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Reliving 1999?

I have often used the late 1990s as a key reference point for global financial markets today. This analogy continues to be a very relevant comparison. The events that have transpired over the last few months suggest that the broad macro environment today mimics that of 1999. These conditions could mean risky assets rally now, but sell off later.

A Brief Recap: 1998 to 1999

By October 1998, emerging market (EM) stocks tumbled nearly 60% from their 1997 highs because of the Asian currency crisis. Many EM currencies fell by 40-80%. Oil collapsed to $10/bbl, a 60% drop from the early 1997 highs due to the spreading EM crisis. On June 30, 1998, Russia let go of the ruble, leading to a 75% plunge in the currency. By August 1998, the Russian government declared a debt moratorium, effectively defaulting on its foreign liability.

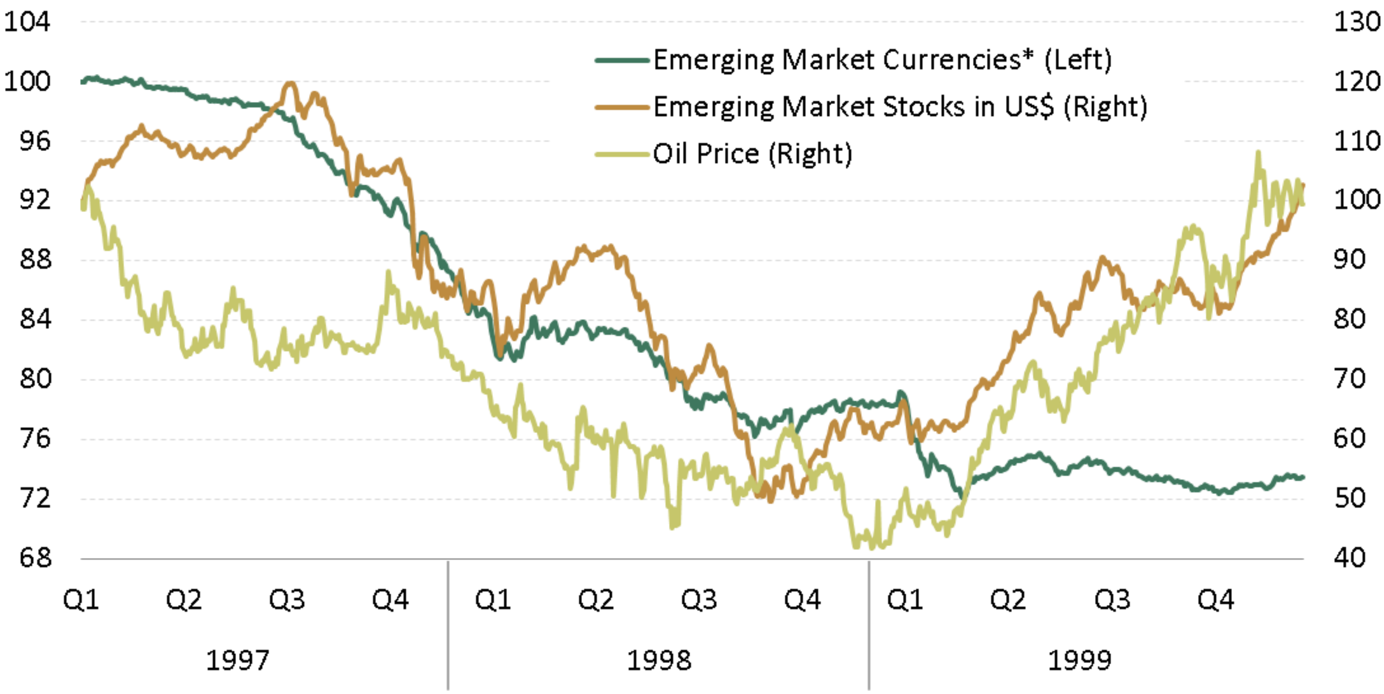
There were serious concerns at the time that the weakness in the EM world would spread into the U.S. economy. The U.S. manufacturing sector was in recession. U.S. trade prices were falling. Long-term bond yields plummeted. U.S. stock prices turned wobbly in March 1998 on poor profit growth, only to be followed by a 19% fall between July and October in the wake of the Long-Term Capital Management (LTCM) hedge fund debacle. To stem systemic risk, the Federal Reserve (Fed) had to reverse its monetary tightening and cut rates three times, totaling 75 basis points between September and November.

In early 1999, a whiff of reflation returned to the marketplace as the global investment community began to realize that the U.S. economy was not in recession. In fact, consumption was booming in the U.S. In the meantime, the EM world in general and Asian economies in particular seemed to have found a bottom. Fed policy had already turned friendly for risky assets. Investors started to poke around the ashes of those badly burned-down markets to look for bargains.

In short, the combination of Fed rate cuts, a resilient U.S. economy, and severely undervalued EM assets, including currencies, began to bring back investors in early 1999. Reflation trades prevailed, triggering a powerful rally in all risky assets. Throughout the year (see Chart 1):

- The S&P 500 Index was up 19%.
- The MSCI EM Equity Index was up 66%.
- The MSCI EM Currency Index saw a modest increase, up 10%.
- Oil went up 114%, from $12/bbl to $26/bbl.
- Treasury bonds sold off, with 30-year yields moving up 160 basis points during 1999.
- The U.S. dollar index was virtually flat from 1998-1999. The next upturn in the dollar developed in 2000 when it became clear that the U.S. economy was booming, propelled by capital expenditures and consumption, and the Fed would need to continue to tighten policy in light of the massive stock market boom.

Chart 1: Financial Markets in the Late 1990s *January 1, 1997 to December 31, 1999*



Source: Thomson Datastream

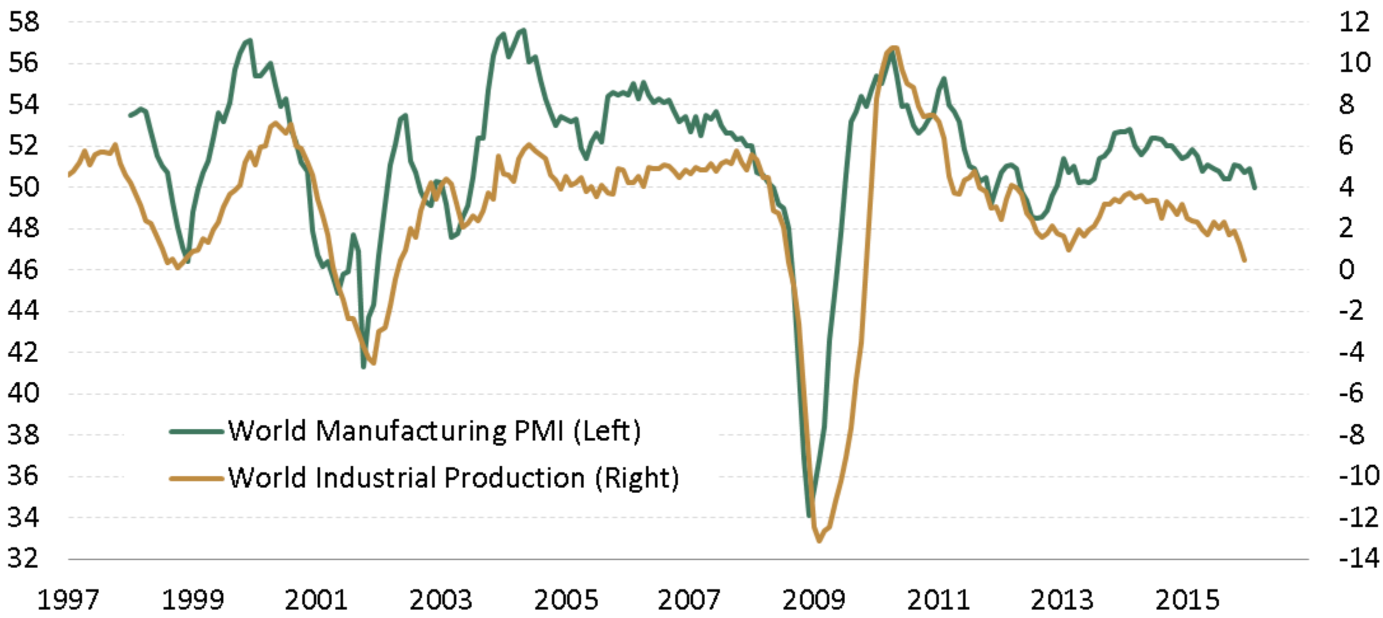
** Market-cap weighted, derived from MSCI EM equity US$ and local currency indices. All series rebased as January 1, 1997 = 100*

The 1999 reflation party was ultimately spoiled by the Fed rate hikes, which led to an inversion of the Treasury yield curve, bursting of the dot.com bubble, economic recession, another round of sharp declines in EM assets, and more crises that culminated in the Turkish debt debacle in 2001. The U.S. dollar kept rising until it peaked in mid-2001.

Déjà Vu: Then and Now

The severity of the EM economic difficulties today is arguably much less acute than the late 1990s, but we have gone through essentially similar adjustments. The U.S. economy has been resilient while the rest of the world has been weak. There also have been serious concerns that the financial turmoil in the developing world will spill into the U.S. Poor profits have put U.S. stocks on shaky footing. Furthermore, U.S. manufacturing is also in recession due to collapsed goods prices and global trade stagnation (see Chart 2).

Chart 2: Economic Similarity Between Today & the Late 1990s *Annual % Change; As of 2/29/2016*



Source: Thomson Datastream

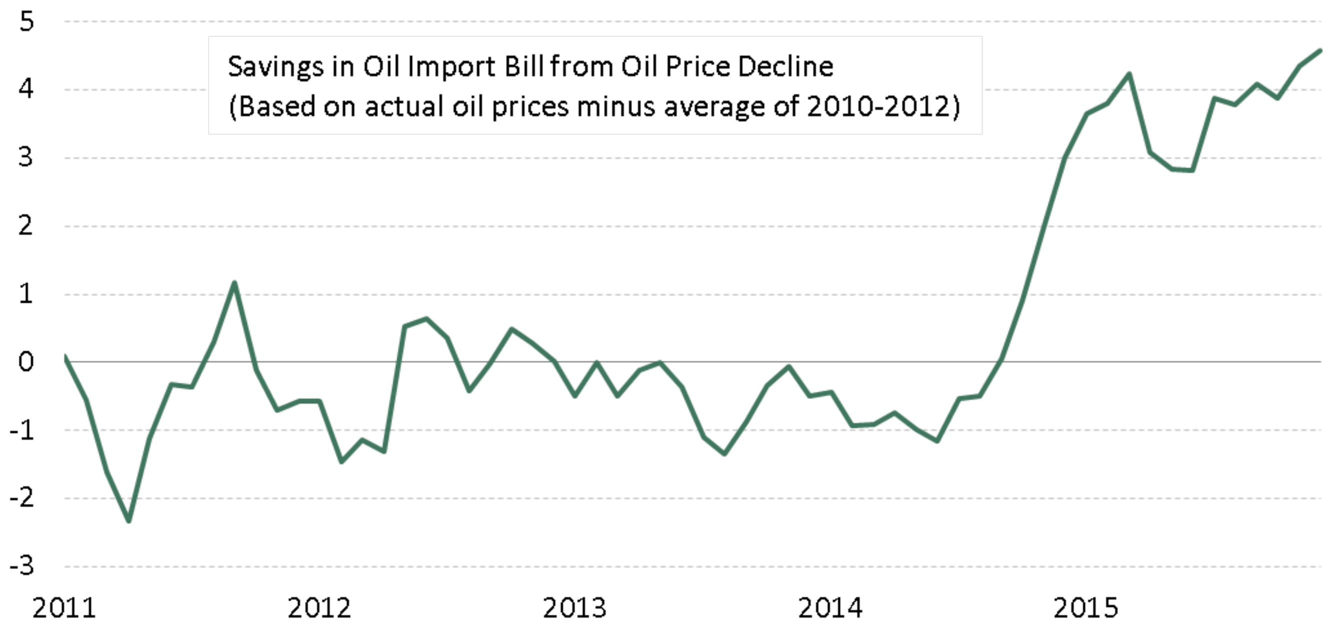
Similarly, the entire EM universe has suffered major asset deflation, with EM equities off by close to 40%. Although the EM currency index has fallen 17% from its previous highs, this moderate drop is mainly due to the fact that China accounts for a large weight in the index, and the Chinese currency has essentially been pegged to the dollar. The Latin American currency index has dropped by 50%, while the JP Morgan floating EM currency index has dropped by 40%. Oil prices collapsed 75% prior to the recent rebound.

Why We Could Be in 1999 Again

First, the Fed has paused its monetary tightening, removing a major roadblock for asset price inflation. China has begun to shift its policy away from supply-side restructuring to demand-side stimulation. These changes can be likened to the Fed reversing its policy tightening in late 1998. Today, the best the Fed can do to promote economic growth is to pause monetary tightening because rates are essentially at zero. China's policy reflation is probably more important than the Fed because the Chinese economy generates 40% of global incremental gross domestic product (GDP).

Second, the U.S. economy has been resilient, and the Chinese economy is still growing at 6-6.5% annual rate. Similar to 1998-1999, although low interest rates, low energy costs, low import prices, and a stronger dollar have hurt U.S. manufacturing, these factors have supported private consumption around the world and protected the service economy in America. Additionally, lower energy costs are very supportive for the Chinese economy because it is still manufacturing-oriented with a large net oil import position (see Chart 3).

Chart 3: China's Huge Savings from the Oil Slump *% GDP; As of 12/31/2015*



Source: Thomson Datastream

Finally, most EM assets have been beaten up badly, and both stocks and bonds are most likely undervalued now. A large number of EM currencies have also undergone severe devaluation and have become cheap. With interest rates still at zero and bond yields having even turned negative in many G7 nations, the search for yields will intensify. This situation paves the way for a rally in both EM stocks and currencies, which will probably be one of sizable magnitude and significant duration this year.

Evaluating Downside Risk

If this is a true roadmap reminiscent of 1999, this year could be dominated by reflation and risk-taking. However, this roadmap would also mean that the expected rally will ultimately give way to another round of selloffs and possibly a bear market. The party crasher will once again be the Fed. Rising asset values today, a resilient U.S. economy, and some signs of rebounding core inflation would eventually persuade and embolden Fed policymakers to raise rates again.

Janet Yellen and other key policymakers at the Fed still believe in the Phillips Curve, which depicts a positive relationship between wage growth and inflation, and continue to use it to guide policy. However, the underlying relationship between the wage rate and the inflation rate has undergone profound flattening for the last two to three decades. The world economy is still starved of aggregate demand and requires a prolonged period of zero rates to regain balance between aggregate demand and aggregate supply. In this fragile environment, it would not take much for short-term rates to reach a choking point for economic activity.

Conclusions

The logical conclusions from our comparison of 1999 to now seem to be:

- **The U.S. stock market could rally now, but sell off later this year on an expected resumption of Fed tightening.**

- **The U.S. dollar remains flat for now, but could rally again in the second half of the year due to higher short-term rates and a stronger economy.**
- **EM assets start to run into problems again in the second half, the result of tighter Fed policy and possibly renewed dollar strength.**
- **Bond yields rise for now, but fall back down again in the second half due to renewed deflationary pressures.**

Careful policy considerations, particularly from the U.S. and China, which allow sufficient recovery time for global demand will be imperative to avoiding a premature end of the rally in global financial markets.

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