Global Perspectives

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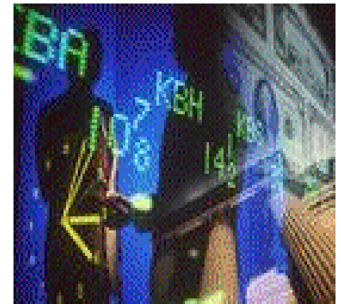

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Global stock markets have found a tenuous footing after the sharp sell-off that occurred over two weeks ago. But they remain skittish, as investors try to digest mixed signals. And volatility is now higher than before.

Two issues are the primary focus of attention. First, the sub-prime mortgage problems in the United States and the probability of a sharper economic slowdown. Second, the yen carry trade. A reasonable assessment is that the former problem constitutes a greater threat of producing an untoward outcome than the latter.

It is noticeable that there has been considerable correlation among stock markets in the past few weeks. As a matter of observation, correlation normally increases during corrections, which means that during such phases diversification doesn't help much to protect the downside. There is greater co-movement in downswings than in upswings.

To the extent that the global economy is becoming more integrated, we should expect this development to be reflected in the way financial markets behave. If capital is free to move, it will tend to result in the equalisation of risk-adjusted rates of return, with the emphasis on "tend". But even those markets that have restrictions on foreign share ownership are not immune to being strongly affected by global forces.

There are risk factors that are specific to a given stock market and others that have a broader impact on all markets. A change in the oil price is an example of the latter. And, of course, factors that move big markets will have a larger effect on small ones than the other way round. A change in US capital spending will affect the Taiwan stock market more strongly than the reverse case.

Needless to say, all asset markets are interrelated: stocks, bonds, commodities and the rest. Any inefficiencies or misalignment in valuations, given the latest information and expectations, are brought back into line by profit-seeking investors. This had always been the case, but what is becoming increasingly important is the extent to which trading by hedge funds is beginning to predominate.

Much of their trading is computer generated, via the implementation of quantitative models. This sort of activity can lead to the dampening of volatility as market misalignments ate brought into line. But a lot also depends on risk-management practices. The search for higher returns may cause the relaxation of standards and, under stressful conditions, could result in a substantial increase in volatility. Recent turbulence does not fall into that category, but from the regulator's point of view it does not pay to be complacent.

While we are on this subject, it is estimated that about half the daily trading volume on US stock exchanges is now accounted for by hedge funds. Given that their trades are often of very large size, and they obviously don't want to reveal their hand to the market, they use algorithms to implement their trades.

The algorithms are computer programmes that break up a total trade size into smaller trades, which also include counter-trades to obfuscate the real intentions of the hedge fund. For example, a buy order would be peppered with some sell orders to confuse the market. Not every market participant is confused, though. Some hedge funds design algorithms that search for these buy and sell patterns in order to exploit an opportunity. So, what we get is a battle of computer programmes.

Turning to the economic picture, the US economy remains the biggest risk factor in the global outlook. Leading indicators point to further slowdown in US growth, but avoiding a sharp deceleration. The most recent employment report, which is comprised of coincident or lagging indicators, is also consistent with such an outcome. Meanwhile, inflation is of the slow creeping variety - - a little troublesome but not dangerous. Also, corporate profit margins are under pressure.

The biggest risk to growth in the United States is of a possible fallout from problems in the market for sub-prime mortgages. Delinquency rates for this category have increased sharply but, thus far, this has not extended to conventional mortgages. Meanwhile, banks have tightened standards for mortgages and are becoming more restrictive regarding consumer and C&I (commercial and industrial) loans, though to a lesser extent.

Mortgage originators who initially granted the sub-prime loans are in trouble. But in the securitisation process, portfolios of these loans were sold on to banks, repackaged, and then sold to end-investors. So, there is exposure at many levels. A problem for the originators is that often there are buyback clauses forcing them to re-purchase the loans under certain conditions. Those buyback clauses are currently being triggered, causing the originators to cut back on loan issuance and to try raising cash.

As a consequence, home repossessions are likely to increase, as well as the total number of houses put up for sale. In a housing market that is already weak, this will put downward pressure on property prices and result in a negative impact on the home equity wealth-effect that has been sustaining household consumption.

A further risk is that many prime adjustable-rate mortgages may also have their rates adjusted upwards. Meanwhile, homebuilders are still trying to work off unsold inventory. So, to summarise, the knock-on effects of the sub-prime problem may extend to house prices, consumer spending and construction activity. This will be a drag on economic growth and increases the risk of a recessionary outcome.

Alan Greenspan, the former Fed chairman, recently put the probability at thirty percent. It is as good a guess as any. But he has been roundly criticised by many for this and earlier statements that contradicted the official talk from the current chairman, Ben Bernanke. The critique is that he is somehow undermining the Fed's ability to manage expectations.

Greenspan, of course, gets paid for his presentations and sure as hell doesn't mind grabbing headlines. But the idea that he should be silent is bizarre. On the contrary, he should be encouraged to express his opinion. Investors are smart enough to assess contending views. There is already too much of the official line pumped through the media. Three cheers for diversity.

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