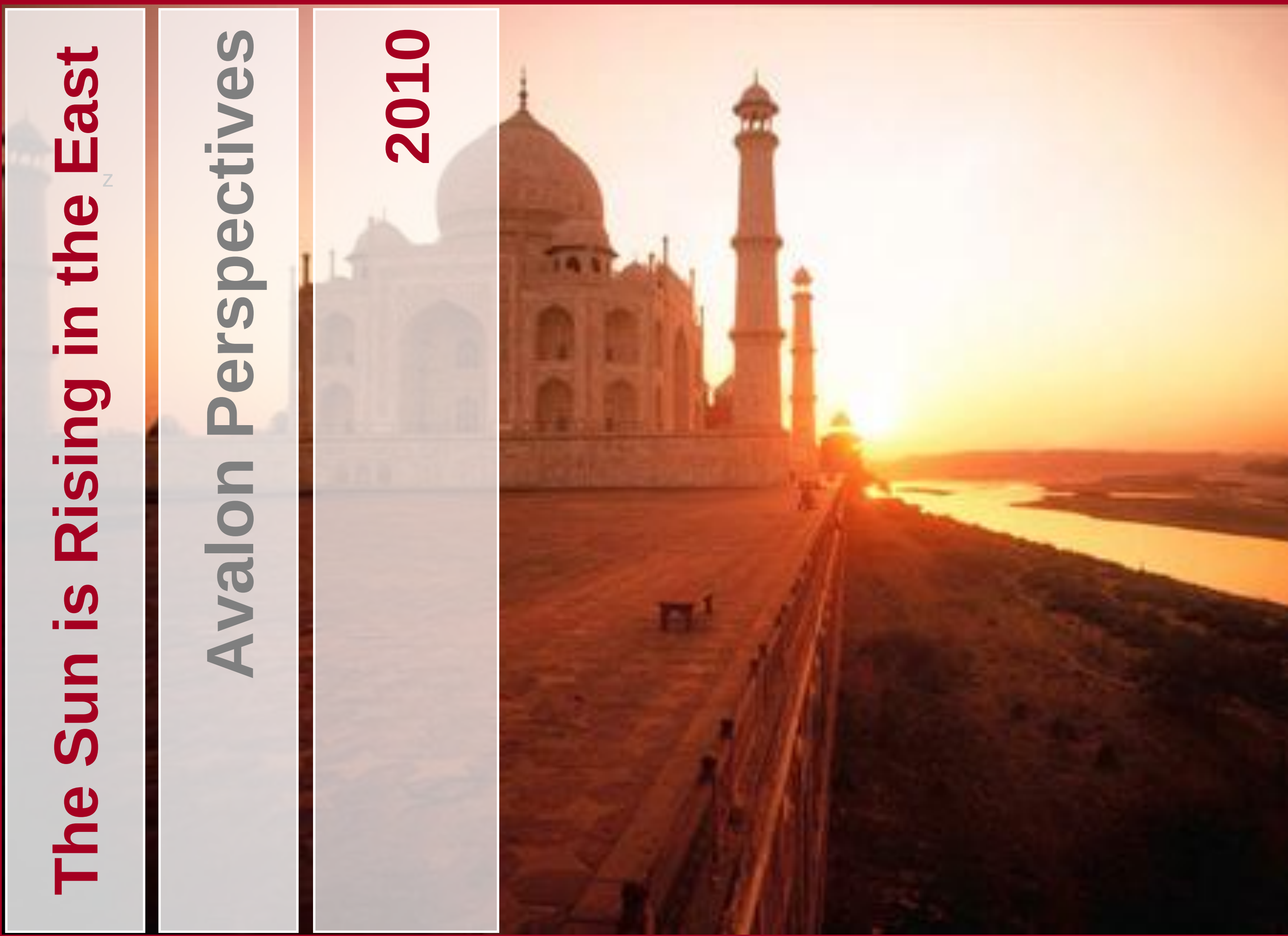

What is in store for 2010?

- Raj Nair,
Chairman, Avalon Consulting

www.consultavalon.com

AVALON CONSULTING

This is that time of the year again, the time to look at the coming year and to look back to see what went right and what didn't in the year gone by. The turn of events in 2009 was relatively easy to correctly predict because we had the great recession on the widescreen for all to see in 2008 and there were sufficient early signals to help us take a peek into the coming year. Looking back at the 33 predictions that I made last year for 2009 about international and domestic events, one went wrong and horribly wrong, viz. that Russia would exert itself more strongly than before in its region. In fact, Russia suffered for most of the year and ended the year with not just a negative GDP growth but also uncertainty about its ability to turn things around internally, leave alone, exerting its power in its neighbourhood. The Russians may still continue their 'No Money, No gas' policy and potentially hurt weak countries like Ukraine this winter. Someone also asked me why I left China completely out of my predictions for 2009. The answer is simple: I just could not figure out what is happening there due to inadequate transparency. I was not in a position to draw meaningful conclusions from unreliable signals other than the obvious one that China would lead the global revival. The lesson that I learnt about China during the course of 2009 is that while in most countries, quarterly GDP growth, automobile sales and the like would be good signals to read, I would rather use electricity consumption as a proxy for economic status, fuel consumption as a proxy for automobile demand, and so on and so forth for some countries like China. More on that later...

It was relatively easy to predict that USA, the UK, Europe and Japan will have a rough time in 2009 and end up with negative GDP growth, lower consumer spending, that US under Obama will focus more on its economy than on opening new war fronts despite provocations, etc. Saying with conviction that India's lot will improve from mid 2009 was also not difficult despite there being many economists predicting as late as the end of Q1 of 2009 that India's revival will start only by the year end when the US economy was expected to show signs of revival. But predicting what will happen in 2010 is more complex than predicting 2009, since there is more than one view on whether the global economic travails are over.

Is the economic crisis over?

The wound has been cleaned and first aid has been administered. Several measures have been taken by developed nations to prevent a global melt down. These are at best, Band Aid solutions and Band Aid does only what Band Aid can do - cover the wound and heal minor problems. In the present instance, a lot of Band Aid

was used but the wound is deep and complex. The economic problem has neither been cured nor can it be wished away irrespective of whether the stock markets reflect those concerns any more. That the stock markets are in a state of stupor can be gauged from facts.

In Nov 2007 when I said that a crisis is at our door step, the nominal value of outstanding derivatives had already scaled the scary $ 500 Trillion mark ($485 Trillion on Aug 31, 2007 rising to $ 595 Trillion on Dec 31). The global GDP at that time was around $60 Trillion only! This reckless level of financial exposure requires many years to restore to safe levels. In the meanwhile, stock markets were rising.

It is instructive to read what Carol Lumis, a friend of Warren Buffett and who edits his annual letter to shareholders of Berkshire Hathaway, had to say about unwinding of derivatives, a few years before the current crisis.

"Our experience should be particularly sobering because we were a better-than-average candidate to exit gracefully. Gen Re was a relatively minor operator in the derivatives field. It has had the good fortune to unwind its supposedly liquid positions in a benign market, all the while free of financial or other pressures that might have forced it to conduct the liquidation in a less-than-efficient manner. Our accounting in the past was conventional and actually thought to be conservative. Additionally, we know of no bad behavior by anyone involved.

"It could be a different story for others in the future. Imagine, if you will, one or more firms (troubles often spread) with positions that are many multiples of ours attempting to liquidate in chaotic markets and under extreme, and well-publicized, pressures. This is a scenario to which much attention should be given now rather than after the fact. The time to have considered – and improved – the reliability of New Orleans' levees was before Katrina."

Has the prime cause of the crisis been licked if not its consequences?

Not really. The notional value of all OTC derivatives outstanding as on June 30, 2009 was $604 trillion, up from $595 trillion on Dec 31, 2007. It had gone up to a high of $683 trillion in June 2008 when the world was deep into the crisis. The derivatives included CDS which are now regarded to be toxic for the uninformed investor. The notional value of the CDS derivatives had dropped only 15% from 42 trillion to 36 trillion in this period. This is high if one were to compare it with the total size of the international bond market which is only about $60 billion. It is interesting that the entire drop in CDS outstanding has happened in multi-name instruments whilst single name instruments remain unchanged at $24 trillion. This level of derivatives is not easy to wish away and it takes a long while to unwind. In the meanwhile, stock markets have been soaring unmindful of all this. There are experts who expect AIG to go back to the US Government for more help.

Hence it is important to not get into a euphoric trance by looking at where the stock market indices have reached now after the scary crash in most derivatives-infected countries The problems are still being tackled; the job is not done although many believe that the worst is over. It is useful to hear what pessimists have to say about a double dip recovery and the impending ride down a slippery slope. It happened before during the Great Depression of 1929 and the years that followed. It is nobody's argument that the Western economies are being propped up by the stimulus programme.

Some say that the music will stop the day the stimulus is withdrawn. Consumer confidence is yet to return in many parts of North America and Europe. A lot of the recovery in the US will be 'jobless' growth in the early part of 2010. The housing mess is not fully cleaned up. Therefore, it is hard to imagine that Governments of developed nations will abruptly withdraw the stimulus. Like cortisone, it has to be withdrawn slowly and carefully to avoid another crisis. But like cortisone, this line of treatment has side effects. Knowing this, the bandits are out again creating a debt bubble with carry trade which is predicated on the availability of low/no interest debt. All sub-categories of derivatives have dropped since Dec 2007 barring interest rate derivatives which had actually gone up from $347 trillion to $437 trillion in June 2009. Is that a signal of sorts?

Will there be inflation in 2010? What about the Dollar value and Gold prices?

Due to the stimulus programmes, there is a huge amount of liquidity in the markets today which financial speculators have easier access to than do genuine businesses. There is more money chasing limited assets now. This ought to lead to inflation in 2010 as country after country gets out of the economic malaise. In some countries, this may reach unpalatable levels. It is already happening in economies where consumer demand is reviving, e.g. India, China, etc.

This is already causing asset bubbles in real estate, gold, stock prices and select commodities in some countries. Financial 'innovators' to whom we owe the global economic crisis are back at what they do best; making money without creating real value. In the US, for instance, at the height of the boom in 2007, the financial services sector accounted for 40% of all the business profits in the country and the listed ones accounted for 23% of the market cap in the US. This unreal part of the economy which has active links with and support of the political bosses in many large economies is likely to escape tight supervision and expose the world to new types of crises in the next 3 years. There will be moves to reduce this liquidity overhang and low interest rates. India along with Australia and Indonesia may go in first but cautiously, starting with interest rate, followed by liquidity mopping after gauging the impact on growth. Many other countries will do likewise during in 2010. It is fair to assume that US will, with the benefit of the lessons of the Great Depression, withdraw the stimulus in gradual steps (liquidity and interest rates) and some of it will happen in 2010, but only after inflation raises its ugly head, will the administration act to reduce liquidity. It is realistic to also assume that there will be a substantial amount of exposure to derivatives still left at that time. This is bound to have some repercussion, mild or strong. The speculative Dollar carry-trade for instance, can go bust if interest rate rises, resulting in another round of losses as the Dollar rises while positions are being squared off by speculators. These and other outcomes could be more predictable if the US Government is prepared to take very hard decisions to regulate the financial markets. But history is not on the side of tight regulation of the bandits. These eels are likely to slither away to play the next money making game, predictably at the expense of the unsuspecting victims. Already, some hedge funds are playing a big game in Japan which the Bank of Japan has not shown the ability to counter so far because the new political master, the Democratic Party of Japan, appears to be unclear whether they should have a strong Yen or a weak one.

The dollar in the medium term is, in any case, on the path of declining value, due to the huge trade and current account deficit. The normal course for gold is to follow the opposite trend. Speculation has provided an added stimulus for gold prices to rise. Only a significantly reduced global demand for gold from India or bust of the dollar carry trade when interest rates harden can cause gold prices to soften significantly. There is huge inventory of gold in India (reportedly 15000 metric tonnes) which is largely idle. Indian Banks will be looking at ways to tap this gold in 2010, through instruments like gold bonds, which will send a small part of this inventory back into the market. It is also conceivable that the huge dollar carry trade may slim down or drastically shrink sometime in the second half of 2010 when the Administration is likely to suck out liquidity and raise interest rates to fight inflation. That could temporarily cause the value of the dollar to rise.

AVALON CONSULTING

China......the economic engine, impact of inflation and Remimbi revaluation

China is facing a dilemma despite leading the way in 2009 and expected high growth in 2010. This is partly because the Communist Party bosses are acutely aware that the impressive growth in 2009 was in large part, ‘created’ by the stimulus and may be to some extent by incorrect statistics. The GDP growth rate number (in excess of 8.5%) does not get supported by electricity consumption (expected increase of 2.5% YoY). It is unlikely that most of the GDP growth suddenly came from the BFSI sector and services in general. The reported car sales are very high (42% in H1) but resultant increase in car population is very much higher than fuel consumption increase and it is also unlikely that the car population became suddenly very fuel efficient. The more plausible explanation is that a large number of domestically produced cars were dumped on State Owned Enterprises in 2009 to stimulate the economy or that the statistics are plain wrong given the lack of sophisticated processes to collect and aggregate data. Stimulation of demand could be done again to an extent in 2010 but there is a limit. The manufacturing engine of China is being propped up by putting money in the hands of the ordinary Chinese and SOEs in order to create a large domestic market to replace the slowdown in exports to the US and Europe. Eventually that is the solution for China but this has created inflation in the recent weeks in vital commodities eg. Pork prices up by 18%, a politically unacceptable situation. This will probably force China to allow the Remimbi to rise in value to contain the input costs of imports- a step that the US will welcome. Predicted revaluation is in the range 6 to 6.30 Remimbi to a dollar. Wage inflation is also disturbing the cost of production in China. It is possible that in 2010, the world will see China moving towards more value added products and in some sense loosening its grip on the ‘lowest cost of production’ ranking. The huge investments in high speed railroads and other infrastructure, way beyond the limits dictated by commonly accepted economic benchmarks of Return on Capital Employed will also reduce the capacity of the country to solve economic challenges in a balanced manner. China will remain an engine of growth for the world but will over the next few years shed the scorching pace at which it grew in the recent years. India and a few other Asian countries will join the club with China.

Will we begin to see strong Economic shift from the West to the East in 2010?

There are unsubstantiated but believable statistics that show China and India accounting for 60% of the world GDP in 1750 and slipping into oblivion during the next two and a half centuries for reasons that are not the purpose of this article to explain. The initially slow but now more rapid reversal of this trend is visible. China and India will shine in the second decade of this millennium, with both likely to end the decade neck to neck in terms of growth rate. The crisis of 2008-09 will hasten this shift in 2010 as the GDP growth of the 3 major global economic engines, USA, EU and Japan, grow slowly relative to China and India. I expect India to post a GDP growth in excess of 8% in 2010 whereas China's growth will be higher. Vietnam and South East Asia will also rebound. South Korea too is showing impressive recovery. The Economist expects the US to post 2.4% growth, followed by Japan at 1.5% and the EU at 1.2%. If the administration in the US panics on account of inflation and withdraws sops too soon, one may witness a double dip or w-shaped recovery in the US, with the next dip happening around the end of 2010. I believe that Japan's recovery has been over-estimated. On the one hand, BRIC nations as a group have recovered much more substantially than the G7 and the world as whole, and there is little to stop them. On the other hand, developed nations are still not out of the woods. Many of them have got seriously indebted. With the global sovereign debt burden racing up to a probable $45 trillion in the next 2 years, the worst case scenario is another round of global economic crisis.

What Japan, the US and Euro-zone have effectively done to plug the holes in 2009 is to borrow heavily from the future to pay in the present for past sins. That postpones the problem and blunts the sharpness of the current crisis but does not solve it. For Japan that could mean public debt of 2.7X of GDP, and for the US-UK-Europe it could be 1X to 1.3 X of GDP in the near future. For the whole world, public debt could be 0.7 to 0.8 X of GDP. That, by the way, is high because it excludes private debt. Add the two and the debt leverage will look formidable. In simple language, a lot of money that could be spent on goods and services in the medium term will go to pay interest and debt retirement. Surely that cannot help the cause of economic growth. The unwinding of debt could be paced slowly, moderately or quickly by Governments depending upon their appetite, availability of non-debt instruments or replacing shorter term debt with very long term debt....and God know what else. Will we see a return to higher rates of direct and indirect taxes after years of decreasing taxes? The Government needs money after all and somebody has to pay for the lunch. Hence 2010 will hasten the shift of economic balance to the East.

Implications for Indian companies in 2010

This is going to be a year of hope, many of which will get fulfilled if the right opportunities are addressed.

- Take the huge middle and lower middle class market that is emerging in India very seriously. India is on a growth path, starting now, It is going to be a huge and scalable market for any product or service that is affordable as India marches inexorably towards a $2000 per capita income level. Quickly figure out what you can do and how your business model needs to change. Social unrest and terrorism are the two negatives to watch out for.
- Start investing now for 2011. Barring cyclical ups and downs prepare for a high growth decade.
- Look for acquisition opportunities in the West. Assets will be reasonably priced for a while longer and many will have excellent customer bases. The Western customer will be much richer than the rest for many years to come although their economies may struggle for a while.
- There will be talent shortage and wage inflation. Look for technical, operations and marketing talent in the West. Many are available and they do not cost much more than top flight Indian managers do.
- Don't over depend upon the West for export growth. Those economies will take a while to recover. Their consumers will continue to be relatively rich but many have learnt to be thrifty. The latter is also an opportunity for producers of high quality low cost products and services.
- Build bridges with China and enter their domestic market. Differential inflation and Remimbi revaluation will make many Indian goods and services viable provided Indian companies don't splurge again having instituted cost cutting measures in the past 12 months. Learn Mandarin and Chinese business etiquette. Explore the Chinese market now so that over a year or two, one can set foot in that growing market.
- Astute business people in each industry sector should be staring at opportunities that situations, such as the present one, create because most people will not notice opportunities. The 'new normal' will be different from the 'normal of 2007'.
- Take Asian markets seriously and invest in building a brand and presence in some of them. That is where the sun is rising. It has not done that for a couple of centuries

Please send your views and comments to raj.nair@consultavalon.com

>> Contact Us

Casa Avalon,
61, Dr. S S Rao Road,
Parel,
Mumbai - 400 012

Phone: +91-22-6619 1100
Fax: +91-22-6619 1122

E-141,
Okhla Industrial Area,
Phase III
New Delhi – 110020

Phone: +91-11-4051 6600
Fax: +91-11- 4051 6650

10, III Floor,
Spur Tank Road,
Chetpet,
Chennai - 600031.

Phone: +91-44-4345 5345
Fax: +91-44- 4345 5338