

Patience is key for 2009

Although markets will likely spend much of the coming year wallowing in a broad trading range, a few macro themes will still dictate underlying trends



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AS THE New Year approaches, investors across the world are feeling like locusts in a desert. After getting used to picking off a feast, there are currently no asset classes that offer any obvious appeal.

In many parts of the marketplace valuations and sentiment do seem quite depressed. But that largely pertains to risky assets and with the global economy entering its worst growth spell since the Great Depression, it's hard to make a universal case for being long risk. On the flip side, government bonds and companies with a relatively steady earnings stream — mainly in the consumer staples and healthcare sectors — offer greater safety but valuations in this space have been stretched to the extent that there's talk of 'risk averse' assets falling victim to the next bubble.

Not surprisingly, then, markets are stuck in a tight trading range. And this tug of war between deteriorating economic fundamentals on the one side and oversold markets with low valuations and hyperactive policy action on the other will likely continue for much of 2009. Patience is the key in such an environment as there could be many false dawns and misleading breakdowns.

A major takeaway from the 1930s' experience is that there is nothing wrong in husbanding cash in a deflationary world. In a piece of telling research, Birinyi Associates estimates that a dollar invested in the US stock market in 1966 would be worth only \$1.11 today if you missed the best five trading days during the entire period. But if you avoided the worst five days, the dollar would be worth \$2,696 — emphasising the point that the first rule of investing is not to lose money. Still, even in a broadly sideways market, it's important to have a fix on the few themes that will prove to be enduring and serve as the fundamental backdrop for making investment decisions in the year ahead:

Japan in the 1990s is currently the play-book for the US: Policymakers in the US will probably succeed in preventing a Great Depression redux, but they cannot engineer a new growth cycle. There is a certain inevitability about what follows a debt binge: total credit as a share of the US economy is at a record 350%, similar to the levels in the Japanese economy preceding the end of its boom in 1990. After having borrowed growth from the future, the US economy will now have to sacrifice growth for a long time to come.

Much the same as Japan over the past two decades, US economic growth is likely to average a meagre 1% for the foreseeable future. That implies some sort of a growth recovery in the US as

policy action will arrest the current sharp pace of economic contraction. The Japanese economy has witnessed several mini-growth cycles within an era of stagnation and those recoveries have led to sharp market rallies. At some point in 2009, the US economy too will start to turn around providing the stimulus for a more meaningful rally in the stock market. Typically, the market bottoms 3-6 months ahead of the low in an economic cycle.

However, any rally will be capped by

global credit bubble. However, emerging markets are nowhere near as leveraged as the US and most other developed countries and should, therefore, be able to expand at their 1980-2002 average economic growth rate of 3.5-4.0%. That is not too bad an outcome at a time when the US and much of the developed world face an extended period of sub-par growth.

The sluggishness in the west will increase the relative appeal of investing in emerging markets. This is in contrast

Commodity prices decline over the long-term as the cost of production falls with better technology, increased automation and greater economies of scale. Although they oscillate wildly around their long-term trend line, the broad direction is unmistakably down.

After overshooting in the late 1970s, commodity prices steadily fell through the 1980s and '90s even though global growth remained robust through those two decades. As the 2003-07 credit bubble artificially inflated growth across the world to well above trend levels, commodity prices surged but are now quickly reverting to their long-term mean. They have no justification for trading above their marginal cost of production and in times of distress, the prices fall well below the cash cost of production. All of this suggests that prices of commodities from oil to copper are going back to levels that prevailed prior to the 2003-07 boom. One clear implication is that the price of oil over the next couple of years is more likely to average closer to \$30 a barrel rather than the consensus price of \$60/bbl factored into estimated future earnings for oil-related companies.

A mix of value and quality at a reasonable price should outperform: The dispersion in valuations — defined as the gap between the highest- and lowest-priced stocks — is currently at near record levels. Ordinarily that would suggest it is time to blindly buy the lowly valued equities and sell the relatively richly priced stocks, typically in the defensive stocks. But the problem is that the cheap stuff is mostly in troubled sectors such as financials. It's hard to see such stocks outperforming unless the bear market regime comes to an end.

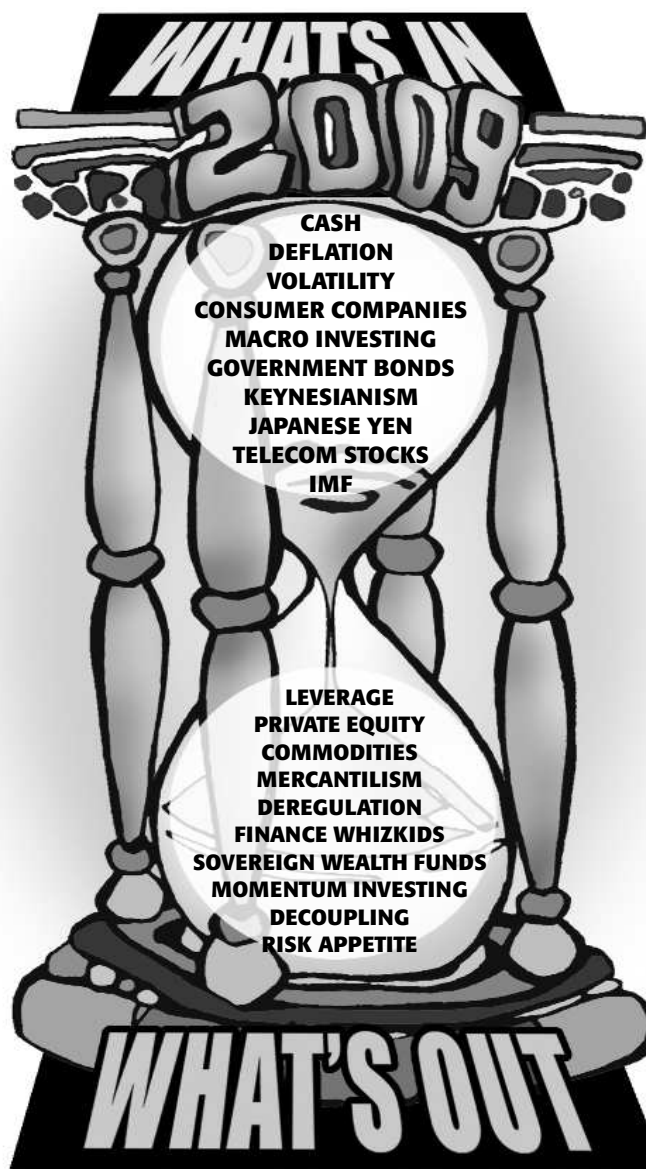
But the valuation gap is too extreme to ignore. Therefore, it's time to overweight that part of the equity universe where valuations are cheap even after normalising earnings and stripping away the abnormal profits of the past few years. However, a premium still needs to be paid for companies with high management quality as survival of the fittest is still an issue and when corporate governance standards are on the decline.

The dollar is most likely confined to a trading range: It's intellectually easy and fashionable to be bearish on the dollar. But as has been the case for so many years now, reports of the dollar's demise are greatly exaggerated. To be sure, the dollar is currently on a declining trend and with US adopting a quantitative easing approach to monetary policy, the image of too many dollars flooding the market readily springs to mind.

However, there will be a limit to the dollar's decline. The deflation of the credit bubble is a global phenomenon and almost all countries around the world are in an aggressive easing mode. It's just that the US is ahead of the curve. But expect other central banks to soon enough engage in a similar accommodative policy framework as the US, which in turn should limit any downside for the dollar. The dollar is unlikely to make fresh record lows against major currencies in 2009.

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the feebleness of the economic recovery given the underlying economic problems related to over-indebtedness. A very firm long-term top for the benchmark S&P 500 index is most likely 1200 — the level that prevailed just before the world changed in mid-September when Lehman Brothers went bankrupt. The episode marked the definitive end of the 2003-07 credit bubble and the hard reality is that the world is not going back to the pre-Lehman days. In technical terms too, support levels from a bull-market era often end up being resistance points in the ensuing bear market regime.

Emerging markets are still the place to be on a relative basis: The acceleration in the growth of developing countries from an average 3.6% prior to 2003 to more than 7% over the following five years was an aberration largely rooted in the

to the 1980s and '90s when the US was growing at a robust 3% — nearly as fast as the developing world — and looked much less risky. Furthermore, emerging markets are currently trading at a 25% discount to the developed world on most valuation metrics. While it will be hard for emerging markets to completely free themselves of the US market's ball-and-chain, this asset class should over time deliver higher returns as has been the case over the past five to 10 years despite the high daily and weekly correlations.

A secular bear market in commodities: It's amazing to see how many financial analysts are still consumed by the myth that commodity prices are in a secular uptrend due to the continued industrialisation of emerging market economies such as China and India. They are forgetting lessons from history,