Global Growth Opportunities: Down But Not Out

By Dirk Hofschire, CFA

Global Recession Continues
While the idea that the pace of economic decline has moderated in the United States over the past two months has become mainstream, the news from abroad has remained mixed. This week, Japan reported a more than 15% (annualized) decline in economic output during the first quarter ending March 31, 2009, its worst contraction in more than 50 years. Last week, the Eurozone countries reported the steepest drop on record for economic output during the first quarter, registering a nearly 10% contraction. Not only were these declines much worse than the 6% contraction in the United States, they were also significantly worse than the pace of contraction registered in Japan and Europe during the fourth quarter of 2008.1 Though some indicators have gotten better in April and May, the signs of incremental improvement in foreign developed countries have remained muted at best.

In general, foreign economies continue to face a number of severe problems. First, global trade has plummeted. Japan and Germany, two of the largest developed economies in the world, have largely depended on export growth to drive their economies during the past several years. Smaller, faster-growing nations in emerging Asia, such as Taiwan and Thailand, have also depended on trade as their main economic engine. With slumping internal demand reinforcing export weakness throughout the global trade network, trade-dependent countries have been stuck in a rut.

Second, the financial crisis has left the credit systems in many countries in an impaired state, particularly in Europe. While bank rescues and other policy responses have helped stabilize the situation, they have also strained state resources at a time when revenues have plummeted, causing worsening fiscal situations in many developed countries.

China and U.S. Key to Global Recovery
In an environment of globally synchronized weakness, countries that depend primarily on exporting to others for their growth will have a hard time leading a worldwide recovery. That is why the most important economies for global growth remain the United States and China, albeit for different reasons.

The United States is the world’s largest importer, accounting for roughly one-sixth of all global imports this decade.4 As such, U.S. consumer spending must at least stabilize for the world’s exporters to find their footing. The fact that the United States entered into a recession nearly a year before most of the rest of the world gives it a chance to also find a bottom earlier than most. That is why the incipient signs of stabilization in the United States, while tentative, are welcome news for the global economy (see MARE article, The Road Map to Recovery: Leading Economic Indicators).

China is the world’s fastest growing large economy and has been the largest contributor to global growth during the past two years, accounting for more than 40% of real global economic growth in 2008 (see

KEY TAKEAWAYS

- The global economy remains mired in its worst slump since World War II.
- However, the most important economies for global growth—the United States and China—have recently shown signs of stabilizing.
- Developing countries continue to maintain solid long-term prospects, and are likely to emerge from the cycle with fewer fiscal and financial after-effects from the global credit crisis.
- With foreign stock valuations still near historically low levels and the possibility of global economic improvement on the horizon, it may be an opportune time to review whether a portfolio has an adequate international exposure.
Exhibit 1, below). Despite this success, China has faced a major slowdown in 2009, because a significant amount of its growth over the past decade was achieved by ramping up its export machine. However, the difference between China and say Germany, is that China has the ability to dramatically expand its internal demand to offset current weakness in its export industries. With a roughly balanced government budget, $2 trillion of foreign reserves, and over one billion people at relatively low per capita consumption rates, China has the means and the motivation to stimulate its economy. The country recently launched a massive stimulus package (6% of gross domestic product over two years) focused on infrastructure investment and encouraging domestic spending.iii By most accounts, the stimulus money has begun entering the economy relatively quickly, with infrastructure spending boosting oil and other global commodity prices over the past several months.

Emerging Markets Likely Leaders
If China and the United States are indeed able to help stabilize the world economy, one group of countries that remains well poised to resume an upward trajectory of growth are developing economies, or emerging markets. China is the largest emerging market (in terms of the size of its economy), and is a solid reminder that the current global downturn has interrupted but not destroyed the group’s long-term growth dynamics that were evident prior to the crisis of 2008. For instance, both China and India are home to populations of more than one billion people, including hundreds of millions at low per capita income rates looking to move toward middle class consumption levels. Demographics in many developing countries are younger and growing, in stark contrast to the aging and shrinking populations found in some advanced economies such as Japan. Most emerging economies have plenty of room to grow internal demand and consumption rates to boost economic growth for years to come.

Internally generated growth in emerging countries will be extremely important because of the lingering effects of the current global recession. U.S. consumers, the engine of global growth for much of the past two decades, remain heavily indebted and will likely save more and import at a less brisk pace than in the past. An eventual global recovery is unlikely to imply an immediate return to pre-2008 trade levels, meaning many developing economies will be unable to rely exclusively on export-driven growth.

Another strength of many developing economies is that though they were impacted by the global credit crunch, they have largely avoided the financial blow-ups and the corresponding fiscal problems associated with the financial crisis in the United States, United Kingdom and other European nations. The aftermath of the financial crisis in Europe and the United States will not only be a somewhat impaired banking system in need of regulatory overhaul, but also bloated government budget deficits as a result of the extraordinary banking rescues, guarantees and stimulus measures that were part of the solution. These budgetary challenges may provide a headwind to future growth in the form of higher interest or tax rates down the road.

**EXHIBIT 1:** China has been the largest contributor to global growth during the past two years, and the United States and China together now account for 20% of the world’s total imports.
In contrast, many emerging markets entered this global crisis with better fiscal and financial positions than ever before (Eastern Europe being a notable exception)—see Exhibit 2, below. As a group, they were net creditors, with manageable fiscal positions, relatively balanced current accounts and lower debt levels than in the past. Unlike in previous crises, this has left them in position to take counter-cyclical measures to support their economies. Brazil’s short-term policy interest rates, for example, are still above 10%, giving its central bank plenty of room to continue to lower them.\textsuperscript{iv} China, Russia and South Korea have announced the largest government stimulus programs in the world relative to the size of their economies, yet their fiscal positions remain relatively stable.

**Foreign Stocks Beaten Down, But Don’t Wait for Recovery**

Solid long-term growth prospects do not, however, make stock markets immune to the challenging global economic backdrop. Foreign stocks actually declined more than U.S. stocks in 2008, with developed-country shares dropping 43% and emerging-market stocks losing more than 53% of their value.

Like markets in the United States, foreign stock markets anticipate economic swings. As a result, foreign stocks have rebounded 43% since March 9, 2009, and are up 6% this year. Emerging-market stocks are up 33% for the year (55% from March 9, 2009).\textsuperscript{v} Similar to the pattern in the United States, the largest gains during bull markets historically have typically accrued to the early stages of an economic recovery, making investors particularly attuned to any signs the global recession may be receding.

Even after this run-up, valuations remain near all-time lows. Price-to-earnings ratios for emerging-market stocks were 10.9 and foreign developed-country stock valuations stood at 12.6 as of April 30, 2009, well below long-term averages of 16.3 and 19.5, respectively.\textsuperscript{vi} While volatility remains a likely possibility given the still uncertain global economic and financial environment, low stock valuations already factor in a lot of this bad news.

**Investment Implications**

Even if the U.S. economy does not stage a robust recovery, its stabilization will be a key ingredient to worldwide improvement, along with China’s massive stimulus efforts. Though many exporting nations need to achieve more balance through internal demand growth, developing countries in general remain well-poised to lead during an eventual economic recovery and to generate relatively high growth rates over the long-term. Investors with global exposure are more likely to participate in these growth opportunities.

With many foreign stocks still near historically low levels and a global rebound not yet apparent, investors may find it an opportune time to consider whether they are adequately exposed to foreign stocks. 

**EXHIBIT 2:** Many emerging-market countries entered the global crisis in better fiscal shape than major developed countries (below left), and are expected to emerge with smaller budget deficits (below right).

![Graph showing pre-crisis and post-crisis fiscal balance (% of GDP) for emerging and developed markets.](image)

2010 figures are IMF estimates. Source: International Monetary Fund, FMRCo (MARE) as of 4/26/09.
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*Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.* Past performance is no guarantee of future results.

[i] GDP growth rates are annualized quarter-over-quarter real rates of change for Q1 2009. Source: Eurostat, Japan Cabinet Office, Bureau of Economic Analysis, Haver Analytics as of 5/19/09.


[iv] Brazil Selic Target Rate stood at 10.25% as of 5/21/09. Source: Banco Central do Brazil.

[v] Performance represented by the following indices: U.S. Stocks - S&P 500 Index; Emerging-markets stocks - MSCI Emerging Markets Free Index; Developed-country stocks - MSCI EAFE Index. Source: FMRCo (MARE) as of 5/19/09.


You cannot invest directly in an index.

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