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Decoupling revisited.

In the midst of the financial crisis in 2007 and 2008, many argued whether emerging markets would avoid the worst of the crisis having effectively decoupled from developed markets and the US. Markets proved the decoupled theory wrong. From August 31, 2008 to March 9, 2009, US stocks, developed markets, and emerging markets declined 47.3%, 50.1%, and 47.6%, respectively.

The two charts at right present information to guide our way forward. Both charts depict the month-over-month rolling relative strength of different market segments. Points above 1.0 indicate relative outperformance and points below 1.0 indicate relative underperformance. The top chart compares international developed markets (MSCI EAFE) versus US (S&P 500), and the bottom chart compares emerging (EEM) to developed markets (MSCI EAFE).

Since Greece's October 4 election of the socialist party led by George Papandreou, developed markets have underperformed US stocks and emerging markets have outperformed developed markets. This suggests the Greece crisis adversely affected developed markets and emerging markets have avoided a slippery situation.

Perhaps, developed markets now reflect excess risks relative to emerging markets.

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"Greece is nothing."

The foregoing quote was from John Herrmann, senior strategist at State Street Global Markets. While speaking to CFA Society of Indianapolis February 25, Mr. Herrmann was unquestionably upbeat on US stocks in part because he dismissed the debt crisis in a country the "size of New Jersey."

Having witnessed sub-prime mortgages in a handful of zip codes cause a systemic collapse, Hawk100 believes the Greek debt crisis is quite relevant. Greece may have averted collapse via support from its EU brethren and the IMF. €110B ($US140B) support announced May 2 is designed to provide Greece the reserves to cover debt service commitments until its fiscal standing rebounds. Yet, this may not be enough to save Greece let alone stem the tide of a global sell off.

Government excess and unfunded public pensions were material to Greece's turmoil. Without a doubt, systemic risks are high and a country default—even the size of New Jersey—could bring another global crisis. So we researched where it would be prudent to invest wealth under such a scenario.

International Developed Markets v. US Large Cap Stocks

International Emerging Markets v. Developed Markets

30-day relative strength. Daily close from Interactive Data

Percent of Gross Domestic Product

	Combined surplus (deficit)(1)	Implied interest impact(2)
Greece	(23.66)	(2.44)
India	(12.20)	(1.00)
Spain	(18.71)	(0.78)
Britain	(18.31)	(0.70)
US	**(18.59)**	**(0.66)**
France	(12.63)	(0.40)
Canada	(6.49)	(0.23)
Brazil	(3.35)	(0.21)
Euro area	(7.10)	(0.20)
Japan	(3.45)	(0.04)
China	3.57	0.12
Germany	5.77	0.16
Saudi Arabia	62.84	0.46
Russia	8.74	0.57
Norway	39.07	1.33

(1) total of trade, current account, and budget balances.
(2) Sovereign debt yield times combined surplus (deficit).

Based on data from The Economist, May 6, 2010.

Scanning the globe, courtesy of The Economist, we reviewed countries' fiscal picture. Of 57 nations tracked by The Economist, 54 run budget deficits for 2010. Only Norway (surplus of 9.4% of GDP), Saudi Arabia, and Hong Kong carry a surplus. It's ugly.

Several countries' pictures improve when you add balances for trade and current account balance, particularly for countries rich in natural resources, but most countries deteriorated. Six countries lose more than 10% of GDP per annum, and the US is third worst losing 18.6%. Despite Germany, the EU still loses 7.1%. It's still ugly.

In recent decades, the impact of deficit spending has been muted by low interest rates. Government borrowing has coincided with historically low yields. We estimated the annual interest impact implied from the deficits. In the US, that implied impact is $95B or 0.66% of GDP based on today's treasury yields. Only four nations, led by Greece, suffer a higher interest impact.

Hawk100 forecasts rising inflation and interest rates. Thereby, we expect interest impact to rise perhaps to unsustainable levels. No, Mr. Herrmann, Greece is something, but it looks ugly for most countries.

By Richard Clemens, CFA, President