

Stepping stones to recovery

Emerging markets are in a good position to recover faster than their developed world counterparts, argues **Stefan Hofer**.

Following the darkest hours of the financial crisis, often pinpointed by the September 2008 collapse of Lehman Brothers, many argued that two important conditions had to be met before the global economy could recover in a sustainable way. First, credit markets had to start moving again, ending the paralysis that threatened to starve corporate and household borrowers of capital. Second, the US housing market had to show signs of stabilisation, not to mention recovery that would help heal the starting point of the global recession. Almost one year after the Lehman bankruptcy, investors have grappled with steep declines in GDP around the world, coupled with high and rising unemployment and lingering questions as to where and when the global recovery will take off.

With regard to credit markets, the situation has improved markedly. Using emerging markets as an illustrative example, bond issuance has been robust. According to market reports, January through July this year saw an emerging market corporate bond issuance of US\$59 billion, which is equal to the full amount that was issued last year. All key regions – emerging Asia, Latin America and emerging Europe – have all been able

to place bonds, most of which have been concentrated in the three- to ten-year range. At the same time, bond spreads (which represent the risk premia over the appropriate US Treasury benchmark yield) have come down to below the pre-Lehman-Brothers collapse level. By such measures, it would seem that markets are pricing in a very positive scenario for risky assets and the overall economic cycle as well.

Given the extraordinary measures undertaken by central banks to provide liquidity, bailouts of systemically important financials and fiscal stimulus, capital markets have been able to gradually recover. Strong equity market performances year to date across the globe have helped boost investor confidence. But what about the origin of this crisis, the US real estate market?

Here too there are signs that conditions have started to improve. While US real estate prices remain at depressed levels, parts of the market are picking up. For example, data from the California Association of Realtors indicates that inventories of houses below US\$500,000 have fallen from approximately eight months worth of supply in May 2008 to less than around four months one year later. This adjustment of inventory levels is

arguably a critical development that should be a precursor to an overall rebound in US housing. But there are still major headwinds facing US households. A case in point was the July labour market report. Although this report came in much better than market expectations, it nonetheless reported that a further 247,000 jobs were lost. With an unemployment rate close to 10 per cent, the US consumer and the housing sector in general will likely remain under pressure for an extended period of time.

Emerging markets have not escaped the negative impacts of the financial crisis and the subsequent recession. Indeed, Russia just released its second quarter GDP numbers, which saw a decline of almost 11 per cent year on year. Other major emerging markets have also seen sharp falls in output and trade, but investors are seeing that emerging markets are on the forefront of the rebound. Beyond emerging Asia, Brazilian data (e.g. unemployment rate and industrial production) suggest that the rebound is on course. Thus, we reiterate our expectation that emerging markets overall are in a good position to recover faster than their developed world counterparts.

The writer is a research analyst at Bank Julius Baer.

