Risk Measures Prove To Be Excellent Forecasters Of the Rise and Fall of Markets Abroad

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Economic risk indicates how foreign investors’ cash flow could be affected by conditions within a country’s economy. It covers inflation, foreign-debt service as a percent of exports, international liquidity (the level of current reserves that the government has to finance imports), foreign trade collection experience (a gauge of how well foreign lenders and traders have been able to collect payments from the government), the current account balance of trade as a percent of exports, and a parallel foreign exchange-rate market indicator (the difference between the officially approved exchange rate and the rate on the parallel market).

Political Risk Services has 150 senior advisers and country analysts stationed around the world. The analysts evaluate a country’s status based on the risk indicators. The results are published every month in the International Country Risk Guide, which has been around since 1981.

Harvey took the 47 countries that have equity markets and evaluated how indexed portfolios would do, based on the political, financial and economic risks tracked by ICRG, plus the composite index of risk. To index his portfolios, he used a combination of the Morgan Stanley Capital International Indexes and the International Finance Corporation Indexes. Because the portfolios were calculated in dollars, they each suffered or benefited to the degree that the dollar fell or rose in relation to the currency of the country in which it is invested. The portfolios were weighted so that an equal number of dollars was invested in, say, the UK and Argentina.

Portfolios were separated into two categories: “upgraded” and “downgraded.” For instance, take economic risk. Harvey began in January 1984 and waited six months to determine whether it rose or fell. If it climbed for a particular country, that nation was put in the upgraded portfolio. If it fell, the country went into the downgraded portfolio. From then on, at six-month intervals, a country would stay in the upgraded portfolio if its index remained the same or rose. It would be shifted to the downgraded portfolio if its index fell. Similarly, a country would stay in the downgraded portfolio if its index remained the same or fell. And it would be shifted to the upgraded portfolio if its index rose.

As Harvey puts it: “There are two different strategies. One is you are buying all the upgraded countries, and the other is you are buying all the downgraded countries. All we are doing is taking a look at the performance of these two portfolios. If there is no difference in performance, then there is no information in these ratings.”

But for the economic index, at least, the difference is significant. From June 1984 through June 1995, the average return on the downgraded portfolios was 18.6% per year; for the upgraded ones, it was 25.8%.

Comments Harvey, “If I heard those numbers, I would say it’s no big deal, because my guess would be that the 25.8% portfolio is a lot riskier. But it turns out the risk is rewarded, no matter how we measure it. In terms of volatility, the downgraded portfolio has a measure of 21.6% per year, while the upgraded portfolio has a measure of 15.1%. So the upgraded portfolio is much less volatile. And if you don’t like volatility, you like beta. The beta is less for the upgraded portfolio.” So according to these two measures of risk, the upgraded portfolio does much better. (Beta measures how much a stock moves relative to a market portfolio--typically moves when the total stock market, of which it is a part, goes up or down.)

The results were different for financial risk and political risk. For political risk, the average return was slightly better for the upgraded portfolio, but the volatility and beta were higher. For financial risk, the average return was slightly worse for the upgraded portfolio. However, when all three measures of risk are combined into a composite measure of risk, the results are slightly better than using economic risk alone.

What about the December ’94 debacle in Mexico, when the stock market tanked? All three of the risk factors anticipated it by November ’94 or sooner.

Says Harvey, “We were very impressed by these results. Those ratings have been available, but nobody has looked at investable strategies on the upgraded portfolio. Our findings really point to the benefits of those expectational measures.”

Friday, the labor department reported that nonfarm payrolls in February had grown by a whopping 765,000. This overwhelming reversed January’s 180,000-position decline. For January and February combined, the net monthly increase in jobs was 259,000. In 1995, in contrast, the average was 144,000.

The biggest advance was in the service sector, which showed a net gain of 552,000. Manufacturing added 28,000 jobs in February, but this wasn’t enough to reverse January’s loss of 75,000 jobs in this sector.

The unemployment rate fell to 5.5% from January’s 5.8%.