

The Unobservable Economic Recovery

The rally in global equity markets masks the fact that economic fundamentals remain weak. The bulls say that the recovery is underway, that green shoots of economic recovery are sprouting, that economies have passed their trough; some even go as far as to suggest a V shaped recovery (Goldman Sachs is one of them). The bears point to the unemployment problem, underfunded pension liabilities and healthcare systems together with an ageing population, unsustainably high household debt, growing public debt, risk of inflation, risk of deflation, higher interest rates, distressed real estate prices, murky bank balance sheets and the list is endless.

Quite how the global economy repairs itself will not be immediately clear to economists or investors. Excess capacity will need to be eliminated, savings rates will need to adjust, down in emerging markets and up in developed markets, bank balance sheets will need to be repaired, Western consumer balance sheets will also need rehabilitation or at the very least a period of rest, international sovereign current accounts, trade balances, will need to normalize towards more balanced positions, and of course sovereign balance sheets will need to be repaired as well, a process that taxpayers are already eyeing with dread.

One thing is for certain. The credit and debt bubble wasn't built in a day, and it wasn't broken in a day; neither will it be fixed in a day. The policies of the various governments and central banks have been variously praised and criticised depending on whether one was hoping they will succeed, the definition of a bull, or hoping they will fail, the definition of a bear.

There is no perfect policy response. Each approach has its

flaws and strengths. The greatest achievement so far of the US led, internationally concerted effort, to save the financial system in the latter half of 2008 is that confidence was restored. If there was no other objective but one, it was to restore confidence and to buy time. Time is a healer, but you need a live patient. This has been achieved.

While the global financial system and the economy have been saved from catastrophic failure, significant problems remain, significant to the point that there will be long term implications for the real economy. That said, the payments system has not failed, money markets have normalized, and the banking system while seriously impaired continues to function.

The road ahead is understandably unclear. What we are certain of is that in each industry, opportunities exist and some of them are significant. Existing participants in each industry will be able to see these opportunities; not all of them will be able to take advantage of them. Some will, if they have the wherewithal, if they consolidate, if they have access to capital. These opportunities will at some point be clear to others, and new entrants will take advantage of them. Thus, industries evolve. As these opportunities are exploited, profits are generated, capacity is increased as it is destroyed elsewhere. It is difficult for entrepreneurs in industries not directly involved or adjacent to these industries to detect these evolutions until they have gained some momentum and volume. It is even more difficult for a macro level observer to detect these evolutions until well after they have become entrenched.

A corollary to this theme is that while macro level, tactical and thematic styles of investing have done relatively better in 2008 and year to date in 2009, the ground is set for more idiosyncratic returns generation. Since late 2007, the fundamental stock picker has had a very difficult operating environment. Markets traded based on relative fear and risk

aversion confounding the most rational of company analyses. As volatility settles down, money markets normalize and markets become more continuous, the environment for the fundamental stock picker has improved significantly, and the opportunities in relative value are larger than ever.

Another corollary is that it is time to revisit the now unfashionable, or forgotten theme of the decoupling of the BRICs from developed markets. There are compelling arguments for and against decoupling. Most of the balance has correlated with the direction and correlation of equity markets. By the time emerging market equities had fallen harder than US and European equities, the decoupling theme had been buried. It may be that the fundamental economies of emerging and developed markets had decoupled but that emerging market listed equities had temporarily decoupled from their fundamentals, dragged by the impact of the exodus of foreign investment capital withdrawn to repair balance sheets elsewhere. Decoupling requires dislocation. The latter half of 2008 has very conveniently supplied this dislocation. It will take some time for fundamentals to take hold and drive markets. Even in the rebound there has been little sign of decoupling. Some point to the strength of the recovery in emerging market equities as sign of the decoupling but this is more likely simply a symptom of higher volatility than actual decoupling. The coming months will tell if markets price in the decoupling that has already begun in their underlying economies.

Where is the decoupling? Emerging markets continue to have higher long term economic growth rates arising from their less than optimal capital to labour ratios, higher population growth and underpriced (not fully paid for) improvement in their technology sets. Also, in the recovery, much of the economic activity will be supported by Keynesian reflationary policies, thus bought at the expense of weakening the sovereign balance sheet. Where balance sheets remain healthy,

growth can be bought. Where balance sheets are already stretched, the propensity to buy such growth is reduced. One of the catalysts to precipitating a decoupling, ironically, is a reversal of globalisation and a disruption to world trade. This occurred last year as trade finance temporarily ground to a halt. Even now, it is only slowly recovering.

It is impossible to predict how the recovery will unfold. This is not the point of this exercise. It is to realize that as the world economy heals, it will be hard to see and it will only become apparent when it has healed to a greater degree. We can only see the recovery in our own industries and in our own towns and adjacent industries and cities. By the time we see it in industries further afield and by the time it becomes widespread, it will have been going on for some time.