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From extreme caution to euphoria

Let me start by saying something that you have heard many people say already, that the last 12-18 months have been one of the most difficult periods in the global economic cycle. The way it played out has surprised not just us but almost every brainy economist, financial expert and even politicians. Whether it be the structural collapse of the financial system in the most developed nations of the world or the dramatic change in behaviour of 'The American Consumer', the change in currency dynamics and the rise and rise of gold and now the euphoric come back as though nothing ever went wrong. The huge doses of stimulus from governments across the globe have seemingly pulled us out of the crisis and it should hopefully be smooth sailing from here on.

Let me add to the already known facts above by saying that do not assume that this is over, we might very well have something very different hitting us in the not so distant future. How strong will this hit be is tough to call but the current rise seems too hard to believe to continue for long.

Before I explain why I think like this, let me take you down the memory lane:

Circa 2007 – Talks of a slowdown in the US have started and most experts are busy figuring out whether it will be a hard-landing or a soft-landing. Despite these talks US GDP is growing well at close to 4% levels, a very healthy growth figure for that economy even though a clear slowdown is visible in the housing sector.

The Dow Jones continues its northward journey

India has ended 2006 on a great note with almost USD 10 billion of inflows from FIIs. GDP growth is 8%+ and RBI is making upward revisions to growth expectations. The central bank alongside is also upping the interest rates gradually and increasing risk weightages for lending to sensitive sectors like real estate to prevent formation of any bubble.

Sometimes in the middle of the year the sub-prime crisis emerges, however the extent of the problem is not known and most people have discounted any systemic risk to the US economy from this sector as the US GDP still continues to show a healthy uptrend. The actual US GDP growth rate for 3Q2007 turned out to be almost 5% so all the talk about soft-landing and recession are being wished away.

To ease problems in the housing market the Federal Reserve starts cutting policy rates expecting that a cut in rates should solve the problem. The cuts become more aggressive towards the end of the year. These rate cuts make credit cheap and leveraging attractive., in effect there is lots of liquidity. This huge flow of liquidity finds its place all over the world including India and China. The rationale being that these countries are safe havens due to their domestic markets and attached consumptions stories. High valuations are justified due to India transformation and sustained growth of Indian corporates. At close India has an inflow of USD 17billion in FII money, the highest ever in a calendar year. In general, things are on a roll.

Circa 2008 – The start to the year is on a very strong note before things start turning bad and then worse. Sub-prime shock becomes real, however write-offs are still slow going up to about USD 150 billion in 1Q2008 (we all know it was much more). Oil is beyond USD 100 and making a vertical climb. A leading investment bank has put out a report with a target price of USD 200/bbl. All commodities are going up along with Oil causing inflation to shoot. RBI is in a tizzy; it is keeping rates steady even as inflation climbs, this is still not in line with other central banks which are cutting rates. Sometimes later in the year, RBI changes stance from ‘managing growth’ to ‘controlling inflation’ and starts hiking rates midway.

Bear Sterns almost fails and is eventually taken over by J P Morgan Chase in a deal arranged by the Federal Reserve. Further rate cuts by the Fed are now not having any impact as people are averse to leveraging and utilising liquidity. In September, Lehman Brothers is allowed to file for bankruptcy triggering a wave of similar expose and almost a systemic collapse of financial markets in many developed markets. The US government has to step in to avert the crisis with a rescue package of USD 700 billion which helps it save further expected collapses of AIG and Citigroup. Central banks and governments across the world have to follow and launch similar rescue measures to avert similar situations.

Stock Markets across the world do not seem to have any clue and are falling crazily every day as investor confidence has vanished almost overnight and everyone wants to keep their money home. Against expectations, the USD appreciates swiftly and significantly against other currencies as it is considered a safe haven. Global recession is a reality the talk is about averting a depression. Despite the strong domestic growth stories Chinese stock market has fallen by almost 70% from its peak and India is close behind with a fall of 60%.

Expecting recession, commodities have cooled off substantially from their highs earlier in the year and units across the world are having to shutdown for lack of demand. Oil has tanked from a high of USD 140+ as the world faces a recession and demand has slumped. Inflation has fallen at a pace equal to its rise which allows RBI to cut policy rates quick and fast.

Circa 2009 – The continued stimulus measures do not seem to have any visible impact, ‘The American Consumer’ starts saving and as a result global trade has reduced substantially. Oil is now at USD 30, a fall of almost 80% from its highs. Lay-offs continue to happen thick and fast.

Sometimes in March/April, things start becoming better not for any other reason but just because they can’t get any worse and sooner than you know it seems that there was nothing wrong in the first place.

Sep2009 - The BSE Sensex is just 20% away from its all time highs even as the Chinese Index is still less than half of its peak and it is accepted that the developed world will have a slow recovery.

While history stated above is crystal clear, it is the future which is the realm of the unknown. Let me also add that I do not wish to spoil the party but the objective of repeating the above was to take cognisance of some less highlighted facts.

- The leverage has not been extinguished; it has simply shifted from individuals and corporates to governments. Across the world, governments are running unprecedented levels of debt which they have to pay back over time.
- The stimulus has to end some day and the expectation is that by then private consumption will pick up. What if it does not?
- To pay-off their debt, governments will have to either increase revenue (read taxes), cut expenditure (forget it...) or print money. In other words the inflation demon could be back sooner than we know it
- The liquidity could dry up. Each central bank is waiting for someone else to take the first step. This free flow of money cannot continue, the day policy rates are tightened, it could take liquidity with it.
- The slowdown has resulted in companies cutting or even stalling their capital expenditures leaving little room for a sustained economic recovery by capacity expansion.
- Individuals and businesses alike are now much more cautious of expanding by leveraging as they battle a tough market on the ground.

In light of the above what policy action will be taken next could hugely impact how the rest of 2009 and 2010 will turn out. As per one hypothesis, for the US to get out of this mess it has to start exporting and make itself cost-competitive by weakening its currency, but a further weakening against the Yen could have disastrous impact on Car Makers on the other side of the world.

To sum up, things as always are being driven in multiple directions and which variable will play out next is not known, so we need to be cautious as you do not know when the music stops. No one wants to be the last man standing. We have all seen that the pace and direction can change before we realise it, and by the time we do it has already travelled a distance.

Action points:

1. Stay alert – the game can change soon
2. Check your asset allocation – do not overexpose to any asset class
3. In case you feel that you shall need money from your portfolio in the foreseeable future then now may not be a bad time to draw
4. Do not repeat the mistakes of 2007, cover your positions.

To close, even though I have painted a gloomy picture which is against my long-term belief in the India story, it is likely that I go wrong. Government actions can change this picture in a different way. Personally, I did not expect the markets to be here so soon and thus am probably upset at having gone wrong so far.

What ever be the outcome, if there is one lesson that the last 18 months have taught me, it is that I should not avoid buying something that I know is available cheap with the expectation that it will get cheaper. Also, I should again not buy something which is expensive with the expectation that it will go higher.

Happy Investing!!!