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The market's new nightmare.

The market's favorite nightmare changed pretty abruptly, last week. It had been "Global Trade War!" (or at least "China Trade War!") Last week, with hardly a moment's notice, it became "Global Financial Panic, Beginning with Emerging Markets!"

"Emerging Markets" is investment-world lingo for a lot of generally poorer nations, most of them making progress toward growth, wealth and financial stability over the past decade or more. That progress is almost completely dependent on each country's political attitudes toward free markets, capitalism, and a good business climate—so naturally the progress has come in ebbs and flows, or even starts and stops. As we might expect, the result today is a wide range of financial strength and vitality among those "emerging markets:" from "precarious" to "impressive" and everything in-between.

And "Global Financial Panic" is investment-world lingo for good old-fashioned bank runs, whose fundamental nature has not changed one bit in a few hundred years, or at least since Jimmy Stewart's building-and-loan bank was almost wrecked by a run in "It's a Wonderful Life." Today's "runs" might be from emerging-market currencies, or mortgage-backed bonds, or even a single non-bank company like Kinder Morgan a few years ago, which had made itself depend too much (for incoming cash to invest in its pipeline business) on the good will and rationality of the stock market. That last phrase, "depend too much on the good will and rationality of the market" could be the epitaph on the tombstones of a big crowd of wrecked financial institutions and even nations, over all the passing years of history.

When all financial markets—stocks, bonds, currencies, commodities—are at the mercy <u>in the short term</u> of the world's vast crowd of speculators, it is never too hard to start a run. That's why (as Outlook has noted a few times) the market's nature is to regularly plunge into nightmares. Most of them don't last, because they just aren't backed up by enough solid, consistently-frightening facts-on-the-ground concerning whatever it is the market is running from, this time. Sometimes it takes a few days for that lack of factual support to become clear. Sometimes it takes weeks or months. So the $64,000 Question, today, about "Global Financial Panic/Emerging Market Contagion," etc., is "What are the most important facts about it?"

- **Turkey, which triggered this latest nightmare, emphatically deserves the "run."**

  Its dictator has been completely irresponsible about his government's financial behavior: money-printing, reckless borrowing, government spending run wild . . . the usual list. Now the chickens are coming home to roost. Turkish inflation and interest rates are at 16% to 18%, and they'll do nothing whatsoever except go much higher before Turkey's pain is over. So Turkey's currency became the run's first target, falling 40% to 60% so far this year (depending on who is measuring, apparently) and accelerating its plunge last week.

  The $64,000 Question for the world's speculators is this: "What took you so long to notice all this?" And the Question for any global lender which shared in the explosion of credit granted to Turkish businesses, these past 5 – 10 years, would be: "Are you kidding? You actually loaned money into that mess?" Both of those Questions are perfectly normal, of course. They come up after every one of the tiny number of panics and runs which actually endure because the unfolding

facts on the ground support them. Each of those rare times, the risks and problems turned out to be standing there in plain sight for quite a while before the nightmare showed up.

- **But there are hardly any other countries which "emphatically deserve a run."**

  Here's the first fact-on-the-ground of interest. *The Economist* magazine lists the world's 25 most-significant "emerging market nations," along with lots of statistics about their economic and financial conditions. Three of those 25 countries have inflation rates over 10%. Almost all the rest are under 6%, and many are under 3%. Turkey, remember, is at 16% and rising. Perhaps the foremost trait of a currency which "deserves a run" is a nation which has already wrecked its own currency by printing oceans of it, to support government spending and stay popular with its people. Those 22 of the 25 nations whose inflation rates land, today, in the 1% to 6% range have not wrecked their currencies that way. The short-selling, speculating crowd will eventually find it hard to deal with that fact.

  Here's another. When an emerging nation (and/or its private companies) borrows in dollars or euros, but makes its sales and profits in lira, zlotys or pesos, it bears big currency risk: that is, if the lira or zloty falls against the dollar or euro, it quickly becomes a lot more painful, or impossible, to make the interest and principal payments. Plenty of the Economist's 25 nations have borrowed enough in dollars or euros to make them uncomfortable about currency risk. None have borrowed on Turkey's scale—which we might call "suicidal" rather than "uncomfortable." Some of the 25—those which fall toward the "distinctly uncomfortable" end of that range—ought to be scared that the currency speculating crowd will also target them. That's already begun, naturally, and the speculating crowd will try hard to push their currencies down, far past what makes sense given their financial conditions (inflation rates, proportions of dollar-denominated debt, etc.) That's how the speculating crowd makes its living, and it can always work for a while. But it cannot endure unless the actual nature of the targets' financial condition is so weak that a run actually makes sense, as it does in Turkey's case.

There is one more factor to name. The mother and father, so to speak, of all runs and panics were the 1929 Crash and Depression; and the 2008 – 2009 "Calamity." The facts-on-the-ground which kept unfolding during those two panics were grim enough to help the panics last for a while, rather than the normal few weeks or months: too much total debt and too much unrecognized bad debt, mainly. But in both cases, those fairly grim facts were not actually grim enough to support the long-lasting panics and plunges which followed. What was needed to make the runs endure was incredibly foolish behavior among the governments involved: in the 1930's, the closure of 1/3 of U.S. banks with total losses to depositors; in 2008 – 2009, the U.S. Treasury's decision to let Lehman Brothers fail, and then take many months to come around to the idea that, in fact, banks are indeed "too big to fail," and that the market is perfectly capable of valuing sound assets at insanely low levels, for a while. (We'll skip the remarks about mark-to-market accounting today—the government-enforced rule which poured gasoline on the fire until it was eliminated in March, 2009.)

An auto company can fail, and the pain is sharp but contained. If a significant bank is allowed to fail, the pain will wash over the investment world like a dam bursting—because the market can't see inside the bank, and recognize its true strength or weakness. (The bank's management has a hard time doing that, if history is a guide.)

It's an “uncomfortable” fact, for us investors, that we must depend on governments avoiding extremely foolish mistakes, when it comes to runs and panics. But only nine years after the end of our last “Calamity,” the most powerful governments in the “rich” world are still making it perfectly clear that they got the lesson. A few years ago the incipient run on European banks (with bad debts to Greece, Italy, Spain, etc.) was ended by Mr. Mario Draghi, head of the European Central Bank, making one statement: “We will do whatever it takes.” Governments and their central banks can print money. Nobody else can (as we’re finally seeing with poor Bitcoin.) That fact makes them able to stop runs, and responsible for doing so. The world’s main central banks might make their 2008 – 2009 mistake again, someday, but not today. The painful lesson is still recent, and still raw.

So Outlook is paying attention to the new market nightmare . . . and to the old one, too (China Trade War!) That is our job. Our judgment is emphatic: we own exceptionally strong companies valued cheaply or reasonably. “Panic and run” against the world’s emerging markets would hurt them if it lasts—but it will not cripple them, whether it lasts or not; and it’s not likely to last.

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