STOCK MARKETS – THINK POSITIVE

Op Ed by Dr Rory Knight

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JOONGANG SUNDAY

JoongAng Sunday is the Sunday edition of the leading Korean language daily newspaper JoongAng Ilbo. It is one of the three largest newspapers in South Korea. The paper also publishes an English edition, Korea JoongAng Daily, in alliance with the International New York Times.

It is tempting at the opening of any year to look ahead. There is currently much hand-wringing about possible trade wars, weak political leadership in the US and Europe, potential increases in interest rates and reductions in liquidity as central banks unwind their balances. However, equity markets are sending more sanguine messages about the future. Hard though it may be for some to accept, prices can reflect rational expectations. Buoyant markets are not always bubbles.

2017 - a very good year indeed

2017 was the best year for stock markets since 2009 and the dire aftermath of the financial crisis. Table 1 presents data based on the US dollar as the common numeraire, on the performance of the world's top 62 stock markets in 2017. The top 20 all scored above 30% - a remarkable result. Average performance was 25%. Only six of the 62 markets turned in a negative performance while the remainder all improved. In fact of the 56 with positive returns all but one exhibited double digit returns. The top performing markets were Ukraine, Kazakhstan and Argentina. Japan, often perceived as a lack lustre performer, generated a creditable 23.6%, taking it to position thirty-eight, five ahead of the US with 19.4%. There is no doubt that 2017 was a milestone year for equity performance, the MSCI All Country World Index (the MSCI ACWI) reported a 21.6% return and the emerging market version 34%.

> "Currency powers performance."

Korea - the won helped

In 2017 the Korean market delivered spectacular returns of 37.4%, placing it firmly in the top ten of all markets and third among G20 stock markets, just behind Argentina and China. Yet there is another factor behind this success: the impact of currencies. Table 1 reveals that the return on the Korean market in won terms was 21.76% but 37.4% in dollar terms for the equivalent period. Clearly the upswing in the exchange rate between the won and the dollar added 15.6% for investors in Korea lucky enough to be dollar-based. The currency contribution represented a staggering 42% of the total Korean return. Overall, across the 62 markets currency changes contributed 27.3% on average of dollar returns, reflecting the general weakening of the dollar over the period. It should however be pointed out that over the whole decade the won weakened against the dollar, costing international investors in Korean equities some 16% in returns.

Take both long and short views

Received wisdom is that the ten-year bull-run is overdue for a major correction. Yet this is by no means inevitable. Table 1 reports the ten-year performance for the period 1 January 2008 to 31 December 2017. The results are surprising and not nearly as good as one would expect for a bull-market. True, the US market did extraordinarily well with a ten-year return of 84.7% (ranked fifth), an important driver of the world equity performance. The top rank went to Argentina with a return of 136% for the full period. Korea held its own in the top 20 ranking seventeenth on the longer measure. Japan threw off its lack-lustre reputation in eleventh place return of 49%. Yet overall the average return across the 62 markets for the ten year period was a dismal -5.8%. Thirty-five of the sixty-two markets registered a negative return for the ten-year period. The MSCI ACWI excluding the US lost 8.5% over the period. This reflects the fact that most stock markets have not yet recovered to the levels of January 2008 before the crisis. In the context of the long-term review, market performance looks less and less like a bubble.

However, to avoid being over-influenced by performance over the past decade in predicting the future, it is necessary to take into account recent signals. Figure 1 contrasts performance over two

periods - the whole decade, then 2017 itself - in China, Korea, Japan and the US. The first two did far better recently while the opposite was the case for the latter two. In fact markets are doing precisely what markets are meant to do: accurately pricing future opportunity to credibly allocate capital.

A lost decade

The last decade has been highly unusual with its volatile equity markets, slow real growth and historically low interest rates. With the benefit of hindsight the key milestones leading to the 2008 crisis are now crystal clear. In early 2007, after a number of years of expansion the US housing market began to experience an increase in loan defaults, particularly in the sub-prime sector. However, few market participants would have been able to predict the events that unfolded in later 2007 and early 2008. Trouble was brewing for financial markets on both sides of the Atlantic with implications as disturbing as those in the run-up to the Great Depression. In Europe BNP Paribas in 2007 closed a fund with exposure to the faltering housing market. Soon after, depositors lined the streets in the UK as Northern Rock faced a bank-run. In 2008 the US bank Bear Stearns, in distress, was acquired by JP Morgan; Lehman Brothers was declared bankrupt and the US government bailed out AIG. These events sent global equity markets into a spin with the MSCI All World Index falling just under 50%, the Dow Jones declining 42% and the MSCI BRIC composite selling off over 63%. By the end of 2017 the MSCI ACWI excluding the US and the MSCI BRIC indices had still not reached the levels of 1 January 2008 despite continuing recovery since early 2009.

During this period real economies also suffered, with output contracting in all major economies. The US, the UK, the Eurozone and Japan all experienced first falling and then negative GDP growth. Fortunately, growth eventually returned, if at a slow rate. The collapse in output could have been far worse and the intervention of central banks around the world averted a major depression. The central bank interventions were two pronged: a rapid reduction in interest rates to zero or negative, to stimulate the world economy; and so-called quantitative easing (QE) to provide liquidity to support financial markets. The combined effect of these interventions certainly avoided another great depression.

However, interest rate policies did not result in as great a stimulus as hoped. QE - a euphemism for pouring money into financial markets - came at a price. Central bank balance sheets ballooned by in excess of $20 trillion - more than the total value of the NYSE. Central banks will inevitably have to unwind these positions. Only recently has the US Federal Reserve started to raise rates and pare back the expansion of the balance sheet. The Bank of England and the European Central Bank will follow in 2018. Despite recent increases, base rates are still extremely low by historical standards. Central bank balances still hang over the world economy like a sword of Damocles.

Yet the prospect is not necessarily all doom and gloom. Central bankers can be expected to nudge up interest rates only very slowly over the next two years. Real rates will remain negative for the foreseeable future - this is good for the world economy. That said, a reduction in liquidity through the shrinking of central bank balance sheets remains a concern. A misstep could be damaging. Several central banks will be changing presidents in the next year, raising the chances of rookie errors. Offsetting that danger is the current trend of appointing non-economists to head central banks. We may finally be free of the tyranny of misguided macroeconomic models which signally fail to take account of financial markets.

What could possibly go wrong?

Geo-political risks will always hang over markets. These have been overhyped in recent years and markets seem somewhat inured to these risks. An unexpected flare-up could cause market jitters. Concerns are voiced about trade wars but these largely remain in the realm of theory. The Bitcoin phenomenon is cited as another risk for financial markets. A crash in cryptocurrencies will be damaging for individuals but this is not a systemic risk. In fact the speculative enthusiasm for Bitcoin may be a useful safety value to release the exuberance of markets, irrational or otherwise. By contrast, the single biggest boost to the world economic outlook will be the Tax Reform Act in the US. A significantly reduced corporate tax rate will be highly stimulatory and benefit investment and consumption in the US. Naysayers claim that the stimulation will increase interest rates and paradoxically be bad for financial markets. This is nonsense. The tax cut will increase valuations. If US markets grow, world markets will also grow.

Reasons to be cheerful

There is much about which to be optimistic looking ahead in 2018. The launch of the winter Olympics next month with the Korean peninsula marching under one flag is something to be celebrated. This time last year the political tensions in Korea were considered to be a major threat to world peace. Despite the choruses of his detractors President Trump has had a modestly successful first year in office including his landmark tax reform. His much touted America First policy has not led to a break down in world trade. The World Bank has recently increased its forecast of the growth rate for the world economy over the next few years. The IMF reports have been somewhat less gloomy of late, stating in a recent report that the global economy was strengthening and predicted a growth rate for 2018 of 3.7%, whilst acknowledging the recovery is not yet complete.

To quote Yogi Berra, predicting is difficult particularly about the future. Predictions are not always accurate or useful. Yet the overriding signal from markets is that we have at last drawn a line under the financial crisis. A decade on, the world economy is well on the way to recovery. Despite possible volatility and scares in the year ahead a massive downward adjustment is by no means inevitable.

But of course I could be wrong...

TABLE 1. International equity market performance ranking

SOURCE: Oxford Metrica. 62 Major markets with shares traded in international exchanges.

Rank	Country Equity Index	Return in $ 2017	Currency impact v $ 2017	Currency contribution 2017	10 year return in $
1	Ukraine	66.4%	-4.8%	-7%	-91.3%
2	Kazakhstan	59.7%	0.4%	1%	-70.3%
3	Argentina	52.0%	-25.7%	-49%	136.0%
4	Poland	51.9%	25.5%	49%	-49.4%
5	Austria	49.1%	18.4%	38%	-38.2%
6	Vietnam	48.4%	0.4%	1%	-24.7%
7	Chile	47.1%	12.1%	26%	63.1%
8	China	46.7%	9.3%	20%	6.0%
9	Czech Republic	40.7%	23.7%	58%	-40.7%
10	Korea	37.4%	15.6%	42%	16.5%
11	Turkey	36.9%	-10.7%	-29%	-34.9%
12	Greece	36.6%	16.9%	46%	-93.9%
13	India	36.0%	8.1%	23%	3.5%
14	HongKong	36.0%	0.0%	0%	8.6%
15	Hungary	35.8%	12.8%	36%	1.2%
16	Namibia	35.0%	13.3%	38%	-23.2%
17	Peru	33.0%	4.7%	14%	6.3%
18	Denmark	31.9%	16.1%	50%	81.3%
19	Portugal	31.4%	16.3%	52%	-65.9%
20	South Africa	30.4%	12.9%	42%	12.2%
21	Italy	29.7%	16.0%	54%	-53.2%
22	Belgium	28.8%	15.9%	55%	62.1%
23	The Netherlands	28.6%	15.9%	56%	-12.9%
24	Germany	28.4%	15.9%	56%	32.4%
25	Singapore	27.9%	9.8%	35%	6.4%
26	Finland	26.3%	15.6%	59%	5.2%
27	Zambia	26.0%	-1.0%	-4%	-43.1%
28	UK	25.5%	10.8%	42%	32.8%
29	New Zealand	25.0%	3.0%	12%	90.9%
30	Norway	24.9%	6.3%	25%	4.7%
31	Thailand	24.9%	11.3%	45%	114.6%
32	Philippines	24.8%	-0.3%	-1%	95.5%
33	Taiwan	24.8%	9.8%	39%	39.6%
34	France	24.7%	15.4%	62%	-22.0%
35	Nigeria	24.6%	-17.7%	-72%	-78.6%
36	Brazil	24.6%	-2.3%	-9%	-35.0%
37	Egypt	24.1%	2.4%	10%	-55.7%
38	Japan	23.6%	4.5%	19%	49.3%
39	Ireland	22.6%	14.6%	65%	-17.5%
40	Romania	21.3%	11.9%	56%	-49.1%
41	Malaysia	21.3%	11.9%	56%	2.4%
42	Cyprus	19.4%	14.8%	76%	-98.8%
43	United States	19.4%	0.0%	0%	84.7%
44	Switzerland	19.4%	5.2%	27%	28.8%
45	Indonesia	19.3%	-0.7%	-4%	61.1%
46	Spain	18.6%	14.7%	79%	-30.2%
47	Australia	16.9%	9.1%	54%	-15.0%
48	Iceland	15.9%	9.7%	61%	-84.5%

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Rank	Country Equity Index	Return in $ 2017	Currency impact v $ 2017	Currency contribution 2017	10 year return in $
49	Sweden	15.7%	11.7%	75%	16.5%
50	Bermuda	14.5%	0.0%	0%	-55.1%
51	Mexico	14.0%	5.9%	42%	-4.6%
52	Canada	13.4%	7.3%	55%	-8.3%
53	Kuwait	13.0%	1.5%	12%	-53.6%
54	Colombia	12.6%	0.6%	5%	-3.3%
55	Luxembourg	12.0%	13.9%	115%	-44.4%
56	Bahrain	9.1%	0.0%	0%	-51.5%
57	Jordan	-2.2%	-0.2%	9%	-46.5%
58	United Arab Emirates	-3.3%	0.0%	0%	-5.0%
59	Lebanon	-5.1%	0.1%	-1%	-22.9%
60	Russia	-11.0%	5.2%	-47%	-48.5%
61	Qatar	-18.9%	-0.6%	3%	-12.2%
62	Pakistan	-19.8%	-4.5%	23%	64.0%
	Average(n=62)	25.0%		27.3%	-5.8%

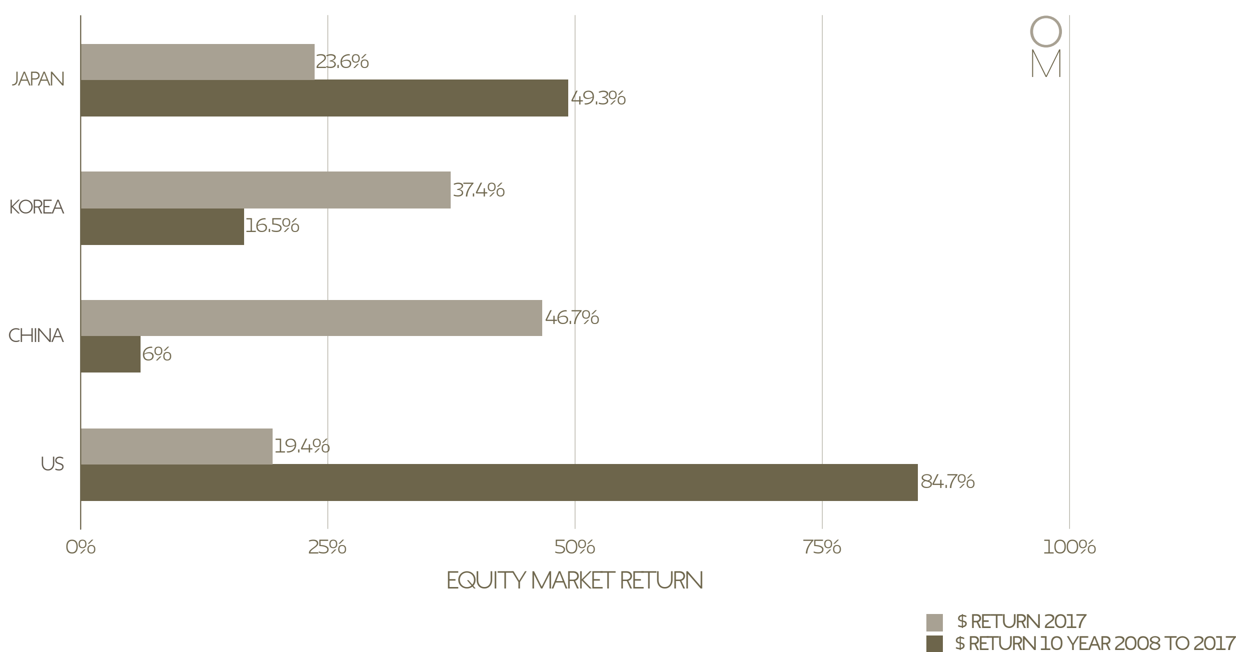

FIGURE 1. Short versus long term performance

SOURCE: Oxford Metrica.

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