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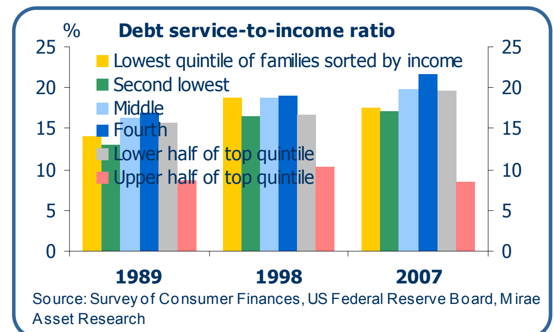
Michael Moore, Misrepresentation and Migrating Plutonomies: A Secret Memo

» **Our Plutonomy research is a "bad guy" in Michael Moore's new movie "*Capitalism: a Love Story*".** According to Moore, undoubtedly exercising liberties with the truth to inflate his polemics, our work on plutonomy at Citigroup was a "secret", "confidential" memo. Purportedly written for Citigroup's wealthiest investors in some sort of cabalistic celebration of income inequality, and pointing out that the lords of finance had better watch out lest the multitudinous many revolt with their vote. Claiming that we thought the US was no longer a democracy. Our reaction to this portrayal in the movie? Utter nonsense. It was a regular research report, available on the internet, covered by the media, and made no moral judgments.

» ***In the next year*, plutonomists, mainly finance industry types, should make a comeback.** Plutonomist consumption is a key driver of overall consumption, is exceptionally sensitive to stock/hedge fund returns, and is a likely driver of US economic recovery in the coming quarters. The top 1% of US households account for 23.5% of income, more than the combined amount of the bottom 60% (including capital gains) who have 21%. Focusing on overall high unemployment as a driver of consumption is a waste of time.

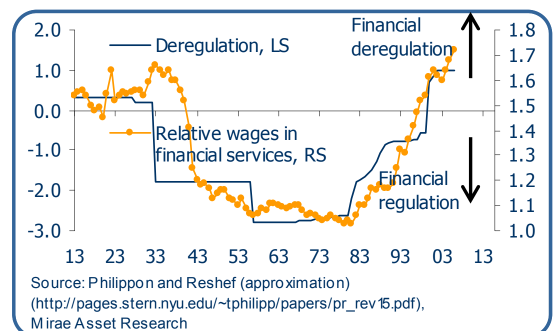
» **This was a plutonomist's recession, and likewise should be a plutonomist's recovery.** Consensus observers of the US consumer make two mistakes: they underestimate the dominance of the plutonomists in the economy, and also under-estimate the variability of their behavior (10x the bottom 80%). Instead, they focus on the "average US consumer", over-burdened by leverage and long housing. This was a useful description of the middle-class, but it does not have much impact on overall consumption data.

Plutonomists have low debt-service ratios.



Source: Survey of Consumer Finances, US Federal Reserve Board, Mirae Asset Research

Financial Deregulation (1982-2007) => complex products engineered by brainiacs => excessive compensation for Wall Street…



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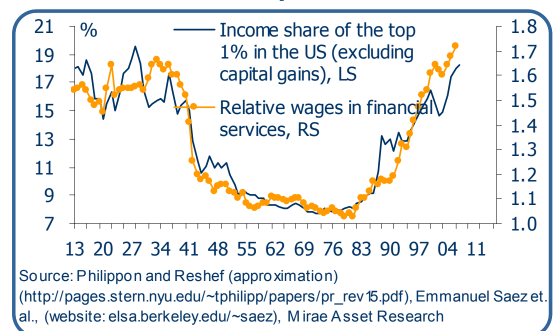
"Excessive" compensation in financial sector correlated with Plutonomy.



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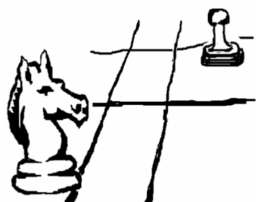

Global Equity Market Exposure Meter: Percent of equity portfolio we recommend that should be invested in equities; the balance in cash.

See the last page for important disclosures

» **Emerging Markets: The next Plutonomies.** The forces that drive plutonomies are gathering momentum in emerging markets even as they weaken in existing plutonomies (the US, UK, Canada, Australia). Global imbalances should diminish as a consequence. In addition, emerging markets have rising Demi-Ashton ratios (the ratio of people in their 40s to those in their 20s) and low leverage ratios, the starting point that should support asset and ego inflation. A reverse brain drain of high dopamine emigrants, increased global connectivity, more military spending which is the key to innovation, respect for the Rule of Law (not the Rule of Man), patent protection, and greater financial deregulation, should all conspire to generate emerging market plutonomies. Wealth managers should set up shop in emerging markets to mine this trend.

» **Buy the ROB ETF: A luxury goods/plutonomy basket.** Plutonomy stocks (PPR, Coach, Tiffany, Burberry etc.) have doubled since the March lows, and should now be seen as emerging market plays and still be bought. They remain undervalued at a PB of 1.8X.

Our Plutonomy research is a "bad guy" in Michael Moore's new movie "*Capitalism: a Love Story*"

It is not often that a research report gets to be one of the bad guys in a movie. We were surprised when some of our friends in the US alerted us that our research work on "plutonomy"[1] in our Citigroup days was featured in Michael Moore's latest film, *Capitalism: A Love Story*. (*The Daily Beast*[2] and *Huffington Post*[3]). The movie has not been released here in Hong Kong, China (where capitalism seems to be working fine), but our moles in the US have seen it. According to Moore, undoubtedly exercising liberties with the truth to inflate his polemics, our work on plutonomy was a "secret", "confidential" memo. Purportedly written for Citigroup's wealthiest investors in some sort of cabalistic celebration of income inequality, and pointing out that the lords of finance had better watch out lest the multitudinous many revolt with their vote. He claims that we said that the US was no longer a democracy. Our reaction to this portrayal in the movie? Utter nonsense.

While we respect the shock value of such assertions, admire the sheer salaciousness of such misrepresentation, and might have done the same thing in our pro-revolution, anti-authority university days, we feel compelled to come clean with the facts. More importantly, we think this is a good opportunity to write this "secret" memo updating you on where plutonomy is headed. This "secret memo" is addressed to co-conspirators, investors (even those investing the proletariat's pensions), random secret society members and cunning capitalists. Just remember the secret handshake and code to access the key points, and don't "leak" the report to Michael Moore.

In this report, we assert that:

1) *Next year*, plutonomists, mainly finance industry types, should make a comeback. Global imbalances, which were narrowing as a consequence of plutonomists in English-speaking countries curbing consumption and raising precautionary savings, are likely to widen again. Plutonomist consumption is a key driver of overall consumption and is exceptionally sensitive to stock/hedge fund returns, and is a likely driver of US economic recovery in the coming quarters. Focusing on overall high unemployment as a driver of consumption is a waste of time.

2) *In the longer term*, the plutonomies in the English-speaking world face multiple threats, and despite a strong expected pushback from entrenched plutonomists, the tide has turned.

3) *In the next decade*, emerging markets are highly likely to turn into plutonomies, along with their projected strong economic growth. The forces that drive plutonomies are gathering momentum in emerging markets. In addition, emerging markets have rising Demi-Ashton ratios (the ratio of people in their 40s to those in their 20s) and low leverage ratios, the starting point that should support asset and ego inflation. A reverse brain drain of high dopamine emigrants, increased global connectivity, more military spending which is the key to innovation, respect for the Rule of Law (not the Rule of Man), patent protection, and greater financial

[1] Plutonomy is a word we invented. It refers to economies that are powered by and largely consumed by the wealthy few. Plutonomies emerge and are driven by disruptive productivity gains, financial innovation, capitalist-friendly governments, overseas conquests and dopamine-heavy immigrants, the rule of law, patent protection, and great complexity exploited by the wealthy of the time. Currently, the US, the UK, Canada and Australia are good examples.
[2] http://www.thedailybeast.com/blogs-and-stories/2009-09-22/the-best-scenes-from-michael-moores-new-movie/full/
[3] http://www.huffingtonpost.com/arianna-huffington/barack-obama-must-see-mic_b_293407.html

deregulation, should all conspire to generate emerging market plutonomies. Wealth managers should set up shop in emerging markets to mine this trend.

4) *In the next decade*, the morphing of emerging markets into plutonomies as the existing over-consuming plutonomies of the US, UK, Australia, etc. become less unequal, should lead to a welcome reduction in global imbalances. The emerging markets (especially their emerging plutonomists) will likely discover the joys of asset-inflation driven consumption, preferably imported baubles and toys from the West. Emerging market luxury property is likely to get even more expensive. Lack of self-control is not the sole prerogative of the West – the US consumer/plutonomist does not have the monopoly on super-sizing consumption.

5) Plutonomy stocks (PPR, Coach, Tiffany, Burberry etc.) have doubled since the March lows, and should now be seen as emerging market plays and still be bought. They remain undervalued. Details on page 19.

Also, we update income inequality data from the masterful work of Emmanuel Saez, et. al., recently released[4].

Before we delve into the details, allow us a few lines on the Michael Moore misrepresentation of our earlier work on plutonomy at Citigroup. First, these were regular research reports that we wrote as the Global Equity Strategy team at Citigroup. They were not meant for internal/senior management or the "wealthiest investors", but for wide distribution to institutional investors and Smith Barney retail investors. It was not "an internal memo that sounded notes of triumph rather than concern", as Tina Brown of The Daily Beast describes in her interview with Michael Moore. Come on Ms. Brown, we are fans of your fantastic website (Thedailybeast.com), but some fact-checking was in order. The same goes for Arianna Huffington, whose website is also bookmarked on my computer, who should have done a fact check. For "secret" memos, the three plutonomy reports were/are easily available on the internet (just google "plutonomy"). Additionally, Barron's magazine, no complier of secret memos, but probably the most respected financial weekly in the world, wrote a cover story in early 2007 on the subject[5]. Also there was wide coverage by other financial and mainstream media outlets through 2007.

Second, Michael Moore conveniently ignored our caveat in the report "We should at this point make clear that we have no view on whether plutonomies are good or bad, our analysis here is based on the facts, not what we want society to look like", page 23 of The Global Investigator: *Plutonomy: Buying Luxury, Explaining Global Imbalances*, Citigroup, October 2005 [6]. We were simply describing the world as it looked to us based on the facts, and the investment implications that followed when viewing the world through the prism of plutonomy. We were doing our jobs as analysts.

Third, as analysts, we were/are obliged to outline risks to any investment views and theses. We highlighted the obvious risks to plutonomy: a labor backlash translating

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[4] Emmanuel Saez et. al., September 2009,
Top Incomes in the Long Run of History,
http://elsa.berkeley.edu/~saez/atkinson-piketty-saezJEL09_1stsubmission.pdf
[5] *Rich America, Poor America, Barron's cover page story*, 22nd January 2007,
http://online.barrons.com/article/SB116925431137882208.html
[6] *Plutonomy : Buying Luxury, Explaining Global Imbalances,* 16th October 2005,
http://www.scribd.com/doc/6674234/Citigroup-Oct-16-2005-Plutonomy-Report-Part-1
Revisiting Plutonomy: The Rich Getting Richer, 5th March 2006,
http://www.scribd.com/doc/6674229/Citigroup-Mar-5-2006-Plutonomy-Report-Part-2
The Plutonomy Symposium — Rising Tides Lifting Yachts, 29th September 2006,
http://www.borsaitaliana.it/bitApp/view.bit?target=StudiDownloadFree&filename=pdf%2F52716.pdf&lang=it

into protectionism or anti-immigration policies, an increasing obsession with financial speculation sucking up productive resources and diluting competitive advantage, a political backlash, war or inflation, financial collapse, and the end of the technology revolution. I quote from the 2005 report "Could the plutonomies die because the dream is dead, because enough of society does not believe they can participate? The answer is of course yes. But we suspect this is a threat more clearly felt during recessions, and periods of falling wealth …there are signs around the world that society is unhappy with plutonomy – judging by how tight electoral races are". This was simply a regular risk analysis in a Wall Street research report, not a threat analysis commissioned for imaginary Gordon Gekko, suspender-wearing, Citigroup senior management or Citigroup's "wealthiest investors". But that version makes good populist cinema, we understand.

Fourth, when I did present the plutonomy thesis to internal senior managers at a regular monthly ideas meeting, as I would present any regular equity strategy research, the thesis was considered too out-of-the-box. Seriously. Far from this being some celebratory "secret" memo prepared by and for Wall Street fat cats, it was a research report for EXTERNAL clients, most of them responsible for managing pension plans and mutual funds for regular folks. Senior management at Citigroup thought it was a provocative thesis and respected my research independence.

The Plutonomist's short-term comeback: Driving US/UK consumption recovery

One of the key insights of plutonomy is that there is no such animal as the "average consumer". The top 1% of US households account for 23.5% of income, more than the combined amount of the bottom 60% (including capital gains). The top 10% account for 47% (including capital gains) of the economy. See Figure 1. They control a disproportionate amount of the economy, and are very long equities and equity-linked assets like hedge funds. Property is not a big chunk of their assets. They have low leverage levels. See Figure 2.

Not only do they dominate the economy, their spending behavior is a lot more volatile than the Average Joe's. On the way up and down, their behavior is considerably more bouncy than the overall economy.[7] "The growth rate of those in the top ten percent of households in the distribution of consumption typically changes by 5%, while the change in the growth rate of the bottom 80% is only about a half percent" (page 4, from the Parker and Jorgensen paper). In other words, spending volatility for the top 10% is 10 times that of the bottom 80%. A plutonomist basket of stocks has much greater sales volatility, compared with a "Regular Joe" basket of stocks. See Figure 3. For plutonomy stocks, we simply take the constituents of the Claymore/Robb Report Global Luxury Index ETF (ROB), equal-weight them, and construct an index with a long history.

The consumption volatility of plutonomists, combined with their overwhelming share in the economy make their spending decisions dominate national spending (and saving) data. This recession was a plutonomist-driven recession. Battered by plunging equity markets, loss of job security in the financial sector and low bonuses, their overall consumption dropped sharply and precautionary savings rose. Their behavior drove the national savings rate up, consumption down.

[7] Parker and Jorgensen, January 2009, *Who Bears Aggregate Fluctuations and How?* http://www.kellogg.northwestern.edu/faculty/parker/htm/research/Parker%20VissingJorgensen%202009.pdf

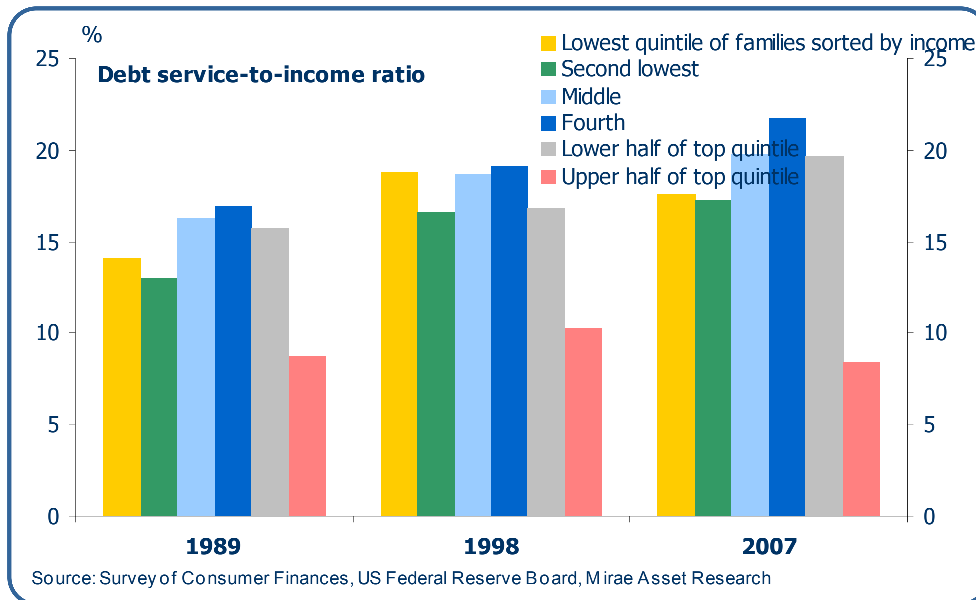
Figure 1: The US Plutonomy – the top 10% account for about half of income, 60% of net worth.

Percentile of income	1989	1992	1995	1998	2001	2004	2007
	Mean Income in thousands of 2007 dollars						
Top 10%	273.6	217.6	237.0	279.5	354.1	331.9	397.7
Next 10%	98.4	92.9	94.1	101.3	114.7	117.0	116.0
Next 20%	65.8	62.6	62.6	69.1	76.2	76.0	76.6
Next 20%	41.7	39.3	40.7	43.3	47.1	47.7	47.3
Bottom 40%	16.6	16.3	16.4	17.9	20.0	20.3	20.3
	Share						
Top 10%	42%	38%	39%	41%	45%	43%	47%
Next 10%	15%	16%	16%	15%	14%	15%	14%
Next 20%	20%	22%	21%	20%	19%	20%	18%
Next 20%	13%	14%	13%	13%	12%	12%	11%
Bottom 40%	10%	11%	11%	11%	10%	10%	10%
Percentile of income	Mean Net Worth in thousands of 2007 dollars						
Top 10%	1,579.6	1,390.0	1,469.3	1,970.1	2,647.5	2,783.7	3,306.0
Next 10%	358.0	326.2	347.9	414.1	534.8	535.3	606.3
Next 20%	218.9	203.6	218.0	261.7	344.0	374.3	375.1
Next 20%	163.1	146.4	138.3	161.0	190.3	213.7	209.9
Bottom 40%	72.8	70.3	83.5	91.6	98.3	106.6	120.1
	Share						
Top 10%	53%	52%	51%	55%	57%	57%	59%
Next 10%	12%	12%	12%	12%	12%	11%	11%
Next 20%	15%	15%	15%	15%	15%	15%	13%
Next 20%	11%	11%	10%	9%	8%	9%	8%
Bottom 40%	10%	10%	12%	10%	8%	9%	9%
Percentile of income	Net Worth to Income Ratios						
Top 10%	5.8	6.4	6.2	7.0	7.5	8.4	8.3
Next 10%	3.6	3.5	3.7	4.1	4.7	4.6	5.2
Next 20%	3.3	3.3	3.5	3.8	4.5	4.9	4.9
Next 20%	3.9	3.7	3.4	3.7	4.0	4.5	4.4
Bottom 40%	4.4	4.3	5.1	5.1	4.9	5.3	5.9

Source: Survey of Consumer Finances, US Federal Reserve Board, Mirae Asset Research

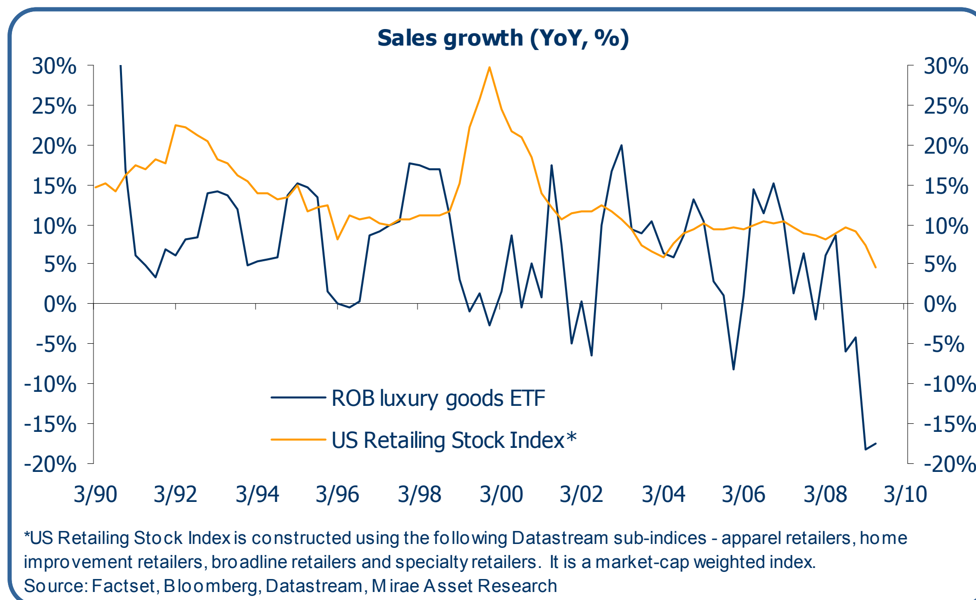
We find the ROB ETF to be highly correlated with US consumption spending, with about three times the explanatory power as the average retail stock index. The recovery in plutonomy stocks versus say, Walmart, tells us what we already know. The financial sector is reviving with government help, write-ups of toxic legacy positions, a very steep yield curve, robust capital markets and less competition. We think the rise in stock markets, the KCE capital markets ETF, the ROB ETF, the expected bounce in financial sector profits and bonuses, the improved employment situation in the financial sector, the reinvigorated bond, IPO, and M&A market, all point to upside consumption surprises in the US (and other plutonomies). The flip side is that the recent spike in personal savings rates are likely to go down again as plutonomist behavior resumes. Consensus observers of the US consumer make two mistakes: they underestimate the dominance of the plutonomists in the economy, and also under-estimate the variability of their behavior. Instead, they focus on the "average US consumer", over-burdened by leverage and long housing. This is a useful description of the middle-class, but it does not have much impact on overall consumption data or changes in it.

Figure 2: Plutonomists have low debt-service ratios. Leverage is an issue for the rest. Remember though, the bottom 80% account for only 40% of income.



Source: Survey of Consumer Finances, US Federal Reserve Board, Mirae Asset Research

Figure 3: Plutonomist consumption is a lot more variable than that of the rest. Because their wage (bonus) income is quite variable and they are super-sensitive to stock market returns.



*US Retailing Stock Index is constructed using the following Datastream sub-indices - apparel retailers, home improvement retailers, broadline retailers and specialty retailers. It is a market-cap weighted index.
Source: Factset, Bloomberg, Datastream, Mirae Asset Research

The migration of Plutonomies from the English-speaking world to Emerging Markets

Historically, there have been six key drivers of plutonomies. In the next decade, these drivers are likely to weaken in existing plutonomies, but should gather strength in emerging markets. These drivers are 1) a technology boom that increases complexity in non-linear ways, and re-arranges the way economies organize themselves (think canals, railroads, aviation, autos, the internet, etc.); 2) capitalist-friendly governments and tax laws; 3) globalization, which allows a reconfiguration of transportation, distribution supply chains, and frees up best-of-breed immigrants to maximize their potential in the vortex of innovation; 4) enhanced financial complexity, innovation and financial deregulation; 5) the Rule of

Law (not the Rule of Man); and 6) patent protection that allows inventions to be profitable for risk-takers.

There are obvious interactions between emerging plutonomists, the governments that police them, and the population at large that eventually grows resentful of the income inequalities that emerge in a plutonomy. Plutonomist interest groups often capture the State, persuade it to remain capitalist-friendly, offer a benign tax regime, allow a permissive immigrant policy, and a liberal, "light-touch" regulatory policy. The occasional invasion of foreign lands to secure resources is also an option available to plutonomies. Sound familiar? Eventually war, inflation, financial crisis, populist backlash, re-regulation, a general culture of effete financial speculation that collapses on itself and protectionist policies ultimately bring an end to plutonomy.

Financial deregulation – a key driver of plutonomy

Let us take a closer look at one of the main drivers of plutonomies: financial deregulation.[8] Figure 4 quantifies financial regulation. As the line goes down in the 1930s, it signifies more financial regulation in the aftermath of the Great Depression. Regulators and regulations were found to be lax in the boom years of the 1920s until the Pecora hearings of 1933 and 1934 made the case for greater regulation. The Glass-Steagall Act, the Securities Act of 1933, the Securities Exchange Act of 1934 followed quickly. This sounds much like the current re-regulation environment. The re-regulation trend lasted until 1980 when the Reagan revolution allowed financial deregulation to take off. This period was initiated by the Garn St. Germain Act of 1982 which relaxed interest rate constraints on Savings and Loans, ostensibly to promote housing. The S&Ls subsequently blew up within the next decade.

Deregulation continued apace – we were all drinking the Kool-aid, Greenspan was tending bar, Bernanke and the academic establishment were supplying the liquor. There were a few outliers (there always are), but they were ignored like Priam's daughter, Cassandra. The ex-Chief Economist of the IMF and my former business school classmate Raghuram Rajan, made courageous attempts to challenge this consensus, but was ignored.[9] Mancur Olson taught us that powerful constituencies and special interest groups often capture the State, have disproportionate organizational power for collective action, and can reduce potential growth.[10] Think of the military-industrial complex in the 1950s/1960s and the more recent financial oligarchy. See the excellent presentation on this issue by Simon Johnson.[11]

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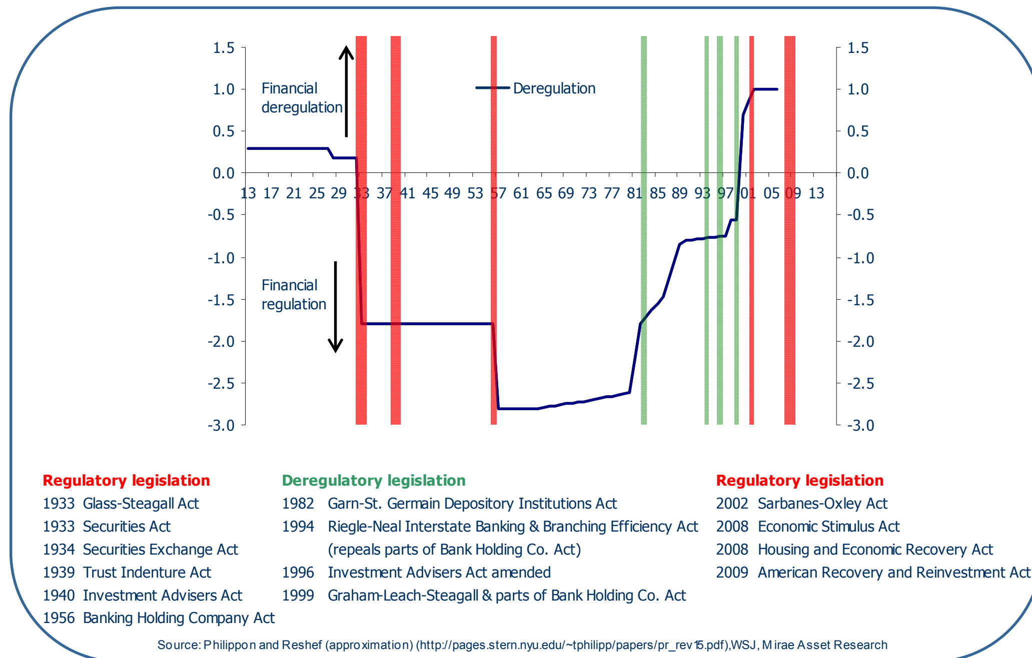
[8] This section draws on the excellent work *Wages and Human Capital in the US Financial Industry: 1909-2006*, by Thomas Philippon and Ariell Reshef, December 2008, NBER and CEPR. http://pages.stern.nyu.edu/~tphilipp/papers/pr_rev15.pdf

[9] Raghuram G. Rajan, 2005. *Has financial development made the world riskier?*, Proceedings, Federal Reserve Bank of Kansas City, issue August, pages 313-369. http://www.nber.org/papers/w11728

[10] Olson, Mancur. 1982. *The rise and decline of nations: Economic growth, stagflation, and social rigidities.* New Haven: Yale University Press.

[11] Simon Johnson, September 2009, http://baselinescenario.files.wordpress.com/2009/09/recovery-and-crisis-presentation-for-glab-sept-14-2009.pdf

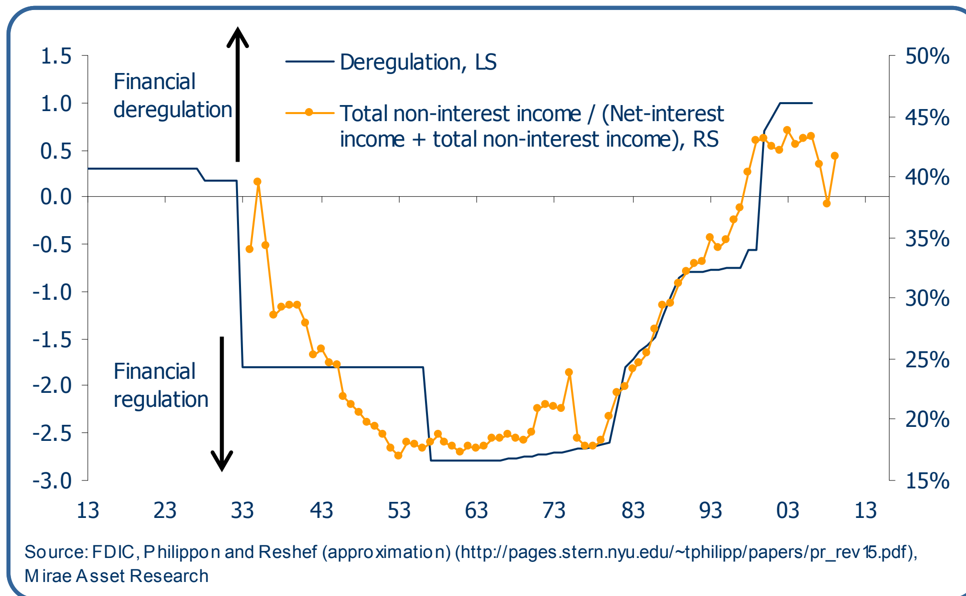
Figure 4: Busts are followed by financial regulation (1933-1982), booms are preceded by financial deregulation (1982-2007). Here comes massive financial regulation in the West.



Financial deregulation is often accompanied by technological complexity and innovation like in the 1920s and the 1980s/1990s. There is a demand for complex financial products from the corporate sector. The financial sector responds by innovating in a deregulated environment, attracting the best talent, which then extracts massive over-payments for being so "brilliant". Figure 5 demonstrates the relationship between financial deregulation and financial complexity. When banks behave like utilities, borrowing at 3% and lending at 6%, and do not leverage their balance sheets because the regulators have not been captured by the financial oligarchs, total "non-interest income" as a fraction of total income is low. There aren't too many "funky" products, no massive fees for complex, brilliant instruments. These are the halcyon days of the "3-6-3" banking model: borrow at 3%, lend at 6%, and hit the golf course at 3PM. This was the period of the regulated 1950s and 1960s and 1970s. The pleasant childhood and youth of Michael Moore that is portrayed as a better, simpler time…the proverbial good ol' days.

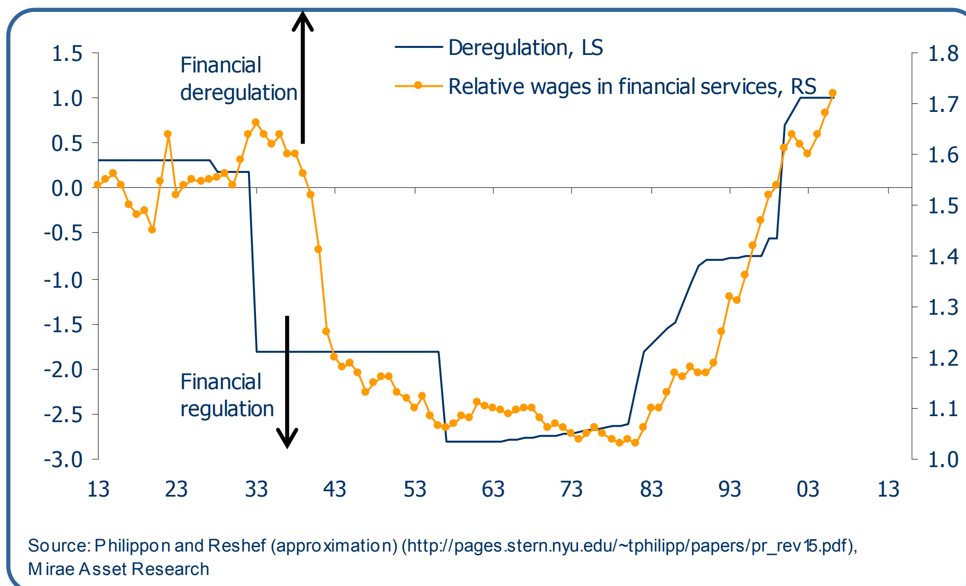
Figure 5 also shows, as financial deregulation intensifies - a product of rising technological upheaval, financial complexity, and regulatory capture - the proportion of bank earnings from non-interest income (funky products/service fees) rises sharply. Complex, brilliant financial services require brainiacs, geeks, as well as over-confident smooth talkers. The best business schools send over these self-selected alpha males (mostly) to Wall Street to construct the complex products the world thinks it needs. Most regulators are light touch, lowly paid, and behind the curve compared with the brainiacs of high finance, who are exceptionally well paid, far above what their skills warrant, as admirable as those skills may be. Eventually the geeks take over, becoming plutonomists. Too bad you weren't nice to them in school. See Figure 6 which shows the correlation between financial deregulation and the relative wages in the financial sector.

Figure 5: Financial deregulation (1982-2007) inspires "funky", complex products, raising non-interest income proportion to total banking income. With more financial regulation, this trend is over.



Source: FDIC, Philippon and Reshef (approximation) (http://pages.stern.nyu.edu/~tphilipp/papers/pr_rev15.pdf), Mirae Asset Research

Figure 6: Financial deregulation (1982-2007) => complex products engineered by brainiacs => excessive compensation for Wall Street…



Source: Philippon and Reshef (approximation) (http://pages.stern.nyu.edu/~tphilipp/papers/pr_rev15.pdf), Mirae Asset Research

When financial types make "excessive" compensation in a deregulated environment, Figure 7 shows us that this is almost perfectly correlated with the income share of the Top 1% of households. Do you see the connection? Financial deregulation leads to a frenzy of complicated financial products, often accompanied by rising leverage (not shown), and substantial excessive compensation to the brainiac financial engineers who supply these complex products to a hungry clientele, and sure enough a plutonomy emerges. Eventually, stability leads to instability (as Hyman Minsky suggested), the leveraging boom explodes on itself, the "people" and their representatives demand more regulation. When all the dust settles the brainiacs are back to practising engineering and medicine. The prior asset price boom combined with massive income inequality that had earlier allowed the plutonomists to consume out of rising asset values, thus driving down the overall savings rate, reverses. Plutonomists become a smaller share of the economy, and regardless of

asset markets, their behavior takes on much less significance relative to the overall economy (much like in the 1950s through the 1970s). See Figure 8.

Figure 7: "Excessive" compensation in financial sector correlated with Plutonomy.

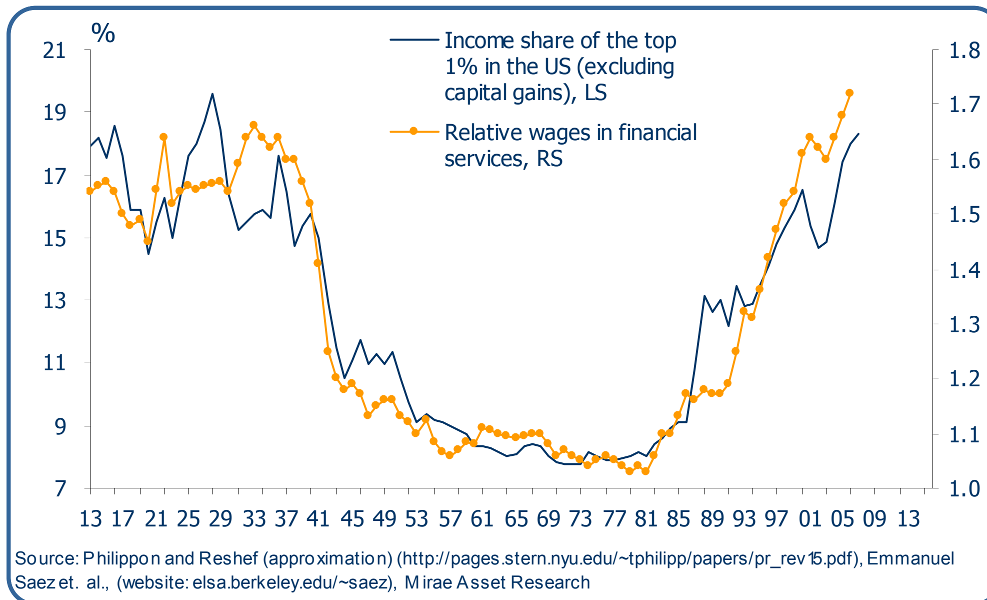


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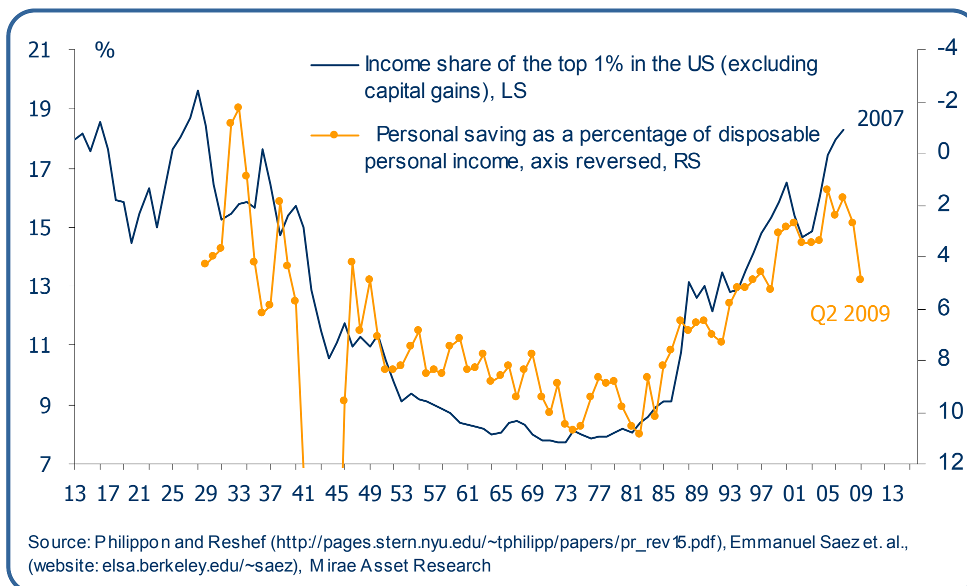
Figure 8: Plutonomy plus asset inflation means low savings rates, current account deficits.



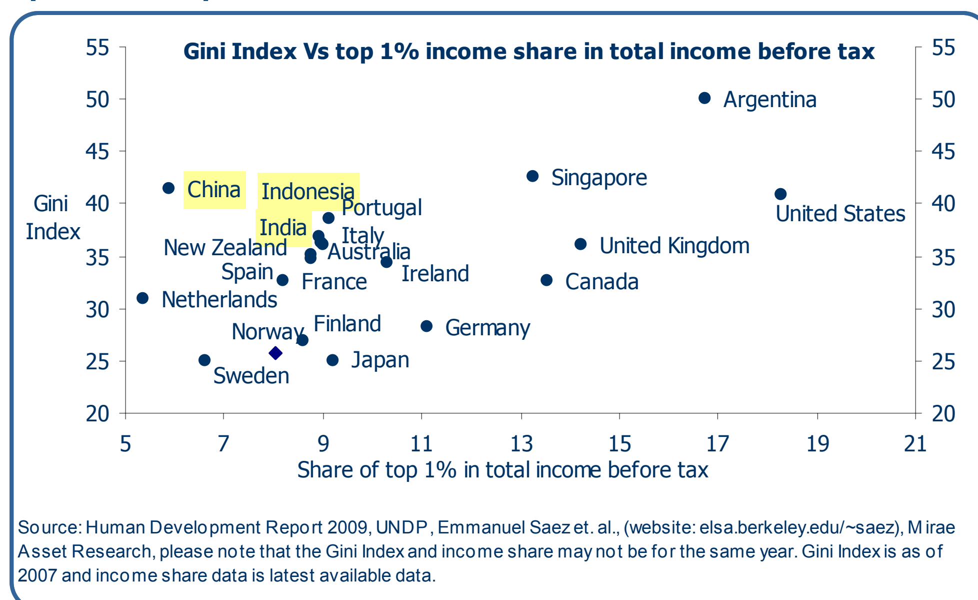
Source: Philippon and Reshef (http://pages.stern.nyu.edu/~tphilipp/papers/pr_rev15.pdf), Emmanuel Saez et. al., (website: elsa.berkeley.edu/~saez), Mirae Asset Research

We think the existing plutonomies (the US, the UK, etc.) are set for a long period of financial regulation. Banking is likely to be more plain vanilla, operating much like utilities. The funds for another financial boom and the stomach to accept risks are just not there. The focus is much more on existing commitments to social programs, healthcare, and on interest payments to creditors. Leverage levels after a boom are, by definition, already juiced up, and the same leverage game that comes with financial liberalization cannot be re-played. While it is easy to talk of the financial sector hijacking regulatory policy, we don't think taxpayers and legislators have much incentive, or the desire to *not* re-regulate the financial sector. Booms lead to busts which ultimately lead to re-regulation.

Emerging Markets: The next plutonomies

We speculate that many emerging markets are fertile grounds for becoming plutonomies. To understand why, we need to revisit the six drivers of plutonomy to see where they might go for emerging markets, in general. We recognize that emerging markets are diverse, united only by their lack of high per capita incomes. Some might suggest that emerging markets are already plutonomies, with high Gini Indices. As Figure 9 shows, the Gini Indices are a flawed measure of plutonomy – an economy powered by the wealthy. The top 1% of households' share of the economy does not match up with the Gini Indices, especially for emerging markets, since it pays more attention to the middle class and not enough to the extremes of the income distribution.

Figure 9: Gini Index* in emerging markets overstates plutonomy – two separate concepts.



Source: Human Development Report 2009, UNDP, Emmanuel Saez et. al., (website: elsa.berkeley.edu/~saez), Mirae Asset Research, please note that the Gini Index and income share may not be for the same year. Gini Index is as of 2007 and income share data is latest available data.

*The Gini Index can range from 0 to 100. A low Gini Index indicates a more equal distribution, with 0 corresponding to perfect equality, while a higher Gini Index indicates more unequal distribution, with 100 corresponding to perfect inequality.

Wealth waves that in history have engendered plutonomies rely on technological advances, and complexity that is handled by high-dopamine [12] immigrants and natives. Check out the brainiacs of Silicon Valley and Wall Street. You will find vast numbers of Chinese, Indians, Israelis, Russians and Eastern Europeans. These are the high dopamine immigrants at the vortex of complexity, pushing technology and structured products, lubricating plutonomy. As Vivek Wadhwa points out [13] immigrants constitute only 12% of the US population but have started 52% of Silicon Valley's tech companies, and account for 25% of US patents. They account for half of US PhDs in Science and technology. They are now headed back to their home countries, attracted by entrepreneurial opportunities, and repelled by the US visa regime. This is textbook behavior – an anti-high dopamine immigrant policy – that dilutes plutonomy. These Chinese, Indians, Eastern Europeans etc. are taking their brilliance home, looking for complexity, ready to engender technological change and wealth waves in their native lands.

[12] *The Hypomanic Edge - The Link Between (a Little) Craziness and (a Lot of) Success in America*, John Gartner
[13] *Why Skilled Immigrants are leaving the US*, Businessweek, March 2009, http://www.businessweek.com/technology/content/feb2009/tc20090228_990934.htm

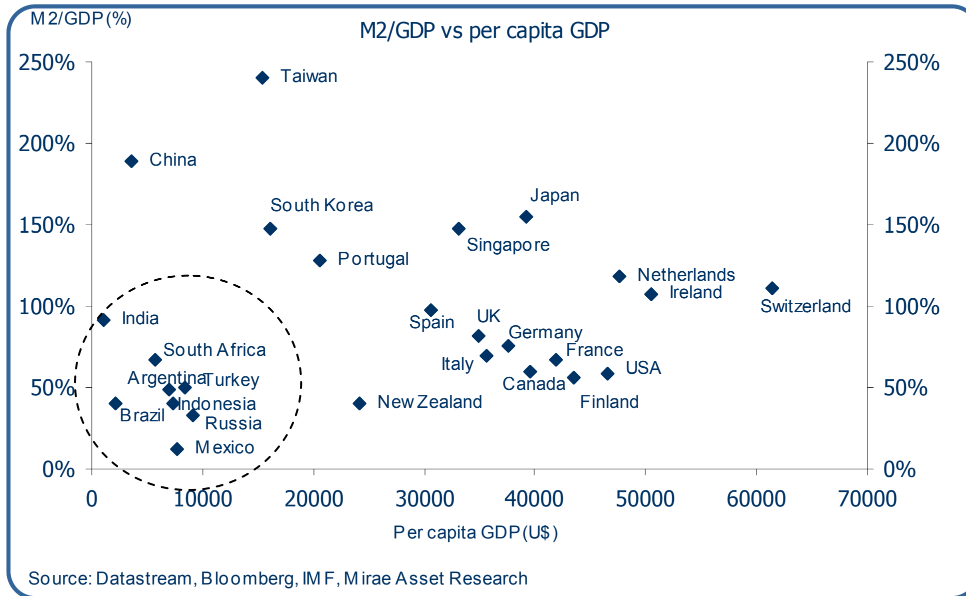
Technological advances often rely on military spending, procurement, and war. Often executed by immigrants in military-oriented labs. Think of the Manhattan Project. Vernon Ruttan in "*Is War Necessary for Economic Growth*?" Oxford University Press, 2006, makes this point elegantly. He cites six general purpose technologies that were given a critical boost by military procurement: interchangeable parts from the US War Department in the early 19th century in the invention of armaments that drove the machine tool industry; military and commercial aircraft; nuclear energy and electric power; the computer; the internet and the space industry.

Innovation can be developed by confiscating wealth (the communist way), generating bubbles (the Anglo-Saxon way), or the threat/reality of War, where taxpayers pony up resources out of fear. Crude, but true. We think that the large socialist bosom of existing plutonomies, promising social security, healthcare to all, Medicare, Medicaid, leaves little for the defence budget. The immigrant scientists are returning to the emerging markets where they came from. Their home countries have their own imaginary trysts with destiny. China, India, Russia, Eastern Europe, Brazil, South Africa – all have the burden of betrayals, the shame of subjugation, colonialism, and suppressed anger. Now is the time for them to call for a multi-polar world. They recognize that military power is a necessary condition for such grandiose thinking. Their elites have generally been at the margins of history (Russia being an exception), but now see their chance. The high-dopamine citizens of emerging markets with their enhanced ability to handle risk and complexity, will increasingly stay at home as the opportunities are greater there. Rockets, credible weaponry, blue water navies, nuclear-powered subs, more nuclear weapons, stealth aircraft etc. are all on the wanted list. These emerging markets don't much like their neighbors either, despite their phony camaraderie. Military-led innovation is likely moving to emerging markets.

Figure 10 shows that emerging market financialization is at the low end, but will likely rise with higher per capita incomes. Also, as we highlighted in our work on the Demi-Ashton ratios[14], most emerging markets will see an explosion in the demand for growth-oriented financial products. The fraction of people in their 40s versus those in their 20s generates this demand for financial complexity. The brainiacs who are returning, back from Wall Street and MBAs in the US, will be happy to supply the impending demand for financial complexity. Figure 11 also shows that most emerging markets have underleveraged corporate balance sheets. Low leverage is a precondition for the financial deregulation that a growing financial sector demands as it captures policymaking. Emerging markets are also making progress in patent protection since they are now bound by global WTO regulations, and are creating intellectual property themselves. The Rule of Law is making dramatic progress in most emerging markets, with the odd lapse into the Rule of Man. The emerging markets are already entwined in globalization, and are reaching out to each other in regional and bilateral trade agreements to intensify this process. Regardless of the political stripe, most emerging market politicians have understood the role of free enterprise, just as the US and Western Europe are questioning it. (Michael Moore's movie "Capitalism" is just an example of this backlash).

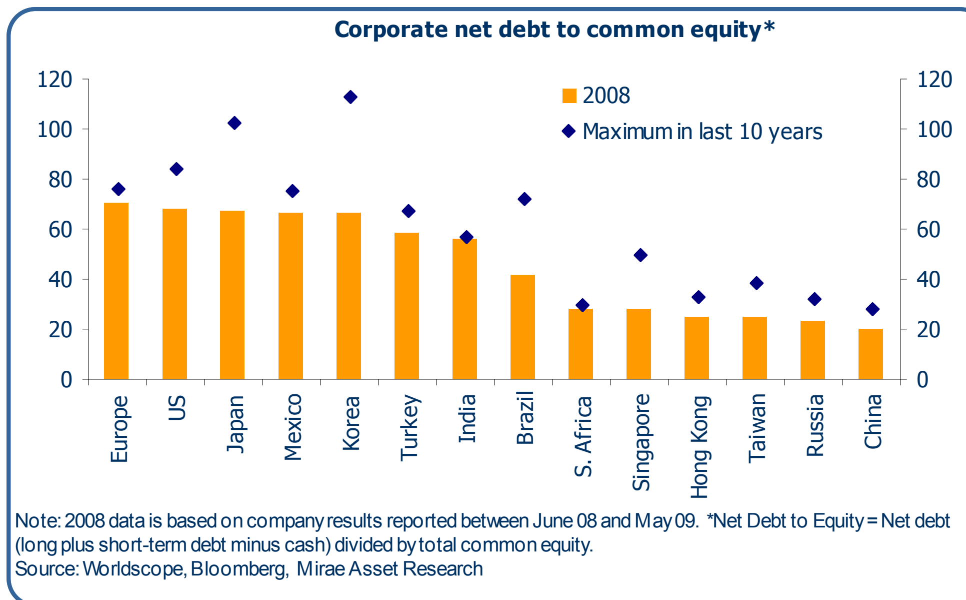
[14] *The Demi-Ashton Ratio, Financial Bubbles and Global Supremacy*, 12th August 2009, http://www.miraeasset.com/ourmarket/outlookView.do?board_id=1125&group_id=1&pageNo=1

Figure 10: Emerging Markets are all set for greater leverage/financial deepening. Here comes the deregulation, the brainiacs, and the complex products.



Source: Datastream, Bloomberg, IMF, Mirae Asset Research

Figure 11: Emerging market corporate sector underleveraged - a releveraging cycle ahead?



Note: 2008 data is based on company results reported between June 08 and May 09. *Net Debt to Equity = Net debt (long plus short-term debt minus cash) divided by total common equity.
Source: Worldscope, Bloomberg, Mirae Asset Research

A long history of Plutonomy and egalitarianism

Messrs Atkinson, Piketty, and Saez do the best work on plutonomy data. Their recently released "Top Incomes in the Long Run of History", September 2008 is masterful for the sheer data history they present. We have liberally reproduced Figures 12 thru 15 from their work, taking data from Emmanuel Saez's website. Figure 12 shows the U-shaped trajectory of the share of the top 1% sorted by income share in the English-speaking countries. Figure 13 shows the L-shaped trajectory of the fortunes of the top 1% sorted by income share in Middle Europe and Japan, Figure 14 looks at the U/L-shaped movement for Nordic and Southern Europe, and lastly Figure 15 shows this information for select emerging markets.

Figure 12: English-speaking countries are today's plutonomies. This trend has peaked.

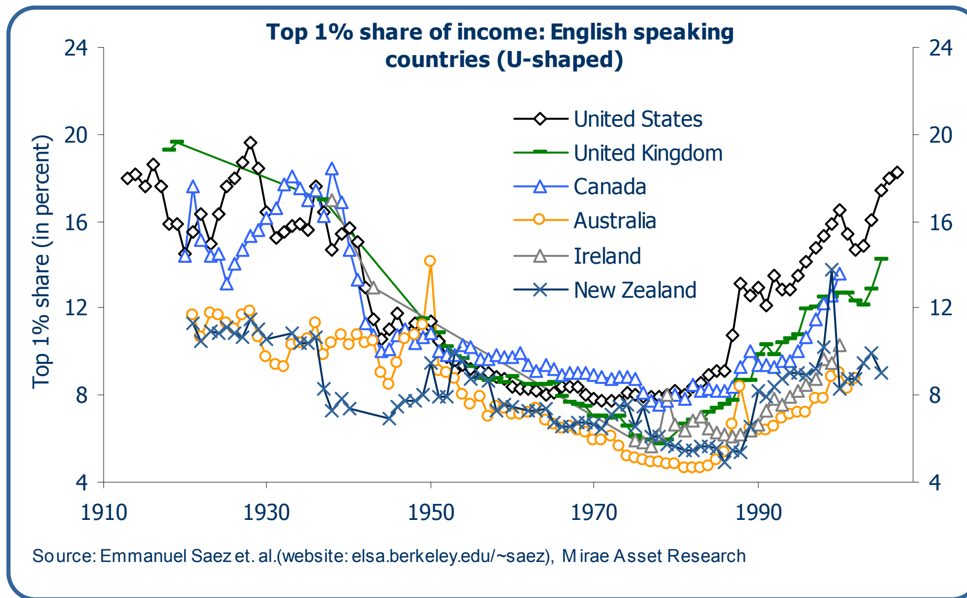


Figure 13: Japan and Middle Europe: Not Plutonomies after WWII.

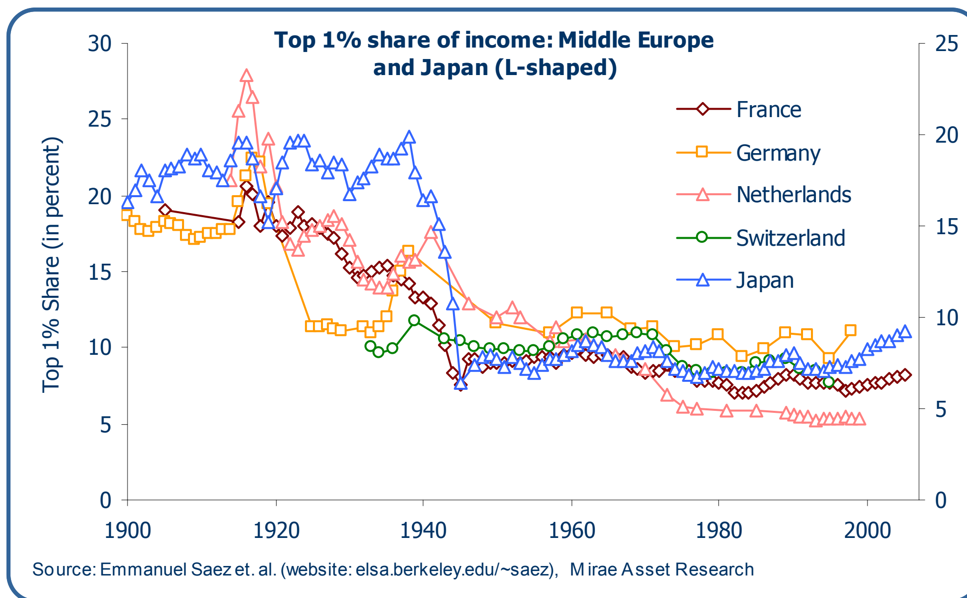
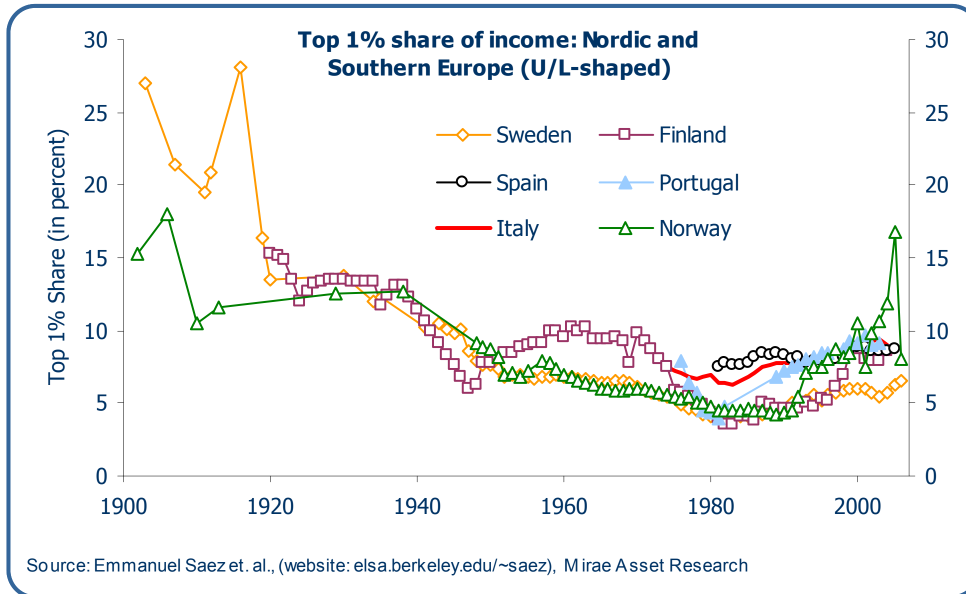


Figure 14: Hot and cold Europe: Not Plutonomies.



The good news from the potential migration of plutonomy from the English-speaking world to the emerging markets is that global imbalances should diminish. Figure 16 shows the current account deficits of the plutonomies and the non-plutonomies for the developed world. The gap between these lines is a measure of global imbalances. The US/English-speaking plutonomies over-spent, pumped up by asset inflation and the dominance of their plutonomists. They are likely to reverse that behavior, the baton of plutonomist-pumped consumption passing on to emerging markets.

Figure 15: Emerging Markets: The next Plutonomies? We think so.

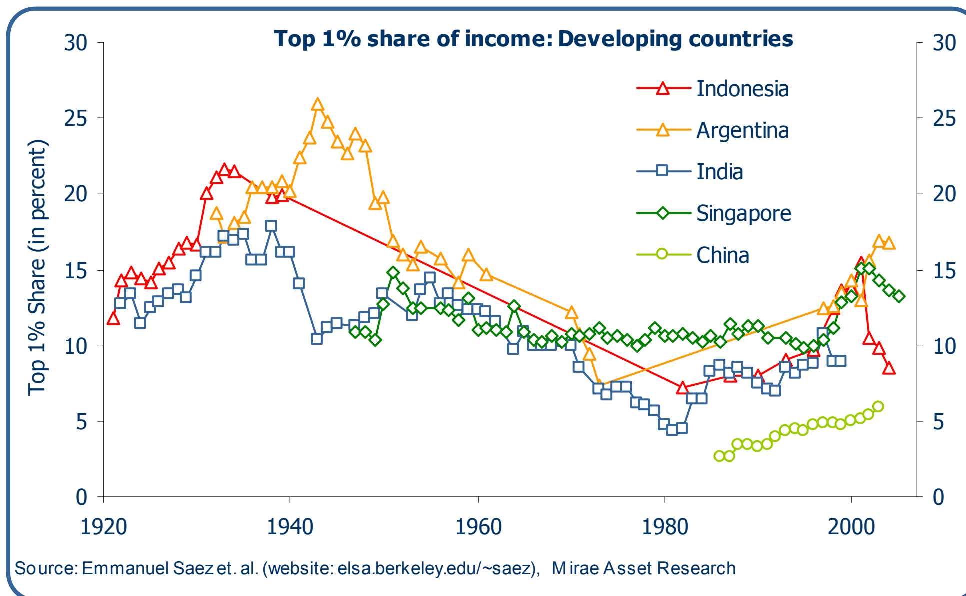
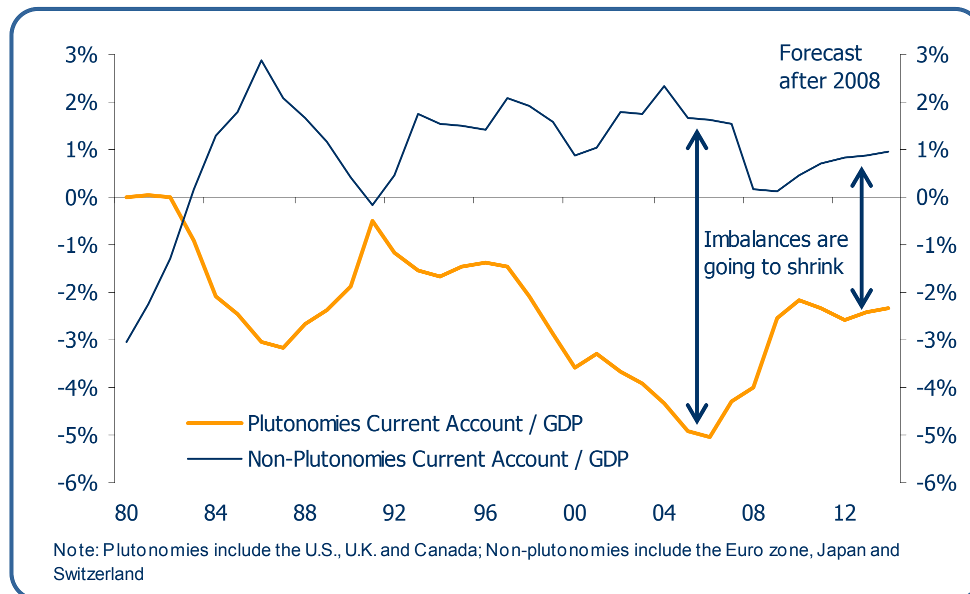


Figure 16: Global Imbalances – A function of some countries becoming plutonomies, running low savings rates and high C/A deficits; while others remained egalitarian, had high savings and C/A surpluses. This is reversing.



Note: Plutonomies include the U.S., U.K. and Canada; Non-plutonomies include the Euro zone, Japan and Switzerland

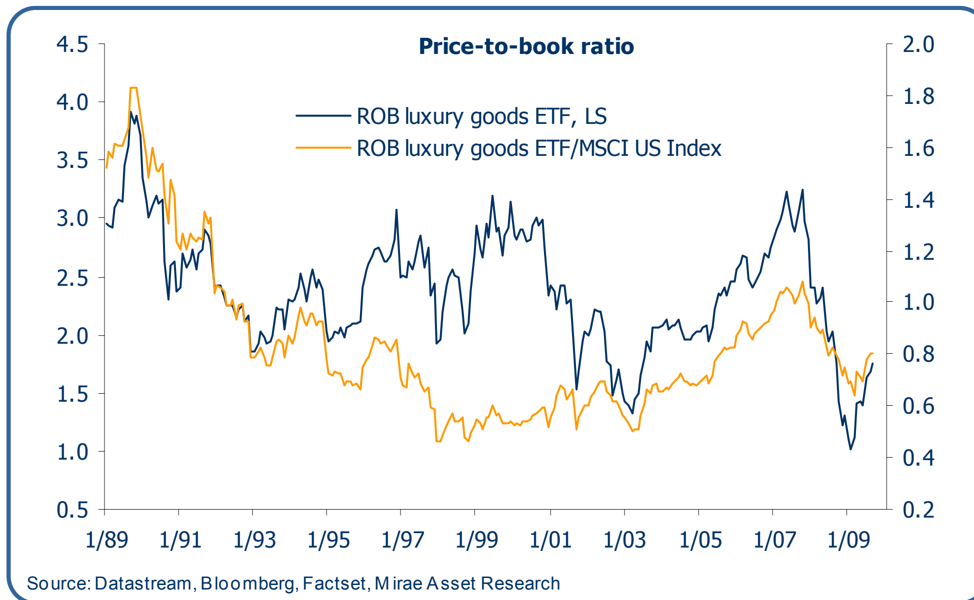
Buying luxury stocks:

We track the ROB ETF constituents on an equally-weighted basis and compute the absolute and relative PB of this basket. See Figure 17. We think that despite the 100% rally from the March lows, these stocks still look reasonably valued. If we are right on the equity markets (maximum bullish), and the short-term rehabilitation of the financial industry, and the longer-term migration of plutonomy to emerging markets, the ROB ETF is still worth buying.

Figure 18 shows the Cost of Living Extremely Well (CLEWI) from Forbes magazine relative to the overall CPI. We think relative pricing power for luxury goods is going to recover in line with financial markets, and massive reflationary policy. We see it in the Hong Kong luxury property market, and recent auctions that have surprised positively. We see it in the packages that guys we hire are demanding compared to six months ago.

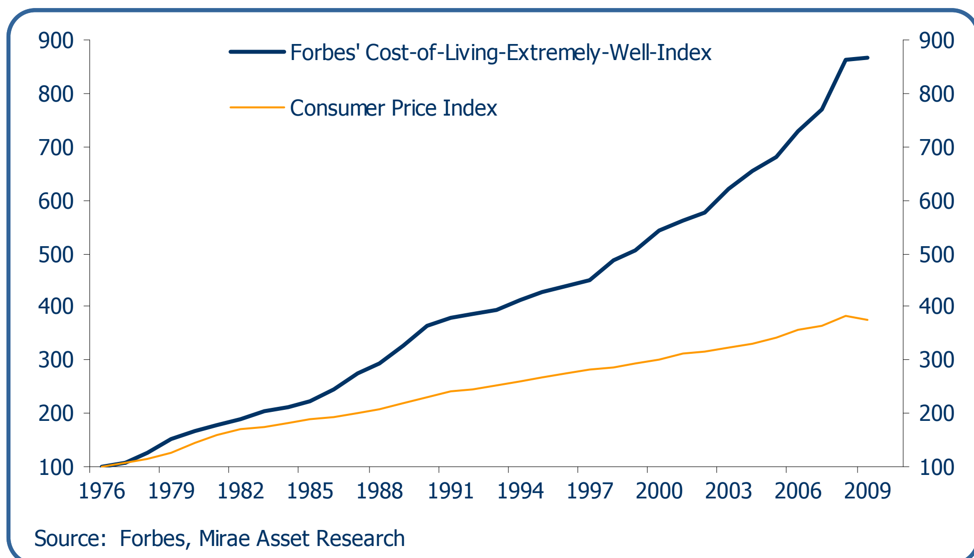
Figure 19 shows the details of the components of the ROB ETF.

Figure 17: Luxury goods stocks: Up 100% from their lows, but still at a relative PB discount, and about 40% below peak PB.



Source: Datastream, Bloomberg, Factset, Mirae Asset Research

Figure 18: Will luxury goods pricing power come back? Already is…



Source: Forbes, Mirae Asset Research

Figure 19: Luxury goods stocks (Constituents of the ROB ETF)

	Company Name	BBG Code	Market cap (U$m)	P/B	Performance since their lows in the last 2 years in local currency	Performance since their peaks in the last 2 years in local currency	2010E EPS g %	ROE (%)
1	PPR	PP FP	16,870	1.3	187%	-34%	12.4	15.4
2	SWATCH GROUP	UHR VX	12,762	2.4	99%	-37%	11.0	13.4
3	DAIMLER AG	DAI GR	52,807	1.3	94%	-57%	n.a.	-11.3
4	BAYER MOTOREN WERK	BMW GR	30,469	1.1	90%	-32%	614.3	-3.3
5	CHRISTIAN DIOR	CDI FP	18,339	2.1	114%	-27%	8.6	17.0
6	WYNN RESORTS LTD	WYNN US	8,451	4.7	346%	-60%	408.3	-6.6
7	LUXOTTICA GROUP	LUX IM	12,118	3.0	84%	-33%	16.2	13.0
8	RICHEMONT(CIE FIN)	CFR VX	14,369	2.3	98%	-66%	9.9	17.3
9	PORSCHE AUTO HL SE	PAH3 GR	7,042	0.5	89%	-70%	46.1	35.1
10	COACH INC	COH US	10,492	6.3	181%	-31%	0.5	38.8
11	PERNOD RICARD	RI FP	20,761	1.6	46%	-28%	-3.5	15.9
12	LVMH MOET HENNESSY	MC FP	49,502	2.6	75%	-23%	7.4	16.7
13	POLO RALPH LAUREN CP -CL A	RL US	4,251	2.7	134%	-3%	12.1	14.6
14	DASSAULT AVIATION	AM FP	7,198	1.2	58%	-38%	18.0	8.4
15	HERMES INTL	RMS FP	15,250	6.5	58%	-17%	8.3	20.1
16	NORTHERN TRUST CORP	NTRS US	13,965	2.3	68%	-34%	21.9	10.7
17	NORDSTROM INC	JWN US	6,956	4.9	311%	-36%	16.5	26.1
18	SHISEIDO CO LTD	4911 JP	7,138	1.9	23%	-44%	2.7	3.8
19	SHANGRI-LA ASIA	69 HK	5,407	1.4	96%	-47%	26.1	2.4
20	JULIUS BAER GRUPPE*	BAER VX	7,901	1.6	n.a.	n.a.	15.4	7.0
21	TIFFANY & CO	TIF US	5,000	3.0	138%	-29%	15.1	9.1
22	EMBRAER-EMPRESA BRAS AERO SA	ERJ US	4,354	1.5	140%	-54%	41.6	11.4
23	BURBERRY GROUP	BRBY LN	3,461	4.0	213%	-26%	11.3	-1.2
24	TOTO LTD	5332 JP	2,190	1.1	31%	-47%	216.0	-13.8
25	BULGARI SPA	BUL IM	2,321	2.2	85%	-54%	650.0	-1.6
26	TOD'S SPA	TOD IM	2,248	2.4	92%	-22%	9.0	14.3
27	REMY COINTREAU	RCO FP	2,021	1.5	78%	-48%	10.7	8.7
28	GAM HOLDING AG*	GAM VX	2,459	1.6	165%	-46%	12.5	7.0
29	MANDARIN ORIENTAL INTL LTD	MAORF US	1,249	1.3	94%	-56%	-57.8	9.9
30	ORIENT-EXPRESS HOTELS	OEH US	809	1.0	272%	-84%	n.a.	-9.1
31	SOTHEBY'S	BID US	1,154	2.1	172%	-70%	n.a.	-11.9
32	WILMINGTON TRUST CORP	WL US	979	1.0	100%	-65%	251.1	-3.2
33	SAKS INC	SKS US	973	1.0	310%	-71%	n.a.	-19.2
	Median		**7,042**	**1.9**	**97.1%**	**-41.2%**	**12.5**	**9.1**

* GAM Holding AG formerly a part of Julius Baer Holding AG. Julius Baer Gruppe listed separately on 1st October 2009.
Source: Bloomberg, Factset, Mirae Asset Research

Risks to our view

Our thesis is that existing English-speaking plutonomies are going to get more egalitarian, driven by more financial re-regulation, less globalization and immigration, weakening military-driven innovation and an encroachment by of the Rule of Man, given an increasing role of the government in the economy. The risks to this view are obvious: if Simon Johnson and Mancur Olson are right, and the financial oligarchy has truly captured policy-making, financial re-regulation is likely to be a temporary, weak irritant, quietly reversed or de-fanged. If the commitment to free trade and immigrants revives along with the economy, and the legislature curbs the Rule of Man in favor of the Law, Plutonomies in the English-speaking world should remain robust and we will be wrong.

Conversely, emerging markets might not become plutonomies, as we forecast. Their elites could remain smug about continued tight financial regulation, having seen the impact of financial liberalization on the Western financial system. They might fear the populace and its possible intolerance of income inequality. Returning emigrants might find their homelands unappealing, and long for the quiet life in the suburbs of Silicon Valley and Connecticut. The defense budgets in emerging markets might not expand and finance innovation like we predict. The Rule of Law in emerging markets could reverse – there is never a shortage of potential tyrants, and democracy in these regions has generally shallow root systems. We will be watching these developments with great interest.

Conclusion

We believe Michael Moore has mis-represented our prior Plutonomy work at Citigroup in his movie *Capitalism: a Love Story*. There was no nefarious or subversive intent behind our research on plutonomy and it was not in the least bit "secret" or "confidential". It was not intended for Citigroup's "wealthiest investors", but for regular Smith Barney brokerage clients and institutional investors who manage pensions and mutual funds for Middle America. We were clinical about our subject and made no moral judgments about whether it was a good or bad thing; yet we recognize that casting Citigroup and plutonomy the way he did makes for juicy, populist cinema.

Here we are, predicting that plutonomies in the English-speaking world are passé, as the risks we had highlighted came to pass: financial crises, re-regulation, a populist backlash, and anti-immigration policies. We think plutonomies are likely to migrate to emerging markets where they are likely to see their financial sectors expand dramatically, further encouraging their high dopamine citizens to stay put to manage complexity and innovation. The inevitable financial oligarchy is likely to demand and obtain financial deregulation in emerging markets, however unfashionable that might seem like now. More income inequality combined with asset inflation should boost plutonomist-driven consumption spending in emerging markets, boosting luxury property prices and lowering current account surpluses. This should boost global re-balancing, and plutonomy stocks.

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