

Be wary of the herd

Kneejerk contrarianism does not have a great track record, but the most money is indeed made or saved by staying away from the herd



Ruchir Sharma

THE way a year or decade begins tells us nothing about how it will end. After all, the dominant trends that marked the onset of both 2009 and the past decade were turned on their head. Investors feared a deflationary death spiral at the start of 2009 but the year ended up as the best for stocks this decade. Yet, the decade itself — now tagged as noughties — will go down in history as the worst 10-year period for global equities even though it began with the tech bang.

Nothing lasts forever, but the duration of any trend seems to have become even shorter in recent times. The markets, to use actor Robert Redford's words, now have the attention span of a lightning bolt. The dramatic rise in stock turnover ratios indicates that long-term investing is passé. Data from Bernstein Research show that on average, the top 100 stocks in a US portfolio are barely held for a quarter these days compared to the 1960s when the time horizon stretched six to seven years.

Extrapolating current trends is, therefore, fraught with risk and it pays to be wary of the herd. In this regard, it is worth enlisting the various conventional wisdoms deeply entrenched in investor psychology and to see how they could possibly go wrong before the year is out:

- *A 3-speed economic recovery will continue to unfold.* The consensus expects economic growth in emerging markets such as China and India to return to levels similar to the 2003-07 boom years. As for the US, the current economic momentum should sustain with the economy expanding 3% in 2010. This pace is sub-par compared to previous recoveries in the US, but in line with past economic cycles associated with banking crises. Meanwhile, Europe and Japan are widely expected to remain economic laggards with both regions experiencing a gently upward-sloping L-shaped recovery.

- *Emerging markets is the asset class of choice and the prime candidate for the next bubble.*

Investors have all come to appreciate the superior growth profile of emerging markets and expect the asset class to continue to outperform in the near future. Even though emerging market equities are now trading at a premium to developed markets on some metrics, the popular thinking is that easy global money conditions and the growth appeal of the emerging economies will keep propelling these stocks higher, eventually taking their valuations to bubble-like levels.

- *The first half of 2010 will be strong for equity markets but policy tightening will erode some gains in the second half.* An accelerating growth momentum and an accommodative monetary policy provided a sweet spot for equities over the past few months. Investors expect the good times to roll on for much of the first half of the

year but fear some sort of a setback in the second half when rising interest rates and richer valuations pose a problem for equities. Analysts, therefore, expect 'a year of two halves', with net gains of 10-15% for global equities.

- *It will become more of a stock-picker's market as earnings, rather than valuations, will drive the rally.* Macro was all that mattered over the past couple of years as a one-dimensional view of the world dictated the performance of various asset classes, sectors and stocks. Following the stabilisation in the global macroeconomic environment, the importance of country, sector and stock-specific factors should increase with growth commanding a premium — especially as valuations have converged across many sections of the market.

- *Huge capital flows into developing countries will put appreciation pressure on their currencies.* After the sudden stop in capital inflows in 2008, policymakers in most emerging markets expect the main challenge this year to be massive inflows, comparable to levels in 2006 and 2007. The biggest recipient of hot money flows cou-

of governments in many economies to fund their deficits. Fiscal problems in Greece and Dubai could be just a teaser with similar funding problems spreading to the UK, Japan and even the US.

- *Credit spreads will continue to tighten.* In contrast to government bonds, yields on corporate credit and particularly in high-yield debt are attractive, according to most sell-side analysts. The past year was one of the best ever for investment-grade debt, but with spreads still high by historical standards and the quality of balance-sheets improving, apparently the spread tightening trade still has enough juice.

- *Gold and oil are the best stores of value.* The bulls and the bears on the global economy think gold and oil can hold their own under almost any scenario. Gold could keep performing well in a liquidity-abundant world but also act as insurance in the event of a debt or currency crisis. Oil too has acquired similar characteristics with the added angle of supply constraints.

- *Commodities are in a secular uptrend.* The commodities 'super-cycle' theory that has many believers is rooted in the

view that emerging markets such as China and India will be large commodity buyers for a long time to come due to greater urbanisation and industrialisation in these countries. The

sharp rebound in commodity prices this year on the back of China's growth has only reinforced this view.

- *China's policymakers will never let its growth slip below 8%.* The government's staggeringly-large policy response to the global financial crisis left both the Chinese middle class and foreign investors stunned. The traction those steps gained in reviving investment makes the dramatic events of 2008 seem like a blip in the country's long march toward more prosperity. China has not recorded growth of less than 8% in any calendar year since 1998 and economists do not see the pace slipping below that auspicious number any time soon.

The common thread running through these consensus views is the optimism on global growth prospects, particularly about the developing world. A bolt from the blue in China or a double dip in the US economy would undermine all current beliefs.

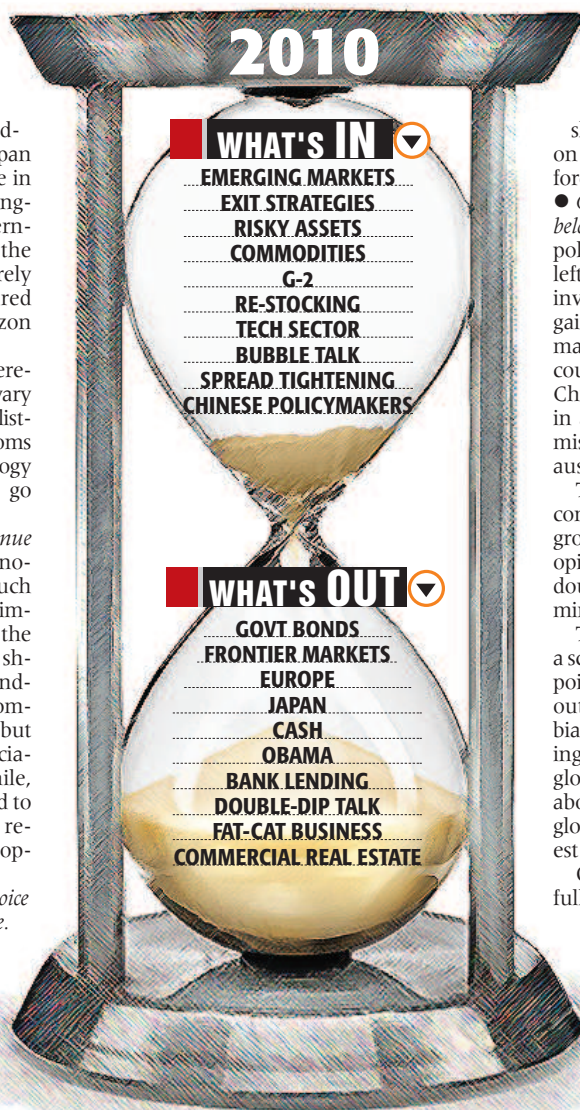
To be sure, it is currently difficult to construct a scenario under which Chinese growth disappears on the downside this year and the news out of the US economy too has had a stronger bias of late. However, investing involves thinking through the tail risks. A double dip in the global economy is the left field event to worry about the most now just as a synchronous global recovery was the outcome with the lowest expected probability at this time last year.

Other potential market dislocations are a full-scale bubble in emerging markets or a debt-funding crisis in the developed economies. The history of markets shows that such outlier events are usually not widely predicted and there is too much talk of an emerging market bubble for it to materialise. Similarly, while a blowout recovery in the US would be a major surprise in itself, other conventional wisdoms — from higher interest rates to firmer commodity prices — would all still play out and hardly make for the unexpected.

A growth relapse is the true contrarian view to engage in 2010. Of course, kneejerk contrarianism does not have a great track record, as fundamentals don't always keep turning on a dime. But the most money is indeed made or saved by staying away from the herd.

(The author is head of emerging markets at Morgan Stanley Investment Management)

The current consensus is much too optimistic on emerging market growth for comfort. It is worth remembering that the conventional wisdom at the start of any period usually turns out to be rather fragile.



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ld be China and, consequently, an inevitable revaluation of the yuan. The only debate amongst the forecasters is what will be the magnitude of the revaluation.

- *Government bonds are not the place to be.* Most economic models suggest real yields on government debt are too low, particularly given the large fiscal deficits, and a pick up in private sector credit demand can lead to a rout in government bonds. Financial analysts believe that any 'next crisis' will be the inability