

# ► On Target

Martin Spring's private newsletter on global strategy

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## **The Risk of an Unseasonal Market Shock**

What are we to make of the conflicting fundamentals that have brought heightened volatility to global investment markets?

Here are the negatives, as I see them:

**The credit squeeze.** Although the immediate panic is over, this is a slow-burning crisis that is going to take a long time to unfold, having an adverse impact on economic growth for years to come.

Banks will hurriedly revert to conservative lending policies to digest their own toxic waste, rebuild their balance sheets, placate angry politicians and activist regulators, and shore up the confidence of their shareholders.

One example of how much further revaluation of structured-credit assets still has to go is that Merrill Lynch was recently forced to cut by 57 per cent the value of one chunk of its mortgage products that had been given the highest credit rating, AAA.

Lots of toxic waste remains buried in packaged investments scattered around the world in the portfolios of conservative financial institutions such as pension funds. It will take years for the losses to become apparent, when the lower market values of those credits are recognized and taken to book.

However, more damaging than the losses themselves – which could well turn out to be not all that great, relative to total assets – will be the damaging impact on sentiment of ongoing uncertainty and the drip-feed of continual announcements of losses. A serious outbreak of caution.

**Housing collapse.** The bubble in the residential property markets of the US and other afflicted countries such as the UK, Australia and Spain has only just started to deflate, and has much further to go.

Stephen Roach, chairman of Morgan Stanley Asia, has raised the prospect that in America, for example, home prices overall could “decline in both 2008 and 2009 – an unprecedented development in... modern-day experience.”

If that happens – and I think it is almost certain – it must have a devastating impact. The most powerful force that has been driving US economic growth is disappearing. The well-known economist Joseph Stiglitz estimates that direct and indirect spending linked to housing accounted for two-thirds to three-quarters of all growth in the US economy since the end of the technology boom.

**Earnings collapse.** Banks and other financial businesses have been providing a third of all the profits of companies listed on US stock exchanges. Much of those profits have been derived from lending money to poor risks, recycling dodgy credits to naïve institutional investors, and financing speculation or high-risk takeovers in various forms.

Much of that business is evaporating, and with it the fancy profits. Banks will be forced to revert to unexciting and low-profit activities such as lending money to blue-chip companies (most of which are cash-rich and won't wish to borrow).

Financial companies are not the only ones starting to experience tough trading conditions. Early indicators suggest that the years of corporate earnings growth, which took profits in the US to an all-time high relative to GDP, have come to an end.

The implications for equity investors are likely to be unpleasant. The *Financial Times* reported recently: “The seven earnings slumps since 1947 have all hit fast (an average of 31 months from peak to trough profits) and hard (cutting a third or so from profits).”

**Inflation.** Years of profligate money creation by central banks, supply/demand imbalances that have driven up the prices of key resources such as oil, the fading impact of unusually-high tech-driven productivity gains, and shortages of high-level skills in many sectors such as global mining and Chinese manufacturing, are combining to bring back the inflation problem.

Central banks have awakened to the risk. But now they are stuck between a rock and a hard place. They want to boost interest rates to combat inflation – but need to cut them to ease the pain of the credit squeeze and reduce the risk of major bankruptcies in the financial sector.

Given mounting political pressures and the risks to economic growth from the crisis in the credit markets, it's likely that the central banks will give first priority to cutting interest rates.

Consequently, inflation is likely to worsen.

**Currency instability.** The US needs to attract an extra \$3 billion in foreign capital every business day to finance its foreign trade deficit. If foreign governments, institutions and private investors become less willing to provide that capital, the dollar will remain under pressure – continue falling in value in terms of other currencies.

Among the adverse consequences will be pressure on US investment markets to offer higher yields to attract foreign money, making it more difficult for the Fed to cut short-term interest rates. Exporters in other countries with costs based in stronger currencies, such the euro, will find it increasingly difficult to compete.

However, the negative fundamentals I've listed will be countered by some positives, especially for investors:

**Strong growth in developing nations.** Emerging markets now generate more than half the world's economic growth, and the proportion is rising fast.

Although any slowdown in the US economy will have global consequences, both softening demand for internationally-traded products and undermining business and investor confidence, the scale of the damage must be less than in the past in a global environment where America is less important than emerging markets as a whole as a source of demand.

It's true that exports have become primary engines of growth for developing nations, providing markets for almost half their production. But...

► The US is not as overwhelmingly important as buyer for those exports as you might think. Globalization has expanded all export markets. Developing nations increasingly export, not only to America, but also to Europe, Japan, and regional trading partners.

Take a look at these interesting figures from Morgan Stanley Asia:

Nation	Export share of GDP	US share of exports
China	37	21
Japan	15	23
Korea	37	13
Taiwan	59	14
ASEAN*	73	14

\* 10 Southeast Asian countries with a combined GNP of \$1 trillion.

► Emerging markets are increasingly driven by their internal dynamics. Hundreds of millions of people are moving from rural areas into cities where they can earn much more. Enormous numbers of them are moving up the income scale into the middle class, with the spending power to acquire decent homes, equip them with nice furnishings and modern gadgetry, and buy cars.

High savings ratios, sound public finances (low spending, low taxes), and foreign reserves running into several trillion dollars, provide the firepower for many governments to stimulate domestic demand to offset falls in export sales.

The focus will probably be on physical infrastructure such as power stations, roads, ports and public buildings, as that provides the foundation for even higher economic growth in future, as well as for provision of better public services.

**Cheap money.** The greater the risk of global recession and of deflation, the more central banks will force down short-term interest rates to combat that risk.

In Japan the central bank offered credit to commercial banks at virtually no cost, and even now charges only  $\frac{3}{4}$  per cent. With policy rates in the 4 to 5 per cent range, the central banks of the US and Europe still have great potential to cut rates and flood their systems with near-free credit, should they deem that necessary.

Although printing money isn't guaranteed to stimulate growth if consumers and businesses don't want to borrow cheaply to finance their spending, it does provide strong underpinning to economies in trouble. Japan's experience proves that.

**Fiscal stimulus.** If economic slowdown becomes worrying, it won't be just central banks that throw money at the problem. Governments will do so, too, by increasing their spending on whatever interests the politicians currently favour.

It is not only developing nations that will be investing in infrastructure. Countries such as the US, the UK and Australia badly need to do so in any case to replace worn-out and inadequate facilities.

**World trade.** The progress of globalization won't cease because of lower growth in the world economy, even though that progress will be slowed somewhat by rising protectionism in the developed nations, where whole swathes of job classes are under increasing pressure from foreign competition.

The process of global integration has gone too far for it to be reversed. Every nation, including the most advanced ones, has become heavily dependent on inflow from abroad of materials, components and finished goods.

Some commentators even argue that with economic slowdown putting corporate profits under severe pressure, managements will be even keener on reducing their costs by shifting manufacture of their products and provision of their business services to cheaper locations in the emerging economies.

Although a weakening dollar will mean greater problems for nations with stronger currencies – especially those in the Eurozone – it will favour a rebalancing. For

the US, for example, it will make exports more competitive and discourage imports, reducing the horrific foreign trade deficit.

**My conclusion?** The negative factors are likely to outweigh the positive ones for a while, generating major difficulties for all the advanced economies. The devastation wrought by the credit crisis will turn the financial services and housing sectors into no-go areas for investors for many years to come, and make life difficult for small and even midsized enterprises, which tend to depend more on credit.

The emerging markets should largely escape unharmed. In the case of Asia, for example, Stephen Roach suggests that a US demand shock could be “serious trouble” for Japan, but not for the rest of Asia. China would actually welcome a forced slowdown of economic growth from 11 per cent to, say, 8 per cent. In India and the ASEAN countries “underlying growth appears strong enough to withstand a shortfall in US consumer demand.”

The Asia-Pacific excluding Japan remains my favourite region for investment. In the case of equities, I would not disagree with the recommendation of CLSA’s strategist Christopher Wood that a five times overweighting – 37 per cent of a global portfolio – would be a good idea.

Resource-focused economies such as Australia, South Africa, New Zealand, Canada, Brazil, and the oil/gas producers, should also not suffer any serious damage from the downturn in the world economy, because of the probable persistence of shortages in supplies of commodities relative to demand.

Donald Coxe, the eminent adviser at BMO Capital Markets, suggests that “reliquification” of the global economy by a weaker dollar “has the potential to unleash a new round of commodity inflation, led by gold, base metals, foodstuffs, and to a lesser extent energy.”

The agricultural sector remains his favourite commodity sector for new money commitments, with fertilizer, farm equipment and seed companies “excellent value for long-term investors.”

## **Equity bull market to continue in its “mature” phase**

Worldwide, stock-market valuations generally are moderate and without bubble characteristics (except in China’s domestic market). Citi’s global equity strategists believe we’re in a typical “mature bull” phase of the investment cycle, which favours equities.

There are often bubbles in such phases, which “usually build on a theme that has already been performing strongly” in the previous phase. This time around, themes that have such bubble potential are emerging markets and commodity plays.

It's important to recognize that in such a phase share prices may rise strongly despite falling earnings, as equities are re-rated favourably relative to alternative investments, such as corporate bonds.

For decades investors have found the best returns, on average, to be in the less-researched and less-liquid small- and mid-cap sectors. However I believe the radical changes in bank lending policies as a consequence of the credit crisis is going to change that for a while.

For the next few years I expect the best returns in developed markets to be in the large-caps -- especially the best-managed with global brand and/or technological leadership (which will be targets for the sovereign wealth funds), turnaround candidates with strong asset bases that attract cheap credit, and multinationals with strong business operations in, or trade with, emerging economies.

For the very short term, I think caution is called for. There are signs of dramatic change in the corporate earnings environment. Prices of many resources look too far above trend. And many of the charts of major stock markets seem to be signalling significant corrections ahead.

Usually the November to February period is one of strength in global equity markets, but I fear that this time around we could suffer an unseasonal shock.

It's time to review your portfolio and consider taking some profits, as I have done recently, to build up cash for the next buying opportunity.

## **Be Selective About Big-Caps**

When investing in American equities it's important to differentiate between those who make most of their earnings out of the domestic market and those that mainly profit from exports and foreign operations, David Fuller says in *Fullermoney*.

Companies in the "domestic" group are suffering because of an economic slowdown due to a burst housing bubble and the credit crunch. "Unemployment is likely to rise, and this will weigh further on consumer sentiment."

It will take time for the "toxic waste" of poor credits to clear and their stench will linger. "I would not bottom fish among the clearly moribund (banks and other financial services companies) any time soon, because their convalescence is likely to be lengthy.

However the weakening dollar is providing "a bonanza for US multinational companies," as their foreign-currency profits, even without growth, translate into higher dollar earnings. The falling greenback also makes US shares cheaper for investors domiciled outside the US.

“If I were investing in the US stock market, I would be trolling among multinational companies that are relative strength leaders... Big-cap tech will increasingly be among the magnificent.”

## Tailpieces

**Spanish justice:** A friend warned long ago of the nasty consequences of Britain’s signing up to a European agreement that allows its citizens to be “arrested in their own homes on the warrant of incompetent or corrupt foreign police forces and magistrates (imagine what could happen at the behest of the totally corrupt legal administrations in Rumania and Bulgaria)”. They can even be arrested for “crimes” that don’t exist in British law, such as Holocaust denial.

Just such a case has now happened.

According to the well-known MP Frank Dobson, one of his constituents was arrested while holidaying in Spain on suspicion of counterfeiting euro notes, although no such notes were found in his possession. He was released at the time – but arrested in his UK home more than three years later and extradited to Spain. Despite “exemplary good character,” he was denied bail, held in jail for months, and then advised to plead guilty – otherwise he would be kept in jail for a further year before his case came to trial.

“Understandably in such dreadful circumstance, he pleaded guilty and got a two-year suspended sentence and a 600-euro fine,” Dobson told Parliament. The treatment of his constituent “is a disgrace” and “the sort of incident that brings European institutions into disrepute.”

**Chinese apartheid:** According to a new ruling, only sportsmen holding local versions of the Chinese passport will be allowed to represent Hong Kong and Macau in next year’s Olympics. As such passports are only given to people who are ethnically Chinese, this move excludes local athletes of other races, such as those of Indian descent.

It interests me that the International Olympic Committee has refused to interfere in this clear example of racial discrimination. Yet another example that condemnation of racism is highly selective, and usually confined to those who lack popularity or power.

**On camera:** A game show where people were strapped to a lie detector and asked 21 increasingly personal questions has been taken off the air in Colombia after a contestant won the top prize (the equivalent of \$50,000) by admitting to hiring a contract killer to murder her husband. Other players were revealed as adulterers, prostitutes and drug smugglers.

British media giant Sky has bought the rights to broadcast *Nothing But the Trust* shows in the UK.

**Hospital breakthrough:** I see that Thailand's Bumrungrad Hospital, the global pioneer of medical tourism listed in Bangkok, has sold to Microsoft 70 per cent of its Global Care Solutions subsidiary. Microsoft wants to expand in the healthcare market. It will offer clinical and back-office software developed by GCS for managing medical records and slashing time spent waiting to see a doctor.

**UK dottiness diary:** Red Arrows, the world-famous air force aerobatics team, have been banned from appearing at the 2012 London Olympics because their association with the British military might to "offensive" to other countries taking part in the Games.

A police crackdown on cannabis factories in the UK run by Vietnamese drug barons was scrapped after officers were warned that their actions might be racist because they were focused on Vietnamese – even though the latter are believed to control most UK production of the illegal drug.

Meanwhile, a man is being investigated by the Thought Police for telling a traffic warden to "f\*\*\* off back to where you came from, you monkey," while the warden is also in trouble for calling him a "white man" in response. Both are black.

A leading charity has warned that children who call their classmates "gay" risk being arrested for committing a hate crime, even if they don't know what the word means. Under new proposals, it will be illegal to use threatening words or behaviour based on sexual orientation, with penalties of up to seven years in jail.

There is already uproar over the hugely expensive cases involving arrest and even prosecution of children for trivial offences, such as stealing half a sausage roll, a nail and a marble.

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