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## 4 Places That Could Be Trouble if the Economy Goes South

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The Federal Reserve's rate-tightening campaign is causing cracks around the world in markets small and big.  
Al Drago/Bloomberg

Good economies are all alike, but every bad economy is bad in its own way.

Fifteen years ago, questionable housing loans brought the economy to its knees and seized up the financial system. Regulators reacted by imposing tough lending standards and higher capital levels for banks. That should help prevent a repeat of the 2007-2009 global financial crisis even if home prices tumble again.

But as the Federal Reserve raises interest rates in an effort to rein in rampant inflation, new stresses are likely to appear in places that regulators and investors aren't expecting them. The Fed "is hunting elephants with pea shooters. They are being extraordinarily reactive. Of course something will break," says Rich Bernstein, chief investment officer of global macro manager Richard Bernstein Advisors.

*Barron's* canvassed money managers, strategists and economists to find out where trouble could lurk. They told us leveraged loans, emerging markets, China and its property market, and Europe—both in high-yield debt and European stocks broadly.

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None of these areas are quite at center stage now. But it's important to remember that few were fretting about the Thai Baht before the late 1990s Asian currency crisis, or subprime debt or auction-rate securities or money-money funds before the Great Recession. All ran into trouble, requiring bailouts or hitting financial institutions or investors with big losses. "It's not little ripples that matter but when they are synchronized that they make a big tsunami and you get banks that are unlucky to have exposure to several of them," says Nicholas Colas, co-founder of DataTrek Research.

Of course, nobody can know in advance how the next recession or financial crisis will play out. But here are four areas that bear watching:

## Emerging Markets

Emerging markets already are in the eye of the storm. Many are getting hit hard by rising food and fuel costs while the yield-hungry investors that had helped finance their

deficits flee as the Fed tightens monetary policy.

It's a time of great peril, says Cornell economics professor Eswar Prasad, former top hand on China at the International Monetary Fund. Though he doesn't see cascading crises at this stage, Prasad says countries with high levels of foreign currency debt, economic and political challenges are vulnerable as global financial conditions tighten.

Sri Lanka is already in default, with political turmoil sinking it into chaos. Chile, once an example for sound policies, is in the midst of a currency crisis. Countries where borrowing costs have spiked include Ukraine, Argentina, Egypt, Pakistan and Kenya. Most investors don't have much in these smaller markets, but even broader emerging market funds like the [iShares J.P. Morgan USD Emerging Markets Bond index](#) (ticker: EMBI) could see losses as liquidity dries up in emerging markets and a stronger dollar causes strains, especially in those countries that have borrowed heavily in dollars.

If emerging markets crises begin to pile up, and banks are exposed to a number of them, the troubles could eventually destabilize financial markets, cautions Raghuram Rajan, former head of the Reserve Bank of India who is now a professor of finance at the University of Chicago Booth School of Business.

## China

The world's second largest economy reported its worst economic growth since the

beginning of the pandemic, hurt by harsh Covid-related lockdowns that brought cities like Shanghai to a standstill.

Most economists expect a better second half, but Covid could derail those expectations and trigger more lockdowns in cities crucial to global supply chains. Instead of helping offset slowdowns in Europe and the U.S., China could add to the malaise.

Another problem is China's property market. TS Lombard analysts write that the sector owes roughly \$1.6 trillion in dollar-denominated debt. And the dollar has been strengthening, making it more difficult to repay this debt. Finally, many Chinese citizens are refusing to pay their mortgages on uncompleted properties, igniting a widening crisis that could spill over into China's banks. Investors should exercise caution with both Chinese bonds and equities, analysts say.

## Leveraged Loans

Leveraged loans are generally given to companies that already carry heavy debt. Though the leveraged loan market is unlikely to send the financial system into a tailspin, it could be one of the first credit markets to pile up big losses in a recession. The Markit iBoxx USD Liquid Leveraged Loan index is already down 6% this year, but could fall much further, strategists say.

Some of them say leveraged loan investors are taking too much comfort in the view that there is enough cash on balance sheets of indebted companies to avoid a rash of

defaults in a recession. The leveraged ETF market hasn't yet been stress-tested for a possible massive unwinding, says Sonal Desai, chief investment officer of the fixed-income group at [Franklin Templeton](#).

Investors have flocked to funds investing in this floating rate debt to get ahead of the Fed's rate hikes. Investors poured \$415 billion into these funds between January 2021 and this May, according to [Morningstar](#).

BNP credit strategists recommend that clients avoid leveraged loans, noting that the pricing for these loans doesn't reflect a non-recessionary slowdown in growth, let alone a nasty recession.

## European High-Yield and Stocks

The war in Ukraine is hurting the global economy but having a particularly dire effect in Europe, where much of the economy relies on Russian energy. If Russia turns the natural-gas taps off for a long period, it could plunge the region into a deep recession.

Liquidity is already beginning to dry up in Europe's junk-bond market. Strategists like Colas of DataTrek are looking for strain in the sovereign debt spreads of Greece and Italy, two countries with among the lowest credit ratings in Europe.

Despite the 22% decline in the MSCI Europe, European equities have more room to fall, analysts say. Strategists at BlackRock Investment Institute on Monday said they were tactically underweight European stocks.

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