Tea Leaf

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Your guide to understanding today's economy and financial markets

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Sovereigns

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Every couple of years important or interesting new acronyms are added to the common dialogue of people around the nation, around the globe…

…you can now add SWFs to the lingo

SWFs are Sovereign Wealth Funds… vast and enormous pools of money that have been and are accumulating in various locations around the globe

These enormous pools of $$ result from 1) oil rich nations—such as the city/state of Abu Dhabi—accumulating vast oil wealth, and 2) other nations—such as China—which generate enormous financial reserves resulting from large trade surpluses. One could also add Russia and Singapore to the list, among others.

These enormous investment funds have traditionally found their way into conservative global investments, including U.S. Treasury bills, notes, and bonds. These SWFs are now adopting more aggressive and potentially more lucrative investment policies than before.

Putting $$ to Work

Recent investments have included $7.5 billion from Abu Dhabi into Citigroup; $9.7 billion by Singapore into banking giant UBS, along with another $4.4 billion into Merrill Lynch; and $5.0 billion by China for a piece of investment firm Morgan Stanley. These passive investments, along with more expected to come, help global financial giants remain solvent, even as they write off billions of dollars of losses from the subprime lending fiasco.

Additional SWF investments in 2008 will be most welcome in financial circles to lessen global credit market anxiety about more multi-billion dollar losses by Wall Street and global investment firms/banks. Some very ugly additional losses will be announced in coming days and weeks in New York, perhaps in Charlotte, and across European financial centers.

Hedge Funds

Large accumulations of funds for investment are nothing new, with hedge funds being a solid example. Many extremely wealthy investors participate in aggressive hedge funds, clearly understanding that a 30% investment return in one year might be followed by a 15% loss the next year. These aggressive funds chase opportunities of all descriptions around the globe.

The *difference* is in regard to who *owns* the investment funds. Abu Dhabi is sitting on an estimated $875 billion to be invested. China's foreign reserves now exceed $1.2 trillion. Even Russia has an estimated $300 billion to put to work, tied to its strong oil revenues *(The Wall Street Journal)*.

Huge $$

SWFs currently have an estimated $3 trillion in assets (twice that of hedge funds), with tens of billions of dollars of new funds added weekly. These funds are currently found in roughly 20 nations and will be "recirculated" into investment alternatives around the globe, with many more dollars coming to the U.S.

Transparency regarding ownership is lacking in most cases. Within the U.S., we see a clear separation between the federal government and the ownership of airlines, steel companies, the media, railroads, etc. Such a separation is not necessarily the case within the SWFs, with eight of the 20 largest publicly traded companies in the world being owned and controlled by foreign governments, mostly non-Democratic nations such as China *(The Wall Street Journal)*.

Foreign investment into the U.S. has paid great dividends over the past 300 years, including those made by various European nations and wealthy Europeans in the 18th and 19th centuries. Foreign investment is important today.

A clear understanding of who the investors in American companies are (transparency) is critical. Private global companies and private investor hedge funds seek solid investment returns, and are impacted by traditional investment relationships regarding risk and return. However, shadow investments by sometimes hostile foreign nations with a political agenda can be something quite different.

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Global '08

Most forecasts for global economic performance this year (yes…2008) have real (inflation adjusted) growth slowing slightly. Expected overall slowing is tied to more sluggish performance in the U.S. and Europe, while the Pacific Rim continues to grow at an impressive pace.

Even as many forecasts have been trimmed a bit, most forecasts have the global economy growing at around a 4.0%-4.8% real annual pace. Such growth would be the sixth consecutive year of the global economy growing by at least a 4.0% pace, an extended period of solid performance matched few times in history.

The U.S.

It's no secret that numerous forecasters project that the U.S. economy is already in…or will soon enter…a recession. We continue to suggest about a 30%-40% chance of a mild recession in 2008.

Most U.S. forecasts suggest real growth around 1.5%-2.3% in 2008, with second half growth stronger than in the January-June period. The International Monetary Fund now forecasts a 1.9% real U.S. growth pace in 2008.

Europe

Europe is also expected to slow, tied to the negative impact on European exports of the strong euro currency, which makes European goods more expensive in such places as the U.S. Numerous European nations, as well as most developed nations around the globe, will also be impacted by the heightened global credit anxiety in place since August 2007. In addition, financial institutions, pension funds, and hedge funds around the globe that bought pieces of U.S. subprime mortgage loan packages will be negatively impacted.

PPP

A recent major change in measurement methodology by the World Bank now suggests the U.S. share of the global economy is actually greater, while the shares of China and India are less. It all revolves around PPP, or Purchasing Power Parity.

You have likely seen estimates of, for example, what a Big Mac or a Starbucks latte would cost around the world when the local currency is converted into dollars. This PPP methodology has now been expanded more completely around the world, using 2005 data.

The new data suggests that the economies of China and India were smaller than previously estimated. Prior data for 2005 had China and India accounting for 14.8% and 6.3% of global economic output.

The new and improved data now suggests economic output of 9.7% and 4.3%, respectively, a net decline of one-third. At the same time, the U.S. share was revised from 20.8% to 22.5% *(The Wall Street Journal)*.

It should be noted that estimates regarding the size of the Chinese economy run the gamut from a #2 ranking behind the U.S. by the World Bank to #3 (also behind Japan) or #4 (also behind Germany) by most other measures. China will likely move into the #2 position in coming years.

China at #1? It may happen within the next 15-20 years. It may not. Note that most forecasters in the early 1990s confidently predicted an eventual #1 ranking for Japan… just before Japan's economy fell on its face.

Other Major Players

No secret here…China and India will lead the Pacific Rim with impressive growth, while Japan will see limited growth. Russia should do well if oil prices stay high.

Uncertainty will be a major factor in 2008, including uncertainty about oil and various commodity prices, uncertainty about inflation and interest rates, uncertainty about the war on terror, and uncertainty about how global credit anxiety will ultimately play out.

Jeff

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…childproof

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