

2007: The Road Ahead

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With the first quarter behind us, it is time to consider the prospects for the remainder of the year. Such a task is requiring an increasingly global approach in order to truly see the risks and pitfalls that lie ahead. If history is any guide, the threat of a significant meltdown or crisis may originate anywhere in the world. The Russian and Asian meltdowns of the last ten years serve as an example that one must be vigilant across the world for potential sources of financial instability that could rock the markets in the United States. The emerging markets have been achieving blockbuster returns with only periodic and reasonable pullbacks. Nevertheless, the risk remains for a repeat of the emerging market crisis problem that has led to global slowdowns in the past.

China: Although, the Chinese economy is growing at an astounding rate, it is not without some concerning issues. The capital system has not been able to keep up with this growth. Many firms turn offshore to Hong Kong to raise money. In addition, the banking system is mired in problems. The banking system does not have the years of lending experience and knowledge of their counterparts in the West. As a result, the amount of bad debt has reached unprecedented levels and is increasingly becoming the Achille's heel of China. By some estimates, China's bad debt write-off could be as high as 40% of GDP. This is truly staggering in comparison to the 3% figure of the US savings and loan crisis.

Furthermore, there remains the ever present threat of an interventionist government. As foreign investors flock to the constrained supply of available equity, the Beijing government from time to time attempts to temper this enthusiasm with veiled hints at intervention by policy. The reluctance of the country to allow the currency to appreciate fully has also led to tensions with the United States.

India: The Indian economy stands in marked contrast to its Chinese counterpart. Democracy, open stock markets and a similarly high expected rate of GDP growth make it an attractive market. However, the increasing burdens of red tape bureaucracy have made it difficult to do business there. In addition, India is beginning to see wage inflation erode its competitiveness. The shortage of managerial talent, especially in the service sector, would pose a serious threat to the

profitability of the sector that has fueled a significant amount of growth in the recent past. With a ramp up in equity prices similar to China, the prospect of an asset value crisis also remains a threat.

Latin America: The region appears to be experiencing an uncharacteristic period of good (but not hyper) rates of growth with an accompanying check on inflation. Latin America's recent growth has helped to stabilize and improve the financial and current account situations in most of the region. Nevertheless, the area remains vulnerable to credit pressures from the global financial system. As it falls behind Asia in growth potential, will the associated risks also drop for Latin America?

Finally, with emerging market yields at historic lows, the possibility of complacency is becoming a real concern. Most market watchers point to the rise of investor complacency as a good sign of possible problems. With yields in some cases only 200 basis points ahead of U.S. Treasuries, the market seems to be lax in properly pricing the inherent risk of emerging market debt. Is this a permanent change in the risk profile of the emerging markets or a sign of impending trouble?