

# THE MPACT REPORT

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## Too Big to Ignore: Rise of the Global Middle Class

By W. Michael Cox and Richard Alm

Some economic events get a lot of attention but are relatively small in the big picture—for instance, Apple unveiling another new iPhone. Other economic events are huge but remain under the radar until they're too big to ignore.

This issue of *The MPACT Report* is about one of those underappreciated trends. It starts with grand shifts in political ideology and economic policies. It ends with consumers buying contact lenses and deodorants. We call it the rise of the global middle class.

Over the past four decades or so, countries in all parts of the world have abandoned dysfunctional economic systems—notably communism and socialism. The heavy hand of big government had left their economies inward-looking, isolated and poor.

By expanding the space for private enterprises and lifting barriers to trade and foreign investment, these countries have committed their futures to global capitalism, the system that gave most of North America and Western Europe the highest living standards the world has ever seen.

Sheer size makes the rise the global middle class something too big to ignore. Some of the largest countries on Earth are among those shifting toward greater economic freedom and its promise of faster growth and higher living standards.

There's China, with a population of 1.4 billion, and India, with 1.3 billion people. Add in Brazil, maybe Russia, South Korea and Indonesia. All told, more than 3 billion people have been added to the global capitalist economy since 1980.

That number makes for a monumental

global transformation. We often grouse about these 3 billion people as producers who compete by shipping cheap goods into the U.S. market. But they are also consumers. Here's how Americans should think about it: *Three billion new consumers with rising incomes are aspiring to consume more.*

Let's take a quick look at China, which began its long journey from the straightjacket of communist central planning in 1978. Taking the capitalist road created a booming Chinese economy, now second in size to the United States. Median household disposable income in China increased from \$1,724 a year in 1990 to \$10,883 in 2016.

How are Chinese consumers spending the added income? They're buying color televisions, household appliances, mobile phones, computers and passenger cars

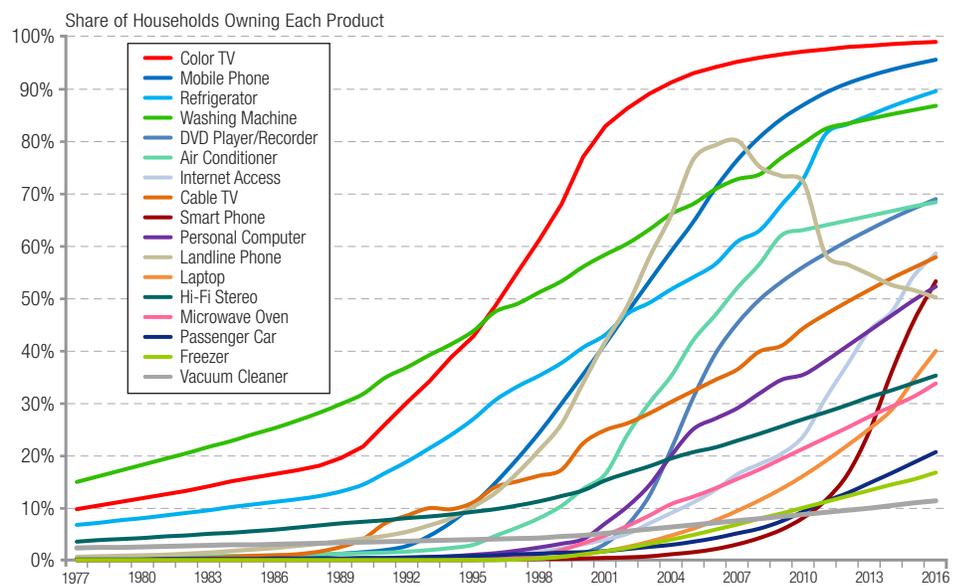
(see chart below). In 1977, only 10 percent of Chinese households had color TVs; four decades later, the figure has jumped to almost 99 percent. A decade or so after their debut as a hot product, smart phones have reached more than half of Chinese households.

### FOLLOWING AMERICA'S PATH

The rise of the global middle class would be difficult for suppliers and investors to grasp if each country had its own idiosyncratic way of spending income gains. Fortunately, that's not true—as the chart's glimpse of China's 40-year consumption gains suggests.

The path established by the United States as the first predominately middle-class nation is to a large extent being followed in other countries. Despite

### China's Consumers: Making Their Way Toward the Middle Class



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differences in history and culture, consumers around the world are remarkably alike in how they spend the gains from faster economic growth.

The reason is simple: Basic human needs and wants are broadly the same the world over. People first seek to take care of their most immediate needs—food for sustenance, clothing for warmth and protection, shelter from the cold and bad weather. In poor societies, incomes are so low that most households face a daily struggle to reliably acquire food, clothing and shelter.

Societies address less-pressing needs only when incomes start to rise above subsistence—out of poverty and into the middle class. Overall consumer spending tends to increase in an orderly way, moving down a conceptual list of needs and wants. The grand themes of the progression are necessities to luxuries, goods to services, and the tangible to the intangible.

As their incomes climb, families are likely to buy home furnishings to make their everyday surroundings more pleasant and comfortable. Next might come appliances, such as refrigerators, washing machines, air-conditioners and vacuum cleaners. Televisions provide information and entertainment. Cable hookups and DVD players spice up the viewing.

Today's electronic gadgets are enticing and getting cheaper nearly every year. Households might leap-frog over the fading technology of landline telephones and start out with mobile devices. Computers, smart phones and Internet access are becoming new markers of middle-class status. Almost everywhere, a family car is still a sign of having made it.

Households moving down their lists of needs and wants don't continue to stockpile goods. Higher incomes lead to greater consumption of services. The prudent will buy insurance, for example. Families will invest in a better education for their children. Personal pampering at the beauty salon provides a respite from the drudgery of daily life.

As incomes rise, workers will take some of their productivity gains in the form of better working conditions, including shorter working hours. Time off

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to enjoy life leads to greater spending on recreation and leisure activities. Travel becomes affordable, first close to home, then overseas. The rising number of Chinese tourists in New York and Paris are a sure sign of the country's progress in building a larger middle class.

### NEW POLICIES, BETTER RESULTS

The path to the middle class starts with the kind of broad economic success capable of producing large and sustained gains in productivity and incomes. For the United States, the moment arrived after the Civil War, when the Industrial Revolution reached critical mass in a free-enterprise economy.

Some countries emulated the United States in grabbing capitalism's progress, but many others lagged, largely because they rejected markets and put their economies in the hands of autocrats, bureaucrats, or communist *apparatchiks*. Highly centralized economies struggle to create a middle class because they stifle the individual initiative and human ingenuity that ignite progress.

For a variety of historical and political reasons, it took decades for many

countries to see the error of their ways. In the end, the prospect of falling further and further behind the United States and Western Europe in living standards doomed communism's strict central planning and import substitution's misguided protection of local industries from competition.

The move to freer markets is a work in progress for China, India and other countries, but incomes have been rising fast enough to fuel the middle-class aspirations of ordinary people. Since 1990, China's total disposable income—what consumers have available to spend—went from \$1.7 trillion to \$10.9 trillion, an average annual gain of a stunning 7.3 percent (*see table above*).

Other big countries don't come close. However, they do show consistent and substantial increases in disposable incomes. Indonesia's is up 4.2 percent a year. India gained 2.7 percent a year, with Brazil at 2.4 percent and South Korea at 1.9 percent.

By comparison, wealthier nations where the middle classes already dominate saw much smaller increases in their spending power since 1990—0.8 percent a year for the United States and 1 percent for Great

### Disposable Income Growth: How Much Can Nations Afford to Buy?

Country	Income in 1990	Income in 2016	Change: 1990-2016	Average Annual Change: 1990-2016
	Median Disposable Household Income, Billions of 2016 Dollars			
United States	63,659	78,989	15,530	0.8%
United Kingdom	38,340	49,365	11,025	1.0%
Japan	61,009	45,059	-15,950	-1.2%
South Korea	22,117	35,994	13,877	1.9%
Brazil	6,778	12,707	5,929	2.4%
China	1,724	10,883	9,159	7.3%
Indonesia	2,344	6,829	4,485	4.2%
India	2,426	4,845	2,419	2.7%

Britain. Disposable income actually fell by an annual average of 1.2 percent in Japan, a mature Asian economy struggling through three decades of slow growth.

The big, emerging economies with growing middle classes have a lot more to spend. What have they been spending it on?

**EXPORT OPPORTUNITIES**

The short answer: Everything that middle class households might covet.

From 1990 to 2016, the four countries with rapidly rising disposable incomes showed healthy increases in real consumer expenditures on a number of broad categories. The Chinese, for example, expanded their outlays by an average of 13.1 percent a year for pharmaceuticals, 12.4 percent for travel packages, 11.1 percent for electricity used at home and 10.1 percent for insurance (see chart below).

For Indonesia, the fastest growing consumption categories were 14 percent a year for insurance, 13.1 percent for financial services and 12.5 percent for jewelry. India's leading categories were financial services at 9.9 percent and insurance at 9.8 percent. South Korean families skewed toward travel packages (12.2 percent) and jewelry (8.7 percent).

These products indicate movement down the list of needs and wants; most likely, people did without them before incomes began to rise. Now, more households can afford to indulge middle-class aspirations.

More developed economies don't show the same percentage gains in consumption. Like the Asian countries, the United States spent more on all categories of consumption—but outside of pharmaceuticals the gains were in the low single-digits. Japan actually shrank its spending on financial services, jewelry, travel packages and personal care.

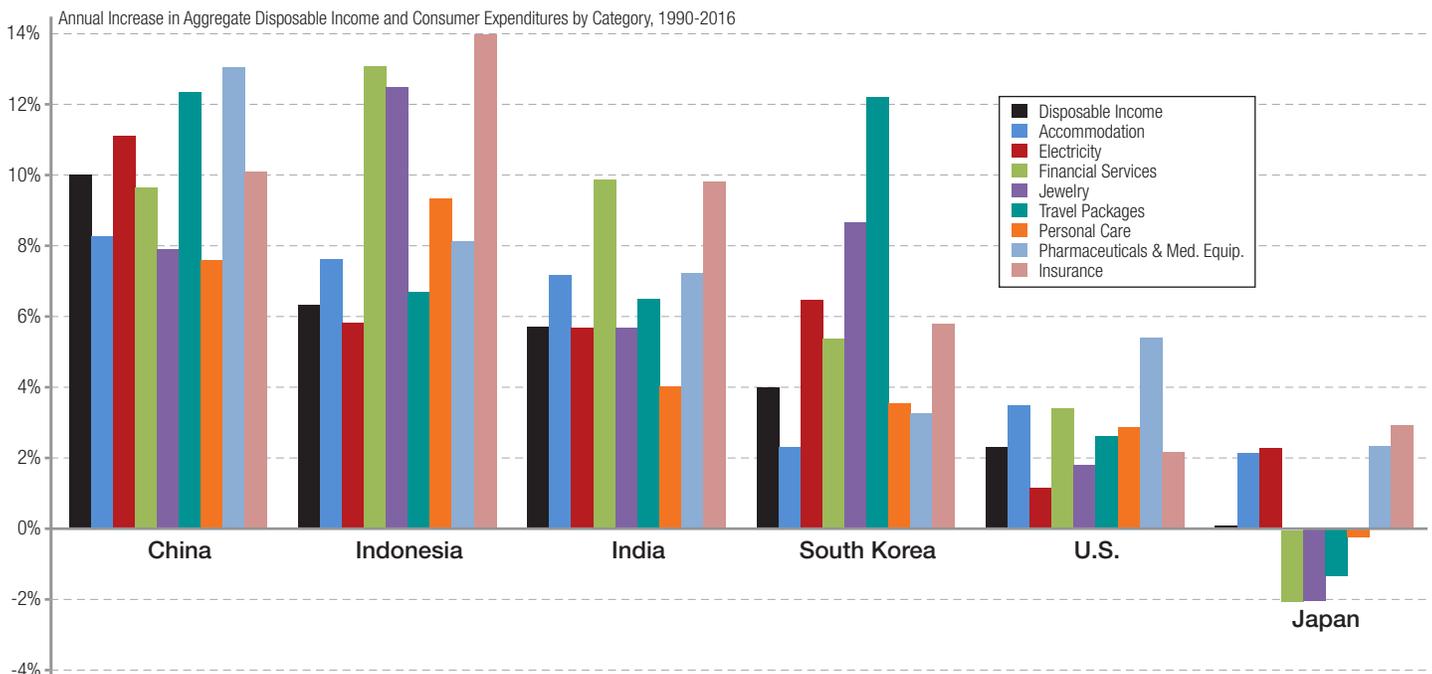
Data on retail sales, adjusted for inflation, reveal explosive growth in some personal-care products, evidence of a desire to look and feel better. Since 2003, sales of weight management and well-being products soared by 498 percent in India, 420 percent in Indonesia, 233 percent in China, 192 percent in South Korea and 134 percent in Brazil. The category declined nearly 15 percent in the United States—and not because Americans no longer need to diet.

Deodorant sales were up sharply in all the emerging countries, led by increases of 943 percent in Indonesia and 771 percent in India. China saw sales gains of 255 percent for skin-care products and 200 percent for contact lenses and solutions. Color cosmetics rose 807 percent in India and 172 percent in China.

These products indicate movement down the list of needs and wants; most likely, people did without them before incomes began to rise. Now, more households can afford to indulge middle-class concerns about comfort and appearance.

The rise of a global middle class too big to ignore presents opportunities for U.S. businesses. Competition for these customers will be fierce. Consumer-goods producers from Britain, France and other will want a piece of the action. Home-grown companies won't easily give up their turf.

**How Up-and-Coming Countries Spend Their Growing Disposable Income**



The United States should be able to hold its own. The country has had a sprawling middle class for more than a century, so our companies have plenty of experience in catering to this demographic. Surveys show that foreigners favor American brands—from Apple to Disney.

Many firms are already cashing in on the growing global middle class by extending their overseas production and marketing functions. For example, Texas-based Kimberly-Clark sells Huggies disposable diapers and other paper products in 175 countries. Procter & Gamble, the maker of Crest toothpaste and other well-known brands, gets almost two-thirds of its revenue from foreign sales. Ketchup-maker H.J. Heinz and pharmaceutical giant Pfizer also earn at least \$6 of every \$10 abroad.

Yum Brands has been in China since 1987, cashing in on the new middle class' growing appetite for American-style fast food. Before spinning off its China operations in 2016, the company opened 5,000 KFC fried chicken and 1,600 Pizza Hut outlets in Chinese cities, earning millions of dollars in licensing fees and other income every year.

Plenty of other companies could reap profits by targeting countries with huge populations and rapidly rising incomes, where consumers are following the path to higher living standards blazed by Americans. The global middle class will continue to expand rapidly for years to come, and the opportunities for U.S. companies and their investors can only get bigger.



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**CHARTING THE ECONOMY**

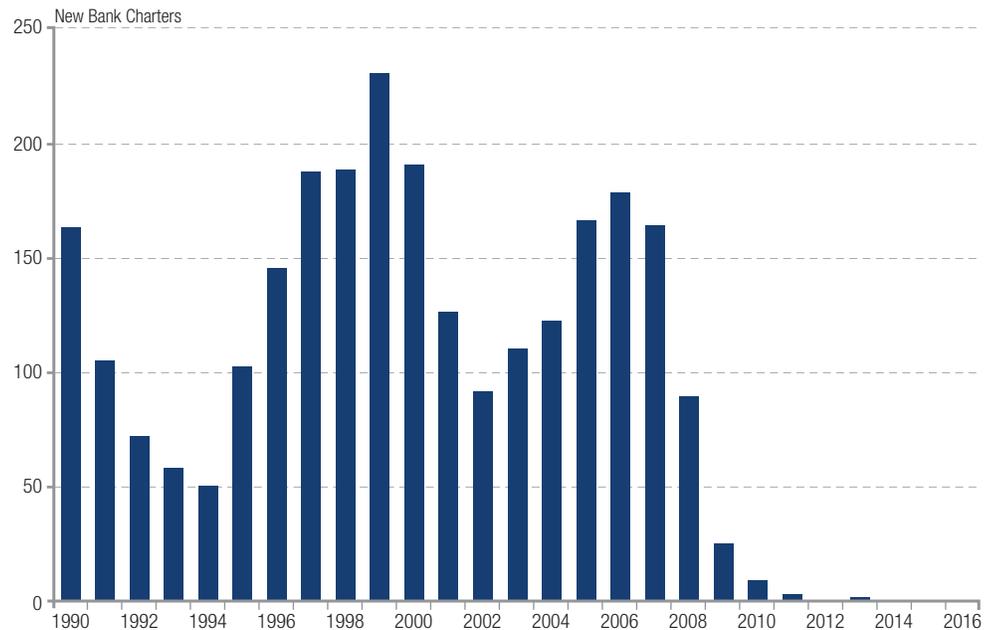
**Four in Six Years: Regulatory Hurdles Strangle Bank Start-ups**

**New banks start out small.** As niche players in the financial industry, they compete by offering customers personalized service, filling banking voids in small communities and targeting businesses that big institutions ignore.

Before the financial crisis of 2008-09, these banks popped up fairly routinely—230 in 1999 and 178 as recently as 2006. From 1990 to 2007, only four years had less than 100 new banks.

In the past six years, new bank charters totaled just four. What changed was regulation, exemplified by the Dodd-Frank act of 2010, that imposed higher costs on the banking industry.

Big institutions can afford to pay them, small ones can't. The upshot: The biggest banks are grabbing a larger share of the market while some customers and communities go unserved.



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