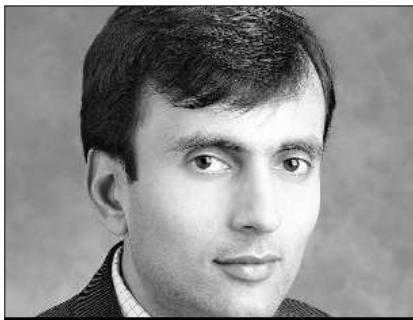


# Riding the cyclical bull

Current indications are that the stimulus packages should keep the global economy on the path to recovery in the coming months



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**T**HE recent plight of the global investment community is best captured by a Russian proverb: "Ignore history and you will lose an eye, stare at it too long and you will lose both."

After the global credit bubble burst dramatically last autumn, catching many investors unawares, there was a frantic rush to brush up on economic history lessons, particularly those dealing with the Great Depression. But just as market participants were done positioning themselves for a long drawn out downturn, based on all the compelling parallels with the dark periods in economic history, one of the fiercest rallies broke out in stocks worldwide.

Rarely have so many investors felt so much pain at the sight of rallying markets. Over the past three months, US equities have risen by more than 30% — the most powerful advance since the 1930s, while emerging market equities have surged by a staggering 60% during the same period. Once again, the price action shows that every significant deviation from the long-term trend is followed by a strong bounce back in the equity market. The fact is stocks tend to appreciate over time; after adjusting for inflation, the trend return for the benchmark S&P 500 index is 6.4% over the past 150 years.

In mid-March 2009, the US market fell to a level that can now be termed as a secular bear market low — defined as the point from where markets have always yielded positive returns and investors have never lost money. There have been seven such secular bear market lows since 1850. In six out of those seven instances, the extent of the deviation had been broadly similar to what was seen in March this year. The only time that US stocks deviated by an even greater margin from their long-term trend line was in the early 1930s.

While there is a remarkable number of similarities between the current economic environment and that of the 1930s, the major difference is the willpower of governments across the world to avoid a Great Depression redux. Since October 2008, governments have systematically enacted steps that have turned out to be the largest fiscal and monetary stimulus in history. The stimulus measures finally started to gain traction on a global basis from March this year, as evident from economic data that have consistently surprised on the upside since then.

The developing world led by China has already returned to positive growth in the current quarter while the US economy is also likely to exit negative growth territory by the third quarter of 2009. This marks a remarkable turnaround in economic activity; even in the first quarter of this year, the global economy shrank nearly 8% on an annualised basis.

The questions now are how much of the improvement is already reflected in the value of stocks and what will the nature of the economic revival be hereon? Following the massive rally of the past three months, stocks are no longer cheap and have reverted to their historical trend line. As the chart shows, the Indian equity market too is now trading right in line with its historical average (it has returned 11% per annum since 1976 in dollar

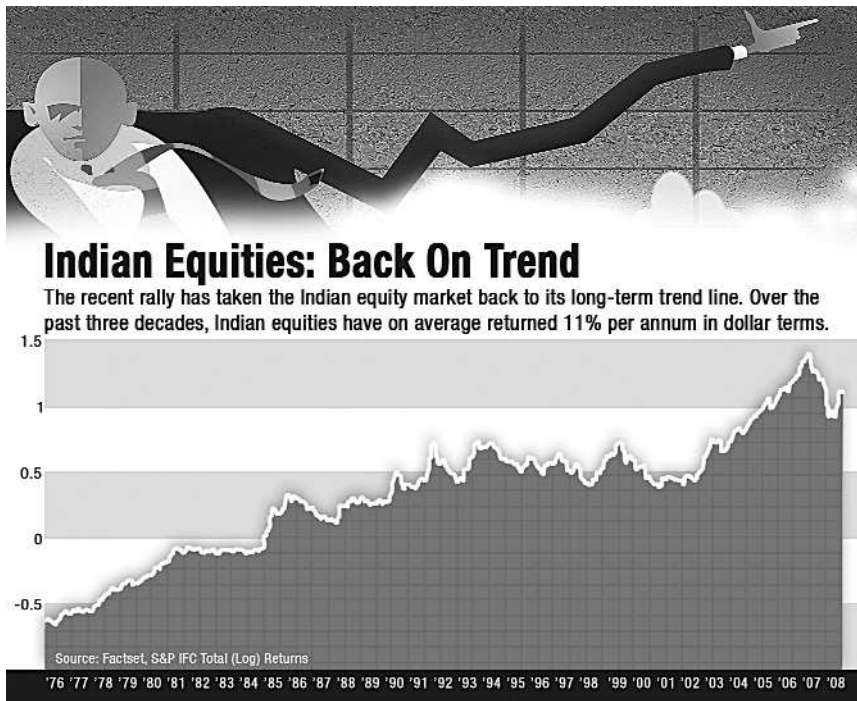
terms). Indian equities should perform close to their historical norm over the next decade, assuming the economy grows at an average pace of 5.5-6% during that period.

It then makes sense for any long-term investor to hold a majority of the financial net worth in stocks since the asset class should deliver superior returns over time compared to almost all alternatives. However, most investors don't have the patience to view investments on a 10-year basis and are at best willing to take a 1-3 year time horizon. And the issue here is that the outlook for global equity markets over the next couple of years is a lot less clear. With stocks no longer extremely undervalued, further rises in the near-term are more likely to be determined by the economic momentum that needs to keep improving and possibly surprise on the upside. For one, data out of the US will need to show that the economy is not just contracting at a reduced pace but is actually expanding again.

tor's contribution to economic growth continues to remain anaemic at best. Meanwhile, governments will not be in a position to provide any major fresh stimulus, given the poor state of their finances.

A sampling of the world's 30 largest economies shows that governments are expected to run, on average, a fiscal deficit of around 6% of GDP both in 2009 and 2010. Bond markets are already beginning to fret about the massive borrowing programmes required to fund such deficits; the US 10-year treasury yield in recent days has risen sharply to 3.7% from 2.1%. If the yield rises to above 4% any time soon, it could undermine even any cyclical recovery this year.

Another risk to an economic upturn materialising in 2009 is a premature resurfacing of inflation. Some investors have been buying "hard assets", or commodities, in the belief that the loose monetary policies followed by central banks across the world will do more to reignite



From the US to China, the most important data to track are the Purchasing Managers Indices (PMI) that capture the pace of manufacturing activity and tend to be the earliest available gauge of overall economic activity. Current indications are that all the government stimulus packages should keep the global economy on the path to recovery in the coming months. However, some of the structural issues relating to the over-indebted US consumer and the export-dependent Chinese manufacturer will come back to haunt the global economy once the economic impulse from government spending plans begins to wear off early next year.

As a result, both the global economy and stocks are likely to suffer some sort of a relapse in 2010. Although governments can play a role in shoring up economic activity to a certain extent, eventually it's the enterprise of the private sector that creates sustainable growth. The structural problem is that the private sector is still heavily indebted in the developed world whereas it will be some time before emerging markets can reorient their economic model to be more domestic-led than export dependent.

The path then for equities in the short-to-medium-term is likely to be quite jagged. The current economic momentum inspired by government spending will likely keep financial markets well-bid for much of this year but the environment will be more challenging next year as the debt-impaired private sec-

inflation than revive economic growth. It is highly unusual for commodity prices to be rallying sharply — as they have been over the past few weeks — so early in an economic expansion. They tend to perform well at the late stages of an economic cycle when growth is overheating. The recent price action in commodities essentially reflects a loss of confidence in paper money as the demand and supply fundamentals don't justify the recent uptrend. If the price of oil were to rise much beyond \$70 a barrel in the immediate future, it would defeat all the stimulus efforts as the increase would act as a tax hike on consumers.

Barring any such major setbacks, involving bond yields and oil prices spinning out control, a cyclical bull market should continue to take shape this year followed by a relapse in 2010. The implication for emerging markets such as India is that they are likely to oscillate in a broad trading range around the long-term trend line over the next couple of years. Hopefully by 2011 enough time would have lapsed for the private sector in the developed world to get its leverage ratios in more decent shape and for emerging markets to evolve their economic models to become more robust on the domestic demand front. Such structural changes would allow a meaningful global economic expansion to take hold. That in turn would herald a truly new secular bull market.

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A cyclical bull market in stocks persists globally on the back of massive government spending efforts. However, a relapse is likely once the stimulus impulse wears off next year.