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As the end of one of the worst (inflation-adjusted) decades in stock market history draws near, investors might be forgiven for viewing the years since the bursting of the dotcom bubble as a 'lost decade'. But while equity returns have been dismal, the last 10 years have not been entirely in vain. Of greatest long-term significance, perhaps, has been the growing recognition of the potential of the BRIC nations and their integration into the global economy, both as producers and as consumers. That process has materially transformed millions of lives and opened up a wealth of previously untapped resources and talent.

The global financial crisis, meanwhile, underlined the economic and political importance of emerging markets. The resilience of the Chinese economy helped to drive the global economy even as demand in the developed world evaporated. And, in a move both symbolic and pragmatic, the G20 (which includes countries such as China, India, and Brazil) replaced the G8 (which does not) as the main forum for global economic discussion and co-operation.

That progress is, we believe, on the verge of being translated into real gains for patient investors. The key investment questions of the next decade will centre on identifying the companies best placed to benefit from that remarkable transformation.

The World In 2009: A Bird's Eye View

Over the last six weeks, I've met and talked to a number of companies. Throughout, what struck me were the similarities between the outlooks of companies in entirely different industries and markets. Every chief executive I talked to was keen to emphasize their company's exposure to the BRIC economies. This, I think, gets to the heart of what matters to investors in late 2009. Emerging markets (in general) and BRICs (in particular) are no longer peripheral or ancillary to the developed world – they are absolutely central to the global economy.

China, of course, has tended to dominate the headlines for most of the last decade. While it is well deserved, the attention directed towards China should not be allowed to overshadow the opportunities on offer in Brazil and India.

Although arguably less fashionable than China, Brazil has been the world's best-performing market this year. The Brazilian real, meanwhile, has been the world's strongest currency. The Latin American giant's emergence as an economic power may have lacked the drama of the liberation of 1.3 billion Chinese from communism, but the investment opportunities that it is creating are every bit as real. Since his election in 2003, President Lula has wrought a dramatic change in Brazil's economic fortunes, pursuing prudent economic policies that have belied his reputation as populist firebrand. In recognition of this prudence, ratings agencies have bestowed investment-grade status on Brazil's sovereign debt. Oil revenues are likely to continue driving economic growth and a viable consumer economy is starting to emerge in Brazil.

India, too, has quietly undergone its own economic revolution. The decisive mandate awarded to the government in May's election has given it the opportunity to pursue a reformist agenda. With a premium growth rate, India offers a broad range of investment opportunities across a variety of sectors.

The picture in Russia, however, is less clear. This year's sharp recovery in energy prices has seen both the stock market and the ruble rebound. Ongoing corporate governance concerns, however, mean that Russia remains a market for the brave.

Building Companies For The Next Cycle

In addition to the central importance of emerging markets, another common thread has run through our recent conversations with the companies in which we invest. While there is still widespread reluctance to commit to a 'view' on 2010, there is general agreement that the cyclical lows are behind us: the worst is over.

In fact, many companies are finding themselves well-positioned to benefit from the next cycle. In the absence of capital to fund inventory, stocks have been cut aggressively. The closing of money and credit markets has had a galvanic effect, shocking companies into taking painful but necessary steps to eliminate excess structural costs: surplus labour has been retired, redundant plants have been shuttered, and, where possible, soft costs have been stripped out. There is, it would seem, a commitment to maintaining these leaner operating models into the next cycle, which should prove beneficial – particularly as pricing remains firm.

But while pricing has held up, input costs have fallen. Lower raw material prices, particularly in the early part of 2009, have enhanced margins. Volumes have recovered. This means that corporate earnings could return to or pass peak levels – even if consumer spending fails to rebound to its pre-crisis levels.

A Macro-driven World

The similarity between the outlooks of companies operating in unrelated sectors and markets suggests that we continue to live in a macro-driven world. As ever, the messages from economic data are mixed. But as clarity in macro trends begins to emerge, many of the companies I spoke to – and all of those in which we invest – are ready to respond. Furthermore, some key trends do seem to have gathered momentum in recent weeks:

- **Employment**

Recent data have indicated that the rate at which workers are being laid off is starting to slow. In the U.S., the unemployment rate actually fell in November, declining to 10.0 per cent from 10.2 per cent. That confirms the improvements in the rolling three-month non-farm payrolls, which have been on a less negative trend for some time.

- **Consumer spending**

News from the retail sector has also been consistent for some time: consumers are looking for value and trading down. Perhaps more surprising has been the strength of consumer appetite for luxury goods, which is most evident in the emerging markets. Cost-cutting is also helping to underpin margins.

- **Property**

Trends in the U.S. housing market, where many of our recent economic woes germinated, are increasingly positive. There has also been speculation that the UK's troubled commercial property market may have finally turned a corner. Signs of improvement are, however, less evident in the U.S. commercial real estate market: bank default rates on commercial property loans are continuing to rise.

- **Currencies and the gold price**

In recent weeks, the market's focus has been on a number of closely connected questions: inflation, the gold price, quantitative easing, and exchange rates.

The relative fortunes of the world's 'big three' currencies – the dollar, the yen, and the euro – have fluctuated in response to economic data and the waxing and waning of risk appetite. Speculation regarding the timing of the withdrawal of quantitative easing has added to the uncertainty. Gold, which is still trading at around \$1000 an ounce below its 'real' (inflation-adjusted) highs of the early 1980s, received added support from the Indian central bank's decision to buy 200 metric tons from the IMF. Gold bugs have started to salivate at the prospect that other countries with large foreign currency reserves, such as China, might decide to increase their bullion holdings; gold still represents a relatively small proportion of the central bank reserves of many developing countries.

Much of this gold fever is a direct result of investors' growing concerns that the U.S. dollar's long era of dominance may be waning. The worry is that the Obama administration's lack of a 'dollar focus' will prompt creditor nations in the Middle East and Asia to shift their dollar reserves into gold or call a halt to their buying of U.S. Treasuries.

But currency worries aren't confined to the U.S. The rapid rise of commodity-based currencies such as the Australian dollar, the Brazilian real, and the South African rand have prompted concerns that manufacturers in those countries will lose competitiveness. The euro and the Japanese yen have also seen significant appreciation in recent weeks, causing problems for Japan's large manufacturing sector and making Europe a prohibitively expensive holiday destination for British and American travellers. In the short term, at least, it seems likely that this process has gone too far: economic fundamentals in Europe certainly don't justify the euro's recent strength. In particular, the threat of sovereign debt default has increased, with Greece the focus of recent worries. In Japan, meanwhile, the return of deflation means that rates seem likely to remain lower in nominal terms than in Europe and the U.S. for some time.

In the long run, it seems inevitable that the world's reserve currency must be grounded in the sound economic fundamentals of one of Asia's larger economies. Of course, the small matter of foreign exchange controls must be addressed before that can happen.

The World In 2010: Learning From Japan

As 2009 draws to a close, the focus of investors is inevitably beginning to shift to the coming year. Broker releases brim with detailed forecasts for markets and sectors. At present, the consensus seems to be that emerging markets will outperform again in 2010 in both economic and stock market terms. Recent conversations with the companies in which we invest supports that thesis: corporate investment flows into

the BRIC economies will be powerful in 2010 and beyond. There is a consensus that developed markets will, in comparison, be rather dull, particularly as fiscal stimulus and monetary support are withdrawn. The U.S. has already signalled that we are at the 'beginning of the end' for some elements of quantitative easing.

In our view, the global economic recovery in 2010 seems likely to be both gradual and prone to the occasional sideways (or even backwards) move. One area where we think markets have the potential to be negatively surprised is jobs. While positive, a decline in the rate of layoffs is a very different matter from job creation. With so much corporate investment being directed towards emerging markets rather than Europe, it is difficult to see where new jobs will be created. The U.S. is in a slightly better position, as the fall in the dollar is helping the competitive position of its industrial base. Even here, however, the prospect of new jobs being created remains a distant one.

That said, we believe the biggest risk as we head into 2010 is that policy makers fail to heed the lessons learned in the decade-long macro-economic laboratory experiment that was Japan during the 1990s. Ask any company and the message is consistent: banks are not recycling capital. U.S. companies are hoarding cash and/or buying bonds. This is the failure of the money multiplier and it has worrying parallels with Japan's experience in the 1990s. It will both limit governments' scope to rein in stimulus spending and prevent central banks from withdrawing easy money as soon as some commentators expect. In our view, inflation could be lower than the market expects for far longer than it expects.
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