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Three Waves of Global Financial Crisis

Brian J. Friedman, CFA

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The financial crisis reverberated around the world in three waves. The initial tsunami was the bank panic and "Great Recession" in the United States from late 2007 through early 2009. This tsunami ultimately pushed a tidal wave of financial and currency turmoil toward Europe from 2009 through 2012. A smaller, but globally significant, wave lashed China in 2012 and 2013. In an attempt to avoid the mounting global panic in 2008, China unveiled a massive stimulus program which ultimately created a real estate bubble and inflation. The Chinese government was then forced to apply the brakes in 2012 and 2013 and economic growth decelerated in response.

A sluggish recovery in the U.S., falling consumption in Europe and stagnant demand for commodity imports from China conspired to depress economic growth in many emerging countries. Just as the United States led the world into crisis and recession, we believe the U.S. is now leading the world back toward growth. The U.S. stock market performed very well in 2013 and American economic growth accelerated in the second half of the year. Europe showed signs of stabilization and many emerging countries remain promising despite reduced demand for their exports last year.

Emerging Markets are not "Out for the Count"

While exports are certainly very important for most emerging countries, they are not the only – or even the primary – source of economic growth. The most important economic phenomenon in the world today is the continued momentum toward reform. Competition for capital and the globalization of economic activity are placing pressure on countries to either improve their economic systems or face declining prospects. Countries choosing counterproductive policies such as Venezuela, Argentina, Egypt,

or Russia face dim prospects. Other countries that were previously doing quite well, but seem to be backtracking on reform - such as Turkey, Hungary or India - face critical choices regarding their long-term future very soon.

Many other countries, however, realize that ongoing improvements to their economic structure are required to maintain global competitiveness. These countries include China, South Korea, Malaysia, Taiwan, Singapore, Hong Kong, the Philippines, Mexico, Colombia, Peru, Chile, Poland, The Czech Republic, Slovakia, Spain and Israel to name a few.

Economic Reform can Threaten Entrenched Interests

Reform is not an easy choice for most countries. Opening markets to competition or improving access to capital often threatens the interests of very powerful people. Most economic activities in poorer countries are controlled by politically connected monopolists. They established their monopoly position by obtaining privileged access to capital from government influenced banks or perhaps from beneficial regulations that limit competition. Carlos Slim is one of the richest men in the world because he controls most of the Mexican telecommunications market through his companies Telmex and America Movil.

Despite his power, however, the Mexican government changed the laws protecting his monopoly in 2013. Although it will take time, more competition will ultimately lower prices, expand access and create jobs. The recently elected Mexican government also passed legislation allowing competition in the oil and gas industry for the first time, improvements in the tax collection system and a major overhaul of the bankruptcy courts designed to improve bank lending. Mexico took these bold actions because investment shriveled in recent years as business fled to China. The Mexican government also saw its energy sector outclassed as innovative American companies tapped vast reserves with new technologies.

New technologies open up tremendous potential for business competition around the world. India created a booming outsourcing industry in the 1990's and 2000's by opening up its telecommunications sector to competition, allowing prices to plummet and foreign companies to tap its educated, English speaking labor force. In recent years, however, other countries such as the Philippines and Costa Rica muscled their way into this market by reforming their telecommunications and labor laws. India, meanwhile, did not follow-up its earlier momentum and growth is now slowing. This has become a major issue in the upcoming elections for their next Prime Minister.

Some analysts are concerned that China may not push tough reforms in the coming years because quite a few Communist Party cadres became rich from their privileged business interests. The next wave of reforms must create a more level playing field for new competitors, as well as financial institutions that can flourish without government connections. If not, the Chinese economy will fail to create enough jobs to absorb the millions of migrants flowing into cities from the countryside. Social unrest could mount. The National Communist Party Congress recently announced a slew of reforms including improved property rights for rural farmers who are angry at local government officials for confiscating their land. The key will be whether the Chinese government backs its talk with implementation.

China’s slower paced reforms and rising labor costs in recent years opened the door for Vietnam, Cambodia, Thailand and Bangladesh to compete in certain manufacturing industries such as textiles. All of these countries improved some of their protections for entrepreneurs and financiers as well as foreign investors. Most likely China will react to this increased competition by pushing ahead with its reform program.

Colombia and Peru sustained economic growth rates in excess of 5% by adopting market oriented policies and improved governance. Other countries in the region are positioning themselves to benefit from the Panama Canal’s expansion in 2015. Of course, all of this reform momentum will put further pressure on China to maintain its competitive edge.

New Competitors are Establishing Beachheads in Emerging Markets

Our globalized economy means that countries compete for capital and jobs. Improved technologies allow capital to move faster if a country offers an attractive home for investment relative to one of its competitors. For those countries committed to economic improvement the reform process is now endemic. It must be maintained or else growth will dissipate as capital moves elsewhere. Some countries choose to maintain the status quo and protect the privileged interests of their elites, but they will continue to experience erosion in their living standards as long as protectionist and anti-competitive policies are maintained.

The reason emerging markets are “emerging” is because entrenched monopolists are being challenged, often for the first time in their history. New competition is coming from a variety of directions including foreign corporations, entrepreneurs tapping previously inaccessible capital via the internet and social networks or business models that utilize inexpensive technologies. As competitors establish beachheads against traditional monopolists, governments are increasingly responding with supportive policies allowing some of these enterprises to expand. Improved competition and greater access to capital is the reason emerging markets will continue to provide attractive investments over the long-run despite mediocre recent performance.