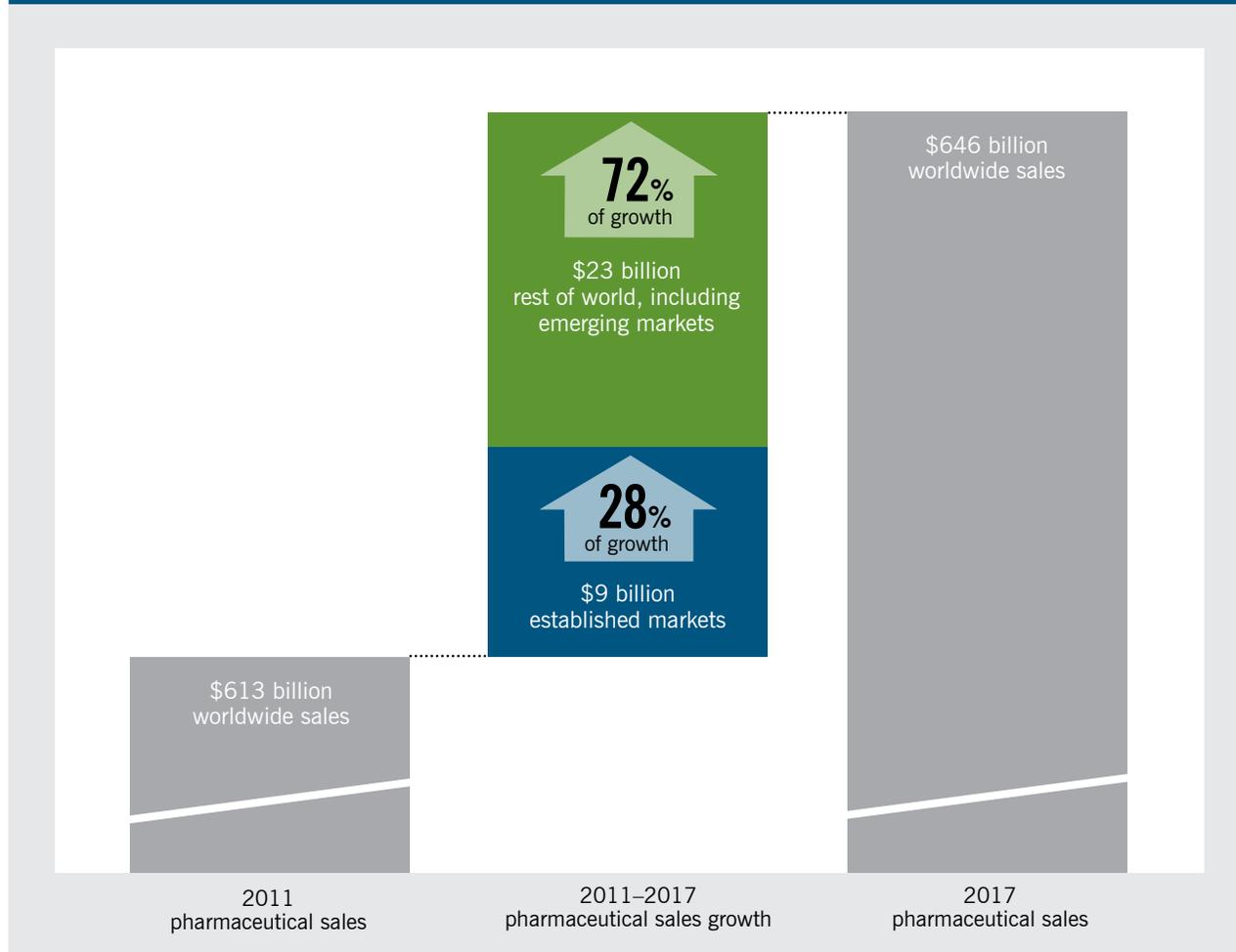
Source: 2011 China Luxury Market Study, 2011, Bain & Company.

- Nowhere in the world is the rise of the consumer class more significant than China. Just as the remarkable transition of the Chinese economy has lifted millions into the middle class, it has also created a class of global consumers whose affluence has transformed the worldwide luxury goods market.
- In a relatively short period of time, Chinese consumers have become the world's No. 1 buyers of luxury goods, ahead of the Japanese, Americans and Europeans. Globally, China's affluent account for 25% of luxury spending.
- The chart details how aggressively many of the world's top luxury brands are expanding to meet the demand in China for everything from clothing to cosmetics. Luxury cars have also been in demand. In the first nine months of 2012, BMW's Chinese sales climbed 34% from a year earlier to 237,056 cars.
- The growth of the luxury goods market has slowed recently along with China's economy. But Chinese shoppers helped push luxury to its third straight year of double-digit growth in 2012. Luxury goods, of course, aren't immune from the ebb and flow of the global economy, but luxury spending and the companies that provide such objects of desire seem a durable theme that has the potential to reward long-term investors with a global perspective.

"I think we will continue to see demand for luxury goods in China. But China's growth, while robust in comparison to other nations, is slowing. Ultimately, China may be moving toward a more balanced economy that may be more durable over the long term."

— Steve Watson, portfolio counselor

The emerging global consumer is expected to spend more on health care



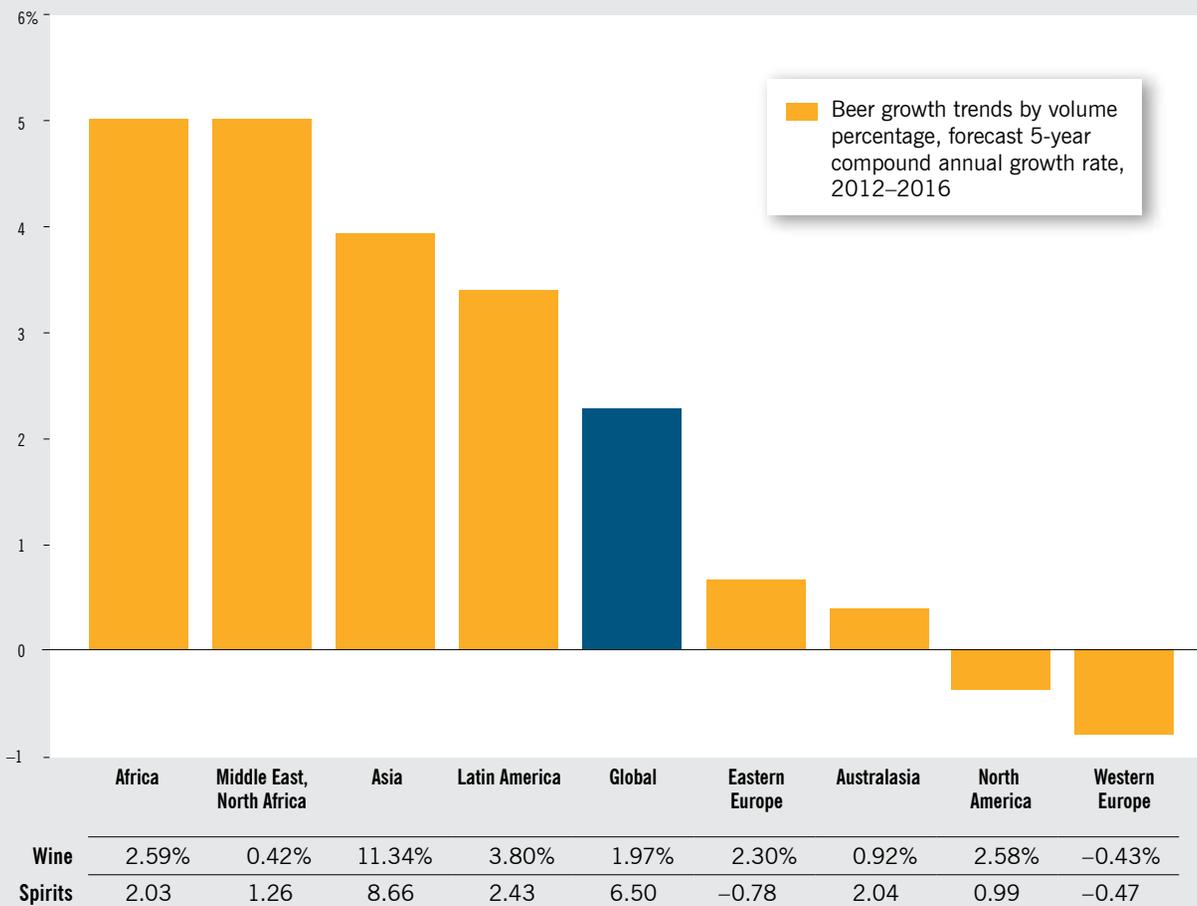
- In the pharmaceutical business, developing countries aren't called emerging markets. They're called "pharmerging" markets. Such countries are expected to significantly increase their spending on medicine over the next four years, accounting for about 70% of the projected increase in sales for the leading pharmaceutical companies through 2017.
- The increase in developing countries will be driven largely by rising incomes. Government programs designed to increase access to treatments and encourage greater use of medicines could also play a role.
- The pharmaceutical industry may also grow from several other developments. The U.S. and Europe are experiencing a demographic shift toward older age groups, which are likely to require more health care. In developing markets, increased consumption may lead to increasing obesity, which leads to diabetes, high blood pressure and heart disease.

"There are reasons to be constructive about the pharmaceutical industry. One of them is that developing markets are a source of growth because as societies get wealthier, they invest more per capita in health care."

— Jay Markowitz, *investment analyst*

Sources: Datamonitor and Datamonitor's PharmaVitae Explorer, which contains sales of the industry's leading pharmaceutical companies. Established markets represent United States, the EU-5 (France, Germany, Italy, Spain and United Kingdom) and Japan. Figures shown are based on estimated data. The \$646 billion sales figure for 2017 is a rounded number.

The thirst for beer, wine and spirits in developing countries is driving growth for drink companies



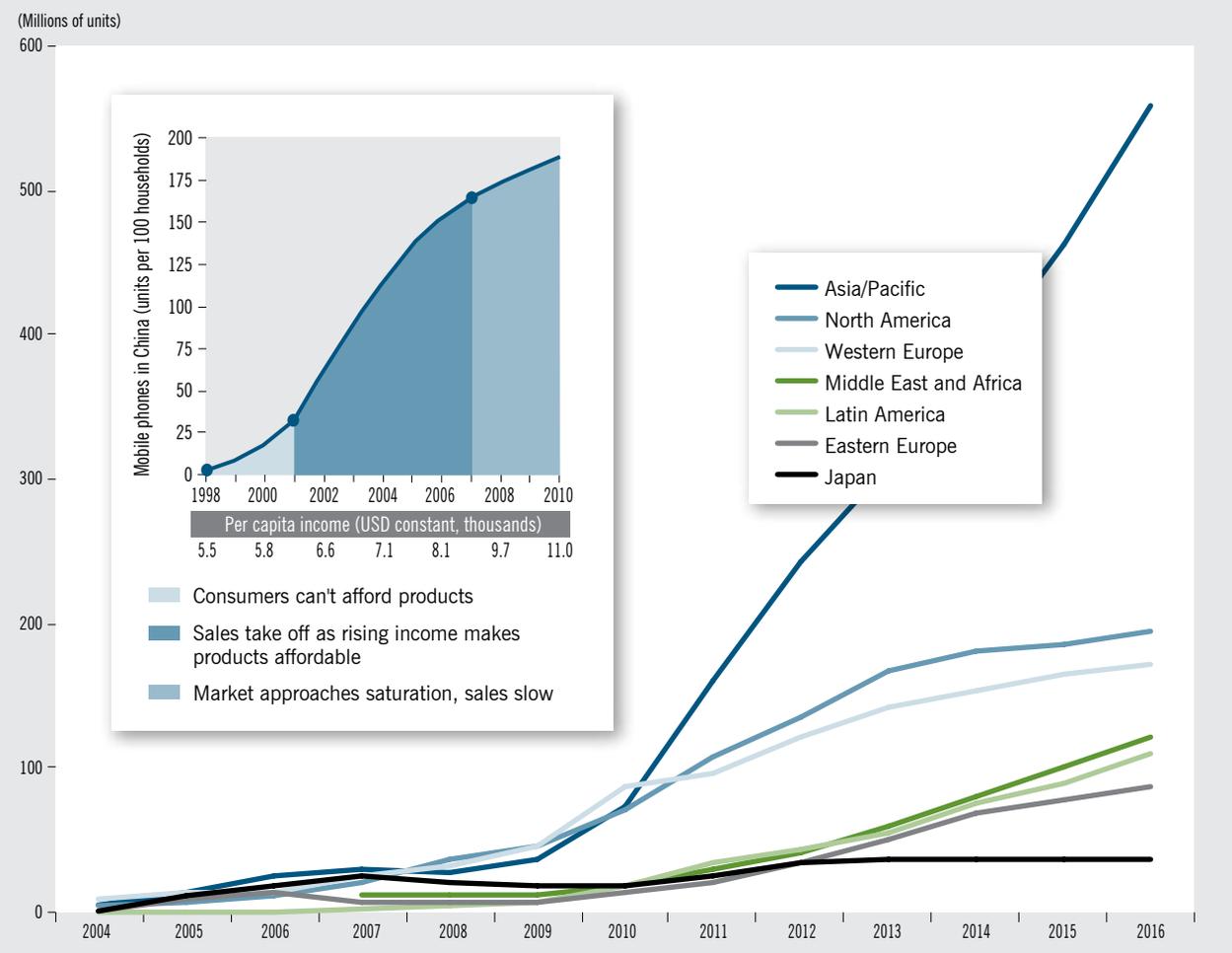
Source: Canadean.

- From China to South America, cups runneth over. While beer consumption in the developed world is flat, it's rising rapidly in developing countries. China, for example, accounts for a quarter of all beer consumption worldwide (the U.S. is a distant second in consumption at about 13%).
- The chart shows that demand for beer in Asia is expected to grow at nearly 4% a year through 2016. Demand for wine and spirits in Asia is also soaring. Africa is also a rapidly growing market for beer.
- The growing thirst for beer, wine and spirits in developing countries is good news for a number of global companies, including such companies as Anheuser-Busch InBev, SABMiller and Diageo, whose brands range from Jose Cuervo to Guinness. Diageo reported in October that it expects 50% of revenue to come from developing countries by 2015, including Africa, Asia and Latin America, up from 40% in 2012.
- A look at Anheuser-Busch InBev is illustrative of the global scope of the beer industry. Over recent years InBev, based in Belgium, refocused on the Americas and select developing markets, including China. The execution of the strategy involved InBev's acquisition of Anheuser-Busch in 2009. The company now reaches around the world, with global sales of beer in 2011 totaling 8.96 billion gallons — enough beer to fill 13,560 Olympic-sized swimming pools.

“Over the next 10 years, much of the growth in the global beer economy will arise in the Americas, which represent a significant profit opportunity for appropriately positioned companies.”

— Juliette Amos, investment analyst

As the income of the global consumer has risen, phone sales have gone into high gear



Source (chart): Gartner, Inc.; data from 2012 to 2016 are estimates. Source (China inset): McKinsey Global Institute, attributed from *Urban World: Cities and the Rise of the Consuming Class*, June 2012; reprinted by permission.

- As a new wave of consumers grows around the globe, there is likely to be a period during which the purchase of goods and services accelerates at a rapid pace. The cycle is sometimes charted along an “S” curve. At the low end of the curve, products are still too expensive for many consumers, and sales are slow. But as incomes reach a threshold where the product becomes affordable, sales take off.
- The inset in the chart uses the sales of phones in China to illustrate this dynamic. As incomes have risen, the number of phones per household has increased by nearly five times along the steep part of the “S” curve. The broader chart shows that sales of smartphones in Asia are expected to continue climbing the curve for several more years, while sales are likely to slow in North America and Western Europe.
- This pattern is likely to be followed on goods ranging from refrigerators to cars, but smartphones serve as an example of a product that provides numerous companies with an opportunity to grow their business. For long-term investors, the changes in technology, and the adoption of products among the consumer class, can provide an investment opportunity that few could have imagined even a decade ago.

“It’s incredible that a person today has access to more or less the entire globe’s information. When you think about how powerful a trend that is, you get a grasp that we’ve really just seen the beginning of how transformative this technology is going to be and how many really huge companies are going to be built on the back of it.”

— Brad Barrett, *investment analyst*

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