

The Long View

Investment Insights

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Reaching
for a
Better Life

Reaching for a Better Life

“Rising affluence in developing countries should be a durable trend that can not only continue for many decades, but underpin investment returns.”

Rob Lovelace, Portfolio Manager

Around the world, millions of people in developing countries have two things in common: They are reaching for a better life, and they want to keep things cold. As incomes rise in developing countries, one of the first things people buy is a refrigerator, the household appliance that for decades now has changed lives and transformed societies.

The evolution of a middle class in the developing world is now well documented. What may not be as well known is that there is a new chapter in the evolution of developing countries: The number of people in the upper-middle class – and even upper class – is beginning to rise. The human desire to reach for a better life is a powerful force that could have significant ramifications for the global economy and companies around the world.

In Asia, Latin America and other developing regions, people have moved from a bicycle to a scooter to, in some cases, a luxury car. They stock the fridge with better food and fine wine. They are not only taking their first plane ride, they are becoming frequent flyers.

Portfolio manager Rob Lovelace believes the trend has the potential to be one of the primary engines of global growth, but cautions that some developing countries will have to endure a difficult period of adjustment as their economies find new balance.

“In my view, rising affluence in developing countries should be a durable trend that

can not only continue for many decades, but also underpin investment returns,” Rob says.

Portfolio manager Christopher Thomsen says the evolution of consumers in developing countries, particularly Asia, can provide opportunities for investors. “Despite the recent economic slowdown in emerging markets, I continue to have strong conviction that the evolution of the middle class and structural growth of Asian consumption, driven partly by wage inflation and the transition to service economies, will remain one of the most important investment themes of this decade.”

Luxury goods from Europe and elsewhere are aspirational brands for some consumers in developing countries, many of whom have quickly become increasingly sophisticated and discerning. But the recent slowdown in consumption of luxury goods in developing countries demonstrates the need for ongoing fundamental research and insight into regional economies.

“Over the long term, the outlook for luxury goods spending remains strong given the cachet of these brands and the rising incomes of the middle class,” Chris says.

The changes present significant investment opportunities and represent a welcome direction in the standard of living in many countries. “In Asia, Latin America and elsewhere, millions of people are now beginning to have a lifestyle that not so long ago seemed unattainable,” says Rob.



Noriko Chen

Portfolio Manager

23 years of investment experience

A New Class of Consumers

During the next 10 years, developing countries are expected to add about a billion people to the middle class and beyond. These emerging economies will account for nearly half of total global consumption, or about \$30 trillion. I believe that is going to have a transformational impact on the world's economy.

This incredible transition will, of course, continue to benefit the many companies around the world that are already taking advantage of the growing need for goods and services in these countries. But it is also an opportunity for companies in developing markets.

Today, we are seeing more and more investable public companies that are leveraged to consumer growth in these emerging markets. Indeed, the number of companies in the MSCI Emerging Markets Index recently totaled more than 800.

Not long ago, investment opportunities in emerging markets were mostly limited to old economy sectors, such as large utilities. Now there is a greater breadth of companies, some with high quality management and strong products. Many of these companies present a significant opportunity for investors in countries playing an increasingly important role in the global economy.

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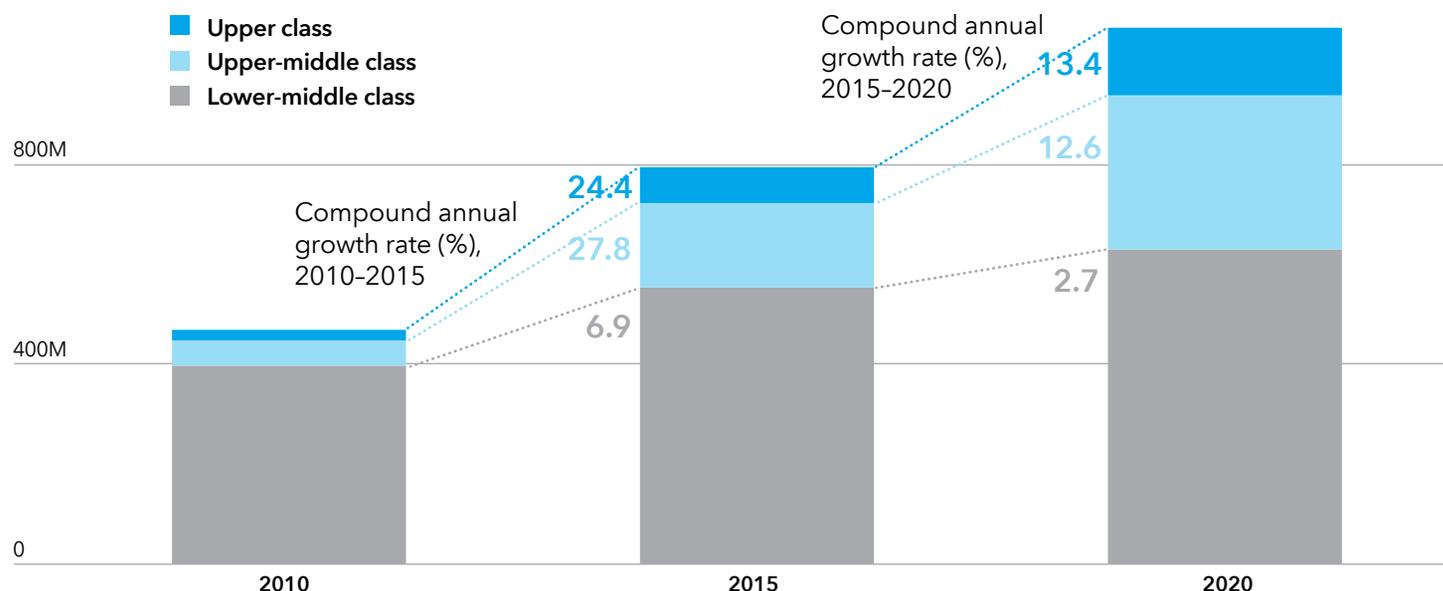
Moving On Up: The Upper Income Brackets Are Booming

The standard of living is on track to rise at a remarkable rate, and lift demand to a higher level

“I think what’s in front of us is the ongoing, steady increase in the wealth of the middle and upper classes around the world.”

Gregg Ireland, Portfolio Manager

1.2B Combined population of Brazil, Russia and China by income bracket



Source: Euromonitor International Ltd. The income brackets for the three classes are as follows: \$5,000-\$15,000 for lower-middle class, \$15,000-\$30,000 for upper-middle class and \$30,000+ for upper class. Data are as of December 2012. The income distribution data are the result of research into income and earnings from national statistical offices and central banks in major countries across the world. Three specific sources of income data from national sources – household surveys, national accounts and administrative records – were used to produce the income estimates. Gaps in time series were filled by means of estimation. Income distributions can change due to economic and demographic factors and government policies.

- A new wave is building in developing countries around the world. The first wave saw millions of people moving into the middle class and creating a consumer class with discretionary income. This remarkable demographic and economic transition is now entering a new phase, one that’s likely to shift the demand for goods and services from such basics as diapers and detergent to the finer things in life. Now, millions of people are moving into the upper-middle class, and even the upper class.
- Indeed, those income brackets are expected to be the fastest growing in many emerging markets during the next five years. By the end of the decade, about 440 million people are expected to achieve these income levels in Brazil, Russia and China alone. Rising living standards alter consumption patterns. A smaller percentage of income will be spent on necessities, and an increasing amount will be spent on affordable luxuries as people begin to enjoy a lifestyle that once seemed unattainable.
- Better health care and education are generally among the first priorities as populations get richer. Travel and leisure are also usually near the top of the list. For some, more money means a luxury automobile. For others, it’s a high-end handbag, or a prestigious wristwatch. This broad expansion of a consumer class with greater discretionary income represents a milestone in the evolution of emerging markets, and a significant opportunity for multinational companies and local businesses across a variety of industries.

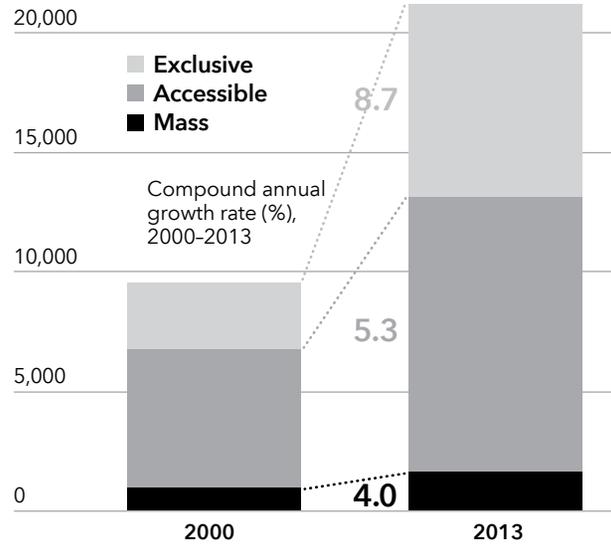
A New Wave of Watch Buyers Makes Up for Lost Time

As income rises, buyers tend to move from needs to wants to wishes

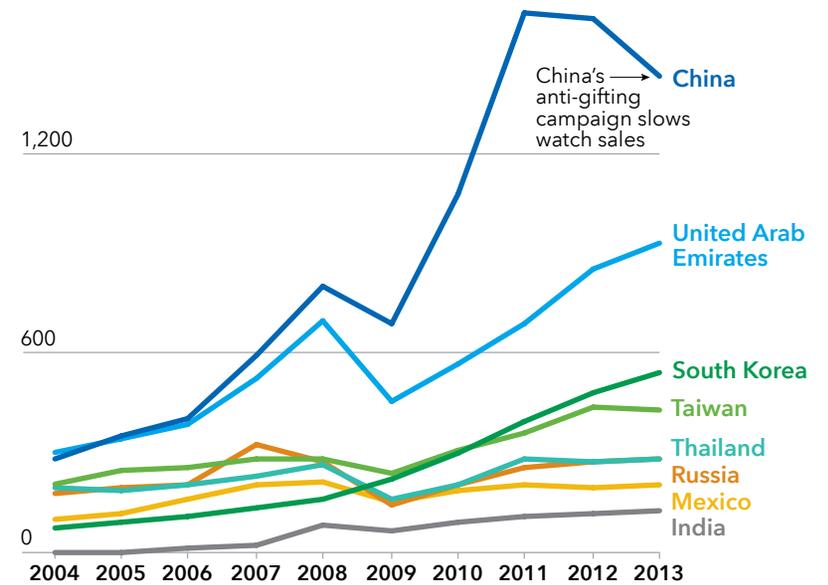
“There are opportunities to be found among makers of luxury goods that are able to cultivate brands that are coveted by the rising upper class. Those are companies that will benefit from the growing purchasing power of developing world consumers.”

Michael Thawley, International Advisor

25,000 Swiss watch exports by segment (CHF, millions)



1,800 Swiss watch exports by country (CHF, millions)



Sources: Federation of the Swiss Watch Industry FH. Data – measured in millions of CHF (Confoederatio Helvetica Franc), or Swiss francs – are based on foreign trade statistics prepared by the Federal Customs Administration. Swiss watch exports by segment represent global sales of exclusive (platinum and gold), accessible (silver, gold-plated, steel and gold-steel) and mass (other materials/metals) units.

- Finally, there’s money left over. In many developing countries, food and other basics are no longer consuming nearly every penny in the paycheck. Now, and increasingly so, there is money left over at the end of the month that can go toward the finer things in life, fun stuff like travel abroad, fine wine or a Swiss watch.
- The art of fine watchmaking continues to thrive in Switzerland, and a Swiss-made wristwatch remains an enduring symbol of precision engineering, beautifully displayed. For many generations, a Swiss watch has been a symbol of success and

stature. Now, as income levels rise in many developing countries, the allure of a fine timepiece seems to be alive and well. The Swatch Group, the company, often associated with the colorful plastic timepieces that were introduced in 1983, also owns such high-end brands as Omega, Blancpain, Breguet and about a dozen other brands, including Harry Winston. Although the growth of the luxury goods market has slowed recently, shoppers in developing countries have helped boost sales of watches at the higher end of the range.

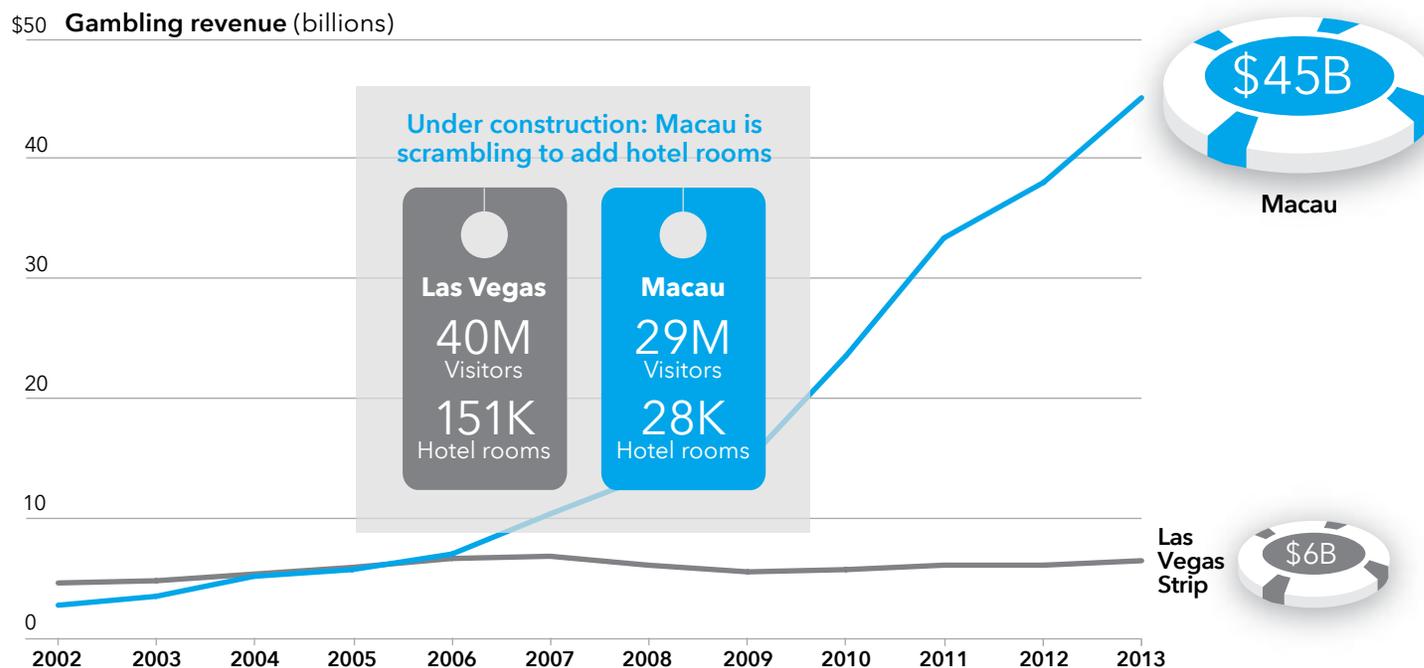
- In Peru, for example, spending in the category that includes watches increased 255% from 1995 to 2012. In India, the category is up 589% during the same time. In Lithuania, 272%.
- Luxury goods aren’t immune from the ebb and flow of the global economy, but luxury spending and the companies that provide such objects of desire seem a durable theme that has the potential to reward investors with a global perspective.

In This High Stakes Game, Macau Has a Big Stack of Chips

Some of the increase in disposable income seems to get left on the table

“The important factor to focus on is that the overall pie of gambling revenue in Macau is expected to grow at a mid-teens rate for the foreseeable future and, on top of that, the companies are starting to pay dividends with their substantial cash flow.”

Christopher Thomsen, Portfolio Manager



Sources: University of Nevada, Las Vegas, Center for Gaming Research (for gambling revenue); Las Vegas Convention and Visitors Authority, and Government of Macau Statistics and Census Service (for number of visitors and hotel rooms, as of 2013).

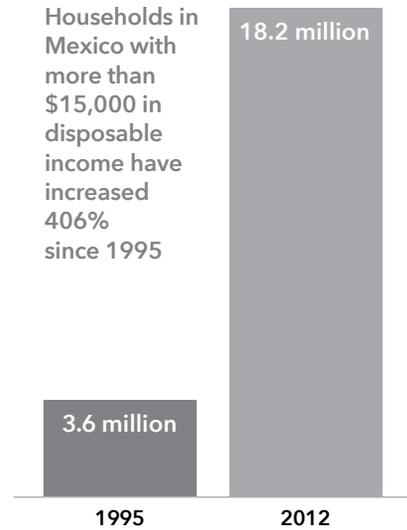
- What happens in Vegas ... is nothing compared to Macau. In 2013, Macau’s casinos generated seven times more gaming revenue than Las Vegas. In other words, it took Macau’s gamblers just one day to wager what’s bet in an entire week on the Las Vegas Strip.
- Macau is a tiny region located about 40 miles from Hong Kong that became a Chinese territory in 1999, when the Portuguese handed over sovereignty to China. Gambling has been legal in Macau for more than a century, but it was mostly a backwater operation with small, seedy casinos. Although gambling is part of the culture in China, the government prohibits casinos on the mainland. But it allowed the casinos to remain open in Macau making it the only place in China where gambling is legal. Until 2002, there was only one gaming concession, but that year the Chinese territory awarded six casino licenses. Among the recipients were Las Vegas Sands, Wynn Resorts and MGM Resorts, all of which benefit from the gaming boom through their Macau units.
- Gambling in Macau faces some hurdles. Revenue from high rollers, typically rich Chinese who are brought to Macau by middlemen known as junkets, has fallen due to Beijing’s crackdown on the practice. But plans are moving ahead to open perhaps eight new resorts over the next three years. Macau is also expected to benefit from the 2017 opening of a series of bridges and tunnels that will connect the gambling hub to Hong Kong, allowing visitors to fly into Hong Kong and drive to Macau rather than ferry across the Zhujiang River Estuary.

Made in Mexico, a Higher Standard of Living

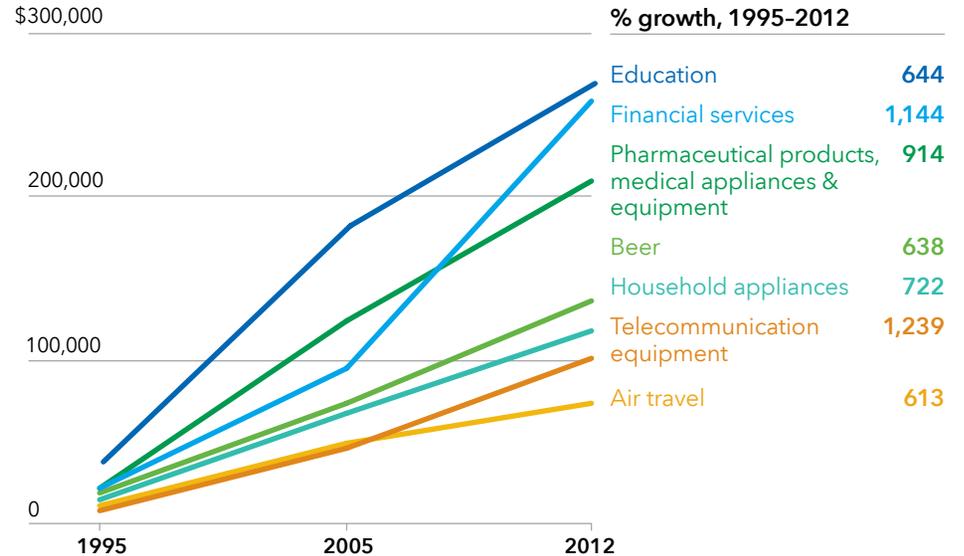
Consumer spending has surged, along with investments in the country

“I think you’re seeing some huge changes take place in Mexico – big supply-side changes. The standard of living is rising, and Mexico’s right next door to the U.S. and should benefit from that economic growth as well.”

Mark Denning, Portfolio Manager



Mexico: Consumer spending patterns at current prices (Mx\$, millions)



Source: Euromonitor International Ltd, *World Consumer Income and Expenditure Patterns 2014*. Households with more than \$15,000 in disposable income represent those households within the income bracket of \$15,001-\$55,000+.

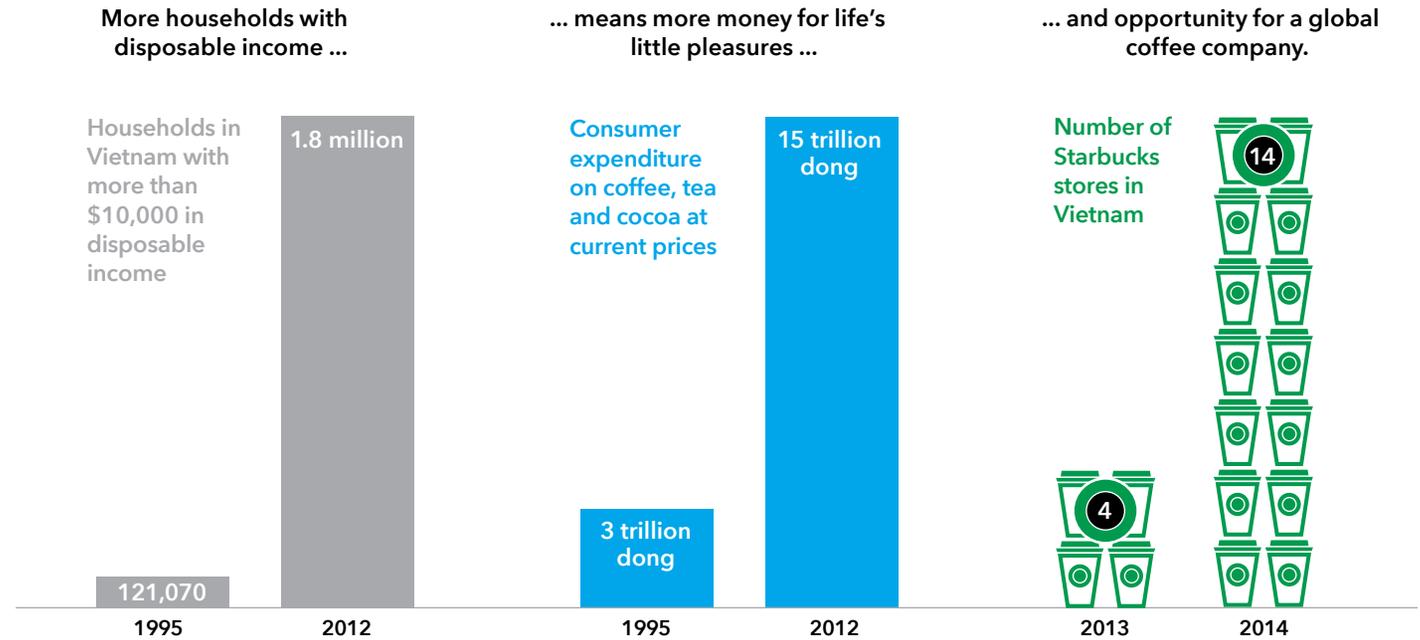
- For many, life in Mexico is nothing like it was 20 years ago. In 1995, only about 18% of the households had more than \$15,000 in disposable income. By 2012, that number had risen to 61%. That’s meant a better life for millions of people across the country.
- Where does the money go? The chart shows the increased spending for a variety of products. More broadly, spending on health care, housing, education and leisure and recreation all have increased more than 500% during that period.
- Mexico’s increasing purchasing power has been one of the elements of an economy that has the potential to be a major force in the long run.
- One of the drivers of growth is manufacturing. Many appliances are made in Mexico, and the country now rivals Brazil as the top Latin American automaker. Nissan, Honda and Mazda have invested a combined \$4 billion in Mexico, while Audi is building a \$1.3 billion plant, and BMW is set to invest \$1 billion in a plant to make 150,000 cars a year.
- Mexico’s proximity to the United States is also a boon. The country sends nearly 80% of its exports to the U.S., including many automobiles. Canada is another large destination for exports, and demand from China is increasing.
- The growth of disposable income is largely the result of a relatively robust economic expansion. As millions of people move into higher income brackets and make purchases aimed at improving the standard of living, the impact on the global economy could be significant.

Something New is Brewing in Hanoi's Coffee Culture – Starbucks®

As disposable income rises in Vietnam, a pricier cup of coffee becomes an affordable luxury

“One way of accessing the fast-emerging middle class in developing economies is by investing in the broad array of companies domiciled in the U.S. or Europe that are doing business in those countries.”

Nick Grace, Portfolio Manager



Sources: Euromonitor International Ltd, *World Consumer Income and Expenditure Patterns 2014*, and Starbucks Corporation. The number of Starbucks stores for 2014 is as of June 2014.

- In terms of news value, Starbucks opening a new store ranks right up there with dog bites man. But when the coffee giant recently opened three new stores in Hanoi, the capital of Vietnam and a city with a coffee culture dating back to the days of Dutch and French colonization, it seemed attention must be paid.
- Starbucks' first store in Hanoi is at the intersection of Hang Bai Street and Ly Thuong Kiet Street, one of the busiest business corners in the city. The store opened in July and two others soon followed.
- Starbucks is no stranger to Asia; the company has nearly 2,000 stores in China. But the company only recently entered Vietnam, where a rise in disposable income has created an opportunity for relatively expensive coffee. Starbucks' coffee, according to *The Wall Street Journal*, is priced slightly higher than most of its local competitors with prices ranging from \$1.65 to about \$5 a cup, depending on the drink size. A cup of traditional Vietnamese coffee at a local cafe usually costs less than \$1.
- But for an increasing number of people in Vietnam, that's a price they're willing and able to pay. Vietnam is one of many countries in Asia where economic development over the past decade has not only elevated many into the middle class, but beyond. Adjusted for inflation, disposable income has increased 149% since 1995. Spending on coffee and tea has increased nearly 400% during the same time. In addition to three stores in Hanoi, Starbucks also has eight coffee shops in Ho Chi Minh City.

Reaching for a Better Life

- A new chapter is being written in the evolution of developing countries – the upper income brackets are booming.
- Greater disposable income is boosting spending on goods and services from Swiss watches to health care.
- Global research and active management can help investors by identifying select companies poised to benefit from this new wave of consumer spending.

The statements in *The Long View* are the opinions and beliefs of the speaker expressed when the commentary was made and are not intended to represent that person's opinions and beliefs at any other time.



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