

# Market Analysis, Research & Education

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## Investor Whiplash: Trend Reversals in the Global Economy

*World Economic Growth Under Pressure*

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The five-year period ending in mid-2008 was marked by a number of related global economic trends, some of which accelerated during the first half of this year. During the past three months, the dramatic reversal in many of these trends has contributed to a collective whiplash experienced by some inves-

tors, companies and countries around the world. This whiplash has fed back into the credit market turmoil and has reinforced the economic downturn, spreading the problems throughout the globe.

### Trend Reversal

For roughly five years until mid-2008, several tenets of conventional wisdom for many investors had been:

#### KEY TAKEAWAYS

- Forced selling, de-leveraging and investor anxiety have spread throughout the world, contributing to a worsened outlook for global economic growth.
- Through financial contagion and the negative impact on real economic activity, most countries have now felt detrimental effects from the fallout of the U.S. financial crisis.
- The abrupt reversal in several multi-year global economic trends—including rising commodity prices, a falling U.S. dollar and rapid economic growth in emerging-market economies—has whipsawed many investors, companies and countries around the world.
- However, many of the larger developing economies remain in better shape to face this downturn than during previous crises, bolstered by more limited borrowing needs and relatively solid financial positions.
- A global economic recession appears increasingly likely; however, global asset prices already reflect a dire scenario, and the policy response by governments worldwide continues to grow.

- Developing countries (emerging markets) could grow at a brisk pace even if the U.S. economy faltered, and could possibly even “decouple” from the rest of the world.
- Inflation—stoked by raging demand for energy and other commodities by developing countries—would continue to rise in a world confronted with increasingly scarce resources.
- Lagging behind due to a housing downturn and debt-laden consumers and government, the U.S. economy’s preeminence would continue to wane as other faster-growing economies grew in stature.
- Directly related to the U.S. economic decline and large external debt, the U.S. dollar would continue to lose value indefinitely.

An investment strategy guided by the above tenets would have done extremely well from 2003 to mid-2008. During that period, emerging-market stocks far outpaced U.S. stock returns. A falling dollar boosted returns to all foreign stocks (held by U.S. investors). Commodities and the stocks of natural-resource-related companies rose far more than the rest of the market. Inflation, commodities, and Treasury Inflation Protected Securities (TIPS) continued to rise even after a bear stock market began in the first half of 2008.

Today, however, the headlines are filled with evidence that some of these trends have come under pressure or reversed completely. While problems with the U.S. economy and financial system continue to be well represented, the headlines have shifted to developments almost unthinkable three months ago—let alone two years ago. Smaller emerging-market economies dependent on foreign borrowing, including the Ukraine and Hungary, have experienced financial crises. Larger developing economies, such as China, have reported slower growth. Commodity prices have plummeted, with the per-barrel price of crude oil less than half its record high set just three months ago. Despite massive new U.S. government borrowing to rescue its banking system, foreign investors are flocking to U.S. Treasuries as a safe haven, pushing the dollar up more than 25% versus the euro and U.K. pound during the past three months.<sup>i</sup> Some analysts now speculate the recession in Europe may be longer and deeper than in the United States, and most countries in the world are scrambling to deal with the effects of a dramatic slowdown in the global economy.

### **What Happened?**

The most proximate and concise explanation for the sudden reversal in several global economic trends is that the struggling credit markets in the U.S. underwent a panic-like de-leveraging in September and early October, sending tremors throughout the globe. As asset sales forced more asset sales, prices plummeted in a chain reaction that has tightened credit around the world. It has become obvious that in a global marketplace there is no immunity from the troubles of other major economies.

In some regions of the world, the U.S. housing-related credit crisis was very directly related to the problems they are now experiencing. European banks owned many of the same distressed assets as U.S. institutions. Similar to what transpired in the United States, some financial institutions in Europe and elsewhere binged on lending to their overheated real estate sectors, indulged in securitizing or writing complex securities and derivatives, and generally took excessive risk. On the flip side, some smaller countries took advantage of a world awash in cheap credit. Iceland, Hungary, the Ukraine, Pakistan and others borrowed excessively in foreign currencies to boost their economies. There also have been plenty of examples of fundamentally sound businesses that pushed the envelope on the financial side. Some

successful foreign corporations made big bets that the dollar would continue to fall. Even billionaire Russian oligarchs apparently levered up their portfolios by taking out massive loans in foreign currencies.

Although the abrupt reversal from risk started in the United States, it has quickly spread throughout the world and, as the global de-leveraging accelerated, it has impacted even creditworthy borrowers. Countries whose currencies had appreciated markedly against the dollar in recent years—from Brazil to Russia to South Korea—have been forced to intervene in foreign exchange markets to prop up their exchange values. Borrowers whose debts must be repaid in dollars now face a double whammy of higher interest rates and depreciating currencies, making servicing debt even more troublesome.

With global lenders tightening credit and the U.S. and European economies (which together account for nearly half the world's output) likely headed into recession, the damage also began to spill over to the rest of the world in a more indirect way. The impact now is not merely financial; it is an economic downturn spreading throughout a globe whose national economies had become increasingly intertwined. Exporters around the world, particularly fast-growing areas such as China and emerging Asia, have felt the influence of dropping demand from their main customers in the U.S. and Europe. Slowing global growth has slackened demand for commodities, extending the impact to commodity exporters in Latin America, Russia, Africa and the Middle East. The global slowdown has become increasingly synchronized and self-reinforcing.

### **Emerging Markets: Tough Times But Better Prepared**

Even though the turnabout for many emerging market countries has been sudden and dramatic, developing nations as a whole are better equipped to deal with the turmoil than during previous crises. True, the list of developing countries facing financial and economic distress continues to grow. Countries with poorly managed macroeconomic policies and excessive debt are the most at risk, including Pakistan, Hungary, the Ukraine, and several others. Countries whose recent economic success was due more to high commodity prices than sound economic policies—including Argentina, Nigeria and Venezuela—also have come under pressure.

The difference this time around is that many of the larger emerging economies have entered this downturn with some combination of more limited borrowing needs, plentiful foreign exchange reserves, and more prudent and flexible economic policies. Some also have high savings rates and the potential to stimulate their consumer markets. China, the world's third largest economy by some measures, has a government budget surplus and nearly two trillion dollars of central bank reserves it can utilize to deal with the slowdown. Other major developing economies including South Korea, India, Brazil, Mexico, Taiwan and Russia have limited external borrowing needs, and some even still have current account surpluses and are net creditors. Most have flexible exchange rate regimes that allow their currencies to adjust to changing conditions. This is a far cry from the 1997-98 financial crisis in emerging economies, when large economies from South Korea to Russia went into freefall, unable to defend their fixed exchange rate regimes that eventually collapsed under unsustainably high dollar-denominated debt.

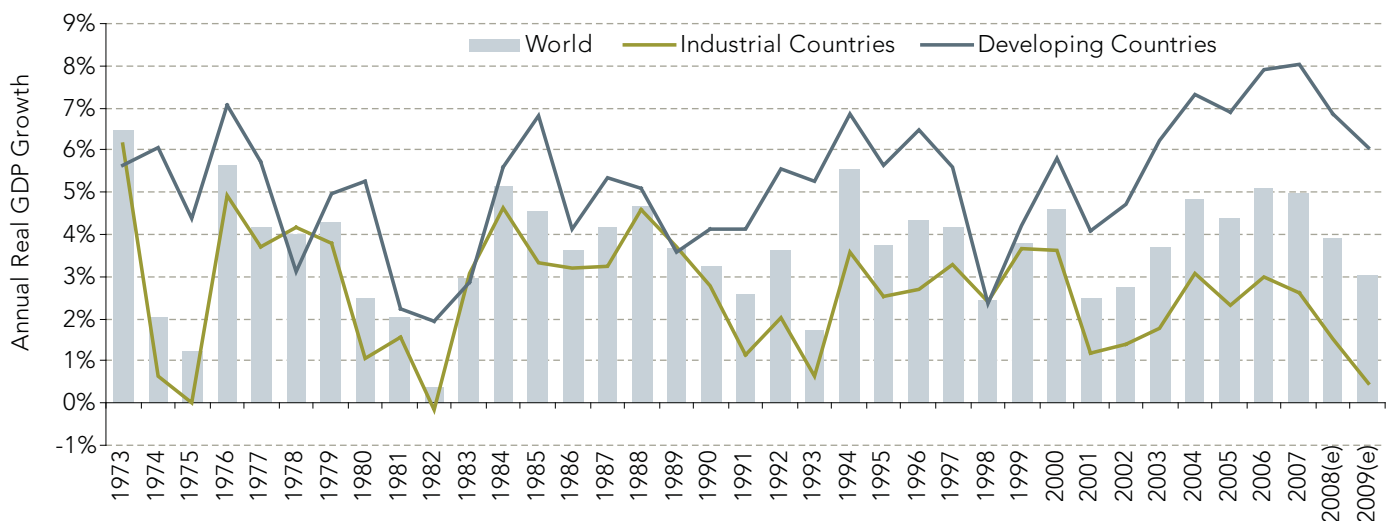
So while emerging market economies are suffering, as a group they are still likely to grow at a faster clip than developed-country economies (see Exhibit 1, below). This is important because emerging markets account for twice as much economic

output as they did three decades ago, making up about 40% of the global economy (see Exhibit 2, next page). Emerging markets have clearly not decoupled from the world economy, but as a group they may still provide more stability to global growth than during previous downturns.

### Deflationary De-leveraging Overwhelms Commodities

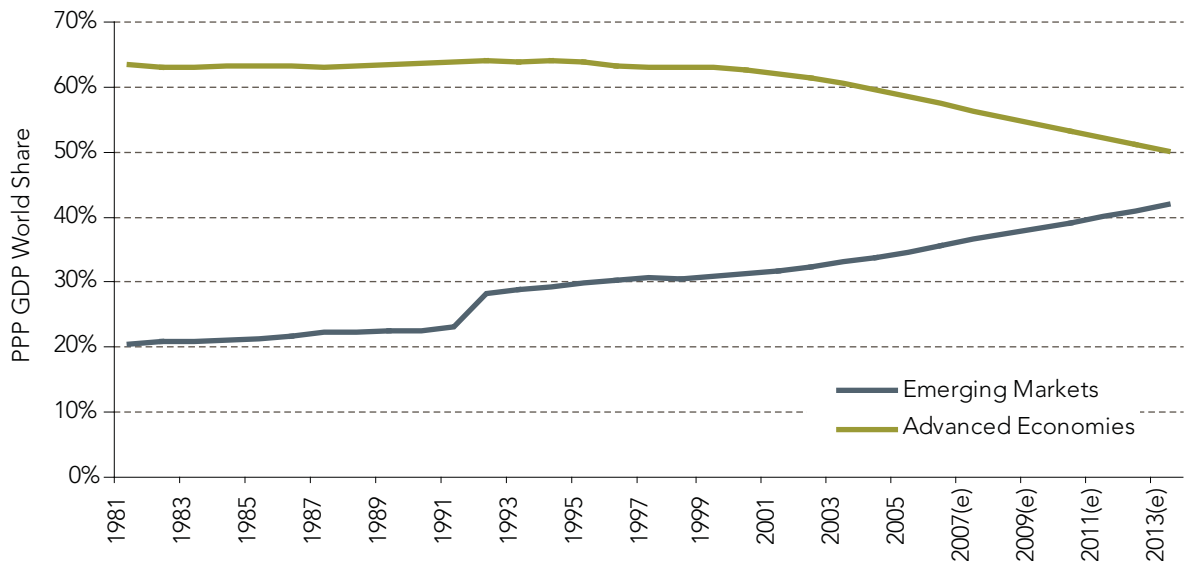
De-leveraging is the process of shoring up balance sheets by reducing debt. When de-leveraging is practiced by many entities at the same time, it can result in across-the-board sales of similar assets that is, by its very nature, deflationary. As asset prices fall, their value as collateral for other types of borrowing declines as well, which provokes additional asset sales to reduce debt, falling prices of debt (and rising costs of borrowing), and a self-reinforcing deflationary ripple. As asset deflation continues to weaken the global economy, falling demand has caused price declines in commodities and other economically sensitive items. It may be too early to declare the era of cheap oil to have returned, particularly if large emerging economies such as China and India are able to maintain high levels of growth. On the supply side, the excess production capacity of oil is small compared to the early 1980s, and the marginal cost of new production is significantly higher. However,

**EXHIBIT 1: Despite estimates of slower gross domestic product growth for 2008-2009, developing countries are expected to maintain a higher rate of year-over-year growth than industrialized countries.**



Note: Data prior to 2006 are from IMF International Financial Statistics report; data for 2006-2010 are from IMF World Economic Outlook. Five countries (South Korea, Hong Kong, Taiwan, Israel, and Cyprus) are categorized as developing prior to 2006, and industrialized thereafter. Source: International Monetary Fund, Haver Analytics, FMRCo (MARE) as of 10/9/08.

**EXHIBIT 2: The percentage of global economic output from emerging-market countries has risen to nearly 40% of the world's economy, and is expected to continue rising in future years.**



Note: Taiwan excluded. Source: International Monetary Fund, Haver Analytics, FMRCo (MARE) as of 10/9/08. GDP measured on a purchasing-power-parity basis. See footnotes for definition of advanced economies. Emerging Markets include countries in the MSCI Emerging Markets Index.

in the near-term, de-leveraging and falling demand has overwhelmed everything else, and a sustained rise in inflation and commodity prices will likely be tied to an eventual recovery in the global economy.

### U.S. Demise Exaggerated?

Unfortunately, the carnage to the global economy underscores how the U.S. economy and financial system—still the world's largest—are critical to world growth. The surge in the U.S. dollar seems a remarkable turnaround at a time when the U.S. economy and financial system face their toughest challenges in decades. In part, it represents how abruptly conditions have worsened in other countries. However, it also probably signals that the perceived relative decline of the United States was somewhat exaggerated. In times of great distress, people around the world apparently still want to hold dollars instead of most other currencies, and it is possible the U.S. is actually being viewed by some investors as a relative safe haven during a period of great uncertainty.

### Investment Implications

The abrupt reversal of several multi-year global macroeconomic trends illustrates the danger—for all investors—of assuming current market conditions will continue indefinitely. Indeed, there are no one-way

bets. While some of these trends may eventually prove to have simply detoured from their long-term path, others may have entrenched in the opposite direction for a significant time. The combination of these developments—global tightening of credit, weakness in emerging-market currencies and economies, and falling commodity prices—make a global recession over the next year increasingly likely. That realization serves as the primary reason global stock markets fell off a cliff in late September and October, and have lost 40%-60% of their values from their 2007 peaks. Offsetting this bleak outlook is the flurry of government policy responses aimed at improving the flow of credit and stimulating economic growth that have been announced by a long list of countries in recent weeks (see recent MARE article, *Governments Expand Financial and Economic Rescue Efforts*). This list of policy actions is likely to continue growing as the economic news remains challenging in coming months. Government responses and the relative strength of some of the larger emerging-market economies, such as China, are not likely to keep economic data from weakening and corporate profits from declining in the near future. However, a global economic slowdown is no longer an obscure possibility, it is a well documented trend. Like all trends, this one too may eventually change course. ■

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*Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.*  
Past performance is no guarantee of future results.

[i] - Source: Haver Analytics, FMRCo (MARE) as of 10/27/2008.

Advanced economies (29 countries): Australia, Austria, Belgium, Canada, Cyprus, Denmark, Finland, France, Germany, Greece, Hong Kong SAR, Iceland, Ireland, Israel, Italy, Japan, South Korea, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, Taiwan Province of China, United Kingdom, and United States.

The MSCI® Emerging Markets (EM) Free Index is a market capitalization weighted index of over 850 stocks traded in 22 world markets.