The International Economies at Year End

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A year ago, my colleague David Kotok wrote a Commentary entitled "2010: The Year to Focus on Sovereign Debt." That has certainly proved to be correct. The year that is drawing to a close witnessed a welcome recovery in the global economy that was overshadowed by a fiscal crisis in the periphery of the eurozone that periodically undermined investor confidence worldwide. While the economies most directly affected and requiring external assistance, Greece and Ireland, were very small, investors feared contagion to larger economies of more systemic importance, and some even feared a break-up of the European Monetary Union (EMU) and the end of the euro. While the European drama continues and further difficult times likely lie ahead, we maintain our view that the EMU will survive and the euro will eventually emerge a stronger currency.

The recovery from the global financial crisis was evident at the beginning of 2010. Nevertheless, as the year progressed, the sovereign debt problems in Europe, together with concerns that financial tightening in China would cause that locomotive of the global economy to slow dramatically, along with persistent high unemployment and depressed housing investment in the US, and deleveraging in many markets, led to fears of a "double-dip," that is, a return to global recession. A mid-expansion slowdown in the summer months stoked those concerns. However, more recent economic data have, for the most part, been positive and encouraging. Double-dip fears have now largely receded as the recovery, both in the US and globally, has proven to be resilient, even if more subdued than was typical of past recoveries. The global economy grew by almost 5% in 2010, compared with a 0.7% decline in 2009. As we anticipated, the emerging markets led the recovery, with their real GNP advancing by an estimated 7.8%, whereas the advanced or developed economies grew by a more modest 2.6%.

The pace of the global advance may ease moderately in 2011 but should still be better than 4%. The easing is expected to be due to some slowing in the emerging markets (for example, China's growth easing from 10+% to a still very strong 9+% rate, Brazil's growth slowing from 7+% to less than 5%). The advanced economies as a group are likely to advance somewhat more rapidly. This is particularly the case for the US, where 2010's growth of 2.9% looks likely to be followed by a 3.5% advance in 2011. The eurozone's growth will probably be pretty close to this year's 1.7% advance. Japan's economy, which suffered a sharp 6.3% drop in 2009 and recovered partially this year, with a 4.4% advance, may slow to a more moderate 1.5% in 2011.

This year provided strong evidence that macroeconomic growth rates do not always provide a good guide to the relative performance of equity markets. On a broad aggregate basis, the stronger growth of emerging markets was reflected in the outperformance of the MSCI Emerging Market Equity Index, which year-to-date through December 17th was up 15.4%, as compared with the 10.3% advance for the MSCI World (advanced economy) Equity Index. Yet the Shanghai market, situated in the country leading the global macroeconomic growth league, China, is down -10.8% this year, reflecting domestic Chinese investor concerns about the effects of a series of monetary tightening moves taken to counter growing inflationary pressures, and signs of a possible bubble developing in the real estate market. International investors in ETFs for Chinese firms listed in Hong Kong fared somewhat better. The SPDR China ETF, GXC, which Cumberland uses in its International and Global Portfolios, has registered a 5.4% total return year-to-date.

In contrast to China, the strong economic growth in India, 8.9%, was accompanied by a sustained advance in its equity market. The MSCI India Equity Market Index is up 15.4% year-to-date. While the

Indian monetary authorities also expressed concern about inflation, they have held policy rates constant and injected additional liquidity into the economy.

There have been similarly divergent experiences in Latin America. Brazil's economy registered a strong 7.5% advance this year, but its equity market limped along, advancing only 1.3% year-to-date, as measured by the MSCI Brazil Equity Market Index. In contrast, Chile's economy, despite the effects of a severe earthquake, registered a healthy estimated 5.4% growth rate for the year, buoyed by a booming global copper market and sound economic policies. Investors were attracted, pushing the equity market up by 45.4%. The neighboring and somewhat similar economy of Peru did even better, with GNP advancing by 8.9% and its equity market by 49.9%.

Among the advanced economies outside the US, the eurozone was the weakest region; the MSCI EMU Equity Market Index declined -4.75%, with Greece down a staggering -41.1 %, and Ireland -20.2%. Even relatively healthy France was down -3.7%, and the Netherlands market was off -0.7%. Germany is the strongman of the eurozone, with very healthy export performance. Its equity market managed an 8.1% advance year-to-date, despite the troubled economies surrounding it. Aside from Germany, the best performers among the European equity markets were in the Nordic countries (Sweden, Norway, Finland, and Denmark). The MSCI Nordic Equity Market Index advanced by 22.02% year-to-date, with the market for Sweden, which is in the European Union but outside the eurozone, up a remarkable 32%. Outside of Europe, the equity markets of the advanced economies in the Asia-Pacific region, benefiting from the strong growth in emerging Asia, registered solid advances year-to-date, as measured by their respective MSCI Equity Market Indices: Singapore: 17.2%, Hong Kong: 21.6%, Australia: 10.9%, Japan: 11.8%. The equity market of our neighbor to the North, Canada, also helped by the continued global boom in commodities, advanced by 16.7%. In short, despite the turmoil in the eurozone, international equity investors have had a range of attractive opportunities in 2010 in a still-recovering global economy.

Looking forward to 2011, continued very low short-term interest rates and ample liquidity, a phasing down of de-leveraging in the private sector, increased fiscal stimulus in the US, very healthy corporate profits, the beginning of a recovery in the US housing market, and continued strong growth in Asia will combine to keep the broad global recovery on track.

There are, of course, risks to this positive outlook. Here are several examples. While general inflation is not a near-term threat in the advanced economies, further increases in the prices of food and oil could create a headwind for growth in consumption. If the recent upward spike in long-term interest rates is maintained and followed by yet higher rates, the hoped-for recovery in housing in the US could be further postponed. Further rate spikes could spook equity investors. Failure by European authorities to take the actions needed to avoid sovereign defaults would trigger serious turmoil in European markets and great risk of contagion. A sharper than expected slowdown in China would impact the Asia-Pacific region as well as global commodity markets. And there are always geopolitical risks, with the Korean peninsula and Iran being areas of current concern. These are not in our base-case outlook, but they illustrate why it will be desirable to have well-diversified portfolios and to closely monitor developments.

Within the eurozone, most equity markets, aside from Germany's, are likely to underperform in an environment of sluggish growth and uncertainty generated by the further unfolding of Europe's sovereign debt problems . Elsewhere in Europe, the Nordic equity markets, in particular that of Sweden,

look likely to continue to outperform, while those of Switzerland and the UK should at least reach the average performance of the advanced-economy markets.

With respect to advanced-economy markets in the Asia-Pacific region, Australia, Singapore, and Hong Kong are expected to outperform for the year. The Japanese market is positioned to record a relatively strong performance in the first quarter, with its relative price-to-book at an all-time low and a weaker yen helping exports. It is less evident that the Japanese market will be able to sustain strong performance throughout the year. Finally, the Canadian market should benefit from the stronger US economy and expected outperformance of the US equity market, particularly in the first half of the year.

As noted earlier, the emerging-market economies are expected to again lead the global economy in 2011. However, that fundamental strength may not be accompanied this time by outperforming equity markets, for several reasons. Emerging-market equities as a group have become more expensive than those in the US and the advanced markets as a group. Policy interest rates are being raised in many of the emerging markets as inflation concerns rise. While still beating the advanced economies, the rates of economic growth are projected to moderate for most emerging-market economies. And as pointed out by our friends at Ned Davis Research, emerging-market equities historically have tended to underperform in the second halves of global recoveries. The inflection point could well occur this coming summer, if not before.

Among the emerging markets, Taiwan and Korea appear likely to benefit from the renewed growth in North America and strength in the technology sector. The Mexican market also will likely do well because of its proximity to the US market. The Chilean and Peruvian markets should continue to ride the global boom in copper. The largest emerging-market economies, China, Brazil, India, and Russia (the BRICs) look likely, at best, to average the emerging-market benchmark performance, with the possible exception of Russia, which has been late to join the recovery, following a steep recession, but which recently has shown renewed strength.

It may be safe to go back in the water, but just how safe depends on which pond you choose to swim in.

Best wishes for the new year.