

Cyclical bear stymies secular bull

Global equity markets will struggle to break new ground over the next few months. For the bull run in emerging markets to resume, food prices need to stabilise so that central banks can start easing policy, says Ruchir Sharma.

MARKETS stop panicking when policymakers start panicking. That old trading saw describes the reaction function of investors over the past few days with global equities rebounding 10% from the lows they hit on January 22, when the US Federal Reserve indicated its willingness to pull out all stops to rescue the US economy. Before the emergency rate cuts, market participants were terribly worried that the Fed was keying off a wrong economic forecast that didn't incorporate a recession scenario.

The debate now is whether the rally has any legs or if it is the typical bear market bounce from oversold levels. The judgement call to make is how severe a slowdown the US economy will experience after the counter-cyclical policy measures and whether the decoupling thesis is truly dead.

The US is unlikely to experience a sharp recession though the recent downturn may well mark an end to its multi-decade consumption and credit boom. While it is hard to argue that the US consumer is going to stage a comeback anytime soon given all the balance sheet problems, the process of de-leveraging will probably be a long drawn affair rather than one involving a sudden withdrawal. Sharp recessions usually take place when the corporate sector is stretched and is forced to aggressively cut spending and job growth to meet profitability targets while consumers try and hold on to their lifestyles to the extent possible, making slow changes over time.

Apart from the troubles in the financial sector, US corporations are in fairly good health. Profit margins are close to record highs and investment levels are in line with historical norms. US firms never got around to overspending during the current business cycle, as scars left from the tech boom-bust cycle were still fresh in their minds. Furthermore, inventories with manufacturers are fairly lean inventories as the slowdown has come well advertised. This is in contrast with past recessions that were characterised by over-investment and high inventories at companies, forcing major



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cutbacks in spending and hiring.

The most likely trajectory for the US economy is many quarters — if not years — of sub-par growth rather than a dramatic downturn. The US consumer will gradually downshift spending levels while companies won't be compelled to retrench significantly but will remain very cautious in their investment plans. Under such an economic outcome, the US market is likely to be stuck in an extended trading range.

The low point of that range will be when markets price in a recession — as was the case when the main US indices were down more than 20% in late January — and the highs will be hit when the mood swings to believing that policymakers can offer an instant fix to the more structural problems of the US economy. Such a long road to nowhere, but not a fall into an abyss by the US economy, does offer an escape route to the rest of the world. It seemed to be playing out that way for much of last year. After all, the US economy had been slowing since the middle of 2006 but the developing economies — the growth leaders of this decade — kept

charging ahead almost oblivious to the US deceleration. The feedback loop was in fact working the other way with strong growth in emerging markets providing a lift to US exports as well as earnings of the increasingly globally-oriented US firms.

HOWEVER, emerging markets began to 'recouple' with US financial markets from November onwards following a major shift in the policy stance of their central banks. Inflation in many countries rose beyond the tolerance limit often defined as a headline rate of 5%, forcing central bankers to respond more. Nowhere was this more apparent than in China.

In this regard, the present fall in emerging markets may prove to be more than just another fleeting phenomenon. Stock markets in the developing world have experienced falls of similar magnitude and velocity since the secular bull run began five years ago. In each of those past instances, markets were able to recover swiftly driven by their powerful underlying growth momentum. This time around, the one-two punch of a US slowdown and domestic policy tightening to curb inflation

will dash any quick snapback hopes.

But comeback these markets will, once the inflation scare passes away and central bankers can start easing liquidity conditions. There is no reason to believe that the secular bull run in emerging markets is over. What kills a bull market is the combination of expensive valuations and an end to productivity gains signalled by a major outbreak of inflation.

Even at the peak of their performance in November 2007, emerging market valuations never got to the maniacal levels that mark the end of a secular bull run. On the inflation front, the current spike has been led mainly by food prices, which on average constitute a large 30% of the price indices in developing countries. Food prices are catching up with the big gains recorded by the wider commodity complex and will sooner rather than later invoke a supply response. Farmers have the flexibility to raise production in response to price moves and there are already signs of such activity.

Outside of food, inflation is reasonably well behaved. Productivity growth is high and wage growth — despite some signs of acceleration — is picking up from a low base. In effect, emerging markets are likely to experience a cyclical bear market within an overall secular bull market — similar in pattern to what the US experienced in 1990 during its long bull run. A cyclical bear market phase for emerging markets would involve a peak-to-trough decline of 25-30% and last for around 6-9 months. US stocks rose at an annual rate of 18% a year between 1982-99. During that period, there were some serious cracks that included a mild recession in 1990 precipitated by monetary tightening to head off a cyclical rise in inflation.

Such downdrafts in financial markets are part of the game as nothing goes up in a straight line and are, in fact, periodically required to cleanse the system of budding excesses. In the long-term, the current decline will prove to be nothing but a healthy shakeout even though the next few months will be stressful as a bear market regime is never fun.