# Where to Look for Surprises in 2013

## History suggests that 2013 should be favourable for markets, but if you are looking for negative surprises, look in parts of the emerging world where complacency reigns

RUCHIR SHARMA

ARINDAM

If the stock market rises in grim economic times, and few are celebrating, is it a bull market? This was the existential riddle of 2012. In the US, the stock market continued its ascent — with the S&P 500 up 14% for the year — capping a four-year run that is almost exactly on par with the average for the 10 major bull markets over the last century. But this may be the first bull run without the bulls, in large part because the US is also four years into the second-weakest economic recovery from any recession in a century. With stock trading volumes down 17% in 2012, with retail investors pulling more money out of stock funds, and with layoffs still thinning the ranks in the financial industry, the general public was feeling way too worried to be making any bullish noises.

The unhappy rise of the US stock market could again be a defining trend in 2013, because the historical roadmap suggests the bull run is likely to continue for another year. Looking back at the major market rebounds since 1907, the S&P 500 usually rises by about 10% in inflation-adjusted terms in year five, which we are entering now. The stock markets has been able to perform way better than economic activity in this cycle as profit margins of companies are at a 70-year high, with managements aggressively focused on productivity increases, particularly in the manufacturing sector. Manufacturing accounts for 60% of the S&P 500's profits but only 14% of the US economy and employment.

The crowd on Wall Street increasingly recognises the 'anti-fragility' of US' corporate sector, with most strategists calling for another good year in the markets. That's not unreasonable as the markets may still have a wall of worry left to climb given the persistent concerns about the underlying economic and debt situation. Therefore, the search for surprises has to zero in on the most likely of the unlikely scenarios, events that could truly upset the consensus.

On the positive side, the most likely of these surprises could be in Europe, which may have nowhere to go but up. Industrial production fell by 20% across the eurozone after the crisis hit in 2008, and is now climbing back up. The investor mood is still wary, and stock market prices are strikingly low. Today, the average ratio of stock market value-to-GDP in any given country, worldwide, is about 80%; in peripheral Europe, this ratio is rising but still as low as 19% in Greece and 26% in Italy, close to the lows hit by Asian markets like Indonesia and Thailand during the crisis of 1998. Europe is the best value proposition.

The mood in much of Asia is very different, by some measures more sanguine than it has ever been, a warning sign that a change for the worse could be coming. The latest batch of investor surveys show that most participants expect Asia to be the best performing region in 2013 and more than 80% of investors say they have a constructive view on emerging markets. Given the clear signs of a turnaround in economic activity over the last few weeks in many of the large developing economies, the optimism seems justified. However, from a contrarian standpoint, it is worrying when traders report that over the last month, they have seen the lowest-ever demand for downside protection for Asian stocks into a New Year and the highest-ever demand for upside.

The mood in the global bond markets is even more cheery, following a year in which retail investors bought $680 billion in bonds worldwide, more than double the level of the previous year and an all-time record. Emerging markets bond funds were particularly popular, with their assets rising by a massive 25% in just 2012, a staggering result for a single year on the theory that many emerging markets have achieved macro stability, with debts and deficits under control. After all, since 2008, there have been 189 sovereign upgrades by rating agencies in the developing world versus just one upgrade in the developed world, which has, instead, seen 129 rating downgrades.

So what surprises might deflate the bubbly confidence in emerging markets? The first candidate is China, where the consensus forecast is still for GDP growth of 8% this year despite the fact that growth slipped below that level in 2012 and the strong case that China is just too big and middle-income a country to continue growing so fast. A major growth shock in China could rattle the commodity markets and the indebted emerging market countries, as 60% of the countries in the global emerging market bond indices are heavily dependent on exports of commodities.

Even perma-bulls on China are beginning to worry about two factors: incoming leader Xi Jinping has warned that rising corruption could lead to "the collapse of the party and the country", as he senses the popular resentment that has built up following the sharp rise in cases of bribery, graft and ostentatious spending by government officials in recent years. Second, liquidity outside the traditional banking sector is growing much too rapidly and this striking rise in liquidity is finding its way into all kinds of murky debt products.

**The twin deficits in India are worrying as no one has seen a crisis in a major emerging market in 15 years**

The main issue is that this proliferation of alternative and local sources of credit is very difficult to track, so no one can fully quantify the risks. One investment bank calls wealth management products (WMPs) the CDOs of China — a reference to collateralised debt obligations, the exotic US debt instruments that triggered the global crisis of 2008. That's extreme, but systemic risk to the financial network in China is growing.

Another potential surprise from the emerging market world could come from a nation most likely to disrupt the spectacular boom in the global bond market. The reality is that macro stability, which so many emerging nations laboured to build in the last decade, is starting to erode in a few important markets, including some that have sizeable deficits in both the overall current account balance and the government's deficit. The twin deficits in South Africa and India are particularly worrying, in part because no one has seen a crisis in a major emerging market in 15 years, and because most investors expect 2013 to be much like 2012. If an unexpected shock comes in one of these big countries, it could prove highly contagious.

Given the political winds in South Africa, it looks like the bigger risk. President Jacob Zuma has reversed the one major achievement of his African National Congress successors: macro stability. Government spending is rising fast, fuelling a rise in real wages that is driving up consumption, and both the government deficit and the current account deficit are now around 5% of GDP.

Currently, South Africa's financial system is ranked as one of the best in the world. But with weak foreign reserves and a very heavy foreign presence in its stock and bond markets, South Africa is highly vulnerable to capital flight. Social tensions are also on the rise as the country has one of the lowest employment rates in the world and the economy is expanding at too slow a pace to create new jobs. So, if South Africa begins to totter, its size and reputation could produce a contagion effect.

Let us hope history and the consensus hold, and year five of the market recovery proves uneventful, and profitable. If you're looking for negative surprises, don't look in US or Europe, the starting point of the last two global shocks and where the risks are well-telegraphed. Crises occur when the consensus is too confident, spending and debt too loose, and right now, the early warning signs are gathering in the emerging world.

*(The author is head of emerging markets and global macro at Morgan Stanley Investment Management)*