global stars

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Neil Dwane explains why he believes 2010 will be the year emerging markets begin to power the global economy.

We continue to see more fundamental support for emerging markets, which should lead the global economy in the next few years. There are a number of reasons for this, but clearly the most developed economies are debt ridden and fiscally weak, as well as being over-reliant on consumer spending and housing markets. They are just trying to stay afloat after the credit crunch.

Conversely, many emerging markets enjoy robust finances supported by the growing affluence of their populations, albeit from very low bases. With the G7 countries beginning to reach the limits of their borrowing powers to support their economies and banking systems – and perhaps even beginning to feel that the emergency quantitative easing policies can be wound down – the prospects for these economies with high unemployment and large output gaps remains deflationary and lacklustre at best. Moreover, this uninspiring performance could be exacerbated if governments seek fiscal retrenchment too early, or if bond markets fall in a manner reminiscent of the 1994 bond collapse when investors lost around 20% in about six months.

The BRIC countries, on the other hand, have been able to restart economic growth through aggressive stimulus packages. They have also recognised that their reliance on the US consumer must decline. As a result, they are rebalancing their economies towards their own consumers, although this is a complex and time-consuming process. China looks set to reach nearly 10% GDP growth again soon and Brazil is also rapidly recovering its economic growth prospects.

The prognosis for the US looks worse, as unemployment on some measures is nearly 17%, not 10.2%, and the scale of debt within the consumer sector has only just started to decline. Meanwhile, the budget deficit under the Obama administration continues to grow ever bigger. Indeed it is becoming difficult to see how the administration can afford a second stimulus package as well as a new healthcare initiative. All of this is increasingly undermining the US dollar. The prospects for 2011 remain bleak, with the US facing further headwinds as the Bush tax cuts of old are not reinstated, thereby straining demand.

Europe presents a mixed picture, with the stronger, less property-leveraged economies showing much less economic distress. Ireland and Spain have a long-term struggle ahead as they seek to establish some level of competitiveness against France and Germany – a shift of around 30% in competitiveness is required. The euro will remain strong since the European Central Bank has not resorted to quantitative easing as forecast and will be one of the most proactive in responding to threats of inflation, although the strength of the euro will also mitigate imported inflation, unlike in the UK and the US.

The UK economy looks caught in a multi-year trap, as debt remains high for both the government and consumers. It will find the exit from the massive Bank of England quantitative easing policies very difficult at a time of low yields and weak sterling.

the financial sector

Political strife over regulation and bonuses continues to buffet the financial sector. All evidence indicates that returns will be lower, with greater regulation and transparency. The sector also faces the need for further equity issues along with some deleveraging.

Credit demand within the economies is shrinking as deleveraging occurs and companies with good credit are either not borrowing or accessing the debt markets directly, bypassing the banks. With unemployment high and many housing markets exposed to increasing foreclosures, loan-to-value ratios will continue to rise, stemming demand from first-time buyers.

Worryingly, the lack of honesty on the balance sheets of most banks signals that solvency issues may return to the banking sector, especially when many of the insurance policies are supported by still-weak mono-line insurers and other weakened counterparties. In the medium term, the banking sector will be unable to avoid bearing more of the costs of its collapse as it recuperates. We fear that 'God's work' has only just begun for the banks to repair their shattered reputations. At the same time, new entrants in many markets may be actively encouraged to increase competition.

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limited in supply and of course cannot be printed in unlimited fashion in the same way as fiat money. For the US, the politics of the 'war on terror' are having profound effects, both financially and politically. It would seem this is a war the US and its allies can only lose, which might lift tensions in the Middle East once again.

politics

In 2010 we will likely see new government in the UK, and possibly in Italy. The recent win by India's Congress party also serves to show that the BRIC economies are on a strong political, as well as economic, footing. This should allow and encourage international investors.

Perhaps the most interesting politics in 2010 will be the rising competition for both climate control and commodities, especially oil and agriculture, and the political shift from the G7 to the G20, with a hint of a dominant G2 emerging as China challenges the US. China's stance has many interesting facets, from strengthening relationships with Japan, Korea and Taiwan through to Latin America and Africa, coupled with regular criticism of the US dollar and its value to the world. All this has once again drawn attention to gold bullion, which is

central bank policies

Many central banks have become addicted to managing financial markets in their dire need to stop the global financial meltdown. They have, in effect, swapped the credit of their country for dubious financial assets created in recent years. Just as concerning, the Federal Reserve and the Bank of England have ended up controlling huge swathes of the financial markets, such that it seems impossible to expect a smooth exit from quantitative easing over the next few years as economies recover. Politics and policy will have to be delicately handled to avoid major policy errors like those in Japan when the quantitative easing exit was pursued too quickly, or in the US in 1994 when interest rates were raised unexpectedly. Given governments' borrowing needs and the very low levels of yields to start with, it would seem prudent to be cautious of success.

markets

Equities have rallied hard in 2009 and are no longer cheap. But they are not at the top of their valuation ranges either.

Market advances in 2010 will probably be derived from earnings growth and dividends rather than a further expansion of P/E values. The easy money of this rally has already been made and investors from here should increasingly focus on strong, high-quality companies with good business models, solid cash flows, competent managements and attractive dividend yields. There are many of these to choose from since this rally has very much polarised the sectors.

Global M&A will continue to drive some industry segments as markets mature, such as staples and technology. Many companies, however, will focus on product and market opportunities to access the growing emerging markets consumer sector. With the predominance of emerging market growth, the world will see a further tightening of demand for commodities and oil. This will act as a tax on consumption in inefficient economies such as the US, which will drive further investment in clean energy and alternative power sources.

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The views expressed in this article are at 23 November 2009.