

six months. Job creation and greater flexibility were touted as possible benefits. And Jay Clayton, the Trump-appointed chairman of the U.S. Securities and Exchange Commission, wants to look at loosening restrictions on who's allowed to trade shares in companies that have yet to go public.

Either proposal can be framed as a way of making equity investments a little less boring and predictable. Yet it's strange to think that a market that's

created more than \$20 trillion in value in less than a decade should need more strategies to burnish its image. If companies are so sick of the stock market after a run like this, the mind reels to consider what they'll think after the crash of 2019, or 2020, or 2025. —Chris Nagi

THE BOTTOM LINE Even as investors are willing to pay high prices for equities, companies have been slow to go public, and the stock market has lost much of its cultural buzz.

Emerging Markets Meet Tighter Money

● The long era of quantitative easing made investors more willing to put their holdings in riskier places. Suddenly that's over

Emerging markets are suffering their worst slump since 2015. The MSCI Emerging Markets Index entered a bear market in early September after dropping 20 percent from its early 2018 peak. A benchmark index of emerging currencies has dropped more than 8 percent from its high on April 3, while the Bloomberg Barclays Emerging Market dollar-bond index is on track for only its second annual loss since the global financial crisis.

Argentina has made a desperate push to stabilize itself, raising interest rates to 60 percent. Turkey saw its stock market value tumble by \$114 billion this year through August. India's rupee slid to an unprecedented low this month, while Indonesia's currency hit its weakest level against the dollar since the Asian financial crisis two decades ago.

While each country has its own challenges—Turkey's president, for example, has unnerved investors by arguing that lower interest rates can pull down inflation—the U.S. Federal Reserve has played a key, if unintentional, role in triggering the stress. It's all about the Fed's campaign to move off its emergency policy settings dating from the aftermath of the financial crisis a decade ago.

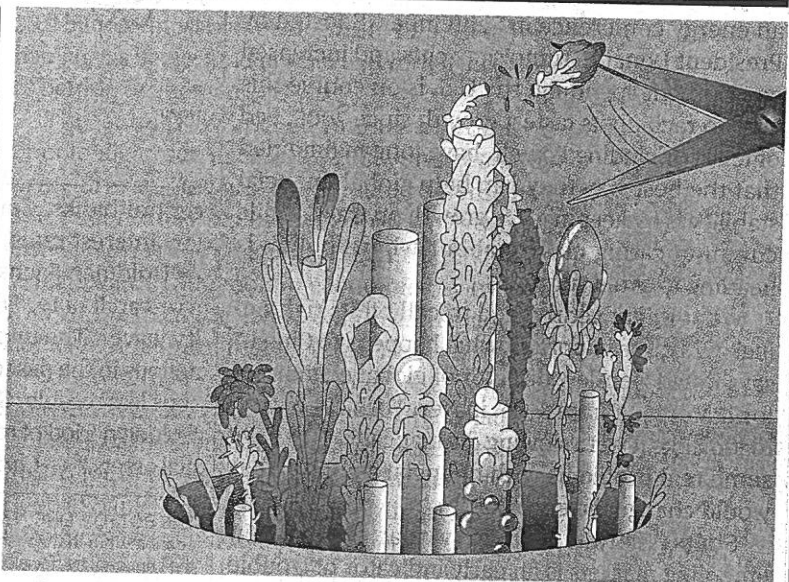
With the American economy enjoying a strong upswing, the Fed has been raising interest rates. It's also been unwinding its bond-buying policy, known as quantitative easing or QE, by not replacing all the bonds it owns when they mature. In effect, this is shrinking the outstanding supply of U.S. dollars. The Fed's counterparts in Europe

and Japan are simultaneously scaling back their stimulus programs. While the big three central banks pumped an extra \$1.82 trillion into the global financial system from January through August 2017, this year the tally is just \$99 billion.

The Fed is having an outsize impact because of the dollar's crucial role in the world economy. As the Fed's bond purchases pulled down the cost of borrowing in dollars, companies in emerging markets were among those that took advantage of the cheap funding. Developing nations had \$3.8 trillion of overseas bonds—mostly in dollars—outstanding at the end of March, up from just \$1.3 trillion at the start of 2010.

The Fed's policy turn has left emerging-nation borrowers scrambling to get more costly greenbacks to service their debt. "You can't blame what's happening in emerging markets on growth—like, there's not some massive China slowdown," says James McCormick, global strategy coordinator at NatWest Markets in London. But now that the sell-off has started, growth is at risk, too, as countries raise their interest rates to give their currencies support.

The Fed, led by Chairman Jerome Powell, has ►



◀ been pressing ahead, because the U.S. economy is near full employment and inflation is close to its 2 percent target. And from a domestic standpoint, U.S. monetary policy remains in easy mode. Even after repeated increases, the Fed's 1.75-to-2 percent target range for the federal funds rate is well below the 2.9 percent that policymakers reckon is neutral for the economy.

Emerging markets are facing "a stressful time," but the U.S. central bank should continue to hike rates given the strength of the American economy, Dallas Fed President Robert Kaplan said at an energy conference in September. Boosted by President Donald Trump's tax cuts and increased government spending, the U.S. is on course this year to rack up its fastest growth since 2005. Fed officials, including Powell, have long maintained that the best way they can help global financial stability is by keeping U.S. growth on track, while communicating clearly about where policy is heading to avoid surprises.

What might get the Fed to call off its tightening? "It's quite important what happens to China," says David Hensley, director of global economics for JPMorgan Chase & Co. in New York. "If it were to look like it were slowing dramatically or to have some real problems with financial stability, that would change the equation."

Some analysts do worry that the pain in emerging markets is an early indicator of trouble for other kinds of investments as central banks tighten. Although assets in the U.S. aren't threatened by a rising dollar the way those in emerging markets are, investors are constantly on the lookout for signs that the era of easy money is over. "For a long time we were pleased with the positive impact on asset prices of QE—at the same time, we always harbored this concern of the negative consequences when it was withdrawn," says Stephen Jen, chief executive of hedge fund Eurizon SLJ Capital Ltd. in London.

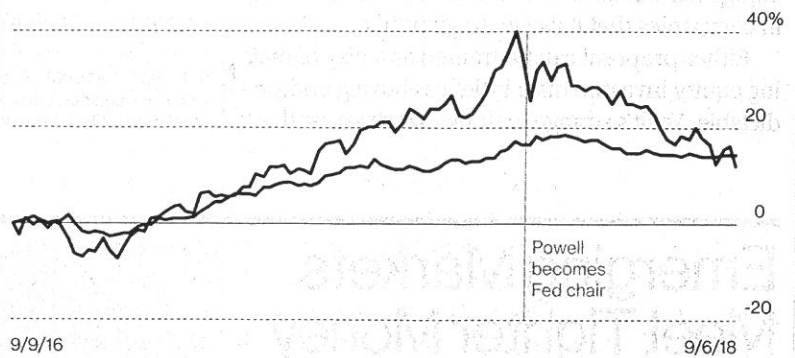
If the Fed stays on track, then "we're going to see the pressure spread" beyond emerging markets, says Jen, who served as an International Monetary Fund economist in the 1990s. But it's hard to gauge what will happen next, in part because rising rates haven't led investors to flee Treasury bonds. NatWest's McCormick and other analysts had expected such a sell-off in the U.S. bond market this year as the Fed tightened. But while Treasuries did drop early in the year, they've been largely stable for months.

Emerging markets and Treasuries were just two of the asset classes that benefited from the liquidity expansion engineered by the Fed and its fellow

Tides of Fortune

Change since Sept. 9, 2016

- ✓ Combined assets of the Federal Reserve, European Central Bank, and Bank of Japan
- ✓ MSCI Emerging Markets Index



central banks. Corporate bonds saw historically low interest rates, while U.S. stocks have surged. As Goldman Sachs Group Inc. strategists put it in a research note, "all boats were lifted by the liquidity wave." The unprecedented nature of the Fed's actions in the past decade make historical comparisons less reliable, Goldman warns. Their best guess? "A long period of relatively low returns across financial assets." —*Christopher Anstey and Rich Miller*

THE BOTTOM LINE The Federal Reserve sets policy for the U.S. economy, but that doesn't stop the rest of the world from feeling the impact of its decisions.

The Hedge Fund Curse of 2008

● These managers made their reputations in the crisis and faded in the decade that followed

In the spring of 2008, hedge fund manager David Einhorn gave the most memorable speech of his career. At a conference in Manhattan, he took to the stage at the standing-room-only concert hall and delivered a scathing attack on Lehman Brothers.

Lehman filed for bankruptcy four months later. Around the same time, another New York hedge fund manager, John Paulson, was minting a fortune by betting against U.S. subprime mortgages. And in London, a firm run by a lower-profile manager,

Alan Howard, had prepared for a financial crisis by cutting risk and buying investment contracts that would profit from market volatility.

The financial crisis that unfolded in 2008 was terrible for the hedge fund industry—on average, funds lost a record 19 percent. Strangely, though, it added to mystique of the hedge fund manager. Einhorn, Paulson, and Howard were part of a small cohort who showed foresight at a time when others were racing toward the cliff. That's what hedge funds are supposed to do. While other investors ride the market's ups and downs, hedge funds charge high fees (traditionally 2 percent a year, plus 20 percent of profit) on the promise that their managers can beat the faulty wisdom of crowds. But in the decade since the crisis, Einhorn, Paulson, and Howard have all, to varying degrees, lost their cachet.

The problem with a business based on geniuses is that few remain geniuses forever. "Regression to the mean is a very powerful force in the universe," says University of Pennsylvania psychologist Philip Tetlock, who studies the track records of professional forecasters. "It's harder for hedge funds to sustain high performance in the long term, especially when you have a lot of smart people second-guessing each other." Einhorn, Paulson, and Howard declined to comment.

Einhorn's tale is one of a classic value investor, the dogged researcher seeking overlooked gems to buy, or, sometimes, overhyped trash to short, that is, bet against. By 2008 he was already renowned as a bold stockpicker and a gadfly, and his Lehman short cemented his reputation. It still proved a hard year. Einhorn's Greenlight Capital lost about 23 percent in 2008 as the rest of the portfolio was dragged down in the market slide. Then again, an investor in a sensible S&P 500 index fund lost 37 percent.

Now Einhorn is struggling in a bull market. Greenlight has fallen 25 percent this year. He has bet on a crash in technology stocks, including Netflix Inc. and Amazon.com, that hasn't happened. He's been long on Brighthouse Financial, which has tumbled 31 percent this year; General Motors, down 17 percent; and Bayer, which has slumped about 31 percent. He's also bet on gold, which has lost 8 percent. Einhorn told investors in July that it's been a frustrating environment for value investors. "Right now the market is telling us we are wrong, wrong, wrong about nearly everything," he wrote. "And yet, looking forward from today we think this portfolio makes a lot of sense." Investors pulled about \$3 billion from Greenlight in the past two years, leaving it managing about \$5.5 billion in assets, less than half the peak of \$12 billion three years ago.

Paulson's great bet, which involved buying

insurance against mortgage defaults, earned \$15 billion and catapulted him from obscurity into a Wall Street celebrity and billionaire. His namesake fund ballooned to \$38 billion in assets by 2011. After that victory he got a taste for the big trade. But Paulson proved too bullish on a U.S. economic recovery soon after the crisis and too bearish about Europe's sovereign debt turmoil. He thought Greece could default and the euro would unravel, but neither happened. Gold, he said, would rise in the face of inflation. After reaching a record high in 2011, it has tumbled. Paulson's firm now manages about \$8.7 billion—most of it belonging to him. He's overhauling his hedge fund in a bid to return to his roots of betting on mergers.

The fund Howard co-founded produced double-digit returns in 2007, 2008, and 2009. His firm, Brevan Howard Asset Management, had \$40 billion in assets by 2013. Howard is what's known as a macro manager. Such traders make wagers on the direction of economies by trading everything from the yen to oil. Howard made his name with bets on interest rates. He sidestepped the bond market rout in 1994 and the collapse of Long-Term Capital Management four years later.

But lately he's faced the problems that have beset macro funds in the years after the financial crisis. Central banks have taken extraordinary steps to keep markets calm, leaving fewer opportunities for traders who thrive on volatility. Policymakers have telegraphed changes in interest rates, making it difficult for Howard and others to bet on them. While he and some macro managers have staged something of a comeback this year—Brevan's main fund is up 10.2 percent, and Howard posted a 44 percent profit in the first five months in a fund he solely manages—Brevan's assets have shrunk to \$7.5 billion.

The star turns by hedge fund managers in 2008 may have marked the high point of the \$3 trillion industry's glamour. Since the start of 2016, investors have pulled a net \$62 billion from hedge funds, according to Hedge Fund Research Inc. Meanwhile, some hedge fund strategies are being sold to the mass market, says William Goetzmann, a finance professor at Yale University. Factor investing, which groups stocks by common traits such as price volatility, is being used in ETFs. "What was considered the secret sauce of hedge funds, retail investors can now get cheaply," says Goetzmann. The darlings of Wall Street now are private equity funds, which raised a record amount of money last year. Some have increased their fees to boot. —Saijel Kishan



● Einhorn



● Paulson



● Howard

THE BOTTOM LINE The list of people who saw trouble ahead in 2008 is short, and some of them were hedge fund managers. But it's hard to make great calls year after year.

EINHORN: ADAM JEFFERY/NBCU PHOTO BANK/GETTY IMAGES; PAULSON: FRICK MANNING/BLOOMBERG; HOWARD: PRENSA INTERNACIONAL/ZUMA PRESS; DATA: FEDERAL RESERVE; ECB; BOJ; MSCI; BLOOMBERG