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A Global Economy: Connected

As the European sovereign debt crisis unfolded in 2011, international and emerging markets portfolios experienced significant negative volatility in their holdings that was not echoed in the holdings of similar domestic market portfolios. The difference between the performance of domestic and emerging markets was so acute that it prompted Bill Andersen, CFA, a successful investor and early participant in international money management to comment that it was "One of the largest disconnects in markets I have seen in my (26 year) career". This **dramatic volatility**, especially in the natural resources exporting countries, and the emerging market sector, was likely a direct response to the continuing fiscal crisis in Europe, showing that the world economy is far more interconnected, and interdependent, than it may at first appear.

As the European banking crisis devolved into a sovereign debt crisis, Europe responded with austerity measures to reduce government debt. The austerity had two unintended consequences. Firstly, it further suppressed already anemic European economies like Greece, Italy, Spain and Portugal; and, secondly, it reduced consumer demand across Europe.

As Europe implemented governmental austerity plans, it quickly became clear that Greece, especially, would be unable to find the balance between austerity and the spending required for economic development that would allow them to pay down their debts. Without the option of inflation, due to participation in the Euro, the possibility of default reared its ugly head. With Spain, Portugal, Italy, and Ireland also at risk of default, the future of the Euro began to look shaky. As a result, Euro-denominated bond prices suffered significant declines, making it even harder for the at-risk countries to raise cash. Further, already distressed banks, afraid of incurring another source of bad debt all but stopped lending both locally and internationally. Interest rates spiked and liquidity dried up.

Investors reacted with panic selling. For 2011 the British market was off -5.6%, Germany was down 14.7%, and France -17%. Investors in Europe liquidated stocks and bonds and purchased the U.S. dollar, U.S. equities, and bonds, as a short term "safe haven" from the European financial banking and sovereign debt crisis.

The second effect of Europe's response to their sovereign debt crisis was a drop in consumer demand. Coupled with the cutbacks in large government projects, the loss of demand spells disaster for manufacturing and extraction economies around the world. It is estimated that the Eurozone represents about 35% of world consumer demand. Given the overwhelming size of that number, there is no way for the rest of the world to make up for a fall in European demand. **The effects of austerity in Europe are global** and those effects can already be seen.

In the panic selling that followed the European austerity measures, shares in natural resource businesses, including producers from large exporting countries such as Canada, Australia, and Brazil, were liquidated. The anticipated lower growth from other exporting countries, including China, implies slower internal GDP growth and lower investment returns.

As trade disruption increased, selling continued. A significant number of foreign equity prices declined dramatically, especially in the Emerging Markets (see Table 1). The interconnected financial and trading partners experienced the supply/demand risk elements of the 21st century global economic interdependence.

Table 1

MSCI Indexes[1]	2011
Emerging Market	-20.41%
Brazil	-24.85%
China	-20.33%
India	-37.97%
Korea	-12.84%
Russia	-20.95%
Turkey	-36.75%

Given the magnitude of the international and emerging markets sell off, great opportunities now present themselves. The GDP growth of the ***emerging and developing economies*** is estimated to be **6+% vs. 1.8%** for the Advanced Economies. The global market capitalization of the emerging markets is now **30%**, up from **10%** in 2001. Emerging markets represent **55%** of total global GDP, up from **31%** in 1980. Developed country percent of total global GDP has significantly declined during the past 30 years and is now **45%** down from **69%** in 1980. Government debt, as a percent of GDP, is an estimated **38%** for the Emerging Markets. (Government debt to GDP exceeds **90+%** for the United States.) Emerging market net shareholder equity to corporate debt is a very conservative 6 to 1. Industrial production growth is approximately **6%** in the emerging markets, vs**. 2%** in the developed economies. Personal net worth in the emerging markets is up **250%** since 1970. Real domestic consumption growth is over **5%** in the emerging markets vs. **2%** in the developed countries.[2]

Specific Emerging Market value portfolios are now witnessing extremely compelling valuations trading near the market lows of 1974, 1981, 2002 and 2008. The margin of safety is quite significant! At a **.7** price to book ratio, a **6X** PE ratio, **3.6** price to cash flow and a **4.5%** dividend yield, investors are likely to be very well rewarded over the next few years allocating capital to this sector.

The interconnected global economies cannot escape the impact of the European banking crisis and the probable European recession to follow. It was difficult emotionally for investors to participate in this volatile ride but as markets declined, compelling investment opportunities were made available in 2011, and remain equally compelling as we enter the New Year.

- *Roger Johnson*

[1] http://www.msci.com/products/indices/performance.html
[2] Zamorano, Gerado, CFA. Brandes Due Diligence Symposium 2011, p. 115-127