Global Financial Markets Perspective
First Quarter 2009

A NEW WORLD ORDER

Just after the first quarter of 2009 drew to a close, the world's leaders gathered in London for the G20 to solve the global financial crisis. The substance of the group's conclusions will have to convince capital markets, financial institutions, investors and consumers that they can start to lend, borrow and spend again. The symbolism of the event may be more important than the substance. The G20 countries are an odd ad hoc assemblage initially brought together by the Asian financial crisis in 1997 representing a new element in the world political order. They are not the Group of Seven – the club of western powers and Japan – or the G8 (the G7 plus Russia). The use of the G20 at this moment of global crisis is an indication that the old order has outlived its time.

Interestingly, the U.S. National Intelligence Council (NIC), part of Washington's security apparatus, published a startling forecast in November of last year stating that the international economic system as constructed after the second world war would be "unrecognizable" by 2025, thanks to globalization, the rise of emerging powers and "an historic transfer of relative wealth and economic power from West to East". The authors stated that the next 20 years of transition to a new system are "fraught with risks" and that "strategic rivalries are most likely to revolve around trade, investments and technological innovation and acquisition, but we cannot rule out a 19th-century scenario of arms races, territorial expansion, and military rivalries."[1]

Today, several fundamental corrections are taking place in the global economy at the same time. The end of the cold war with the fall of the Wall in 1989 cleared the way for new powers to rise – namely China and India – and removed most ideological obstacles to globalization. Cross-border migration has surged. The technological revolution of the Internet has transformed communications, the flow of information, financial trading and political awareness. As a result, a massive rebalancing is starting to take place in world trade flows. The underlying switch in power from West to East would normally take decades to be realized. The NIC report also identifies that this shift will happen more rapidly and that these Eastern powers will reassume the prominence they maintained when Europe was in the Dark Ages.

History tells us that geopolitical events like the disappearance of Mao in China or the fall of the Berlin Wall have far greater consequences than financial shocks. When we look at the technology, media, telecommunications (TMT) bubble of the late 1990s, there were no obvious consequences. The 1970s oil crisis also did not have geopolitical ramifications. Yet, the Depression of the 1930s and economic collapse in Europe after

WWII did have important results. The former led to the rise of Nazi Germany, the isolationism of America and the outbreak of war. The latter resulted in the Marshall Plan that financed the German Wirtschaftswunder and economic revival across the rest of the Continent that led to the eventual establishment of the European Union (EU). The lessons of the 1930s also led to the setting up of the Bretton Woods institutions – the World Bank and International Monetary Fund (IMF) – to bring monetary order to the main industrialized states and a system of crisis management that has survived for more than 60 years. Today their legitimacy and representativeness are being called into question.

A new world order may be replacing the old but a transition won't be easy. French President Nicolas Sarkozy said that the global financial crisis would result in the demise of "Anglo-Saxon capitalism." History suggests that the U.S. has the greatest resilience and capacity to recover quickly suggesting the old world order will be around for a while. The UK, EU and Japan seem stuck with sluggish growth and declining demographics suggesting their models will be first to change. Emerging market economies have been hit with a collapse in trade flows and a dramatic fall in commodity prices forcing a change in their economic models. Second hardest hit are those commodity producers that have always faced social and demographic challenges, such as energy-rich Russia and Venezuela. Even Persian Gulf oil producers have been affected by a collapse in oil prices and falling demand. All had become used to huge export and tax revenues and face a re-adjustment. Finally, those emerging economies still in transition from poverty to prosperity – or from communism to democracy – have been caught by the economic crunch before they could build stable systems of governance.

Today, the central nation in the ongoing geopolitical transformation is China. It is also the most difficult to read. "They want everything and nothing," says a senior IMF official. "What they really want is just to be among the big players. The coming 20 to 30 years will be the era of the U.S. and China. They are preparing for this game." Despite a desire to have a larger share of IMF votes, Beijing did not want to donate to the G-20 Fund because China is still, per capita, a poor country. Finally, Beijing contributed $40 billion as part of a $500 billion total emphasizing its growing superpower status.

As our clients know, we have been proponents of investing in emerging market equities for many years and have penned many articles promoting such opportunities. The first three months of this year vouch for our continued interest in developing equity markets and demonstrate a wide divergence in markets' performance. Domestically, the broadest stock market measure, the Wilshire 5000 index, fell more than 10% even with an 8.7% rally in March while the widely-publicized Dow Jones Industrial Average of 30 companies fell by 13%. Many developed foreign equity markets such as Europe and the United Kingdom had declines in the double-digits as well. In contrast to last year's

universal collapse, emerging market equities went their own way during the first quarter with Brazil, China, Russia and Taiwan posting double-digit gains.

In the U.S., stock declines were encouraged by the inauguration of a young, new president who has little managerial experience. There was also a flurry of mixed news as to the qualifications of key people in the president's cabinet of advisors. Economic news was not encouraging either. The fourth quarter data for economic activity reflected bad news: the real economy's output fell 6.2% with an equal or greater decline expected for the first quarter of this year. Add to that fears of major bank failures and the collapse of General Motors and you have the market falling to the lowest levels of this decline. Citibank fell to a share price of 97 cents -- down from a high of $57 at the end of 2006. General Electric, viewed as the mightiest of the industrial companies, fell to a price of less than $6 -- down from a high of $42 in 2007. As unemployment rose above 8% with double digits expected later this year, there was little to cheer about. There are 13 million people unemployed in the United States at this writing, the highest levels ever.

The only one of four major components of the domestic economy with growth prospects is federal government spending and lending. The consumer, business and foreign sectors are all in decline. To arrest these declines, the Obama administration put forward a $787 billion stimulus program that was quickly passed by a Democrat-controlled Congress. This plan was followed by an annual budget that exceeded tax revenues by over $1.7 trillion according to the latest Administration's budget forecast. Don't forget that the last administration's TARP (trouble asset relief program) spending of $700 billion also adds to the stimulus. These programs take total incremental spending by the executive branch of the government to nearly $2 trillion. Federal government spending of this magnitude has never occurred before! Fiscal stimulus from Asian governments, namely China, are also at record levels.

Monetary policy has also contributed billions of dollars of stimulus to the domestic economy. Last year, the Fed reduced their target interest rate to near-zero indicating the doors were wide open for borrowers to get loans. The Fed announced a program to buy long-term treasury bonds to force interest rates lower and more recently introduced the Public-Private Investment Program (PPIP) that is a constructive step forward to repair the financial system. The program employs government subsidies, leverage and liquidity to restart markets for toxic (legacy) securities and to promote price discovery for both mark-to-market and accrual assets.

The Bank of England (BOE) continues its aggressive monetary accommodation in the form of a quantitative easing program in addition to implementing £75 billion in asset purchases financed by the creation of central bank reserves. The European Central Bank (ECB) has also started to employ quantitative easing in order to provide liquidity to financial markets. The Bank of Japan cut its overnight target rate to just 10 basis points

partly due to peer pressure but also due to evidence of the economy entering recession again. The BOJ has continued to expand the magnitude and scope of purchasing government bonds and commercial paper. The Reserve Bank of Australia (RBA) has continued to ease aggressively since September of last year against the backdrop of rising downside risks and plummeting commodity prices.

In deep recessions like the one we are experiencing, inventory liquidation usually will turn to accumulation, promoting snapbacks in output and eventually in hiring. Not this time. Despite six quarters of inventory liquidation, the real inventory to sales ratio in manufacturing and trade came within a whisker of its 2001 high. Sales for the year ended in January tumbled by more than 8% and inventories declined by only 2%. While corporations are adjusting to the slowdown in product demand, aggressive production cuts and plunging imports may be reducing the imbalance between sales and stocks. Unfortunately, in the current downturn, the ongoing credit crunch will likely delay both sales and hiring. The 3.5% plunge in payrolls over the past year – the most acute decline since 1958 –means that the negative feedback loop from production to income and spending is likely to continue.

Moreover, the current recession is likely to be longer due to the fact that the private sector cannot cushion the downturn. In the recession of 2001, a deep tech bust resulted in only a mild recession because housing and consumer spending held up well. This time virtually no sector of the economy is immune from the credit crunch. Likewise, the current global recession means that neither the U.S. nor its trading partners can rely on each other for export demand. Despite a seven-year decline in the dollar, real U.S. goods exports have been crushed -- plummeting at a 43% annual rate in the last six months.

CONCLUSION

The bottom line is that capitalism failed – or to be more precise – capitalists did. Businesses, governments, and consumers submitted to excess and got too greedy. Just as this crisis was inevitable, so the pendulum will swing the other way. Capitalism will be overturned and we will see the return of forms of government corporatism that characterized the Seventies. Just as business is poor at government, government is ineffective at running business. The traditional laissez-faire policies of the Bush Administration have fallen by the wayside and government intrusion into everyday corporate life is a reality. Populism is on the rise and corporate executives are the target of anger and scorn encouraging government to pass even more laws restricting private enterprise. The Democrat-controlled executive and legislative branches are moving quickly to implement change in the way the system works. So far we have seen the bright side—spending and lending that has cushioned the economy from the prospect of a depression with an unemployment rate at 20% that characterized the 1930s. From 1933 through 1936 the U.S. economy boomed, growing at a 9.4% annual rate. Not until President Roosevelt raised marginal tax rates, introduced a payroll tax and raised

interest rates did the economy return to the depression levels of the early Thirties and an unemployment level that characterized the Hoover administration.

Fiscal stimulus, repair of the financial system and monetary ease will help to foster positive domestic economic growth late in 2009 and sustainable recovery starting in 2010. The key to policy traction lies in breaking the negative psychology created by the credit crunch. Restarting global credit markets, repairing viable lenders' balance sheets and liquidating others, and foreclosure mitigation are essential. Additionally, the restoration of world trade will be the linchpin in returning to a global growth environment. A slip into protectionism will only exacerbate the downturn. So far, there haven't been any major indications of a return to the trade policies of the 1930s but vigilance by free market advocates will help avoid potential problems.

The new world order will have an Asian flavor – more orderly, more pragmatic and more flexible. Neither China nor India has lost faith in capitalism, because both have elites who well remember living with the alternatives. The Chinese well remember the disasters that followed from the Maoist centrally planned economy. The Indians well remember the slow "Hindu rate of growth" under Nehruvian socialism.

We should not be surprised to discover that the greatest global believers in capitalism are in Asia. But it will be an Asian mix of capitalism not the Western formula that will become the dominant form of global capitalism, where the "invisible hand" of free markets will be balanced by the "visible hand" of good governance. The shift to this new world order will be a gradual process underlying the global economic and political landscape for some time to come.

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[1] United States National Intelligence Council: Global Trends 2025: A Transformed World. To view electronic version:
www.dni.gov/nic/NIC_2025_project.html