Macro is all that matters

The current economic momentum inspired by stimulus efforts will likely keep financial markets well bid for much of 2009

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> Global equity markets have staged their strongest rally since 1933 to return to normalcy. Now with valuations and sentiment no longer compelling, economic data needs to keep surprising on the upside for the bull run to continue.

SUCCESS, according to legendary US army general George Patton, is how high you bounce after hitting bottom. Judging by the stunning rally in global equity markets, it seems policymakers across the world have been remarkably successful in engineering a recovery from the depths of last year's panic.

Several economic and financial market indicators have returned to pre-crisis levels less than a year after the world apparently changed on 15 September 2008 — the day that Lehman Brothers went bust. The pace of the comeback has been truly stunning. Emerging market stocks have rallied by 90% off the lows and are now at exactly the same level as on 12 September 2008, which was the last trading day before Lehman's collapse. Similarly, investment grade corporate bond yields, bank credit default swaps and VIX — a popularly used gauge of fear in the equity marketplace — have all returned to levels that prevailed just before the Lehman bankruptcy.

The benchmark US stock market indices are still 20% below the September 12 levels but the 50% rally from the March 2009 trough represents the fastest advance for stocks since 1933. The only other two comparable periods in terms of pace and magnitude of recovery are 1938 and 1974-75, when the US market rose by around 50% in seven and nine months time respectively.

The resurgence is not just a financial market event. Economic growth too has hooked higher, led by China where sequential growth is running at a record pace. The global economy is set to expand by over 3% in the current quarter, driven by a rebuild in stocks after producers dramatically cut back on inventories and jobs earlier this year fearing a Great Depression redux. It is clear that such an extreme economic outcome will not materialise but the debate is now over the path forward. There are three camps of thought out there:

Camp 1: This is it, nothing comes next. While the inveterate bears are willing to concede that the worst is over, they believe that any recovery will be shallow since the still over-indebted global economy will take a long time to work off the excessive leverage in the system. The bears argue that the US consumer has just about begun the process of deleveraging and will refrain from any major new spending until the personal savings rate gets back to the historical norm of 8% from 6% currently.

Under such a scenario, the economic rebound will prove to be a one or two quarter wonder, driven merely by the vicissitudes of the inventory cycle. Even China will not then be able to sustain the revival in its economic activity, as it essentially remains the world's manufacturing base and will need the export engine to start humming again soon.

Chinese policymakers are attempting to reorient their economy by encouraging greater domestic consumption but such structural changes take a long time to pan out. A big chunk of the Chinese fiscal stimulus has meanwhile gone towards increasing fixed asset investment although investment as a share of GDP is already at abnormally high levels of more than 40%.

During other fleeting economic rebounds within structural downtrends, market rallies too fizzled out after gains of around 50%. From a technical perspective, the S&P 500 is currently at the same level in inflation-adjusted terms as it was at the low of the previous bear market in 2002. In a secular downtrend, the low point in the previous cyclical bull market usually ends up acting as a resistance in the subsequent rebound.

The fact that many financial market indicators are back at pre-Lehman levels should act as a line in the sand as it is too soon to return to the world that existed before the Lehman episode. All of this would have us believe that markets the world over are currently in the process of peaking.

Camp 2: The cyclical bull market still has some way to go. This camp is willing to acknowledge the structural problems that plague the global economy but thinks that concerted policy actions by governments across the world will lead to at least a one year-long economic upturn. The cyclical bulls say a simultaneous expansion in the global economy is well underway with the US too coming out of a recession. The momentum should be strong enough to take the S&P 500 back to the pre-Lehman level of 1,250 before both economic growth and markets run into structural headwinds again.

A further 25% rise in the S&P 500 could result in even more fireworks in the emerging market space. A global easing of monetary policy usually leads to a greater channelling of liquidity towards the least broken asset class. In late 1998, interest rates were cut in the US to deal with the deflationary shock emanating from the emerging market crisis. That led to a bubble in the tech space. This time around, emerging markets are the bubble candidate as money chases the best growth story around. The meteoric rise in emerging market indices this year is already reminiscent of the Nasdaq's performance in the immediate months following the policy actions to tackle the Asian and Russian financial crises in the third quarter of 1998.

However, the cyclical bull camp holds that any rally will start to fade in 2010 once the effects of the stimulus begin to wear off in the US and policymakers in developing countries start to withdraw liquidity as they become wary of asset bubbles forming in their domestic markets. In short, the current economic momentum inspired by government stimulus efforts will likely keep financial markets well bid for much of 2009 but the environment will be more challenging next year.

Camp 3: A full-fledged economic recovery is underway. The outright optimists argue that the discussion on the global economy's future is much too US-centric and that in turn exaggerates the negative effects for the rest of the world arising from the relative decline of one major power. Back in the late 1980s, Japan's economy too had become the biggest contributor to global growth, and its stock market accounted for half the world's market capitalisation at its peak in 1989. Still, a sharp fall in Japanese economic growth and its stock market did not unravel the global economy.

The bears at that time warned of a full-scale capital repatriation by Japanese investors to shore up their balance sheets at home. Such fears proved to be unfounded, mainly because the US economy was in a position to assume the global growth leadership role. Emerging markets led by China seem to be taking on that status now, according to the folks in the bullish camp. The Shanghai A-share market has indeed become as much of a trendsetter for global equity markets as the S&P500. The current rising wave of optimism in the marketplace may well then turn out to be the start of a major expansion cycle, setting off a multi-year bull market run.

All three camps share the common feature of a macroeconomic forecast lying at the heart of each thought process. Valuations and sentiment from a contrarian standpoint are not presently an issue — as those variables tend to matter only at extremes and not when they are stacked in the middle. My tent is still pitched with the second camp: a cyclical upturn and a bull market this year followed by some sort of a relapse next year as structural problems of excessive leverage come back into play.

But we all need to retain the flexibility to switch camps at the slightest sign of incremental change, especially with many financial market indices back at the pre-Lehman levels. For markets to move higher hereon, economic data needs to keep surprising on the upside for as goes the global economy, so go the markets.

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

THE COMEBACK STORY

Several financial market indicators have now returned to the levels that prevailed just before the collapse of Lehman Brothers

Performance Compared To Pre-Lehman Levels

	12 Sept 2008	Latest	% Change
S&P 500	1,251.70	1,010.480	-19
MSCI Emerging Markets Index	855.47	855.520	0
MSCI China	49.15	60.034	22
MSCI India	375.87	386.770	3
VIX	25.70	24.760	-4
The CRB Index	429.05	380.380	-11
Crude Oil	94.77	73.190	-23
Copper	7,095.00	6,025.000	-15
Gold	763.45	962.150	26
Baltic Dry Index	4,800.00	2,907.000	-39
DXY (The Dollar Index)	78.96	78.900	0
US 10-Year Bond Yield	3.72	3.850	3
US Investment Grade Spreads	3.45	2.930	-15
Emerging Market Bond Spreads (EMBI)	357.35	346.090	-3

Note: All figures In USD

Source: FactSet.Bloomberg