

CHAPTER 1

The World Right Side Up

One thought always strikes me in my travels. I'll be sitting in a comfortable bistro in Medellín with its doors open to the warm night air wafting in gently from a quiet street, in a restaurant on a man-made island gazing up at the tallest tower in the world twinkling on a starless night in Dubai, at a bar in Cape Town, in a noodle shop in Beijing, or countless other places around this ever-fascinating planet of ours. And the thought will hit me.

If I close my eyes, I could easily imagine myself in New York, Washington, D.C., or any number of American cities. Of course, each of these places is different from each other in many ways, and yet they are much the same.

People are people around the world. They like many of the same things. They want to have a better life. They want to have a safe home, wear clothes they like, and have friends. They want to have leisure time and eat well. They all want something.

They share all the same traits that make us human. People everywhere are humble and vain, generous and greedy, wise and foolish, and many other qualities besides. They've made mistakes. They have hopes and dreams.

Yet great disparities and differences exist, too. Since the Industrial Revolution, the Western world—mainly the United States and Western Europe—has vaulted well ahead of everyone else. Traditionally wealthy economies, such as China and India and parts of the Middle East, were left far behind. The Western world dominated—in manufacturing might and in military power, especially.

This gap probably reached its apex sometime in the 1950s. According to *Power and Plenty*, a good reference book on trade, the Western world (excluding Japan) represented 90 percent of the world's manufacturing output as late as 1953. The United States bestrode the globe as Tiger Woods

once lorded it over golf's majors. America's economy alone was nearly half of the world's industrial output.

But things started to change in the late twentieth century. The gaps narrowed. And these trends continue to unfold in the present. My thesis is that such narrowing of the gaps will continue for decades. This will be the most important long-term investment theme of the twenty-first century.

I call it "the world right side up" because it is, in my mind, a more natural world, more the way the world ought to be. It's a Western conceit to think that the current technical, economic, and military superiority of the West is normal. When you look at the history of our planet over a longer time frame, the dominance of the West is a relatively recent affair.

The Polynesians had prosperous farming villages across a great swathe of the South Pacific while Europeans were still living in caves. In double canoes, using only the stars and their wits, Polynesians crossed distances as great as those of Columbus thousands of years before Christ was born. And of course, you surely already know the long list of inventions first made by people in China or Arabia.

The distinctions between "emerging markets" and "developed markets" are starting to disappear. Indeed, the term may already be obsolete. Such is the thesis of Everest Capital, which made the case in a white paper called "The End of Emerging Markets."

First, in terms of size, these emerging markets make up about half of the global economy. Take a look at Figure 1.1. GDP, or gross domestic product, is a flawed statistic, but it serves as a rough guess of economic size. "Purchasing power parity" (PPP) aims to take out the distorting effect of different currencies.

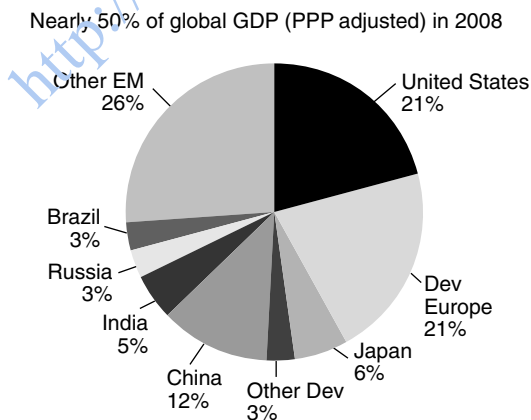


FIGURE 1.1 Let's Call It Even

Source: Everest Capital.

This is astonishing, but the comparisons get more interesting by country. Emerging markets make up 10 of the 20 largest economies in the world. India is bigger than Germany. Russia is bigger than the United Kingdom. Mexico is bigger than Canada. Turkey is bigger than Australia. These are things that I think would surprise the casual observer of markets, rooted in a Western view of the world as it was.

These trends will become more pronounced over time. The creation of new markets, the influx of hundreds of millions of people who will want cell phones and air conditioners and water filters, who will want to eat a more varied diet of meats and fruits and vegetables, among many other things, will have a tremendous impact on world markets. In fact, we've felt the impact in many areas, as we'll see.

In these pages, I'll focus on where these markets have been, where they are, and where they're headed. It is, necessarily, an eclectic and idiosyncratic look at the world. The world is still a big place. There are many patches of Earth and stretches of sea where I've never set foot. There are many places I don't write about here. This is not a comprehensive guide to global markets. It is one curious investor's sampling of that world.

That world is always changing. I first visited Dubai in 2007, when it was a boomtown. Buildings were going up everywhere. Trucks filled the highways. Cranes crowded the skyline. I learned later that two-thirds of the world's cranes were in Dubai back then. It had all the buzz and confidence of boomtowns I've seen in many other places.

My second trip was in October 2009, when everything was bust. It was a completely different place. There were still cranes, but they weren't moving. The many construction sites were still there, but there was no activity on most of them. The place was dead. The third palm island dredged out of the Arabian Gulf—it's never the Persian Gulf in that part of the world—wasted away in the waves and wind.

That's part of the business. Just when you think you've got a bead on a place, something happens that forces you to revisit all you thought you knew.

But the broader narrative never changes. The rest of world is catching up. That's the overwhelming tidal force in markets, and one that will continue to surge on its shores well into the twenty-first century. (Dubai is coming back, slowly, but surely. It's not going away; we'll take a look in Chapter 7).

The evidence is all around us, as you'll see in these pages. Every day, I find new snippets of it as I peruse the *Wall Street Journal* and the *Financial Times*. As I travel and meet people and research new investment ideas, I am confronted with this narrowing gap again and again. These experiences inspired this book.

The key idea is simply that the Industrial Revolution set off a yawning gap between the “West” and the “rest of the world.” That gap is shrinking and will continue to shrink. Don’t be afraid of this change. All is as it should be. The aberration was the last 200 years. The anomaly was that China, in 1970, had an economy smaller than that of Belgium. For hundreds of years before that, it was the world’s largest economy.

It may already be on top again.

Arvind Subramanian, a senior fellow at the Peterson Institute, makes the case that China’s economy is already the largest in the world, passing the United States in 2010. “On this basis,” he writes, “the average American is ‘only’ four times as wealthy as the average Chinese, not 11 times as rich, as the conventional numbers suggest.”

It might seem funny to you that we can’t to seem agree on how big economies are. But it is not easy to estimate the size of something that doesn’t sit still—so you can count it—and that consists of billions of transactions. All of these things are estimates, but the impact China’s had on the global economy is real and not in doubt. We’ll take a look at China in Chapter 5.

I stay away from statistical abstractions like GDP. What is GDP, or gross domestic product, exactly? What does it mean, and why should we care? The truth is there is an awful lot of guesswork in such figures, and they are not practical. You could lead a very successful and rich life as an investor and never know a thing about GDP figures.

In this book, I will stay away from such economic monstrosities as much as possible. This book is a boots-on-the-ground view, a first-hand look. It’s more practical, and the aim is to stay close to what is happening and what we can understand in more tangible ways.

For instance, we may debate the size of China’s economy—as many people spend an inordinate time doing—but don’t doubt its impact. Take a look at Figure 1.2 to see the tangible impact of the growth of China on commodities.

So it is impossible to be an investor in iron ore, coal, or wheat without considering what’s happening in China.

In any event, my view here is that we are headed back to a world more in line with a “normal” historical perspective. It is a world right side up.

The work of Angus Maddison, the late British economist, offers this helpful illustration. Again, I am skeptical of the ability to measure economic size in general—much less for, say, 1600—but I think Figure 1.3 makes intuitive sense.

During the Song Dynasty (960–1279), for instance, the capital city of Hangzhou had a population over a million people. It was one of the world’s most advanced cities. Lars Tvede describes it in *Supertrends*:

Here you could find hundreds of restaurants, hotels, and theaters. There were tea houses with landscaped gardens, large colored lamps, fine porcelain, and calligraphy and paintings by famous artists. The nightlife was rich and varied, and there were professional puppeteers, sword swallowers, theater actors, acrobats, musicians, snake charmers, storytellers, and whatnot. People with special interest could join exotic food clubs, antiquarian and art collector clubs, music clubs, horse-loving clubs, and poetry clubs. All of that about 1,000 years ago.

So, in some ways, the seemingly sudden and unprecedented boom in China is more a return to what was, when Chinese cities were among the largest and most advanced in the world. It's not there yet, but to anyone who's walked the Bund in Shanghai or seen the gleaming new airport terminal in Beijing or even visited the modern fashion shops in today's Hangzhou, you see the trend unfolding.

I mentioned Everest Capital's white paper earlier. It points to a few more ways in which you see how the gaps are closing.

One is to look at simple liquidity. Not that long ago, the value of IBM shares changing hands in a single day in New York were worth more than all the shares that traded hands in Shanghai or Bombay on a given day. No more.

China's consumption of select commodities,
as a percentage of world consumption

Commodity	China % of World
Cement	53.2%
Iron Ore	47.7%
Coal	46.9%
Pigs	46.4%
Steel	45.4%
Lead	44.6%
Zinc	41.3%
Aluminum	40.6%
Copper	38.9%
Eggs	37.2%
Nickel	36.3%
Rice	28.1%
Soybeans	24.6%
Wheat	16.6%
Chickens	15.6%
Oil	10.3%
Cattle	9.5%

FIGURE 1.2 China: Hungry Dragon

Source: Barclays Capital, Credit Suisse, Goldman Sachs, U.S. Geological Survey, BP Statistical Review of World Energy, Food and Agriculture Organization of the United Nations, IMF.

	Western Europe	Former Soviet Union	United States	Japan	China	India
1500	17.9%	3.4%	0.3%	3.1%	25.0%	24.5%
1600	20.0	3.5	0.2	2.9	29.1	22.5
1700	22.5	4.4	0.1	4.1	22.3	24.4
1820	23.6	5.4	1.8	3.0	32.9	16.0
1870	33.6	7.6	8.9	2.3	17.2	12.2
1913	33.5	8.6	19.1	2.6	8.9	7.6
1950	26.3	9.6	27.3	3.0	4.5	4.1
1973	25.7	9.4	22.0	7.7	4.6	3.1
1998	20.6	3.4	21.9	7.6	11.5	5.0
2008	17.1	4.4	18.6	5.7	17.5	6.7

FIGURE 1.3 Shifting Mix of Global GDP

Source: Morgan Stanley Research.

Today's emerging markets are large and liquid. As Everest Capital pointed out at the time of its report, "Chinese markets (granted, there is a lot of retail turnover there) traded more than the NYSE; Hong Kong and Korea traded more than Germany; India traded more than France; and Taiwan traded more than Italy, Australia, or Canada."

Others see shifting changes in the world's financial markets. My colleague and friend, Eric Fry, at *The Daily Reckoning*, pointed out a few in a piece titled "A Shrinking Distinction."

"The First might become last . . . and the Last, first" Fry wrote. "Generally speaking, the mature economies of the West are slipping, relative to many emerging economies around the globe. The First have not become last just yet, but they are working on it."

He pointed to the five-year credit default swap (CDS) on AAA-rated French government debt as compared to that of Chile's AA-rated debt. (A CDS is a kind of insurance against default. The higher the risk, the higher the price of the CDS.) Remarkably, Chile's CDS rate was lower.

This is not an isolated event; it is of a piece of what's going on all over. The CDS rate on French debt was higher than Brazilian, Peruvian, and Colombian debt. That would've been unimaginable 10 years ago! All three of the latter countries carry BBB-ratings, too, one notch above junk. But the market renders its own judgments, ahead of and more accurately than ratings agencies.

"Ten years ago," Fry continues, "Portugal, Ireland, and Greece were highly rated sovereign borrowers. Ireland was AAA. Meanwhile, Brazil, Peru, and Colombia were all 'junk credits.' Figure 1.4 below shows what has happened since. Today, Brazil, Peru, and Colombia are all investment grade, while Portugal, Ireland, and Greece are all junk credits."

And over this time frame, the stock markets of Brazil, Chile, and Colombia trounced the Europeans' as you can see in Figure 1.5.

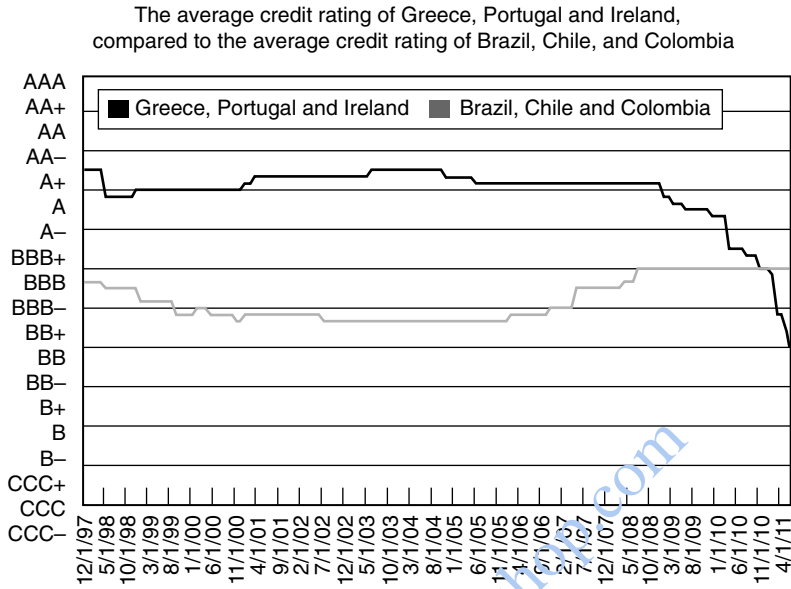


FIGURE 1.4 Submerging Markets

Source: AgoraFinancial.com.

The very strong performance of three Latin American stock markets during the last decade, compared to the very weak performance of three European stock markets

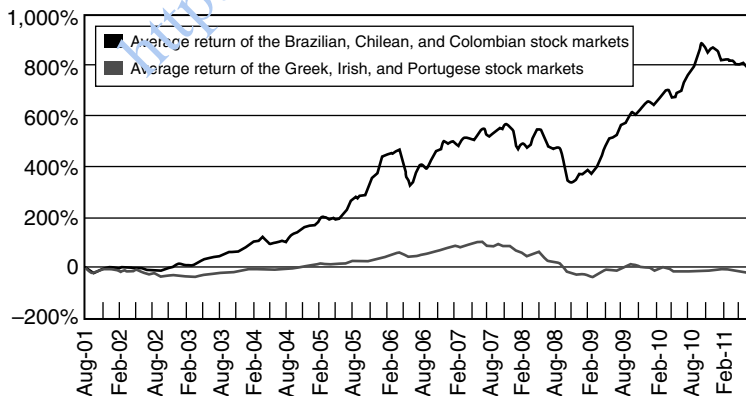


FIGURE 1.5 World Markets Turn Right Side Up

Source: AgoraFinancial.com.

“This glimpse into the past,” Fry offered, “will also be a glimpse into the future. Capital flees from abusive relationships and seeks out environments where it can be fruitful and multiply.”

That is a core truth of wealth creation. That truth drives the world’s financial markets to turn right side up.

Everest Capital’s exhibits should shake off doubt from even the most moss-backed investor. The brontosaurus’s lagoon is no longer his alone. His world has changed. He must compete with new furry and nimble animals.

Beyond this, Everest continues to clear away old attitudes as a man with a broom sweeps away cobwebs. For instance, “The belief that companies in the United States, Western Europe, or Japan are better managed than in emerging markets is also no longer valid. We meet a large number of managements in emerging market countries, and it is impressive to see how quickly they have adopted the best practices in terms of disclosure, governance, and creating shareholder value.”

Supercycles: Where We Are Today?

I am not the only one who has picked up on this idea, which is broadly applicable to many areas of investing. For instance, in early 2011, I attended the 49 North Resources conference in Manhattan, meeting with mining companies and gathering intelligence. I heard mining strategist Christopher Ecclestone give a talk titled “A Mining Supercycle?”

I thought to myself: “Of course, he’ll say we’re in a mining supercycle and how wonderful mining is. I’m at a mining conference, for crying out loud, surrounded by mining companies and geologists. To expect otherwise is like walking into a Star Trek convention expecting to hear a guy talk about how dumb the whole show was.”

Yet he surprised me. He said no, this isn’t a mining supercycle. In fact, he turned the idea on its head. What he said folds neatly into our world right side up idea.

As you know, commodities have been going up in recent years, everything from copper to coal. It’s getting harder to find big deposits of some of this stuff, and what we find is more expensive to dig out.

The Chinese get what’s going on. They are securing supplies of those key resources of which they consume so much. So they’re making deals with Brazil, all over Africa, and in a bunch of other places.

Ecclestone had a good line about the Chinese. He said they are more interested in natural resources than they are in intellectual property “because they know they can rip those off. It’s harder to rip off a coal mine.”

But Ecclestone’s main point is that what we’re seeing isn’t anything new. It’s not a new supercycle for mining. It’s a return to normal. The aberration,

he said, was the period from 1973 to 2003, when mining experienced its dark age.

The aberration was the kind of thinking that took natural resources for granted. “Metals and agricultural commodities were the epitome of cheap—regarded with some contempt as common and plentiful,” he said. “The apogee of this disdain for minerals was during the tech boom.”

Then, an immaterial service-oriented company like Pets.com could command a market cap of billions of dollars. You could’ve bought any number of mining companies for a fraction of that. “Today, Pets.com has evaporated into thin air,” Ecclestone said, while the mines remain and are very valuable.

The 1973–2003 time frame “was a calamitous period for miners and commodity producers,” he continued. “The only commodity for which the sun shone was oil, and even then the late 1990s were gruesome.”

There was a brutal thinning of the herd of mining companies, particularly in the 1990s and particularly in the United States. During this time, we “lost” major mining companies—Anaconda, Kennecott Utah Corp., Magma Copper, Asarco, and many others. “And these were just the big ones,” Ecclestone added. The mid-size and smaller miners were almost wiped out. We saw the “virtual annihilation of the U.S.-listed mining sector.”

Metals became loss leaders. Capital spending fell. Exploration came to a near halt. Most of the mines in Africa closed. Miners also shut down many marginal or low-grade mines. Instead, they focused on the highest-grade ore, the low-hanging fruit of the mining world, just to stay alive.

Why did this happen?

Ecclestone cites a number of reasons that combined to create a kind of perfect storm. The postwar period created a proliferation of mega mines. China, too, became a low-cost producer of a number of metals. It has come to dominate certain sectors entirely (such as zinc and rare earths). Many mines in Africa and South America fell under state control. These states operated them without regard to economics. Later, the Soviet Union’s industrial base collapsed, releasing a lot more commodities on the market. And Cold War stockpiling of metals stopped and reversed, releasing even more supply on the market.

But Ecclestone says, we are returning to something that more closely approximates what prevailed for a much larger slice of history.

The normal state is one that understands and recognizes the value of mineral commodities. The normal state is one in which the producers of these useful rocks and metals earn rewards for the risk and ownership of scarce resources.

Today, no new mega mines exist. The stockpiles are dwindling. That low-hanging fruit is gone. Today, for example, copper miners have to dig

up 50 percent more rock than they did in 1994 to get the same amount of copper. And demand continues to grow apace.

An example of that demand is copper production going all the way back to 1900. Take a look at the nearby chart. Copper is not an exception. You can make the same point with any number of metals. “Where are the downturns in this?” Ecclestone asked showing a version of Figure 1.6. They are comparatively minor and short in a long climb upward. “There is no reason to think copper use shouldn’t go onward and upward.”

Far from being a special case or an outlier, the growing use of commodities looks normal against a long time series.

As commodities get more expensive, we’ll have to change how we use and apply them. “If a lot of commodities get too expensive, then you have replacement and rationing,” Ecclestone said. We could see this soon, as commodities price themselves out of some markets. Boeing opened a window into this future with its announcement that it is considering making the 737—the most widely flown commercial jet—out of plastic.

Ecclestone predicts that when it comes to some metals (lead, for example), recycling will largely replace the need for mining. “In rare earths,” Ecclestone offered by way of example, “there is little recycling, but there will be more recycling soon.”

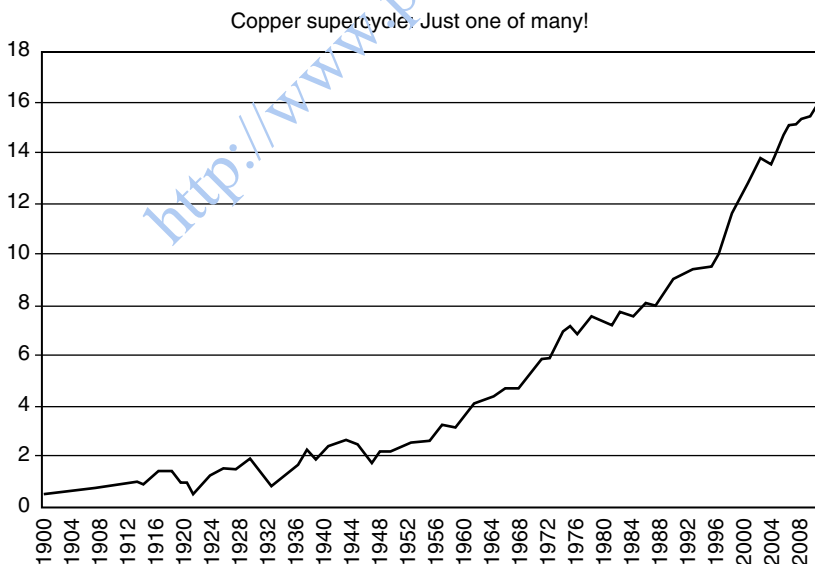


FIGURE 1.6 Find the Downturn

Source: Christopher Ecclestone.

Many interesting investment ideas spin off these last few paragraphs that are not necessarily mining related, but more about specialty materials and getting more out of what we have. A key investing theme for the next decade is how to make materials that make things more efficient, better, and/or longer lasting. There will be many such opportunities.

Even so, the business of mining will remain vital for many commodities. Ecclestone summed up: “[What we are seeing] is a reversal of the late 20th-century trend, which gave all the value to the service and intellectual property. . . . The whip hand is back with the owners of the inputs.”

Our present age is not so much a new era as a return to a more historical norm. Another way to see this is to look at trade.

World’s Economy Is Bigger—and More Open—Than Ever Before

In a little white-walled Spanish-style cottage overlooking a spectacular beach in Nicaragua, I presented to a small group of investors. I shocked them by saying this: The world’s economy is twice the size it was a decade ago.

Think about that. Despite all the bad stuff that has gone down in recent years—including a big financial crisis and the ensuing recession—the global economy is nearly double what it was only 10 years ago!

Living in the United States (or Europe or Japan), one might wonder how that could be. Obviously, these economies didn’t grow that much. Instead, most of the action is beyond the borders of these mature economies, which has a lot to do with why I was in Nicaragua in the first place.

We live during a time that future historians will cite as a hinge in the history of markets. For the first time since before the Industrial Revolution, the so-called emerging markets will be bigger than the Western countries (including Japan). This gap will widen as emerging markets continue to grow faster.

Global trade, too, is more important than ever. “The Super-Cycle Report” is a fascinating research piece put out by Standard Chartered. It shows us just how important global trade flows have become. In fact, global exports are nearly at their prerecession peaks.

Trade made the explosive growth in the world economy over the last 10 years possible. China goes nowhere without its ability to trade for commodities abroad, and Brazil goes nowhere without the ability to supply them.

Trade has been a fertilizing influence since time immemorial. Think of the camel trains laden with silk, indigo, and jewels, making their way across the land mass of Asia to the cities of the West in ancient times. Think of the old galleons under starry skies carrying spices and gold during the age of sail. What a different world it would be with closed borders.

Today, the world is more open than it has ever been. One way to see this is to look at exports as a percentage of the global economy. Today they are at all-time highs.

As an investor, it's been the right call to focus on companies that had exposure to rapidly growing markets overseas. This happy circumstance is something to keep an eye on because trade ebbs and flows. In 1945, for instance, trade was 40 percent below the level of 1913. How did that happen? Let us count the ways: two world wars, the fall of the Austro-Hungarian and Ottoman empires, hyperinflation in Germany, the Great Depression, and the demise of the gold standard. It was a tough 30 years.

The emerging markets still have a lot of catching up to do, which should power expanding trade for years to come. Standard Chartered points out that China's per capita income is still only 9 percent of the United States', or about where the United States was in 1878. If it were to get to half of the United States' total, China's economy would be twice the size of the United States'. Then consider Indonesia—the world's fourth most populous country. It has a per capita income only two-thirds that of China.

Don't underestimate the ability of a poor country to grow very rapidly for a long time under the power of open markets. The authors of the report note: "Since 1945, every country recognized for outstandingly rapid development has achieved 7 percent growth for twenty-five years or more, including China, Hong Kong, Indonesia, Japan, Korea, Malaysia, Singapore, and Thailand."

There are new contenders for the years ahead. Standard Chartered created a "Seven Percent Club." These are countries it estimates will grow 7 percent a year over the next 10 years—doubling in size. These happen to include almost half of the world's population. They are China, India, Indonesia, Bangladesh, Nigeria, Vietnam, Ethiopia, Tanzania, Uganda, and Mozambique. Others that ought to grow fast but will likely fall short of the 7 percent mark include Russia, Brazil, Pakistan, Mexico, the Philippines, Egypt, Turkey, and Korea.

Plenty of rich patches of Earth still exist where the pixie dust of the Industrial Revolution never fell or never really got to do its thing. China was, by far, the world's largest economy until the nineteenth century. It was left behind thereafter but is catching up again.

One of the effects of this second Industrial Revolution is that more and more people live in cities. By 2030, the authors of the report guess that 60 percent of the world's population will be urban dwellers, compared with only 29 percent in 1950.

"Historically, commodity consumption has significantly increased as annual per capita income approaches a level deemed 'middle class,'" the authors continue. "The next 20 years will bring an unprecedented increase in the number of people living in cities (close to 5 billion people will live in

cities by 2030, compared with 3.4 billion). . . . [with] an equally significant increase in the size of the global middle class (from 1.8 billion in 2009 to about 5 billion in 2030)."

As an investor, your mouth should be watering. Think of what so many new consumers mean for businesses ranging from beer brewers to financial services companies. Consumers will use more stuff, eat more food, and use more water. They will buy more TVs, laptops, motorcycles, cars, and mobile phones.

The Old Silk Road and the New

To follow the Silk Road is to follow a ghost. It flows through the heart of Asia, but it has officially vanished. . . .

—Colin Thubron, *Shadow of the Silk Road*

A powerful metaphor that describes what is going on is the Silk Road. Its ghostly trade routes are reawakening.

The old Silk Road was not even a road in the normal sense of that term. It was, as travel writer Colin Thubron describes it, "a shifting fretwork of arteries and veins, laid to the Mediterranean." Thubron covered 7,000 miles in eight months following the old trails of this fabled trade route.

The Silk Road stretched from Antioch, Turkey, all the way to old Chang'an, or what is today known as Xi'an, in China. For a long time, it had no name. A German geographer coined the term "Silk Road" in 1877.

Yet traffic along the Silk Road goes way back into the slipstream of humanity's past. Thubron writes: "Chinese silk from 1500 B.C. has turned up in tombs in north Afghanistan, and strands were discovered twisted into the hair of a tenth-century B.C. Egyptian mummy." Archeologists found silk dating from 1100 B.C. lying in the grave of a prince in Germany. The stuff got around.

The Silk Road carried much more than just silk across its rugged landscape. From China, the West got jade, lacquer, ceramics, the first roses, azaleas, as well as oranges, peaches, mulberries, apricots, and rhubarb. Coming from the West to the East came glass, gold, silver, Indian spices, gems, and linen along with fig trees, flax, pomegranates, jasmine, dates, and olives.

Back and forth went vegetables, fruits, furniture, artifacts of all kinds, musical instruments, even slaves and weapons. The crossbow, a Chinese invention, made its way across the old Silk Road to arm the Norman and Capetian kings in their battle with the dreaded English longbow at Crécy (in which they were famously defeated).

The old Silk Road embraced almost every national and ethnic group from Arabia to Japan, including Persians, Turks, Sogdians, Syrians, Indians,

and many others. (Often called the greatest Silk Road traders, the Sogdians were an Iranian people. The Chinese thought them born traders. Myth held that “their mothers fed them sugar to honey their voices, and their baby palms were daubed with paste to attract profitable things,” writes Thubron.)

None of them made the journey the whole way through. No Roman ever walked the streets of Xi’an or visited the tomb of the Yellow Emperor. No Chinese trader ever gazed upon the pillars of imperial Rome or dipped his toes in the Mediterranean Sea.

Instead, the Silk Road was more like a long relay race. Only luxury items could generally make the whole journey—the jade and the silk, for example—or perhaps incidental items people carried with them, like a flute or an old trader’s pipe. It was simply too expensive to ship most things the whole distance, except those things for which people were willing to pay a heavy price.

Still, the old Silk Road was the dominant trade route in human history for over a thousand years. Its importance diminished only sometime in the sixteenth century, when ships replaced the harrowing journey overland and transported goods much cheaper and faster.

There is a Silk Road revival, though, at least metaphorically. The old trading posts worked in storied cities such as Samarkand, Kashgar, and Meshed. The new Silk Road weaves through Dubai, Riyadh, through Mumbai and Chennai in India, to Kuala Lumpur, Singapore, Hong Kong—even as far as Tokyo.

Like the old Silk Road, the new one is not a road, either. But it’s a great way to describe the surge in trade between the Middle East and Asia. From 1995 to 2005, trade between these two regions increased fourfold, according to McKinsey & Co. Projections call for trade between the six members of the Gulf Cooperation Council (GCC)—Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates—and East Asia to explode from \$59 billion to \$300–500 billion by 2020.

Rapidly growing Asian economies have, at least in part, driven demand for oil. Higher oil prices in recent years mean overflowing GCC coffers. They need to put that treasure to work. More and more, it is winding up in Asia.

It’s a feedback loop. More growth in Asia means more demand for oil—with more and more coming from the Middle East. By 2030, estimates put half of China’s oil imports coming from the Middle East. Asia—including India—could account for half the increase in the world’s demand for oil. That means more cash for the GCC and more investment in Asia—in real estate development, banking, communications, and infrastructure.

In the meantime, Chinese, Indian, and other Asian companies are active in the Middle East. They bring low-cost consumer goods (Dubai is already home to Chinamexmart, which McKinsey describes as a

“mini-city of Chinese companies distributing their products throughout the region”). Asian companies also bid on major construction projects in the Middle East.

Travel traffic is a great barometer of economic activity. As late as 2000, there were only seven daily flights between the Gulf states and China. Today, there are over 50.

Thubron notes on his trip how the influence of the old Silk Road flowed into even remote hamlets. “The nervous system of the Silk Road radiated into the poorest extremities,” he writes. “It traversed minor ecological divides, as well as empires.”

One economist who has a lot of this figured out is Ben Simpfendorfer. His excellent study of this re-emergence of trade with the Arab world and China is *The New Silk Road: How a Rising Arab World Is Turning Away from the West and Rediscovering China*.

Simpfendorfer’s Arabic and Mandarin served him well in his 15 years traveling the New Silk Road from Beirut to Beijing. He got stories straight from individual traders and actual people.

I met up with Ben one day when he was in Washington, D.C., and we talked about the changing world, appropriately, at a fusion restaurant. We’ve since struck up a correspondence. (You can follow Ben’s adventures in his newsletter called *China Insider*.)

One of his most memorable meetings is with a wealthy Syrian trader in Damascus. They meet in a ramshackle 500-year-old office. “Wooden barrels filled with spices and sweets spill out into the streets,” he writes. “The air is rich with the scent of olive soap and musky perfume.” The stalls here have been hawking their wares for centuries, and today, more of these wares come from China.

He meets with other businesspeople in Yiwu, Cairo, Beijing, and many other cities, all offering human-level portraits of this New Silk Road. Change is happening at the grassroots level. “Who notices the activities of an Arab trader in Yiwu or a Chinese trader in Damascus?” he writes. “It isn’t obvious how their activities have a meaningful impact on life in America and Europe.” But this is how major changes begin, with smaller changes at the margin.

Dubai, for example, houses the Dragon Mart. It is the largest building to sell exclusively Chinese-made goods outside of China. It measures nearly 1.6 million square feet. And China seems to go out of its way to make Arabs feel at home in China, even using state money to build mosques. According to the book, the Chinese will issue visas for visiting Egyptians in 24 hours. It takes 18 days for an Egyptian to get one for America. This is just another among a string of many similar anecdotes.

In the bigger-picture sense, oil drives the strengthening of these ties. China needs lots of oil, and the Arab oil producers have it in spades. Arab

oil producers and Iran produce 30 percent of the world's oil; the IEA projects that number will rise to 38 percent by 2030. Much of it will wind up in China.

China flipped to becoming a net oil importer in 1993 and has never looked back. It is the world's fifth-largest producer of oil, but its ability to produce oil lags its own demand by a long way. It is the second-largest consumer of oil, behind only the United States.

Thanks to higher oil prices, the Arab oil producers have staggering amounts of wealth. The task of investing all of that money falls on the Arab wealth funds. These pools of money are market movers.

The Arab wealth funds are very active in non-U.S. markets. Their big purchases reveal a pattern: Djibouti, Guinea, Kenya, Malaysia, and Pakistan, for instance. Arab wealth funds are also active buyers of Chinese stocks.

On Monsoon Seas: A Glimpse of the Future

There's a second way to look at the New Silk Road: its maritime aspect. Here again, we see a revival of an old trading pattern with consequences for today.

The Indian Ocean is one of the world's great trading seas. It was the sea-way for the old windblown argosies laden in spices and silk and much more. Kuwaiti booms, double-ended dhows, little sambuks from the Red Sea, and many more vessels sailed these waters to trade along its rim.

If you ever want to learn more about this storied history, turn to Alan Villiers (1903–1982), a writer and adventurer from Melbourne, Australia, who traveled all around the Indian Ocean.

His dossier is extensive, with voyages up and down the Persian Gulf, the Red Sea, and along the coast of East Africa. A decorated officer in World War II, he oversaw landing craft in the Burma campaign, among other accomplishments. Over the years, he became quite a student of the Indian Ocean's history and geography. I have his 1952 book, *Monsoon Seas: The Story of the Indian Ocean*.

In it, he writes, "The Arab, the Indian, and the Chinese have been ubiquitous merchants and fearless wanderers far longer than it is possible to say." The monsoon seas were often cheaper and quicker and sometimes safer than overland, where you often had to pay tribute as you went. "The west winds could blow a square-rigged ship from Good Hope to Australia in three weeks and less" Villiers notes, "though the distance is 6,000 miles."

It was, in part, the rise of seaborne trade that doomed the old overland Silk Road.

Villiers also weaves in his own experiences with rich descriptions that stay with you. Zanzibar is where the "scent of cloves and . . . salted shark is

heavy in the air.” Mombasa is a “picturesque port, with the sweet smell of copra. . . .”

Maritime bottlenecks existed then, too. For example, the straits of Bab el-Mandeb, the so-called Gates of Affliction, narrow to only 15 miles. The straits were the key to controlling trade in the Red Sea and remain so today.

These waters remain as critically important a seaway as in Villier’s account. But the key commodity traded is oil. About 40 percent of all the trade between China and the Arab world is oil, which makes the strategic importance of this ocean once again very great.

“Asia’s is a largely maritime history, carried on the monsoon winds,” *The Economist* has noted. “Asia’s modern ‘miracle’—economies plugged into globalized networks of supply and demand—is essentially a littoral story too, even when it falters, as now.”

“Littoral” is an old word meaning “of, or pertaining to the shore”—in this case, the rim of the Indian Ocean. Examine a map and let your fingers run around the edges of the Indian Ocean. This littoral territory stretches from East Africa, around the Saudi peninsula, to India, Southeast Asia, and Australia.

Robert Kaplan wrote about its importance in a *Foreign Affairs* piece, later expanded into a book. He pushes us to shift our focus from the Atlantic and Pacific oceans—leftover thinking from the World War II era—to the world’s third largest body of water. “In what quarter of the Earth today can one best glimpse the future?” Kaplan asks. The answer is the Indian Ocean. He calls the monsoon seas a “vast web of energy trade.”

Global energy needs are set to double by 2030—which is not all that far away—and India and China will make up about half of that. They will import most of it. That means the importance of the monsoon seas will only grow over time.

Nearly 80 percent of the world’s crude oil that winds up in China crosses the vast Indian Ocean on its way through the narrow Strait of Malacca. China alone will import more than 7.3 million barrels a day over the next five years. That is half of Saudi Arabia’s planned output.

India will soon be the fourth-largest consumer of energy in the world, behind the United States, China, and Japan. By 2030, it will have the world’s largest population. It, too, depends on energy from faraway sources. India imports four-fifths of its oil, mostly from the Persian Gulf. India also ships coal from Mozambique, South Africa, Indonesia, and Australia. It imports liquefied natural gas (LNG) from Oman on the Arabian Peninsula and from Indonesia across the Bay of Bengal. All of this crosses the Indian Ocean.

The knitting between India and the six Arab states of the Gulf Cooperation Council (GCC) is tightening. Already, there are 3.5 million Indians working in the GCC. India has energy partners in the region, including Iran.

Iran recently began supplying India with LNG as part of a 25-year agreement signed in 2005.

China depends on Iran, too, which is currently its third-largest supplier of crude oil. Iran alone supplies 12 percent of total Chinese oil consumption. In exchange, China inked a deal to help Iran develop its massive South Pars natural gas field. As you can see, given the relations between the United States and Iran, the politics here can get complex.

Indeed, the importance of the monsoon seas extends beyond energy. It bleeds into the world of politics, as well. Tensions arise between China and India as they compete for mastery over the Indian Ocean. Kaplan writes: "As the competition between India and China suggests, the Indian Ocean is where global struggles will play out in the twenty-first century." These struggles will create dramatic changes, as they already have done.

There are parts of the littoral that Villiers would not recognize. When Villiers visited Kuwait in 1939, it had not yet discovered oil. "The oilmen were there," Villiers observes, "but they had as yet found nothing." He describes Kuwait as a "real Indian Ocean seaport of the old times." It was a city of some 70,000 people. It had no roads; the town was a sanded maze.

Today, there are 2.6 million people in Kuwait. Income per capita is over \$60,000 annually. This puts it in the top 10 richest countries on Earth. It has one of the fastest economic growth rates in the world.

Dubai, which Villiers refers to as the mere "roadstead Dubai," is one of the world's largest ports, handling cargo from Asia. It is building what will be the world's largest airport.

Trade and oil have remade the map. But this trend is the continuation of an old idea. The monsoon winds have been blowing for centuries. The countries on the Indian Ocean have been trading with each other since ancient times, and they will continue to do so in the future.

The investment implications of the monsoon sea serve as a strong backdrop for energy investing. In particular, for the crude oil these growing regions need. It's a glimpse into the future. More and more, this part of the world is going to have a bigger say in what that world looks like.

BRICs . . . Meet MENA

Change is like a pin to the balloons of conventional wisdom. Just when people settle into their views, here comes the pin. For instance, it's become widely accepted when talking about emerging economies to focus on the BRIC countries: Brazil, Russia, India, and China. But there is a very important region that gets lost in that discussion.

In fact, this region collectively has a bigger economy than Brazil, Russia, or India. In terms of growth, it is growing faster than any of these countries.

In terms of population, it's bigger than the United States and nearly as populous as the European Union. It holds 60 percent of the world's proven oil reserves and nearly half of its natural gas.

That last clue probably gives it away. I'm talking about the Middle East and North Africa, or MENA. Among its largest economies are Saudi Arabia and the United Arab Emirates.

MENA is one of the fastest-growing regions in the world. Over the past 50 years, its population has gone up more than fourfold. Over the next 30 years, MENA's population will grow more than 60 percent to nearly 700 million people. And the population is still young. The majority of the population is under 25 years old. That means old practices are changing, too.

Syria, for instance, has been a mercantile crossroads between East and West since its days as a link on the old Silk Road. The ancient city of Aleppo was a key stop along the old Silk Road. Even today, it still has the longest covered market in the Middle East—a souk seven miles long. There, you can find goods that take you back in history—soap made from olive oil or silk scarves and keffiyehs of a variety of colors. Head down an alleyway and find gold jewelry and stands of fresh pistachios and sacks of spices and more. Then there are the backstreets of hawkers with lamb—always plenty of lamb—and you smell the scents of lime, garlic, and mint.

Much else has changed. Today, for the first time in more than two decades, banks in Syria can set their own interest rates on loans and deposits. Today, you can change money on the street without the threat of a ball and chain winding up around your ankles.

The largest investor in the country is Haier, a Chinese company, which makes 50,000 washing machines and 50,000 microwave ovens in Syria every year. Another Chinese company, Sichuan Machinery Import & Export, built a \$180 million hydroelectric plant here. There are big real estate projects, including a \$300 million resort on the Syrian Mediterranean coast. Some 40,000 new hotel beds came online in the past few years, up from 48,000. Tourism is already 13 percent of the economy. Syria is basically following the “China model” of maintaining a closed political order but carving out free zones and allowing trade.

Of course, this isn't some Big Rock Candy Mountain. There are all kinds of problems in Syria and elsewhere, but I find the changes taking place so far absolutely remarkable. (As this book goes to press, Syria is in crisis. It remains to be seen how that will impact the economic liberalization documented here.)

Again, we've seen this movie before. Roger Owen wrote the classic study on the Middle East and its economies. His book, *The Middle East in the World Economy*, covers the period 1800–1914, a time of growth and transformation. More than a few points are similar today. Then, as the region experienced a huge population explosion. The Middle East's population

alone grew 300 percent. Then, as now, trade grew even faster under a more liberalized economic regime. The Middle East benefited from growing demand for agricultural goods from European markets. (Ironically, today, the Middle East is a key food importer.)

The takeaway here is that this other, non-BRIC growth engine creates new needs and new opportunities. We'll look at more at the GCC in the Dubai chapter, but for now, I want to leave you with this idea that old trade routes are once again reviving as the world turns right side up.

Snapshots on the Way to a World Right Side Up

In Tbilisi . . .

Travel writer Melik Kaylan wrote about visiting the Georgian capital of Tbilisi, on the eastern edge of Western Europe. He describes it as “improbably beautiful, a postcard-perfect lost kingdom set inside high hills surmounted by ancient forts and rock-steady 1,500-year-old Byzantine churches.”

He meets a young Tbilisian who manages the Georgian investments of an oil-rich Kazakh corporation. He writes this is all “part of a flow of wealth that represents the ancient Silk Road common market coming back to life, Kazakhstan being the new oil powerhouse of Central Asia.”

Kazakhstan is home to the Kashagan oil field, one of the largest discovered in the past 30 years. It will also be one of the most difficult to develop. Nonetheless, oil inspires booms and tickles the fortune-hunting bones. Prosperity in oil-rich Kazakhstan spills over and lends new life to old places in the region—like Tbilisi.

Not so long ago, nearby Azerbaijan, across the Caspian Sea from Kazakhstan, was a big oil producer. In 1901, more than half of the world's oil (about 11 million tons) came from relatively remote Azerbaijan, at the crossroads of Eastern Europe and western Asia. The Rothschilds and the Nobel brothers—including Alfred Nobel of Nobel Prize fame—made a fortune from the oil flowing out of Baku's fields in Azerbaijan.

On the road to Moscow . . .

“Now there are many roads, many cars. Supermarkets are coming. Electricity is coming. The Internet is coming. Credit cards are coming. Everything is becoming the same: Chinese goods and American freedom. Very cheap. Very easy.”

In the quote above, Russian author and hitchhiking icon Anton Krotov was responding to a pair of American journalists. They were feeling rather proud after hitchhiking across Russia. When he did it in the 1990s, getting across Siberia was difficult and dangerous. That was a real adventure. And Krotov has backpacked all over the big landmass of Asia.

The Trans-Siberian Highway, arguably the longest highway in the world stretches from Saint Petersburg to Vladivostok, a distance of over 6,000 miles. For the first time, it connected one half of Russia with the other by road. It's also opened up a sort of curious east-west trade route in all sorts of things, including cars.

Used cars come over from Japan and land in Vladivostok. Some entrepreneurial Russians called peregonchiks (movers) drive the cars from Vladivostok to Russia's big cities in the west. It takes about a week. They sell the cars, make a profit, and head east to do it all over again. One writer called it "a revamped Russian dream: Go east, young man. Then go west. Then east again. Then west again."

McKenzie Funk recently made the 6,000-plus-mile trek and wrote about his experiences in *National Geographic Adventure*. It's a great glimpse at globalization on the frontiers of Russia.

The highway has upped the flow of trade across Russia. It helps Russia bring more timber, oil, and minerals to a hungry outside world. A 2,580-mile-long pipeline parallels the highway for stretches and carries Russian oil to Asian and American buyers. There are plans for a natural gas pipeline that will cut across the Ukok Plateau like a scythe across the plains. "There are plans for new roads to the north and west," Funk writes, "and new oil wells in every direction."

The car trade is also booming. Ships leave Vladivostok with timber and come back with cars. The new prosperity helps business in lots of ways. Funk reports that Vladivostok is so full of tourists and traders from South Korea, Japan, and China it can be hard to find a hotel room. The towns along the road also enjoy a new prosperity.

Lake Baikal, the world's largest freshwater lake, has a new 270-mile stretch specially zoned for tourism. There are plans for golf courses, spas, five-star hotels, and more.

Russia's new middle class also wants to buy cars. Ownership in Russia is still below that of other developing countries. In Russia, about 200 out of every 1,000 people own a car. The ratio is over 500 out of every 1,000 people in Europe and about 800 in the United States.

Some might mourn the passing of Russia's wild frontier. But these changes are like burning charcoal. They can't be undone. Russians, enjoying the taste of this life, would seem unlikely to knuckle under and go backward. Strange things happen all the time, of course, but I'm betting Russia will stay in the big leagues as a rising economic powerhouse.

On the roads, rails, and pipelines crisscrossing Asia . . .

In the early 1900s, Sun Yat-sen called for a countrywide "reconstruction" in China to spur modernization. He wanted bridges and roads and railways. This led one American to say at the time: "The engineering societies of the world should make Dr. Sun their patron saint, because if he ever got in a

position where he could put his plans into effect, there would be work for engineers in China for the next 1,000 years.”

Today, you could think the same kind of thing, except your attention would focus not just on China, but on the great landmass of Asia and the activity along the so-called New Silk Road.

The Economist reports that “[Asia] is no longer mainly a coastline with strong trade links to the rest of the world. Now links across Asia matter just as much. Trade within the region is growing at roughly twice the pace of trade with the outside world.”

Hard to believe, but 20 years ago, China and India barely traded with each other. China is India’s biggest partner. Central Asia’s trade with China jumped from hardly anything in 1990 to grow more than 40-fold. And China is the biggest merchandise exporter to the Middle East.

Pipelines, roads, and railways are crisscrossing Asia, with more on the way. A new 4,400-mile pipeline carries gas from Turkmenistan to China. Russia and China have pipeline projects in the works. Iran and Pakistan are also building a pipeline, one that could, eventually, run all the way to China. There are many new road projects in the works throughout Central Asia and along the Mekong Delta. Railways push lines that may connect Singapore with south Germany.

Or in how the world spends its money . . .

Emerging market consumers are the dominant consumer group in the world, surpassing the United States. We’ve crossed an important threshold.

The next big consumer market to open up might be Indonesia. It has the world’s fourth-largest population, behind China, India, and the United States, with 240 million people. Ford recently opened its first dealership there. Honda says it can’t make motorcycles fast enough. And H.J. Heinz reports that Indonesia is a big part of why its Asia sales rose 40 percent one year.

Or from where the newest products will come . . .

These emerging markets are also becoming a source of innovative ideas. Fortune 500 companies are happy to set up brainy shops in emerging markets. They already have 98 R&D facilities in China and 63 in India. GE has a vast R&D facility in Bangalore, its biggest in the world. Cisco is spending a \$1 billion on a second HQ, also in Bangalore. Accenture has a quarter of its workforce in India. Microsoft’s biggest R&D center, outside of Redmond, is in Beijing.

They are enjoying tremendous success. For example, GE’s Bangalore laboratory invented a new hand-held electrocardiogram that sells for \$800, instead of the usual \$2,000. The cost per test is only \$1 per patient.

The Economist wrote that the emerging markets have become a “fizzing cocktail of creativity” and gave numerous examples. In Chennai, a Tata company created a water purifier that uses rice husks, a common waste

product. A family can enjoy bacteria-free water for the grand price of \$24. New filters every few months will cost \$4. It's cheap and portable and will make a big impact for the poor the world over, most of whom lack access to clean water.

Another Indian manufacturer concocted a \$70 fridge that runs on batteries! A Chinese company, Mindray, makes a lithium battery for \$12, compared with \$40 previously. Bharti Airtel, an Indian company, has the lowest cell phone fees in the world, two cents a minute and nationwide coverage.

One of the most astounding tales belongs to Devi Shetty. He is applying Henry Ford's assembly-line techniques to hospitals. Shetty's flagship hospital in Bangalore has 1,000 beds. (The average American hospital has only 160.) His team of 40-some cardiologists cranks out 600 operations a week. Open-heart surgery costs about \$2,000, compared with \$20,000–100,000 in an American hospital. Shetty and his team have performed tens of thousands of such operations with results as good as the best of American hospitals. Incredibly, these hospitals even make money. According to *The Economist*, "Dr Shetty's family-owned hospital group reports a 77 percent profit after taxes, compared with an average of 6.9 percent in American private hospitals."

The above is just a snippet of the mind bending changes taking place. As Marco Polo once said, "I have not told the half of what I saw."

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