

September 22, 2009

Why the Recovery May be Stronger than Expected

The United States' recent economic meltdown was virtually unprecedented but it is the global economy that matters.

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Many investors are confused about the state of the economy and the financial markets. We believe that much of the confusion stems from “cognitive dissonance,” the discomfort that comes from holding two conflicting ideas simultaneously. In this case, the confusion is being caused by how different the current state of affairs looks from two different vantage points: the domestic and the global.

The domestic perspective

The current US economy would be virtually unrecognizable to a student of history. Over the past three decades, our once manufacturing-dominated economy has evolved into one driven by services and finance, which changes how it reacts to the business cycle. At the same time, the nation is coming off an unprecedented, debt-fueled consumer buying binge that has weakened many personal balance sheets and is expected to restrict consumer demand growth well into the future. As a result, there is a strong consensus that the economic recovery will be far more muted than most past recoveries.

The global perspective

By contrast, we have a global economy that looks quite familiar. The global economy closely resembles the US economy of the 1950s and 1960s, when the domestic manufacturing base expanded significantly to meet pent up consumer demand and dominated the business cycle. As the US economy diversified away from manufacturing, China grew to become the manufacturer for the world, and the bulk of the raw materials China requires comes from a handful of resource-rich countries, of which some are emerging nations. So, the highly cyclical, capital

intensive global manufacturing base and the basic materials that feed an industrialized economy did not go away—they just grew proportionately faster outside the US.

As a result, the global economy should act much like the US economy did from the conclusion of World War II until to the end of the 1970s. That is, we expect to see strong cyclical tendencies caused by the inventory swings and employment cycles that capital intensive industries generate.

Of course, it makes a difference to a US investor if the world's manufacturing base is in the Midwest or China's southeast coast, but the global perspective should be the better indicator of future trends. If that is correct, then this recovery should resemble those experienced during the second half of the twentieth century, and we would expect capital intensive industries to recover first, followed by late cyclicals.

Democracy and free markets

This brings us to a deeper cognitive dissonance. When the Berlin Wall fell in 1989, all seemed to be right with the world, as liberal democracy and free capital markets trounced authoritarian governments and centrally controlled economies. Just when we thought we had all the answers though, China—an undemocratic, centrally controlled economy—began two decades of rapid growth. At the same time, Wall Street—the ultimate symbol of free market capitalism—spun out of control and put the global financial system in peril. That is not how the world is supposed to work.

If we take the perspective of a single global economy, however, the picture comes into focus. The export-driven sector of China's economy, which is the main growth driver, is strong and efficient because it had to compete with the powerful global export market to succeed. Japan—not historically known for the competitiveness of its internal economy or politics—was successful in the export arena as well. However, China will have to move away from the export model faster than Japan because the global economy cannot handle the imbalances that come from such a large economy dominating just one side of global trade.

As China reduces its dependence on exports, it will have to accept the principles of democracy, the rule of law and free internal economic competition—if it wants to continue its economic

development. Long term, the global economy will need China to evolve both politically and economically.

A stronger-than-expected recovery

We believe the economic recovery will be stronger than the current consensus because it is the global economy that matters. Too much attention is being paid to the US economy's unique problems, as if the US was a closed economic system. We think this goes a long way to explaining why the equity markets have rebounded so strongly, and we expect the up trend to continue.

Foreign markets have outperformed the US markets since the beginning of the year because they have a higher representation of early cyclicals and because the US dollar has weakened as investors have become less risk averse. Sticking to the traditional cyclical playbook, market leadership will soon shift away from the early cyclicals and eventually settle on the new bull market leadership, which is yet to be determined.

John joined Evercore Wealth Management as a founding partner in 2008 and has more than 24 years of experience managing balanced investment portfolios for affluent individuals and their families. You can email him at apruzzese@evercore.com