

GLOBAL ECONOMY

Buyer beware

The pace of global economic recovery will vary from country to country, with rising volatility being a risk even in emerging markets

NO doubt 2010 had a volatile start, pushing stocks and commodity prices up and down. The volatility was driven by hastily changing views on the prospects for the global economy. Did the markets fear the arrival of a “double-dip” recession? Investors retrenched, and capital flew to safe havens. Did the markets feel that the recovery was finally underway? All indices rallied, and risky assets went up in price.

This volatility is likely to increase. It is not a comforting picture, but some trends are emerging. After two years of synchronised movements across countries and asset classes, we are likely to see diverging economic performances and falling correlations. While global investors get comfortable with this shift, expect jittery markets.

In 2008 – the worst crisis since the Great Depression – economic growth contracted everywhere. Asset classes took a dive. In 2009, to counter the crisis, governments flooded the world economy with a wave of liquidity. The stimuli – fiscal injections, interest rate reductions, quantitative easing – were co-ordinated and massive. Growth returned, markets rebounded, and asset classes rose, all at once. In other words, the gravity of the 2008 crisis, and the extreme poli-

by **Alessandro Magnoli Bocchi**
thegulf@tradedearabia.net



cies put in place in 2009 to avoid a depression, induced a synchronised performance across countries and markets.

Starting in 2010, we should expect a de-synchronised recovery, with rising volatility. First, emerging markets will recover faster than the industrialised economies. In the US, EU and Japan, economic growth will fare below potential, due to structural fragilities: high unemployment, reduced investment, low confidence, weak consumption, mounting doubts about long-term fiscal sustainability and related sovereign risks.

Conversely, emerging Asia will grow closer to potential because of stronger fundamentals: pro-growth domestic policies, debt-free households and a domestic demand in its infancy. The markets expect high 2010 earnings. In particular, China’s demand is likely to drive Asia’s growth.

Secondly, volatility is likely to rise because the stimuli will be progressively withdrawn. In early 2010, the policy-induced wave of liquidity has pushed the inventory cycle and asset prices. As long as the fiscal and monetary stimuli, including quantitative easing, remain generous, growth will continue.

But policies will soon diverge across governments: at this stage, not every country needs massive liquidity injections. China has already started tightening. In contrast, some countries need to keep spending, even if they cannot afford it. The US and UK treasuries are unlikely to stop their quantitative easing. Liquidity will begin to asymmetrically dry up. Historically, the process of monetary and fiscal tightening has brought about market jitteriness. Asia’s rising prices (there is a risk of asset and commodity bubbles) and its dependence on developed economies will only add to volatility.

Where to invest then? The base-case scenario is a U-shaped recession in the developed economies and a V-shaped recovery in the emerging markets – with Asia on top of the list. This scenario is likely to see Asia’s currencies appreciate because of the rapid upturn. Hence, it is important to increase allocations to Asia and to watch carefully the US, EU and Japan, as they

are set for a below-potential growth. As a double-dip recession is still possible, at least in some economies, it is important to be ready to manage an increased volatility. When markets are volatile, capital preservation becomes a priority. Indeed, the year began with capital “flying to safety”, hammering emerging markets and strengthening the US dollar. Over the course of the year, we are likely to see more investors moving out of riskier assets, back into safe havens. In short, in 2010 investors cannot ignore that emerging markets will come out ahead, but they need to watch – and manage – the inherent volatility to a highly liquid post-crisis environment. ■

Alessandro Magnoli Bocchi is chief economist at the Kuwait China Investment Company (KCIC). The author and KCIC accept no liability for investment decisions based on this article.

Illustration: Tim Gravestock