

ALWAYS
SOMETHING
INTERESTING

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ASI Quick Links

HOW TO PROFIT FROM A BILLION NEW CONSUMERS

China's economic growth has been the prime factor driving the bull market in resources over the past decade. The results have been earth-shaking.

When, at the end of the 1970s, Deng Xiaoping proclaimed "to be rich is glorious," he set off the capitalist revolution that saw the economy grow tenfold and return China to the forefront of global economic powers. With 20% of the world's population, this economic growth would be staggering enough. But there is more going on here. Understanding what it is can mean substantial profits in your own portfolio.

As China's economy has grown, more people move to the cities, transforming the economy to an urban and industrialized one with a growing middle class. At this point, people start to want, and can afford, all the accoutrements of modern living that we take for granted. Automobiles take the place of bicycles. Beef takes the place of soy. Men acquire more than one suit of clothes and women more than one handbag. TVs, cell phones, and washing machines all become commonplace.

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More people with more income want more and better things. All this requires resources to manufacture. And with per-capita GDP about to move further upward, the potential demand for resources is about to explode.

Industrializing economies have typically followed a similar trajectory, slowly increasing consumption of resources until a critical “take-off” point is reached. When people start to enjoy excess income, above their most immediate and critical needs, resource consumption moves up correspondingly. It increases dramatically for a decade or so, until a plateau is reached. China is at that take-off level now. Over the next several years, China’s demand for resources will increase exponentially.

The patterns are remarkably similar across countries and across decades. It requires energy to make anything and lots of oil to run a modern economy. Though Japan and Korea developed decades apart, the pattern for each was similar. In Japan, per capital consumption of oil went from around 2 ½ bb/year at the beginning of the 1960s to 15 at the end of the decade. Oil consumption there has remained more or less at that level since. When Japan was at the take-off point, Korean consumption of oil was less than 1 barrel per person per year. Korea slowly moved up to just under 5 bb before the country hit that take-off point in the late 1980s, and again, within a decade, it was consuming a little over 15 barrels per person, where it still is today. This is a typical level of consumption for developed economies. (The U.S., with consumption of oil around 25 barrels per capita per year, is an outlier.)

Today, China consumes well under 2 bb per person, though that represents a steady increase since the early 1970s, at the onset of the modernization reforms of Deng Xiaoping. Already, China has moved from a country which produced sufficient energy for its needs to a significant importer of energy and coal.

This year China became the world’s number one



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consumer of oil, replacing the United States. Imagine the impact on global oil demand, oil resources, and the price of oil as China's 1.3 billion people start to move toward the developed countries' benchmark of 15 bb per person.

And don't forget, we are talking about per-capita numbers. China's population dwarfs that of Europe and the U.S. combined, so the potential for absolute growth in demand is truly mind-blowing. The impact on prices is clear: It will be catastrophic for many consumers, but highly rewarding for those who invest in mining companies today. Indeed, in research undertaken for just-published book on global resource markets (*Investing in Resources*, published by John Wiley, October 2010), I became daunted by the extent of the problems and their ramifications, both social and economic.

Again, think what increased income will mean for car ownership. Right now, in most industrialized countries, car-ownership stands at between 400 and 600 vehicles per 1,000 people. (The U.S., with nine cars for every 10 people, is once again a unique exception.) In China, there are fewer than 20 vehicles per 1,000 people. Many Chinese are eager to exchange their bicycles for automobiles – and more and more of them are able to do so.

As the number of cars in China moves toward the industrialized world average, the absolute number of automobiles will skyrocket. Anyone who has visited the country over the years will confirm that the number of cars there has been growing dramatically. Already, there are more cars purchased in China than in the United States. Ponder what that number of cars means for the demand for steel, aluminum, zinc, platinum, and so on, as well as the gasoline to power them.

This scenario is similar for any manner of goods, from houses to food. More, bigger, and better translates into a growing demand for resources across the board. It is

important to understand that this is a long-term phenomenon. Equally important, investors must realize that this is not a “one-off” situation and sell too soon. We are witnessing historic changes, not a normal economic cycle.

While the demand for resources has grown dramatically, and continues to do so, the supply side has not kept pace. The number of resource discoveries has not increased substantially over the past decade and is unlikely to do so in the next. Indeed, across the broad resource spectrum, it is becoming more difficult, more costly, and more time-consuming to find and develop new resources. It is not that the world is about to run out of resources, but we are not finding adequate deposits that are economically viable in politically friendly locations.

Take copper, for example. It is one of the industrialized world’s most critical components. Of the world’s top six copper producers, half have been producing for more than 70 years. More significant for the long term is that newer mines tend to be small. Old copper mines tend to experience lower grades, making them more expensive to mine, and they are more susceptible to problems leading to temporary supply disruptions. The average grade declines while costs go up.

The impact of dramatically higher demand and constrained supply on prices is easy to predict. For investors, it offers a once-in-a-generation opportunity for tremendous long-term profits. Rarely comes an opportunity so enormous yet so one-sided, so simple and so obvious that investors have time to get in, yet an opportunity investors can stay with for years. To paraphrase Winston Churchill in another context, we are only at the end of the beginning.

You should be exposed to this sector. It is difficult to make specific recommendations when prices change so dramatically and individual circumstances are different. I favor the junior and exploration companies since

rewards for companies that make discoveries can be phenomenal. But this can be a volatile area.

Better for most: stick with large companies, with solid balance sheets and without significant “warts”, companies such as Franco-Nevada, a gold, platinum and oil royalty company; Freeport Copper, the largest and best copper company in the world; BHP, broadly diversified Anglo-Australian miner; or Devon Energy, domestic oil and gas E&P company with low debt. These may not provide the most leveraged returns but they will ensure you are broadly exposed and will benefit handsomely as commodity prices rise over the years.

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Adrian Day is president of Adrian Day Asset Management, a firm offering separate account management in global and resource stocks. For more information about his services, [click here](#) to send him an email, write him at P.O. Box 6643, Annapolis, MD 21401, or call 410-224-2037, or visit <http://www.assetmanagement.adrianday.com/>. His new book, *Investing in Resources: How to Profit from the Outsized Potential and Avoid the Risks*, is available in better bookstores and on line. Or, for more information, [click here](#).

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