

# Spanning the Pacific

## Making Connections Across the U.S., China, and Latin America



**Prepared by**

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# Making Connections Across the U.S., China, and Latin America

Wells Fargo built its reputation over a century ago by connecting East and West across a young and growing nation. True to this heritage, today we aim to explore the connections between East and West, but this time on a global scale.

As we look around the Pacific, from Latin America to China and back home again, the U.S. economic recovery leads the way in many key respects and appears to be quickening its post-2008 pace. Meanwhile, China and Latin America face important challenges after a decade of rapid growth. Despite these differences, these three regions are increasingly connected.

China's economy now rivals the size of the U.S. economy. With economic reforms in China well underway, we expect this economic rivalry to grow in the coming decade and create new potential opportunities and risks. At the same time, trade ties among China, Latin America, and the United States continue to deepen, adding new dimensions for global investors.

Recently, Wells Fargo Investment Institute (WFII) strategists visited China and Chile. Based on what we learned during these visits along with our years of experience studying the global investment landscape, this report examines how we think current and expected future ties across China, Latin America, and the U.S. will create investment opportunities among these Pacific neighbors.



## Key Takeaways

- 1 Today, the U.S. economy leads the global economic expansion; we currently favor U.S. equities over bonds.
- 2 Chinese and Latin American economies face challenges but so far show encouraging reform progress. We remain neutral on their financial markets, meaning we think investors should maintain exposure to China and Latin America as part of a broadly diversified emerging-market position.
- 3 Beyond this year, we expect reform trends to create new opportunities in China and Latin America, and the ties between these regions and the United States may create broader global investment opportunities.
- 4 We recommend holding diversified commodity and emerging-market financial exposures as part of a long-term strategy in an effort to help smooth portfolio returns and take advantage of current and future opportunities.

## The U.S. Economy Has the Lead in 2015

We expect the U.S. economy to lead in economic and earnings growth amid a generally weak and uneven global economic expansion this year. The improving U.S. economic picture should lead the Federal Reserve (Fed) to begin taking interest rates gradually from near zero toward more normal levels, probably beginning by late summer. The good news is that the last two times interest rates began to rise (in 1994 and 2004), positive confidence, job growth, and other economic fundamentals continued to support the stock market for some time after rate hikes began. In our view, investors should overweight — or favor — equity sectors likely to benefit most from an expanding economy, such as Consumer Discretionary, Industrials, and Information Technology. Conversely, we suggest underweighting — or limiting exposure — to the Consumer Staples and Utilities sectors, which typically underperform when confidence and interest rates are rising.

Regarding fixed-income investments, the transition from zero to more normal interest rates in the U.S. has implications for short- and long-term maturities. Higher short-term rates could potentially provide meaningful low-risk returns for the first time since 2008. In longer maturities, we expect only modest increases in rates as the interest-rate curve flattens. The transition to higher interest rates could be a gradual one, and investors should balance credit and interest-rate risk to maintain performance and avoid overconcentration to any particular risk. A balanced portfolio should allow for investors to experience acceptable performance, limit risk, and adjust allocations for rising volatility as short-term rates rise.

### China's Reforms Advance

Elsewhere around the Pacific, China is realizing the past decade's drivers of economic growth now require reforms that are challenging for an economy of China's size. Following years of state-sponsored investment in construction and manufacturing, the government has instituted multi-year plans that aim to balance the economy between these sectors and the services sector. By consolidating construction and manufacturing, China may suffer a decline in real estate prices or other economic dislocations. The transition has proceeded relatively smoothly for two years but is not yet complete.

To offset such risks during the reform process, China has implemented stimulus programs, which have created some secondary effects. On a recent visit, for example, local market sources reminded us that the recent Chinese "A" shares rally has coincided with the new Stock Connect program and local investor exuberance over expected new monetary easing and government spending. If the stimulus ultimately is less than anticipated, however, investor disappointment could register in lower local share prices. To this point, the Fed's rate policy eventually may constrain China's scope for monetary stimulus. Once the Fed begins raising interest rates, Chinese authorities may feel less comfortable cutting their own rates without also widening the gap with U.S. rates and weakening the Chinese currency's value.

## Glossary

**Chinese "A" shares** are stocks of China-based companies that trade on Chinese stock exchanges. In general, these shares are available only for Chinese mainland citizens to purchase.

**Stock Connect** is a linking program that lets shares of certain big Chinese Shanghai-exchange-listed companies trade on the Hong Kong exchange, which is open to foreign investors.

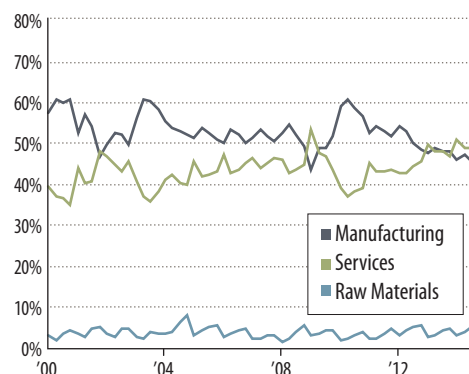
During our visit, we saw some early positive results of China's reforms that may help reduce the need for further economic stimulus. The country certainly has reduced its dependence on exports, which slowed from a 19.6 percent average annual growth pace between 2002-2013 to 9.7 percent in 2014.<sup>1</sup> More broadly, manufacturing and construction, sectors that once drove double-digit economic growth, are giving way to sectors such as mobile communication and services to accommodate changing consumption patterns and rising disposable incomes. In fact, the charts below illustrate that services now contribute more to China's economic growth than manufacturing and employment in the services sector created more jobs than manufacturing in 2013 (latest data available). Our visit reaffirmed our view that officials remain committed to their long-term vision while managing through short-to-medium-term economic adjustments. We therefore retain a balanced view of the risks and rewards of investing in China.

### Latin American Crosscurrents

We believe the current economic and policy trends in the U.S. and China create a balance of positive and negative effects on returns in Latin American markets. The U.S. economic dominance and prospects for rising rates boosted the dollar last year against most emerging-market currencies, a negative for investments denominated in non-U.S. currencies. Also, the strong dollar and China's moderating demand for some industrial commodities have undercut the prices of some key Latin American commodity exports, including copper, iron ore, and oil.

Commodity exports are likely to remain main drivers of the regional economies, but policy improvements of the past 20 years are lessening the economic impact of commodity price swings. Enhanced coordination between monetary and fiscal policies has dramatically lowered inflation and improved policy transparency in most Latin American countries. Also, Brazil, Mexico, and Chile have economic "rainy day" funds, which accumulate value when commodity prices are rising and are available to distribute earnings back into the economy when raw materials cheapen. These policies do not eliminate commodity price impacts but help lessen the economic boom-bust tendencies of the past.

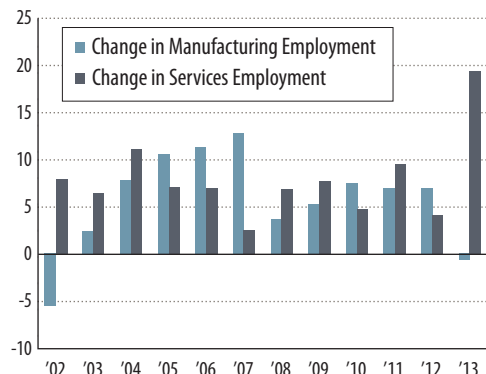
**Share of China's Economic Growth by Sector**  
Percent share of four-quarter gross domestic product growth



Sources: CEBM and Wells Fargo Investment Institute

Data sample, quarterly data, January 2000 – September 2014, as of January 13, 2015.

**China's Annual Change in Employment**  
Millions of people per year



Data sample, annual data, 2002 – 2013, as of January 13, 2015.

<sup>1</sup> Bloomberg from the China National Bureau of Statistics. Data as of January 23, 2015.



Rising U.S. rates also appear to pose a balanced set of outcomes for Latin American financial markets. On the one hand, if U.S. interest rates rise abruptly and sharply, some investors may reallocate capital out of Latin American markets and emerging markets generally. Alternatively, if the Fed normalizes policy gradually, as we expect, Latin American markets may continue to enjoy at least two advantages. First, ongoing low rates continue to allow companies and governments to refinance liabilities and finance infrastructure projects at historically low rates for the region. But low Latin American rates are still comparatively high yields for U.S. and European investors, who may continue to support Latin American financial markets and currencies, especially in Chile and Mexico. (Brazil is a notable exception, and we look for continued currency depreciation due to the government's relatively slow-paced reform program.)

Moreover, many Latin American economies are likely to benefit from the more benign influences of U.S. growth and Chinese economic restructuring. U.S. imports and Asian purchases of food (especially soybeans) have been resilient and may even increase as a result of lower food prices. Finally, energy prices at multi-year lows should reduce production costs for many firms and lift consumer confidence across the region this year. Overall, we look for Latin American 2015 economic growth to improve, and we see a balance between potential regional risks and rewards this year.

#### **Our Views on the U.S., China, and Latin America Within Our Overall Investment Strategy**

As we take a look at the U.S., China, and Latin America within a global strategy, we continue to favor stocks over bonds and cash and have chosen to overweight both U.S. and developed-market equities at the expense of their fixed-income counterparts. Within equities, we favor the U.S. markets. Developed markets should lag the U.S. but could produce solid gains if central banks around the world continue to augment their stimulative policies. Emerging markets probably will trail the U.S. and developed markets because of some combination of lower commodity prices and the strong U.S. dollar. Our neutral views on China and Latin America for 2015 imply keeping exposure to both as part of a broadly diversified position.

We recommend keeping some investments in emerging markets and commodities. As the impact of the 2008 crisis subsides, markets and asset classes are beginning to more closely follow historical trends. A well-diversified portfolio should help smooth returns. As well, we think today's reforms in emerging markets may well lead to future opportunities, which we address in the next section.

## Long-Term Perspective May Offer Broader Opportunities

Looking beyond 2015 into the coming decade, some developing trends look more positive for China and Latin America.

### China

If China's reforms improve efficiency, a slower economic pace may nevertheless expand the potential investment return opportunities. For example, increased competition and better service in its medical, agricultural, and financial services sectors may make these sectors more attractive. Greater efficiency could raise earnings, help sustain wages, and broaden China's middle class. Annual auto sales in China already exceed U.S. local sales, and this trend could continue for years, given that China has roughly 80 cars per 1,000 people, compared with 400 for the United States.<sup>2</sup> Food consumption is also likely to increase, and we foresee opportunities for modest gains in agricultural commodities.

### Proposed New Silk Road and Maritime Silk Road



Source: Wells Fargo Investment Institute

### What Was the Silk Road?

The original Silk Road, or Silk Route, extended 4,000 miles from Asia to Europe. The name was derived from the lucrative Chinese silk trade the road carried between the two continents. Its beginnings dated back to the Han dynasty (206BC – 220 AD); the road disintegrated during the mid-1400s. While it existed, it played a significant role in the development of the civilizations of China, India, Persia, Europe, and Arabia.

The news may also be good for industrial commodities exporters. China has a 2030 goal to create 10 urban centers, clusters of cities linked by infrastructure. China also has begun a new Silk Road (see map above), with branches heading toward Turkey and Germany. A maritime route anticipates new ports on the Indian Ocean and South China Sea and navigates to Africa and the Middle East. The Silk Road plan rekindles the vision of the medieval Chinese empire's grand East-West trade route. Some of these projects will be difficult to negotiate with neighboring countries that harbor some suspicions of the regional giant, but Beijing seems committed to establishing trade routes that directly access its trade partners.

Taken together, these plans would call for 70 new airports, tens of thousands of miles of additional roads and railroads, bridges, ports, and of course, schools, homes, and power and communication infrastructure. Even if not all the plans materialize, Asia's commodity consumption could still sustain positive returns to a broad commodity position.

China's ambitious building plans follow from designs for a larger international role. Beijing recently created the Asian Infrastructure Investment Bank (AIIB) to finance Asian projects that open new trade routes. The U.S. has sponsored competing plans,

<sup>2</sup> Bloomberg from China Automotive Information net, December 31, 2014. Comparison based on total passenger car and light truck registrations.

the Asia-Pacific Economic Cooperation (APEC) and the Trans-Pacific Partnership (TPP) to encourage pan-Pacific trade. These two rivals are keeping each other at a distance: China is not in the TPP; the U.S. is not in the AIIB. China may want to diversify its trade routes to mitigate the risk of a possible U.S. Navy blockade of the Strait of Malacca, through which much of its trade flows.

Another implication of a broader role is a currency strong enough to trade internationally. This encourages Chinese and regional corporate and government borrowers to denominate debt in Chinese yuan. Toward the goal of an internationally traded currency, China intends to lift currency trading restrictions. A strong currency also cements cooperative trade arrangements with South Asia, to direct resources into China, as production and assembly functions increasingly move offshore.

How China develops its international role and its regional competition with the U.S. remains an open question. China's neighbors are cautious, accepting both Chinese and U.S. diplomatic and economic ties to play it safe. Some of the uncertainty surrounds whether China demonstrates good intentions in its interactions with other countries in the region. For the past several years, China and its neighbors have all asserted competing claims over the energy resources situated at the bottom of the South and East China Seas.

### Latin America

Considering these evolving trends, we see improving long-term prospects for Latin America, based on government policies that improve transparency and growth, and in part on new potential opportunities created by China's development. For example, Latin America is well-placed to meet many of China's commodity needs in the years ahead. Over half of Chile's exports are copper, and Peru is another significant provider. We think China will continue to import heavily to provide the refrigerators, air conditioners, and homes that the country will need in the future.

Latin America is also an important food producer: Brazil is the world's largest producer of coffee and sugar and one of the largest in soybeans. Chile is well-known to U.S. consumers for its wines, fish, and especially fresh fruits and vegetables, which are available in U.S. supermarkets all winter. South America's climate is an advantage that makes produce available to northern-hemisphere consumers. Chile's produce exports to the United States have tripled in the past decade.

Commodity prices are variable, and Latin America may not escape its dependence on commodity exports, but policy improvements over the past 15 years should help smooth out the economic impact of commodity price swings. Chile, Mexico, and Brazil have flexible exchange rates, which allow gradual adjustments to price shocks. These countries have solid budgetary discipline, and they have sovereign wealth funds — rainy day funds that build up in good times and make money available to counter costs in bad times. They also have inflation targets, which offer transparency on monetary policy.

### Conclusion

From a practical standpoint, we think it unwise to liquidate emerging-market holdings and commodities and brush them off as today's most challenged markets. History suggests this period of reforms and drive toward greater efficiency can lay the groundwork for potentially better returns as fast-growing emerging markets find better avenues to channel their vast resources.

For this reason, we believe now is the time to maintain emerging-market allocations, while others may be overreacting to challenges that may be closer to an end than the beginning. Regarding China and Latin America specifically, potential risks and rewards seem balanced, and in our view they should be held as part of broadly diversified emerging-market positions.

## About the Authors



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Mr. Cronk is frequently featured in the media including *The Wall Street Journal*, *The New York Times*, *TheStreet*, *Dow Jones MarketWatch*, *Barron's*, the Associated Press, and Reuters, and makes regular appearances on Bloomberg, CNBC, and Fox Business News. He has authored numerous investment-related articles and regularly speaks at investment industry conferences.

With more than 20 years of experience in financial services, Mr. Cronk most recently served as deputy chief investment officer for Wells Fargo Private Bank. He has held a variety of positions at Wells Fargo, including regional chief investment officer, senior director of investments, regional investment manager, senior investment manager, equity analyst, and senior financial consultant. He began his career as a senior credit analyst for Norwest Bank, a Wells Fargo predecessor. He is based in New York City.



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Mr. Christopher focuses on the international economic outlook and offers investment advice on currencies and commodities. He is frequently quoted in the national media, including *The Wall Street Journal*, *The New York Times*, *Forbes*, *Time*, *Investor's Business Daily*, *USA Today*, Bloomberg News, ABC News, NBC News, and CNBC.

Prior to joining Wells Fargo, he developed economic strategies to trade in global financial and commodity futures markets for Eclipse Capital Management. In previous positions, Mr. Christopher supplied international economic perspectives for Wells Fargo predecessor A.G. Edwards, and advised institutional clients of Istanbul-based Global Securities on the oil-based economies of the Caucasus and Central Asia. He has consulted with the governments of Hong Kong, Egypt, Russia, Kazakhstan, and the Kyrgyz Republic on monetary policy issues. He is based in St. Louis, Missouri.



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In his current role, Mr. Lynch is responsible for developing global equity strategy and oversees proprietary equity strategies as well as the equity trading desk. He has represented Wells Fargo to the media on numerous occasions, providing insights and perspectives on the global markets. He has also written extensively about global issues and the implications on client portfolios, appearing in Bloomberg, *The Wall Street Journal*, *USA Today*, *Money*, and on CNBC.

Mr. Lynch has been with Wells Fargo for 17 years. Prior to his current role, he served as a global investment strategist for Wells Fargo Private Bank. He has traveled extensively internationally — from Asia to South America to Europe — to gather firsthand knowledge and information, and has shared his observations and perspectives with clients and team members. He has been in the investment management and trust industry for 24 years. Mr. Lynch is located in Omaha, Nebraska.

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