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Topical Study #40

IS ASIA MINOR?

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Asian Relief Rally: Buy Or Sell? In recent Congressional testimony, Fed Chairman Alan Greenspan said that the impact of the Asian financial and economic crisis on the US economy should be minor. Similarly, many stock investors believe that the Asian crisis will have a minimal impact on earnings next year.

I disagree. Indeed, I lowered my 1998 forecast for real GDP by a full percentage point from 3% to 2% last week largely because of the turmoil in Asia. I also lowered my S&P 500 earnings forecast for 1998 from up 7%-10% to up only 5%, though it might be even weaker.

As a consequence of these and other concerns, I am neutral on the stock market for 1998 and downright bearish for 1999. (See, "Days Are Numbered For Stock Bulls," *WEA*, November 3, 1997.) Nevertheless, in the next 3-6 months, I wouldn't be surprised to see an "Asian relief rally" in stock markets around the world, led by US stock prices moving into record high territory. But I would view such a rally as a great opportunity to shift assets from equities to bonds because I believe that Asia's problems will not go away so quickly. Besides, the far more bearish Year 2000 Problem is looming on the horizon.

Asia Isn't Minor. It is true that US exports to Southeast Asia (Malaysia, Indonesia, Thailand, and the Philippines) are only 4% of total US merchandise exports, as Mr. Greenspan observed in his testimony. He also correctly noted that our exports to the Asian Tigers (South Korea, Taiwan, Hong Kong, and Singapore) represent another 12% of the total. He omitted to say that 10% of US exports go to Japan, so more than a quarter of our exports are to Asia (Exhibit 1).

Furthermore, almost 37% of our imports come from the countries mentioned above plus China and Japan (Exhibit 2). The dramatic currency devaluation in Asia is bound not only to depress our exports, but also boost our imports. A widening trade deficit is one of the main reasons I lowered my forecast for GDP in 1998 (Exhibits 3 and 4).

Deflationary Winds From Asia Bad For Profits. There are other reasons for believing that the Asian crisis will depress US economic growth. Profits growth is likely to be slower in 1998, which could weaken the growth of capital spending and even employment. Profits earned by US companies in Asia are likely to drop. However, they are relatively small, though investors have priced many stocks richly on the now-questionable assumption that Asia will grow rapidly.

A greater problem for profits is the deflationary consequences of the Asian turmoil on corporate revenues at a time when wage costs seem to be rising more rapidly. The ongoing plunge in the price of gold suggests that other commodity prices will soon weaken. (See the November 17, 1997, issue of our *WEB*, "Deflationary Message From Gold?") Undoubtedly, 1998 will be a tougher pricing environment than 1997 not only for basic commodities, but also most internationally traded goods (Exhibits 5 and 6).

Labor markets are so tight in the United States that wages are now rising more than 4%, the highest pace in the 1990s. While I have been a bull on productivity—and I was pleased to see the big jump during the third quarter—I don't believe that the underlying growth in productivity can offset 4%-plus wage gains (Exhibit 7). Indeed, recessions in Asia, possibly in Latin America too, and slower growth in the United States argue against big productivity gains next year.

Something has to give: My concern is that profit margins and profits will be disappointing next year (Exhibit 8). If profits growth is too weak, corporate managers might respond by cutting capital spending budgets and hiring fewer workers. Clearly, such behavior would also lower economic growth (Exhibits 9 and 10).

Most equity investors would like to believe that Asia will soon stabilize, so the worst is over. The biggest risk in the Asian crisis is that it is far from over, as I explain in the rest of this study. Asian banks are polluted with toxic levels of bad loans. Their excessive lending fueled the global economic boom of the 1990s. Now they may cause a global credit crunch that will depress global economic growth. Furthermore, another round of dangerously deflationary competitive devaluation can not be ruled out in the region.

The Rescue Scenario. Senior finance and central bank officials from Japan, the United States, and Asia will meet on November 18 and 19 to try to hammer out remaining differences over an Asia Fund. It is possible that the worst fears about Asia will melt away if the G7 industrial nations in concert with the IMF fashion an Asian "loans-for-reform" bailout plan. Such a plan would have to include the restructuring of Asian banking systems, new independent agencies to close troubled banks and to sell their assets, and greater deregulation. However, the initial impact of such a rescue would be to worsen Asia's recession and deflation as assets are sold at distressed prices and as restructuring causes inefficient companies to fail.

Why won't Asia recover as rapidly as Latin America did following the Mexican peso crisis of 1995? It might, but I doubt it. The 1995 crisis was mostly about one country, i.e., Mexico. It was mostly a balance of payments crisis, not a banking or real estate collapse as in Asia now. The regional power, the United States, had the will and the means to stabilize Mexico. Japan, the regional power in Asia, is more likely to be destabilized by the current crisis than to stabilize the situation.

Deflating In Asia. Asia is the epicenter of global deflation. The October 31 issue of *The Wall Street Journal* observes that "Asia is drowning in excess goods, the product of years of over-investment." Here are some specifics:

1) "Japan's decade-long Asian investment spree built factories with three times France's total manufacturing capacity."

2) " China and Korea now produce more steel than the United States and the United Kingdom combined."

3) “China’s annual output of 30 million television sets accounts for a third of world production.”

4) “Hyundai Group, one of Korea’s largest conglomerates, forged ahead with plans for a $5 billion-plus steel mill, defying government pleas that it shelve the project to help stabilize the steel market.”

5) “Samsung Group is plunging $4.5 billion into an auto plant despite gripes from auto-industry executives world-wide who fret about surplus capacity and falling prices.”

Sleepless In Tokyo. Starting March 31, 1998, Japan’s lending standards will be tightened by the banking authorities. The resulting “Big Bang” in banking could easily push Japan into a deflationary recession again. For the first time, Japanese banks will have to classify the quality of their loans and reserve against the risk of default.

In early November, bank stock prices plunged in Japan. Now that banks must be more prudent and less forgiving with their corporate borrowers, the corporations no longer have an incentive to show their appreciation by owning the shares of their bankers. In other words, this development is the latest assault on Japan Inc.’s unraveling system of cross-shareholding relationships.

Domestic bank credit is not growing in Japan (Exhibit 11). It could start falling soon. Japanese banks will also be forced to reduce their global lending, contributing to a global credit crunch.

Japan’s ruling Liberal Democratic Party announced yet another unimpressive economic stimulus plan on November 14 that has the usual pork-barrel projects like a new international airport for a World Expo in 2005. Around December 10, details of measures to stabilize the financial system are to be announced. I’m not holding my breath.

Seoul Searching. South Korea is the eleventh largest economy in the world. On October 24, Standard & Poor’s Corp. downgraded South Korea’s foreign-currency debt after the government decided to bail out a unit of the Kia Group, South Korea’s eighth-largest *chaebol*, or conglomerate. Stock prices took their biggest one-day plunge in history on that day. The Kia Group has been bankrupt since the summer. On October 24, the government nationalized Kia Motors Corp. in the biggest corporate bail-out in Korean history. Kia Group is the fifth major *chaebol* to have affiliates either default or seek court protection this year. The government forced Kia’s main creditor, Korea Development Bank Ltd., to accept equity for Kia’s bad debts.

Korean management and workers have been resisting the restructuring of the economy. Indeed, the nationalization of Kia was widely seen as a first step toward cost-cutting and triggered a strike by Kia workers.

Korea's woes are compounded by a wobbly banking system. At the end of October, Moody's Investors Service Inc. downgraded the ratings of four Korean banks and put three more for a possible downgrade in November. By one estimate, interest hasn't been paid for three months or more on $33.5 billion in loans (14.7% of total loans) at 11 major banks. If the loans go bad, nine of 11 banks could lose all their equity. The government reports that 7,233 companies went bankrupt in the first half of 1997, up 31% from the same period last year.

Business failures may not be fully reflected in bad-loan figures because they only count those that aren't collaterlized and have not been serviced in six months. Standards for defining bad loans are much stricter in other countries. Standard & Poor's has estimated that a government bailout of the banking sector would cost 20% of GDP compared to only 2.4% of GDP to end the S&L crisis in the United States. Seoul soon plans to create an agency modeled after the US Resolution Trust Corp. to buy up to $20 billion in bad loans.

On Friday, November 14, the majority party pledged to pass a bank reform plan that would replace three government regulatory agencies with one single watchdog agency under the Finance and Economy Ministry. Interestingly, the country's central bank issued a statement opposing a new "Dinosaur Ministry." Central bank workers actually went on strike to protest giving even more power to the Ministry over banks and taking it away from the Bank of Korea.

The won plunged in mid-November below 1,000 won per dollar (Exhibit 12). It could go lower after the December 18 presidential election. The surprise front-runner in the Korean presidential campaign is Kim Dae Jung, the nation's most famous left-wing dissident and a longtime loser of presidential races. The fellow is 73 years old and has little if any experience in government, finance, and international relations.

Insolvent In Shanghai. If the won and the yen continue to fall, the Chinese might devalue their currency again as they did in early 1994. That event triggered the 1995-97 round of competitive devaluation in Asia (Exhibits 13 and 14). A repeat performance by the Chinese could trigger another deflationary and destructive round of Asian devaluation. Strict exchange controls limit the ability of market forces to move China's currency.

In many ways, China's economic and financial situation is at least as bad as its neighbors' if not worse. According to the November 4 issue of *The Wall Street Journal*, nonperforming loans are around $200 billion, or five times the equity capital of all Chinese banks: "China's banking system is essentially insolvent." At least 50% of China's state-owned companies are in the red.

China's stock market is rigged by the government in numerous ways. Workers are compelled to buy their companies' shares. (Ain't it ironic: The communist political leaders are forcing their workers to be capitalists!) New stock issues are priced well below the secondary market value to ensure immediate gains.

All of China's market rigging maneuvers won't stop an economic and financial calamity if foreign direct investment slows as is likely in 1998. Indeed, overseas investment in Guangdong province, which traditionally gets the largest share of Hong Kong's investment dollars, dropped 25% in September from a year ago.

Deflation may already be setting in for the first time since free market policies were first promoted 20 years ago. Consumer prices fell 0.4% in October as weaker consumer spending boosted inventories. Much of the recent slowing of the economy is attributable to Beijing's decision to stop supporting the 47% of state-owned companies that are losing money. The crisis in the rest of Asia can only worsen China's economic outlook.

Retrenching In Kuala Lumpur. Earlier this year, Malaysians were planning to set all sorts of world records: the highest, the longest, the biggest, the most expensive. During the summer, developers in Kuala Lumpur did finish twin 1,492-foot office towers, the tallest buildings in the world. But the Asian crisis forced the delay of numerous other wonders of the world, including the longest building in the world, covering 1.24 miles, a new world-class airport, and a huge hydroelectric dam with the world's longest undersea power-transmission cable. On the other hand, a plan to build a new Silicon Valley in Cyberjaya has been pushed forward.

Unruly In Bankok. Thailand has received a $17 billion bailout from the IMF. Political instability in Thailand threatened to complicate attempts to stabilize the country's economy. In early November, the Prime Minister resigned. The resulting political free-for-all left no one in charge of the parliamentary government.

However, last week the new prime minister, Chuan Leekpai, glued together an eight-party coalition government. The head of the International Monetary Fund met with Mr. Chuan last week. The IMF's man was sufficiently impressed to predict that the country's real GDP, which has dropped to nearly zero from more than 8% a year between 1985 and 1995 should recover by the second half of next year.

I doubt it, especially if the coalition collapses. At least three of the ministers in the new government have been accused of or implicated in corrupt activities. The new prime minister said he had no choice but to accept them because they were chosen by coalition partners whose support he must have to govern.

Meanwhile, the economy is falling deeper into recession. Toyota and Isuzu halted local production until the end of this year. During the past decade, Thailand has become the biggest producer of autos in Southeast Asia.

Ruined In Rio. The Asian contagion has infected the biggest economy in Latin America, namely, Brazil. Jittery over their losses in Asia since the summer, global investors reassessed the risk they were exposed to in other emerging economies. They clearly didn't like what they saw in Brazil, especially a large federal deficit.

To defend the Brazilian real, which is pegged in a band to the US dollar, the country's central bank more than doubled the official short-term interest rate to 43.3% on October 30. Stock prices started plunging on October 23. By mid-November, the Bovespa stock index was down a staggering 33%.

On November 10, the government announced a bailout plan, including a tax hike and spending cuts. The problem is that these deficit-reducing measures will be more than offset by higher interest costs on the public-sector debt ($190 billion) that must be rolled over every eight months! If the Brazilians lower their interest rates and devalue the real, competitive devaluation pressures could mount on the Mexican peso.

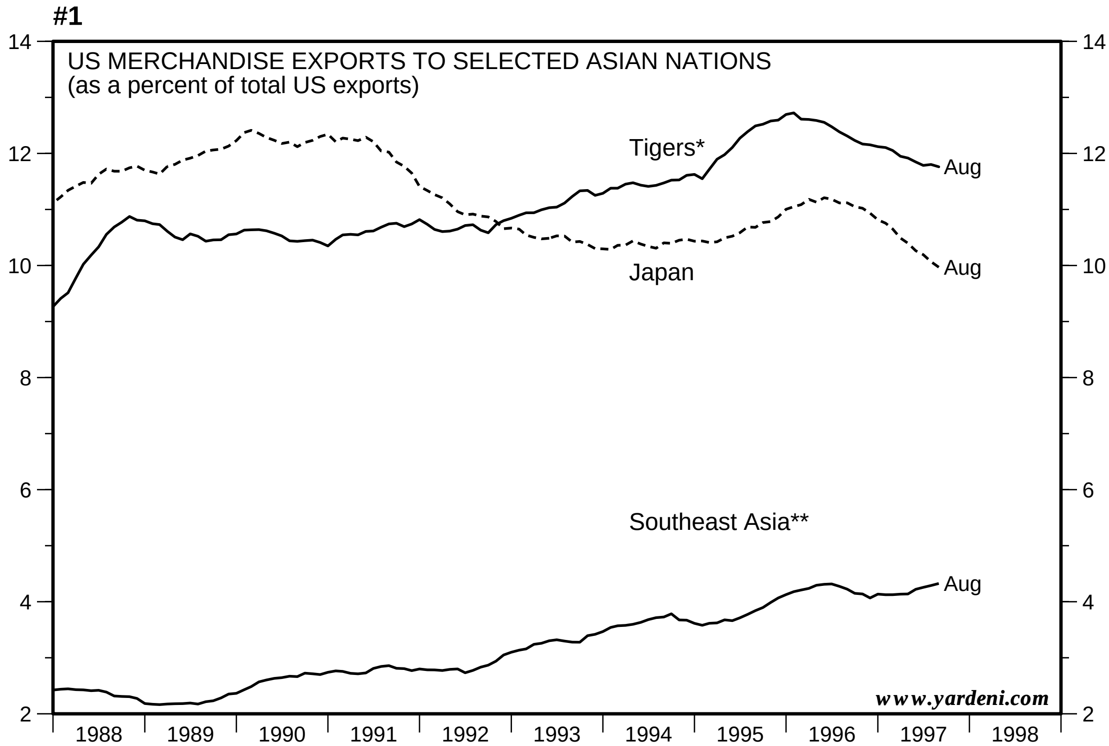
Instead of growing 2% in 1998, as most analysts expected, real GDP in Brazil could be flat or even down 1%-2% next year. Ford will stop production in Brazil for 14 working days and GM Brazil will slash output in reaction to the monetary and fiscal austerity measures. For now, Mexico's economy remains strong, with September's industrial output 13% above a year ago.

Submerging In Emerging. I am not a big fan of investing in emerging markets. Many times in the past, I've argued that most emerging countries are missing two vital characteristics necessary to sustain economic growth: 1) a legal infrastructure that protects property rights, and 2) a relatively equitable system for distributing growing income. In other words, they are missing the two essential ingredients of Capitalism.

The Asian crisis reveals that under the thin veneer of Asian capitalism there is too much corruption. Corruption is the antithesis of Capitalism. Corruption is inherently unfair as the corrupt few get richer at the expense of their many victims. Having acquired their wealth with so little effort, the corrupt usually seek to amass even more by speculating in real estate and stocks. They leverage their bets with loans all too easily obtained from corrupt bankers. The speculative bubble eventually bursts wiping out some of the corrupt and impoverishing all their victims.

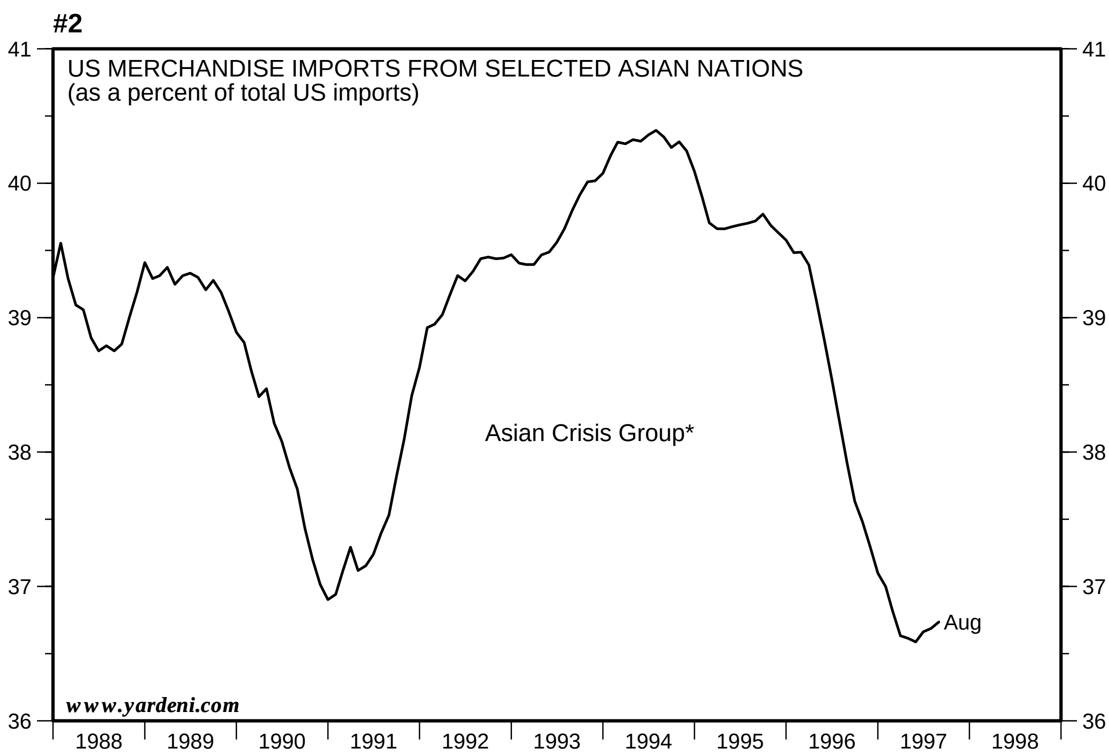
I hope that the Asian crisis will unleash populist pressures to reform the economic and political systems throughout Asia. Countries that make serious strides in this direction may become safe for investors.

- US Imports & Exports -



* Includes Hong Kong, South Korea, Singapore, and Taiwan.
** Includes Indonesia, Malaysia, Philippines, and Thailand.

US exports to Southeast Asia are relatively small, but exports to key Asian trading partners are over 25% of total US goods exports.



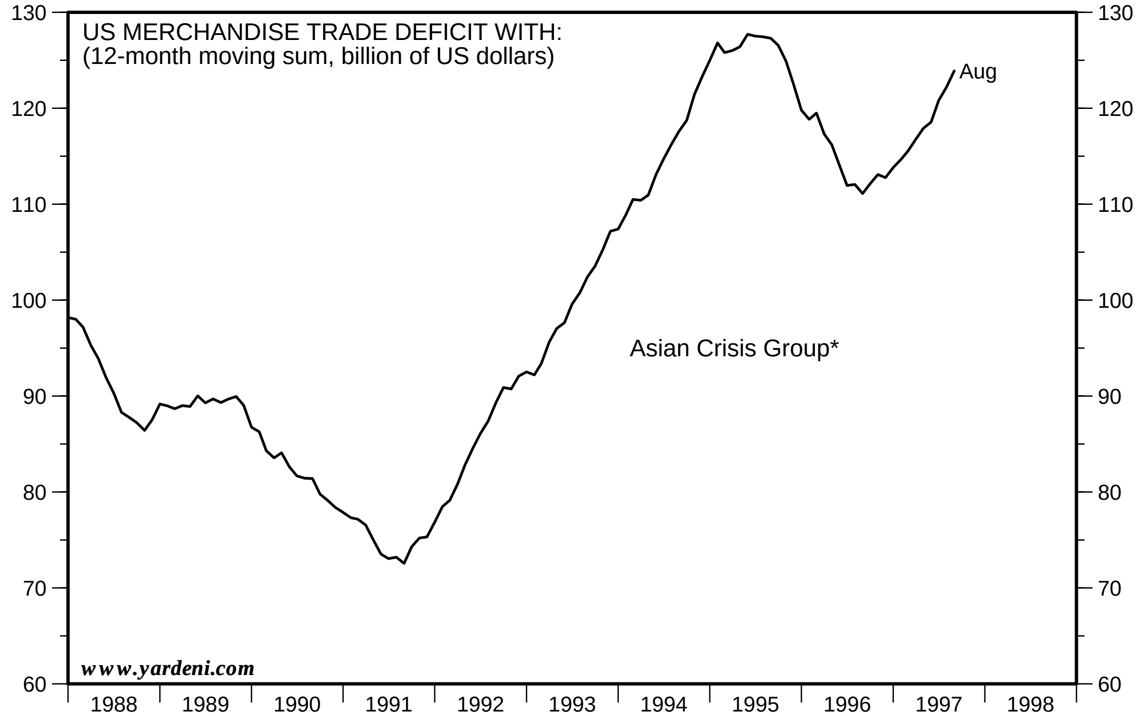
* Includes Japan, China, Hong Kong, South Korea, Singapore, Taiwan, Indonesia, Malaysia, Philippines, and Thailand.

More than a third of US imports come from Asian Crisis Group and is likely to increase in 1998.

- US Trade Balance -

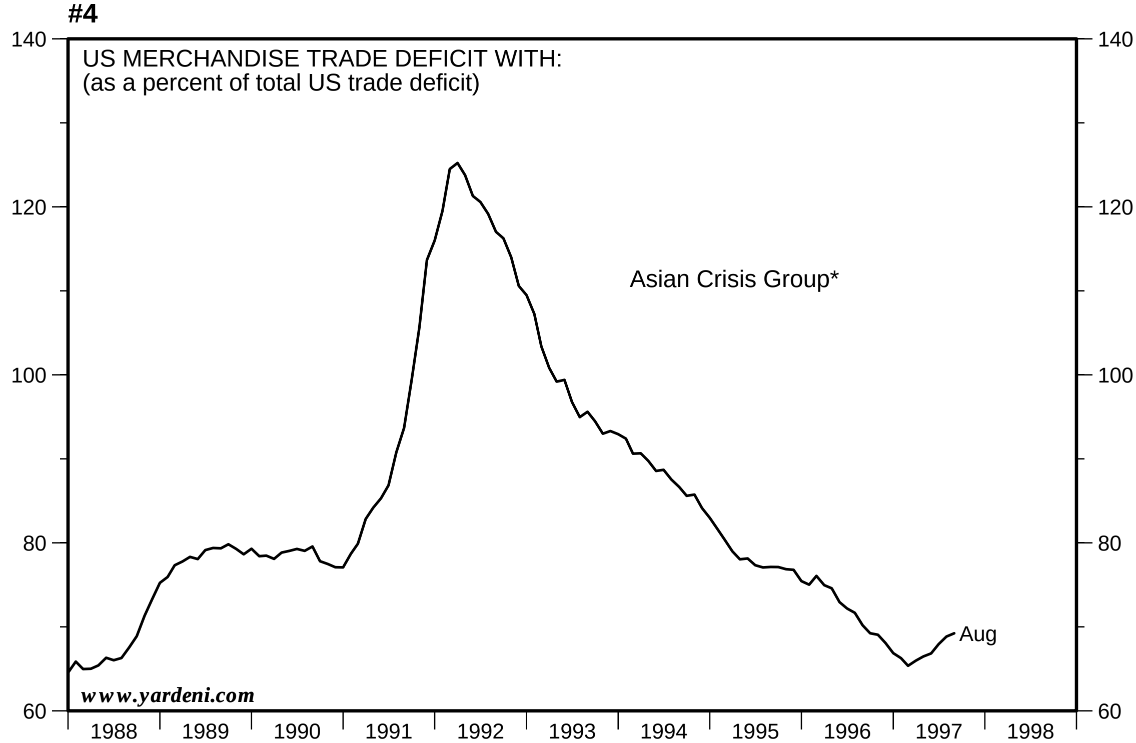
US trade deficit with Asian Crisis Group is likely to widen significantly in 1998. It currently accounts for 70% of US trade deficit.

#3



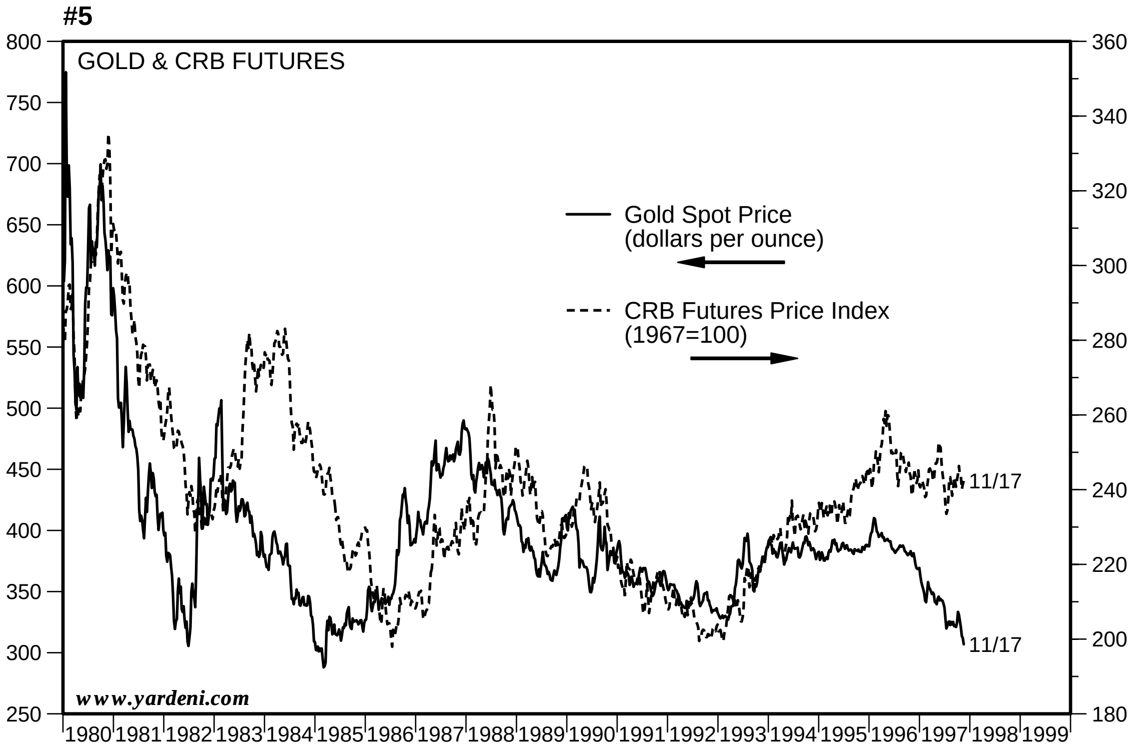
* Includes Japan, China, Hong Kong, South Korea, Singapore, Taiwan, Indonesia, Malaysia, Philippines, and Thailand.

#4

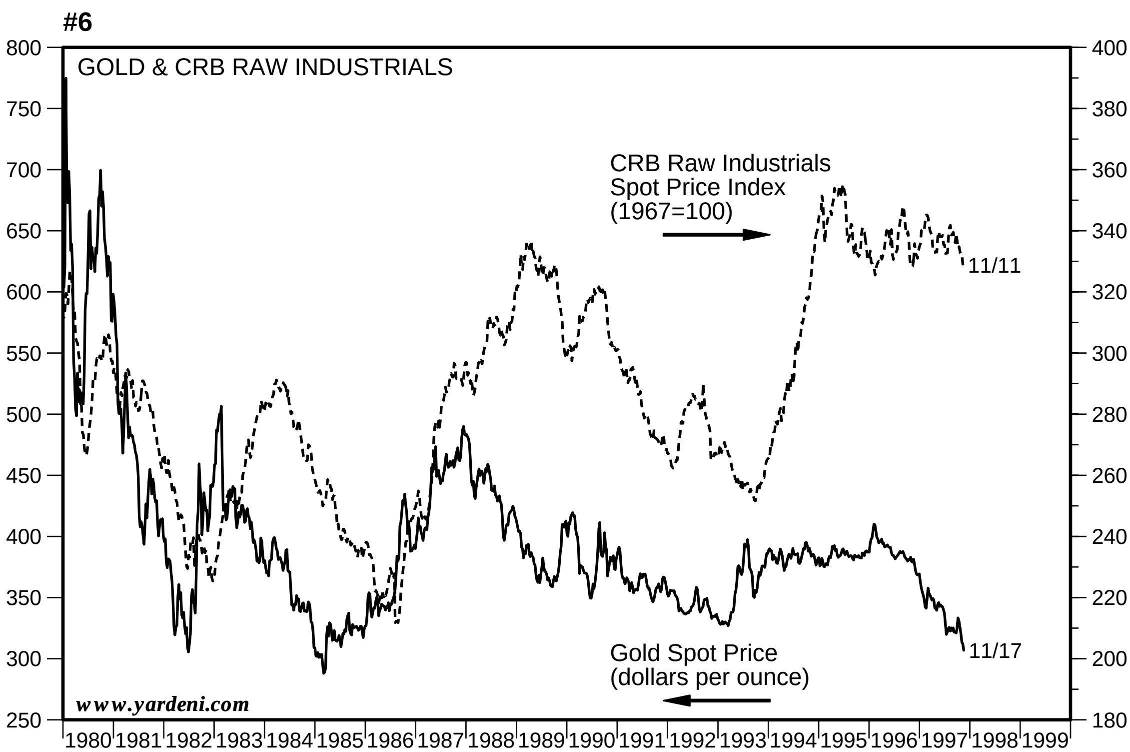


* Includes Japan, China, Hong Kong, South Korea, Singapore, Taiwan, Indonesia, Malaysia, Philippines, and Thailand.

- Commodities -



Gold is a good leading indicator of CRB futures index and is signaling a big drop in this index up ahead.

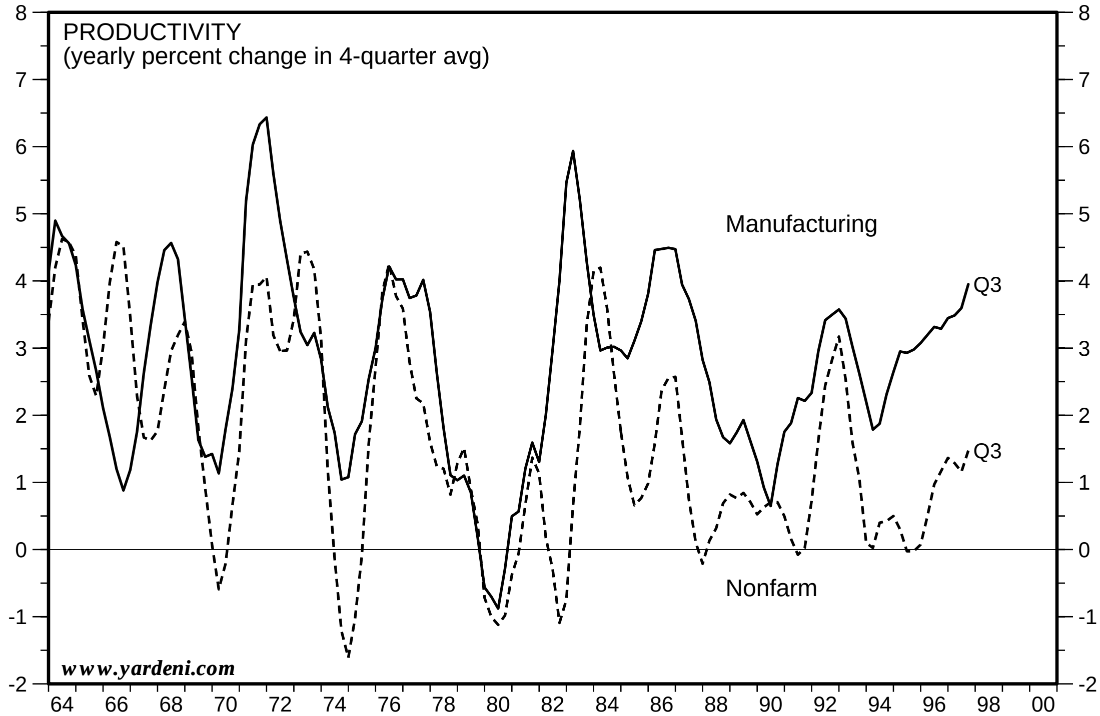


Gold also leads industrial spot prices, but not as well as CRB futures index. Sharp drop in gold suggests CRB raw industrials spot price index will break below 2-year flat trend.

- Profit Margins -

Productivity is growing very rapidly still, but it may not continue to offset wage pressures in 1998. So profit margins could get squeezed especially if pricing is weaker in 1998 following Asian crisis.

#7



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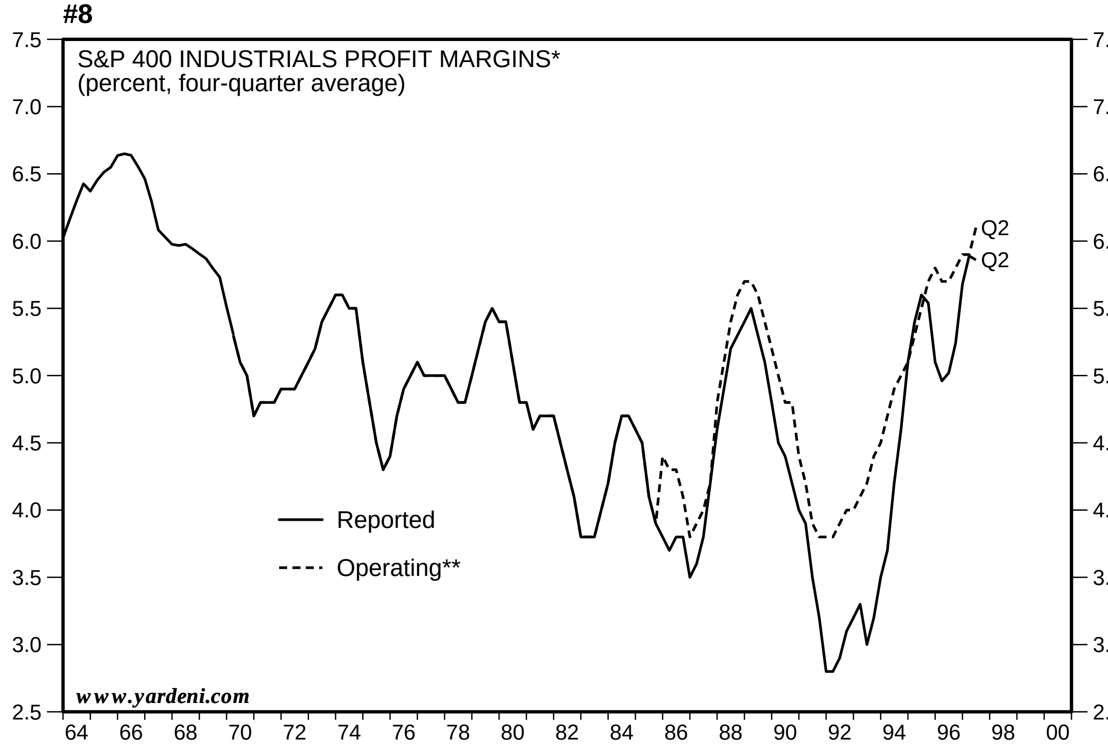
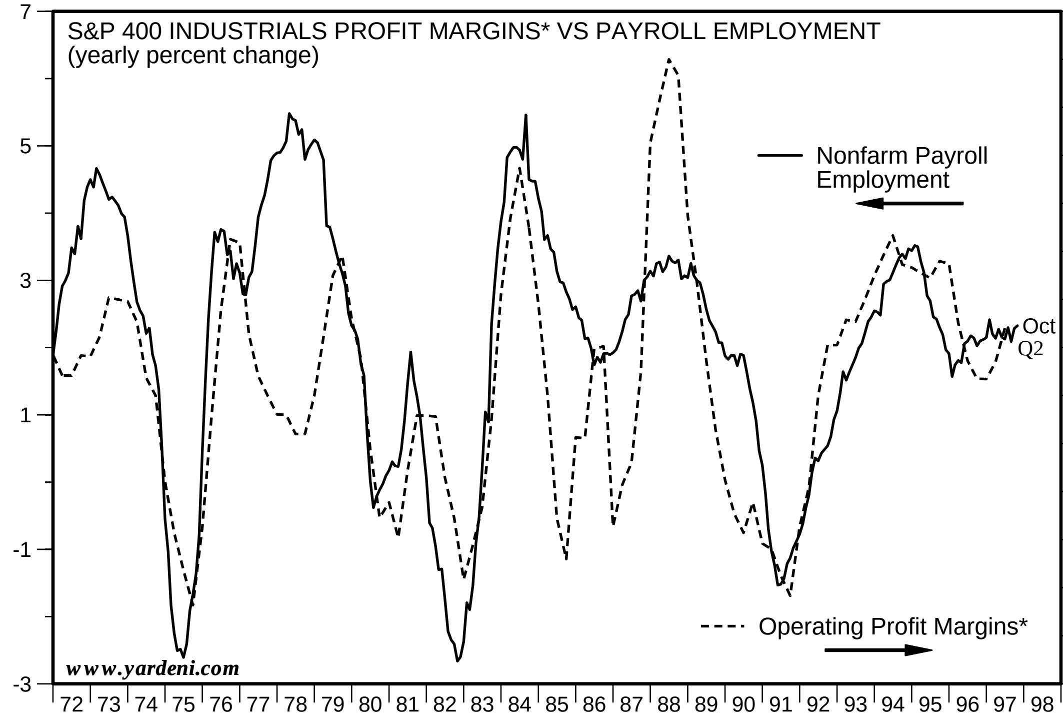


* Earnings (after taxes) divided by sales.
** Excludes write-offs.

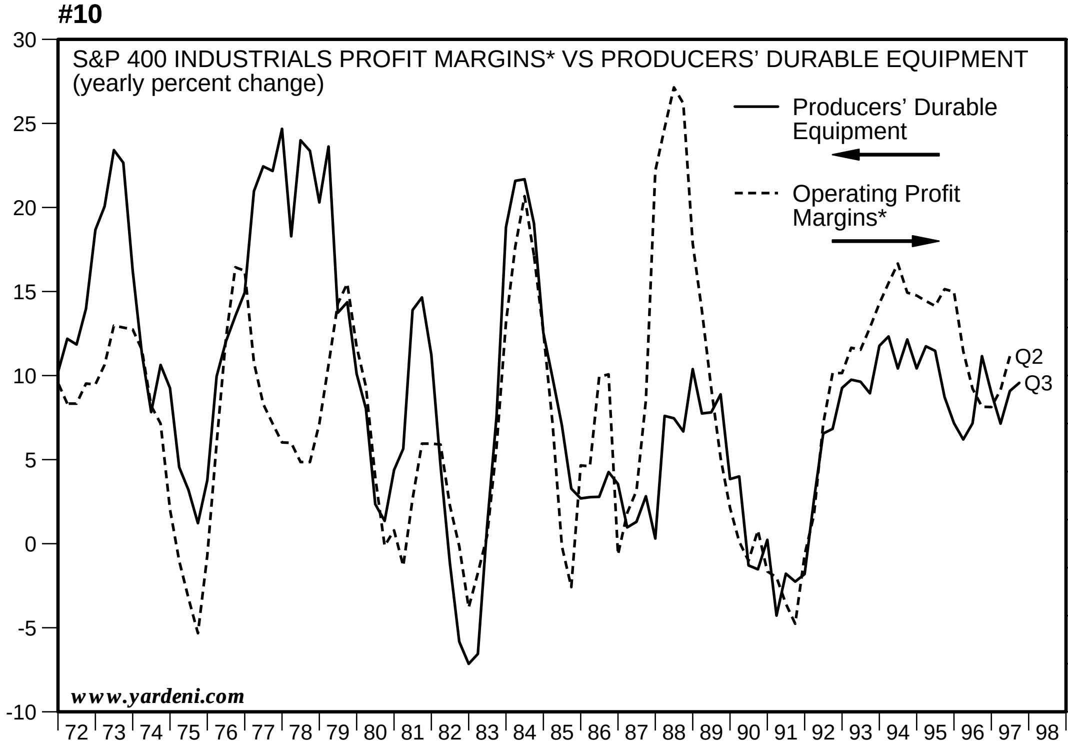
- Profit Margins -

#9



* Excludes write-offs.

#10



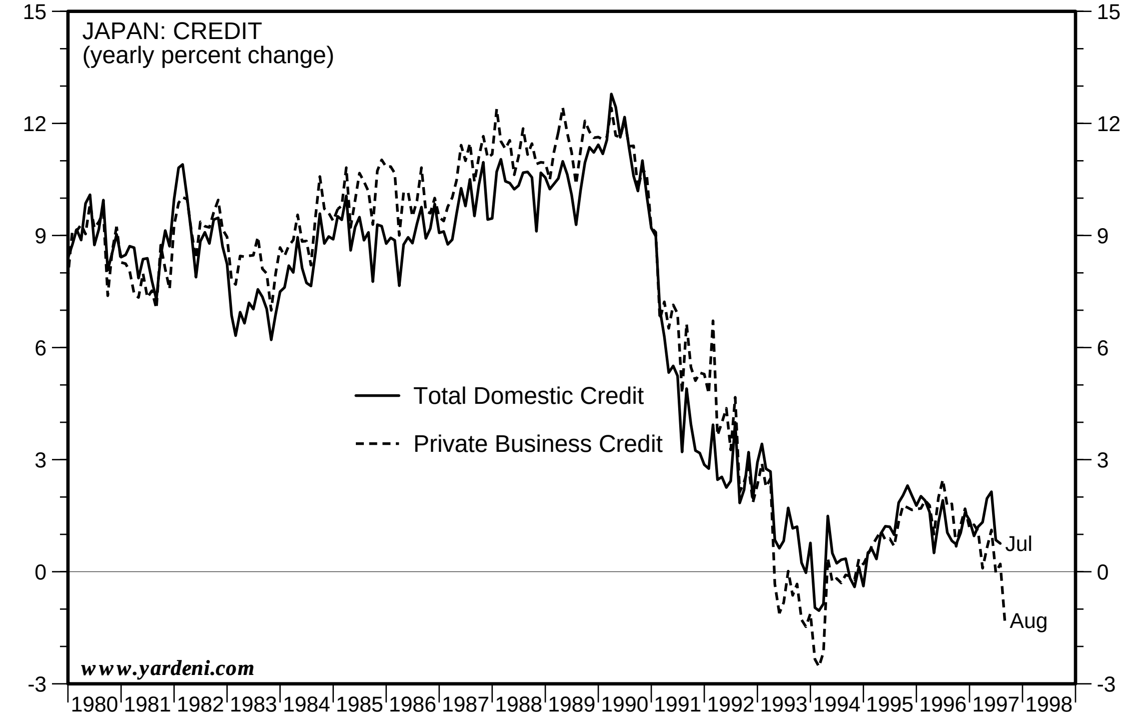
* Excludes write-offs.

Growth rate of profit margin highly correlated with growth of employment and capital equipment spending. Possible 1998 profits squeeze could slow US economy.

- Asian Finance -

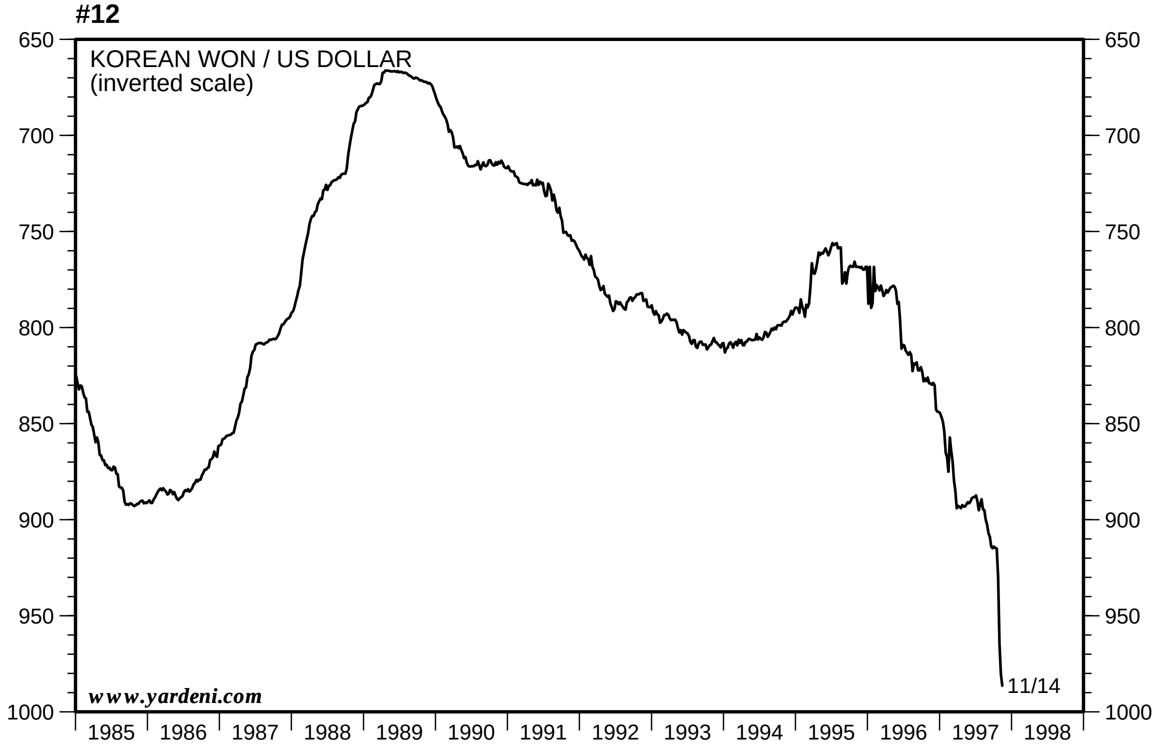
Business credit is falling again in Japan for first time since recession of 1992-1994.

#11



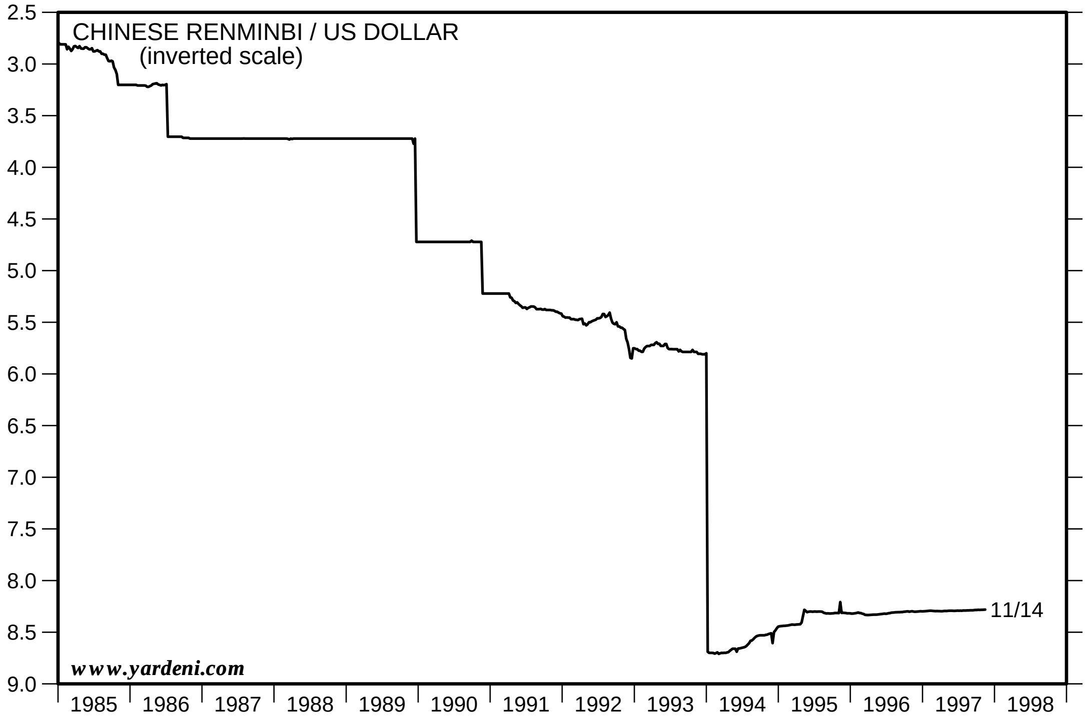
Plunging Korean won could trigger another round of competitive devaluation in Asia.

#12



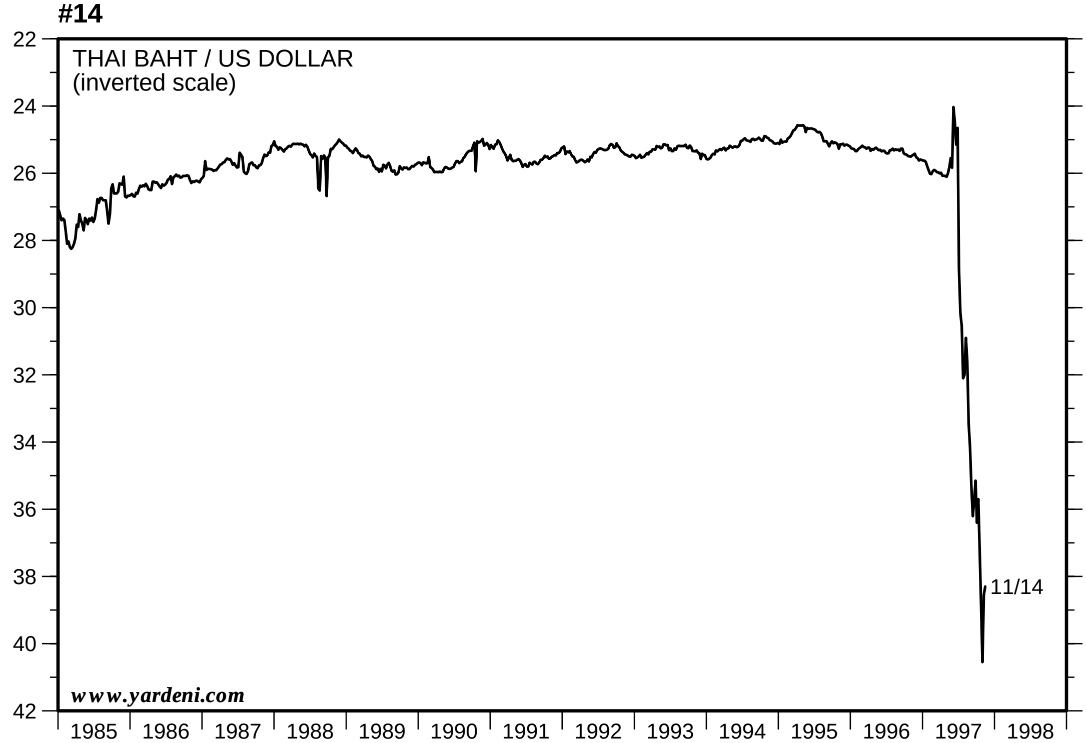
- Asian Finance -

#13



Chinese depreciation in early 1994 set the stage for weaker yen in 1995 and Southeast Asian currency free-fall in 1997.

#14



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#38 *Fed's Stock Market Model Finds Overvaluation*, August 25, 1997

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#28 *Liquidity Story Is Wildly Bullish*, February 12, 1996

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#21 *The Baby Boom Chart Book 1991*, October 9, 1991, with Amalia Quintana

#20 *The Collapse Of Communism Is Bullish*, September 4, 1991

#19 *The Triumph Of Adam Smith*, July 17, 1990, with David Moss

#18 *Dow 5000*, May 9, 1990, with Deborah Johnson

#17 *The Triumph Of Capitalism*, August 1, 1989

#16 *The Baby Boom Chart Book*, January 25, 1989, with Amalia Quintana

#15 *The New Wave Manifesto*, October 5, 1988, with David Moss

#14 *Could Real Estate Prices Fall? And What If They Do?*, August 24, 1988

#13 *The Coming Shortage Of Bonds*, June 20, 1988

#12 *How The Baby Boomers Are Changing The Economy*, April 6, 1988

#11 *The Restructuring Of Corporate America Is Bullish*, December 9, 1987, with Deborah Johnson