Global Powers of Consumer Products 2014

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Deloitte Touche Tohmatsu Limited (DTTL) is pleased to present the 7th annual *Global Powers of Consumer Products*. This report identifies the 250 largest consumer products companies around the world based on publicly available data for the fiscal year 2012 (encompassing companies' fiscal years ended through June 2013).

The report also provides an outlook for the global economy, an analysis of market capitalization in the industry, a look at M&A activity in the consumer products sector, and a discussion of major trends affecting consumer products companies.

Global economic outlook

Last year's report noted that "barring a fiscal convulsion, the U.S. economy is likely to accelerate in the coming year." Well, there was a fiscal convulsion. Consequently, growth was not especially strong. It said that, in China, a hard landing seemed unlikely. That was correct and the economy has actually stabilized at a new level of economic growth. We wrote that "the economic situation in Japan suggests continued weak sales growth and declining prices." This was wrong simply because we did not anticipate that a new Prime Minister would embark on a radically different path. Finally, we noted that, despite a recession in Europe, the decline in the value of the euro combined with wage restraint had boosted the competitiveness of European exports. Indeed today, the burgeoning economic recovery is mainly due to the improvement in export performance.

Overall, we didn't do too badly. What we got wrong was largely due to our failure to anticipate the political environment in both the U.S. and Japan. What we got right was due to drawing sensible inferences from economic trends. Thus, going forward, the question arises as to what changes in the political environment might play havoc with the economic outlook. Around the world, there are some significant political uncertainties. These include whether and how the Eurozone will implement a banking union; whether the ECB will move toward a more aggressive monetary policy; whether Japan's government will endorse a radical program of deregulation; how China's government deals with financial imbalances, and how other emerging markets deal with a new global economic environment.

The pages that follow offer a view on the economic outlook for the major markets and the potential impact on consumer product companies. This is a baseline view. Yet it should be noted that unexpected political decisions, by leaders or voters, can relegate any predictions to the rubbish bin. Hopefully, what follows still offers a useful road map.

Eurozone

The Eurozone is recovering from a prolonged recession, itself the result of the sovereign debt crisis. Prior to the crisis, the creation of a common currency had led to interest rate harmonization and relatively low borrowing costs across Europe. With the crisis came a loss of confidence in the durability of the euro and the ability of some countries to service their debts. Consequently, borrowing costs for Southern European countries increased dramatically leading to a severe drop in credit market activity. In addition, most European countries adopted tight fiscal policies in order to convince financial markets of their commitment to fiscal consolidation. The result was a recession which is only now ending.

The recovery came about for three main reasons. First, the ECB promised to "do whatever it takes" to save the euro. That meant that the ECB would not allow sovereign debtors to default. As a result, bond yields declined, leading to lower borrowing costs. Moreover, this caused an improvement in the ability of governments to service their debts. That, in turn, led to the second reason, which is a loosening of fiscal policy. Today, government finances in Europe are in much better shape than a few years ago. This means that countries can take a more relaxed attitude toward fiscal discipline—at least in the short run. Finally, the decline in the value of the euro, combined with wage restraint and productivity gains, caused exports to grow once again.

In 2014, the Eurozone is expected to experience modest growth. Inflation, which is very low, will remain so, thereby providing the ECB with plenty of wiggle room should it choose to engage in a more aggressive monetary policy. The ECB is studying the possibility of employing unusual policy tools to boost credit market activity. This could include something akin to quantitative easing (already in use in the U.S. , UK, and Japan) or using fees to compel banks to lend. At the national level, several countries are increasingly committed to labor market reforms designed to reduce the cost of hiring and, therefore, reduce unemployment.

Yet perhaps the biggest obstacle to better economic performance in Europe is the absence of financial market integration. European banks are primarily supervised by their national governments. When they get in trouble, the national governments have been forced to assume bank liabilities. Banks holding Greek sovereign debt have been forced to take haircuts and banks in Cyprus have been forced to confiscate deposits. There is no Europe-wide deposit insurance and no Europe-wide system for resolving troubled banks. Negotiations have taken place aimed at creating a banking union, but the outlines agreed upon so far fall far short of true financial market integration.

The countries have agreed to a modest fund for bank resolution, a requirement that national governments get involved if the fund is exhausted, and a requirement for unanimity among Eurozone members to approve using bailout funds to support banks. In other words, there will not be a strong central authority with the resources to support and resolve troubled banks. As such, this reform fails to do what is needed to harmonize credit market activity. Absent a more integrated approach, it is hard to see how credit market activity will heal quickly. It is also hard to see how the Eurozone can succeed in the long-term. It is increasingly evident that a successful currency union requires a different architecture than now exists. It requires integration of the financial system in which all banks are supervised and supported by a central authority with considerable resources and independent decision-making. This is not going to be the case under the plan now being discussed.

There remain considerable risks to the Eurozone. These include potential problems of sovereign debtors such as Greece; possible election of anti-European governments in key countries; failure of countries to enact major economic reforms that would boost productivity; and failure of Germany to boost domestic demand, thereby helping its European compatriots. Indeed much of the failure to reform the architecture of the Eurozone stems from disagreements between Germany and the other countries. Germany is worried that any joint liability involving financial institutions would effectively be a German liability. As such, it is reluctant to endorse a more integrated approach to financial reform.

The outlook across Europe varies by country. Here are some highlights:

Germany

Growth in Europe's largest economy is expected to accelerate in 2014, driven by a combination of rising consumer spending, business investment, and exports. The implementation of a minimum wage will boost consumer incomes, but will also cause a modest increase in unemployment. Other aspects of the agreement of the governing coalition will have a negative impact on competitiveness. Germany remains highly dependent on exports of capital goods. A deceleration in investment in China could have a negative impact on Germany's economy. The revival of growth in the rest of Europe, however, will be helpful.

France

France has become the weakest link in the Eurozone. The economy is barely growing and 2014 is expected to be a weak year. Poor business confidence, engendered by a failure of the government to enact significant labor market reforms, will suppress investment. A partial reversal of the government's plans for very high tax rates has not convinced businesses to invest. France has lost competitiveness as productivity has lagged. Consequently, it is not experiencing the export revival seen in other Eurozone economies.

Spain

Spain is finally recovering from a long recession and growth in 2014 is expected to be modest. Spain's financial situation has improved, with bond yields now at relatively low levels. Fiscal austerity has been eased and the export sector is performing well following an improvement in competitiveness. On the other hand, the financial sector remains weak, with bank lending continuing to decline. The economy remains fragile.

Italy

Italy's longest post-war recession is finally ending. Moreover, the ascension of a new reform minded Prime Minister could lead to new efforts to reform the economy. The government is shifting away from fiscal austerity and towards more labor market reforms. In addition, Italy is gradually becoming more competitive, thereby boding well for export performance. The result is likely to be modest growth in 2014. On the other hand, Italy faces a number of problems. These include continued high government debt, poor demographics, high unemployment, and continued weakness in credit market activity.

Japan

Japan's economy, having grown rapidly in the first half of 2013, slowed in the second half. Still, economic performance in 2013 was the best in years. This was largely a result of the monetary policy component of Abenomics (the other components are fiscal stimulus and deregulation). The monetary policy has involved sizable asset purchases by the central bank designed to suppress bond yields, create inflation, suppress the value of the yen, and boost consumer and business willingness to spend. So far it has been a modest success. Inflation is finally returning to Japan, albeit modestly. Bond yields remain low, thereby creating an environment of low capital costs which encourage investment. The yen has significantly depreciated, thereby helping export competitiveness and helping to revive Japan's manufacturing sector. A sizable increase in wealth, due to higher equity prices, has boosted consumer spending.

Despite the positive news from Abenomics, there are reasons for concern. First, Japan will face a large increase in the national sales tax in April. This was already in the pipeline prior to Prime Minister Abe's accession to office. It is designed to improve the sustainability of Japan's pension system in the future. Yet the increase is expected to hurt consumer spending. Moreover, earlier strength of consumer spending was partially due to consumers purchasing big ticket items before the tax increase takes place. Although the government intends to implement a sizable fiscal stimulus to offset the impact of the tax increase, it is possible that, after April, the economy will slow down considerably.

Second, sustained growth of consumer spending will require increases in wages. Yet while prices have risen, wages have not. This means declining real purchasing power for consumers. The government has encouraged businesses to boost wages, and a leading business lobby has recommended that its members take action. Whether wages will rise in 2014 remains uncertain. If wages continue to stagnate, economic growth will suffer.

Finally, the longer term benefit of Abenomics will require radical deregulation of the economy. The details of what the government intends remain unknown, and the government has delayed implementation of some aspects of deregulation. Absent significant reform, Abenomics will not have a lasting impact on productivity growth and economic growth.

China

The Chinese economy has slowed considerably. The critical manufacturing sector has been stung by slow overseas growth, a rising value of the yuan, and rapidly rising wages, all of which have hurt export growth. Instead, the economy has relied heavily on domestic demand, especially investment in fixed assets. This has been fueled by massive borrowing by local governments, corporations, and individuals investing in the frothy property market. Unfortunately, the growth of debt, mostly off the balance sheets of banks (in the so-called shadow banking system) has created a sizable risk to the Chinese economy. This threatens to either derail economic growth or cause further problems in an economy already suffering from serious imbalances. Although the massive investment in fixed assets has maintained employment, it has often generated negative returns. It has not contributed to the ability of the economy to grow. The government will likely have to bail out troubled financial institutions, force them to reduce lending, and thereby cause a drop in economic growth. The best way to avoid a serious crisis would be to implement significant reforms of the financial system as soon as possible.

As such, the government recently announced a range of reforms intended to create a more normal economy.

The reform program proposed by the Chinese government is radical yet cautious at the same time. On the one hand it proposes increased competition for state-owned enterprises (SOEs). On the other hand, it fails to propose privatization of SOEs. On the one hand it proposes to protect private property rights, but on the other hand it fails to give up state ownership of land. On the one hand it does much to decentralize economic power by empowering the private sector. Yet on the other hand, it pulls more power into the hands of the central government, often at the expense of local and regional governments. As such, it is a mixed bag of reforms.

Despite a bit of ambiguity, it is clear what the government generally hopes to achieve. The reforms, if implemented successfully, should lead to faster economic growth, less financial risk to the economy, and a shift in growth away from investment in fixed assets. In addition, the reforms tackle a variety of social issues. The reforms will lead to greater fairness by promoting more income equality as well as a more powerful and less corrupt judiciary. Finally, the reforms are somewhat conservative in that they should help to stabilize the economy and society by engendering greater predictability. There should be more transparency of financial markets and SOE finances, more professional management of SOEs, less reliance on the decisions of fickle local officials, and more reliance on market forces to determine allocation of resources.

As to the potential impact of the reforms, this depends on how fast they are implemented and the degree to which they are fully implemented. Many of the reforms will only bear fruit over a relatively long period of time. Reform of the financial system, on the other hand, might have more immediate implications for the functioning of financial markets. Given the problems in the banking system, the faster China improves the efficiency of its financial services industry the better.

United States

During the post-recession period, the U.S. economy has actually grown faster than the economies of Western Europe and Japan. Despite this, there has been considerable disappointment in the U.S. with the pace of growth, especially given the continued high rate of unemployment. As 2014 begins, the U.S. economy is recovering nicely after a prolonged period of modest growth. During the last two years, there were factors that held back growth.

In 2012, the recession in Europe hurt the U.S. recovery. In 2013, a severe tightening of fiscal policy in the U.S. probably reduced economic growth by 1.5 percentage points. Yet in 2014, these factors will not play a role. Rather, Europe will be in recovery and U.S. fiscal policy will have a modest positive impact on growth—especially now that the Congress has agreed to scale back the sequestration.

In addition, there are a number of positive factors. These include rising overseas demand, increasing investment in energy production, pent up demand for household formation, and improvements in the functioning of credit markets. Indeed the economy has shown signs of strength. This has included continued growth of consumer spending, especially spending on automobiles. Significantly, it has also included a sizable rebound in the U.S. housing market. Home prices have risen, sales of new and existing homes are up, and construction of residential property has risen. The strength of housing reflects low mortgage interest rates, declining unemployment, improved credit conditions, and the fact that private equity firms have invested heavily in foreclosed properties. The latter has contributed to the rise in property prices which, in turn, has enabled millions of homeowners to return to the market.

On the other hand, the U.S. Federal Reserve has begun to taper its program of quantitative easing. This will entail reducing the pace of asset purchases. In the coming months, depending on economic conditions, the Fed will continue to cut back on asset purchases. Meanwhile, it will maintain a relatively loose monetary policy, keeping interest rates historically low for a longer period than previously planned. It will also take actions to boost credit market activity. Still, the tapering has already led to higher bond yields and mortgage interest rates. These can be expected to continue rising, putting some downward pressure on housing market activity. In addition, the Fed's policy is putting upward pressure on the value of the dollar. This could hurt export competitiveness. In the short term, it is creating some turmoil in emerging markets where currency values have been under pressure.

There remains uncertainty about the economic impact of the implementation of Obamacare. If large numbers of young and healthy individuals fail to purchase insurance, then insurance premiums will rise, possibly having an adverse impact on business. If, on the other hand, such individuals purchase insurance in large numbers, premiums could actually fall.

United Kingdom

In the course of 2013 the UK went from being one of the rich world's growth laggards to being one of its stronger performers. This surprised just about everyone. However, before we get carried away we need to put the British picture in perspective. On average economists forecast the UK will grow by 2.3% in 2014. Before the financial crisis that would have been regarded as a normal, if unremarkable, rate of growth. But after five years in which the economy has shrunk, 2.3% growth looks relatively good and, if realized, would represent the strongest growth since 2007.

Why is the economy rebounding? There are several factors. First, consumer spending is growing despite a sizable drop in real incomes. Evidently there is considerable pent up demand and consumers are dipping into savings and taking on new debts. Plus, wages are starting to turn around. Second, housing has soared, largely the result of a government scheme designed to spur home buying. Third, monetary policy has been expansive. The central bank has been engaged in quantitative easing. Fourth, fiscal policy, having been tight, is starting to ease as the government is close to achieving its fiscal goals. Finally, the recovery in the Eurozone is having a positive impact.

On the other hand, business investment has not risen accordingly. It appears that businesses are not yet convinced of the durability of the recovery. Moreover, the rise in consumer spending may not be sustainable given the weakness in consumer income. A debt financed rise in spending, similar to what happened in the last decade, is hardly the basis for a firm recovery. Britain will need to export more.

Emerging markets

Brazil

Economic growth in Brazil has decelerated considerably. The country has been beset with inflation, currency depreciation, some social unrest, and business pessimism. The central bank has tightened monetary policy in order to slow inflation and resist currency depreciation. The outlook for the short term is, consequently, not very good. In the longer term, Brazil has many favorable attributes including good demographics, a likely dramatic increase in energy production, increased foreign interest in the manufacturing sector, and increased exports of services. On the other hand, Brazil continues to have a variety of challenges which require legislation. These include overregulated labor markets, inadequate infrastructure investment, and trade restrictions.

India

India had a few years of astronomical growth that turned out to be unsustainable. It led to bottlenecks that created inflation. Plus, the growth was financed by an accumulation of external debt that cannot be sustained. The central bank has significantly tightened monetary policy in order to quell inflation and stabilize the currency. Meanwhile, the government has failed to implement many of the reforms that would boost productivity and unleash more investment and faster growth. Rather, such changes must await the next election which will take place in 2014. For now, therefore, India appears to be on a lower growth trajectory.

Russia

The Russian economy has slowed considerably in the past two years. Over the past two decades, Russia's economic performance was usually correlated with the price of oil. However, that relationship has shifted. Today, the price of oil is relatively high but growth is slowing. Evidently, Russia has some fundamental weakness. There has been inadequate investment in energy, resulting in a decline in output. There has been very modest investment in non-energy industries. The population is declining, thus creating a labor shortage which has resulted in higher wages and low unemployment. While consumer spending has been strong, household debt has increased, thereby hurting potential growth. Inflation remains too high and the central bank has, therefore, not eased policy despite a slowdown in growth. Moreover, the country faces growing competition in its core energy export based. Thus, the economic outlook is modest at best.

Other markets

Many emerging markets have seen a deceleration of growth in the past year. This follows a period of very rapid growth that was driven by several factors. These included plenty of inbound investment fueled by low returns in developed markets, excessive accumulation of external debt—especially given the cheap cost of borrowing, and the commodity boom that was fueled by China's massive investment spending. Now, things have changed. Further accumulation of debt is not feasible. In addition, capital flows have reversed now that bond yields have increased in the U.S. Moreover, this has caused a decline in the value of emerging market currencies, thus forcing central banks to tighten monetary policy in order to stabilize exchange rates. Such action has a dampening effect on growth. In addition, the very rapid growth of recent years caused bottlenecks leading to inflation. That is another reason for central bank tightening. Finally, the commodity boom is over, thus dampening growth for commodity exporting countries.

Going forward, the emerging world is likely to have a year or two of disappointing growth while imbalances are unwound. However, the longer term outlook remains positive. Indeed for those emerging markets that did not accumulate too much debt, the outlook is quite good. Among the more promising markets are Colombia, Mexico, Philippines, and much of sub-Saharan Africa among others. These countries have improved governance, competitive industries, and favorable demographics. They should experience strong growth in the coming decade.

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