Wall Street Gurus See World Economy Decoupling From Wounded U.S.

By Simon Kennedy
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Wall Street economists are reviving a bet that the global economy will withstand the U.S. slowdown.

Just three years since America began dragging the world into its deepest recession in seven decades, Goldman Sachs Group Inc., Credit Suisse Holdings USA Inc. and BofA Merrill Lynch Global Research are forecasting this time will be different.

Goldman Sachs predicts worldwide growth will slow 0.2 percentage point to 4.6% in 2011, even as expansion in the U.S. falls to 1.8% from 2.6%. Underpinning their analysis is the view that international reliance on U.S. trade has diminished and is too small to spread the lingering effects of America's housing bust.

Providing that the U.S. pain doesn't roil financial markets as it did in the credit crisis, Goldman Sachs expects a weakening dollar, higher bond yields outside the United States and stronger emerging-market equities.

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"So long as it doesn't turn to flu, the world can withstand a cold from the U.S.," Ethan Harris, head of developed-markets economic research in New York at BofA Merrill Lynch, said in a telephone interview. He predicts the United States will expand 1.8% next year, compared with 3.9% globally.

That may provide comfort for some of the central bankers and finance ministers from 187 nations who came to Washington for annual meetings of the International Monetary Fund and World Bank on Oct. 8-10.

IMF chief economist Olivier Blanchard last month predicted "positive but low growth in advanced countries," while developing nations expand at a "very high" rate.

"The world has already become partially decoupled," Nobel laureate Joseph Stiglitz, a professor at New York's Columbia University, said in a Sept. 20 interview.

Sixteen months after the world's largest economy emerged from recession, the U.S. recovery is losing momentum, with factory orders falling 0.5% in August and unemployment forecast to increase to 9.7% in September from 9.6% the previous month, according to the median estimate of 78 economists in a Bloomberg News survey.

Their predictions don't include another contraction, with growth estimated at 2.7% this year and some indicators showing progress. Orders for capital goods rose 5.1% in August, and the number of contracts to purchase previously owned homes increased 4.3%; both were higher than forecasts.

Even so, emerging markets are showing more strength. Manufacturing in China accelerated for a second consecutive month in September, and industrial production in India jumped 13.8% in July from a year earlier, more than twice the June pace.

"It seems that recent economic data help to confirm the story of emerging-markets outperformance," said David Lubin, chief economist for emerging markets at Citigroup Inc. in London.

The gap in growth rates between the developing and advanced worlds is widening, Lubin said. Emerging economies will account for about 60% of global expansion this year and the next, up from about 25% a decade ago, according to his estimates.

The main reason for the divergence is: "Direct transmission from a U.S. slowdown to other economies through exports is just not large enough to spread a U.S. demand problem globally," Goldman Sachs economists Dominic Wilson and Stacy Carlson wrote in a Sept. 22 report titled "If the U.S. Sneezes . . . "

Analysis

Take the so-called "BRIC" countries of Brazil, Russia, India and China: While exports account for almost 20% of their gross domestic product, sales to the U.S. are fewer than 5% of GDP, according to their estimates. That means even if U.S. growth slowed 2%, the drag on these four countries would be about 0.1 percentage point, the economists reckon. Developed economies — including the U.K., Germany and Japan — also have limited exposure, they said.

Economies outside the United States have room to grow that the U.S. doesn't, partly because of its outsized slump in house prices, Wilson and Carlson said. The drop of almost 35% is more than twice as large as the worst declines in the rest of the "Group of 10" industrial nations, they found.

The risk to the decoupling wager is a repeat of 2008, when the U.S. property bubble burst and then morphed into a global credit and banking shock that ricocheted around the world. For now, Goldman Sachs's index of U.S. financial conditions signals that bond and stock markets aren't stressed by the U.S. outlook.

The break with the United States will be reflected in a weaker dollar, with the Chinese yuan appreciating to 6.49 per dollar in a year from 6.685 on Oct. 1, according to Goldman Sachs forecasts.

The bank also is betting that yields on U.S. 10-year debt will be lower by June than equivalent yields for Germany, the U.K., Canada, Australia and Norway. U.S. notes will rise to 2.8% from 2.52%; Germany's will increase to 3% from 2.3%; and Canada's will

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grow to 3.8% from 2.76% on Oct. 1, Goldman Sachs projects.

Goldman Sachs isn't alone in making the case for decoupling. Harris at BofA Merrill Lynch said he didn't buy the argument prior to the financial crisis. Now he believes global growth is strong enough to offer a "handkerchief" to the United States as it suffers a "growth recession" of weak expansion and rising unemployment, he said.

Giving him confidence is his calculation that the U.S. share of global GDP has shrunk to about 24% from 31% in 2000. He also notes that, unlike the United States, many countries avoided asset bubbles, kept their banking systems sound and improved their trade and budget positions.

A book published recently by the World Bank backs him up: "The Day After Tomorrow" concludes that developing nations not only are decoupling, they also are undergoing a "switchover" that will make them such locomotives for the world economy that they can help rescue advanced nations. Among the reasons for the revolution are greater trade between emerging markets, the rise of the middle class and higher commodity prices, the book said.

Investors are signaling they agree. The United States has fallen behind Brazil, China and India as the preferred place to invest, according to a quarterly survey conducted of 1,408 investors, analysts and traders who subscribe to Bloomberg. Emerging markets also attracted more money from share offerings than industrialized nations last quarter for the first time in at least a decade, Bloomberg data show.

Indonesia, India, China and Poland are the developing economies least vulnerable to a U.S. slowdown, according to a Sept. 14 study based on trade ties by HSBC Holdings PLC economists. China, Russia and Brazil also are among nations with more room than industrial countries to ease policies if a U.S. slowdown does weigh on their growth, according to a policy-flexibility index designed by the economists, who include HSBC Holdings.

Analysis

"Emerging economies kept their powder relatively dry, and are, for the most part, in a position where they could act countercyclically if needed," the HSBC group said.

Links to developing countries are helping to insulate some companies against U.S. weakness. Swiss watch manufacturer Swatch Group and tire maker Nokian Renkaat of Finland are among the European businesses that should benefit from trade with nations such as Russia and China where consumer demand is growing, according to BlackRock Inc. portfolio manager Alister Hibbert.

"There's a lot of life in the global economy," Hibbert, said at a Sept. 8 presentation to reporters in London.

The increasing focus on emerging markets may present challenges for their policymakers as the flow of money into their economies risks fanning inflation, asset bubbles and currency appreciation. Countries from South Korea to Thailand already have intervened to weaken their currencies, along with taking steps to restrict capital inflows.

Stephen Roach, Morgan Stanley's nonexecutive chairman of Asia, remains skeptical of decoupling. He links the optimism to a snapback in global trade from a record 11% slide in 2009. As that fades amid sluggish demand from advanced economies, emerging markets that rely on exports for strength will "face renewed and formidable headwinds," he said.

"Decoupling is still a dream in much of the developing world," said Roach, who also teaches at Yale University.

The Goldman Sachs economists argue that history is on their side. The U.K., Australia and Canada all continued growing amid the U.S. recession of 2001 as the technology-stock bust passed them by, while America's 2006-07 housing slowdown inflicted little pain outside its borders, they said. The shift came when the latter was transformed into a financial crisis, prompting Goldman Sachs to declare in December 2007 that 2008 would be the "year of recoupling."

The argument finds favor with Neal Soss, New York-based chief economist at Credit Suisse. While the supply of dollars and letters of credit that fuel international commerce dried up during the turmoil, that isn't a problem now, so the rest of the world can cope with a weaker United States, he said.