

ECONOMIC REVIEW

Global Economic Recovery – Optimism Rules Ok?



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“Twixt the optimist and pessimist the difference is droll; the optimist sees the doughnut but the pessimist the hole”.

Mc Landburgh Wilson.

The second quarter saw the continuation of the equity rally that had commenced in mid March. Such was the turn-around in sentiment that major western equity markets managed to wipe out most of the first quarter losses to end the half year modestly either side of flat, whilst Far Eastern and emerging markets recorded strong six monthly returns. However, Fixed Income was more mixed, with yields in conventional Government rising, whilst corporate bonds saw a revival in fortune as investors sought value in that sector.

The move away from the more risk averse assets coincided almost perfectly with the depth of gloom being experienced in economic statistics. Since financial markets are discounting mechanisms, this perhaps should not have been too much of a surprise since they look beyond the actual numbers and try to interpret future trends. Hence, as the leading indicators (especially confidence), showed signs of reaching a bottom, or even turning upward, investors began to factor in the possibility that the worst had already been seen. Being ‘less worse’ therefore, became akin to ‘getting better’ in the minds of equity optimists, which proved one of the major catalysts to drive equities higher.

The rapid shift from pessimism to optimism is partly a reflection of the gloom that descended on markets in late 2008 and the early months of 2009. Equity markets had priced in almost an Armageddon scenario and therefore, as the mood shifted from pricing in catastrophe to contemplating a tough, but survivable, economic backdrop, investors began to try to re-evaluate equity valuations. This involved the process of either seeking out those companies that looked well positioned to benefit from a recovery and/or re-visiting those companies that had looked likely to fail (or be nationalised). In the latter case, those that were considered as now being survivors rather than casualties-of-war saw significant recoveries, albeit from very depressed levels.

However, markets have a tendency to over-do moves on both the upside and downside and therefore it is perhaps opportune to reassess whether or not the swing from pessimism to optimism has now gone too far.

The Economic Alphabet

To determine whether or not investors have now become over-optimistic, it is necessary to examine the various economic scenarios of recovery that could occur of which there are numerous possibilities, ranging from 'V', 'U', 'W' or even 'L'. This equivalent of the economic alphabet can be confusing, but in essence, the most positive is the 'V', since it envisages a rapid rebound in activity. A 'U' would see economies bottom out but then essentially make no headway for about 12 to 18 months before some sustained recovery could begin. More worrying is a 'W' insofar as it involves an initial recovery followed by further downturn, thereby resulting in a 'double-dip' recession and a more prolonged period of uncertainty. However, the most pernicious is the 'L' as it involves a prolonged period of economic stagnation similar to the one experienced by Japan in the 1990s after the bursting of its housing and equity bubble.

The extent of the recent equity rally suggests investors have been factoring in a 'V' shaped economic recovery. If this pattern does indeed pan out then equities, despite their sharp recovery, still look reasonable value. However, if any of the other patterns become more established, there is a very good chance that equities will be forced lower again as investors have to defer their expectations for a recovery in corporate earnings. This would also have ramifications for Fixed Income, since there would likely be a shift back towards more risk averse assets, which should favour conventional Government Bonds over Index Linked and corporate issues. Under any scenario whereby recovery was delayed, the US Dollar would probably find renewed support, whilst commodities would struggle.

Of course, we are still not back to what can be described as 'normal' economic conditions. The global economy as a whole has suffered a serious shock and this will take time to heal. Interest rates remain at historically low levels and the Western consumer remains caught between high levels of personal debt, falling house prices and rising unemployment. In the US, for example, unemployment is already over 9% and in at least one-quarter of the States, it is in excess of 10%. In the Eurozone, the unemployment rate, too, is over 9% whilst in the UK, it has reached 7.2%. Given the current trend, unemployment may not peak for some time to come and when it does, it could be well in excess of 10% in all three regions.

On the broader economic front, revised first quarter GDP in the US was -2.5%, whilst in the UK and the Eurozone, the figures were -2.4% and -2.5% respectively. However, whilst Industrial production continued to be weak, there were signs that the violent inventory de-stocking had come to an end, which could be reason behind the upturn in the confidence numbers. These statistics are at the very core of the 'green shoots' thesis,

but whether they portend the start of a sustainable recovery or merely evidence of stabilisation remains to be seen.

Highlights of the Second Quarter:

Geo-political:

The nuclear ambitions of North Korea and Iran have continued to cause concern and the overtures made by President Obama seem to have had little effect to date. The global economic downturn has also seen a shift to the 'right' in recent EU elections and the increasing unemployment rate amongst the under-25s remains a serious problem. The risk of creeping protectionism on a global scale remains and this could derail recovery should it take serious hold.

Global Economics:

Central Banks have continued to inject vast amounts of liquidity in the financial system. The US and UK have embraced 'quantitative easing' (QE), whereas the ECB has been more active in the SWAPs market. The recent ECB move to provide unlimited liquidity by offering 1 year funding at 1% proved to be successful with over 1,200 institutions taking up the offer.

On the inflation front, core CPI has proven to be stickier than expected, although it is on a declining trend. The risk of deflation remains in the short term but there are still concerns that inflation will rear up again in the medium to longer term, especially if a 'V' shaped recovery occurs.

Equities:

Equities continued to rally on hopes of economic recovery, although there have been signs in recent weeks that the upward move is faltering. In local terms, gains have generally ranged from 8% to 18%, although some emerging markets led the charge much higher. In China, for example, the Shanghai SE Composite rose over 24%, whilst the Hang Seng Index in Hong Kong and the BSE Sensex Index surged 35% and 49% respectively.

On the corporate front, earnings have generally held up better than many had feared, thereby supporting the spring rally. Expectations were pushed down so low that even companies reporting large declines in earnings often beat market estimates and so found buying support. Companies seem to have learned some lessons from previous downturns and have therefore been more efficient in controlling overheads. Job losses continue

to mount but many companies have tried to hold onto their skilled workers as long as possible as it is often difficult to replace them once the upturn begins. Of particular interest is the way many workers have reacted to this downturn, insofar as many have been prepared to accept pay freezes (or even cuts), or short-time working to preserve jobs.

Corporate cash raising has continued apace, with many financial institutions shoring up their balance sheets via bond, convertible or equity issuances. Other corporates have also been raising cash via 'placings' or 'rights' issues, since this is a cheaper way of raising finance than issuing debt. The pace and extent of these cash raising exercises are of some concern, as it is not known how long the markets can continue to absorb the vast amounts being requested.

Fixed Income:

First quarter risk aversion was replaced by increased investor willingness to re-discover the corporate debt market. This shift in emphasis coincided with the rally in equities, but fear over the burgeoning levels of Government debt was also a powerful factor. Consequently, yields at the 10-year end of the spectrum rose in the US from 3.2% to 3.5%, whilst in the UK the 10 year yield rose from just under 3.2% to 3.7% over the same period. In Europe, there was more stability, with the 10 year yield in Germany, for example, ending the quarter around the same level as it had begun (3.4%).

The move towards the corporate bond market allowed spreads with Governments to narrow. Demand for higher quality corporate debt remained brisk and new

issues were often heavily over-subscribed. The shift into corporate bonds began at the investment grade level, but there were also signs that the appetite for lower grade debt was beginning to increase. Spreads on distressed debt also narrowed, but still remained at high levels.

Commodities:

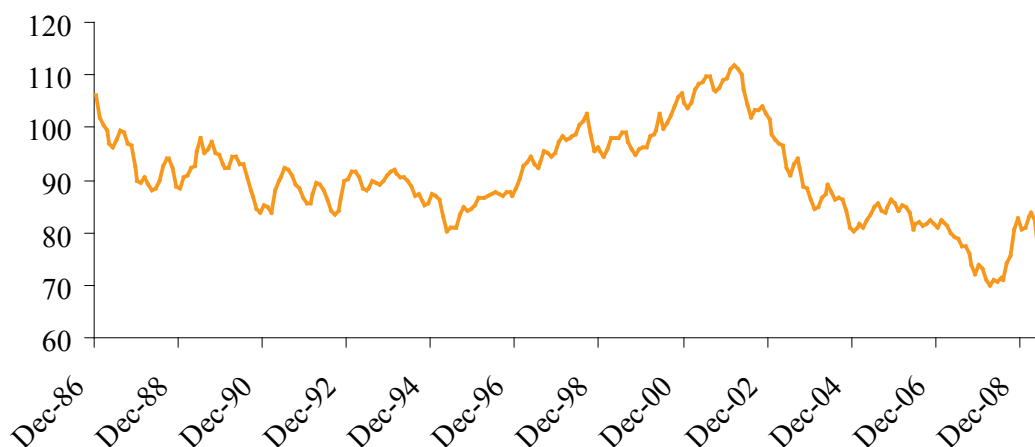
Oil commenced the period at around \$52 per barrel but soon began to move higher on hopes of improved demand, to end the quarter at around \$70 per barrel. Copper also saw some firmer demand and rose from an opening level of \$4,040 per tonne to close at just under \$5,000 per tonne, having hit a high of \$5,376 on 11 June.

Gold remained range-bound and finished the quarter around \$930 per ounce (from \$920 per ounce as at the end of March). The price was supported by a generally weakening US Dollar, but as a counterbalance, the 'flight to safety' premium was eroded somewhat by the increase in risk appetite.

Currencies:

The 'safe haven' appeal of the US Dollar began to wane, causing the currency to come under selling pressure. The trade weighted index fell from 83.83 at the end of March to just over 77 at the end of the review period. The Index still remains above the 70.7 level recorded in May 2008, but it is looking increasingly vulnerable as shown by the graph below:

US Trade Weighted Major Currency Dollar March 1973 = 100



Source: Bloomberg

Concerns over the longer term viability of the US Dollar to remain the world's reserve currency also weighed on the currency and there has been an increasing belief that interest rates at the 10-year end will have to rise still further to ensure continued support from Treasury buyers such as China. Sterling continued to make progress, not only against a generally weak Dollar, but also against the Euro during the quarter.

Outlook:

The third quarter begins with a nervous air of optimism that the worst of the global slump is now behind us. However, whether we emerge from this downturn sooner rather than later is still a matter of conjecture. Much of the hope for global recovery seems to rest on the shoulders of China, which is predicting growth of 8% for 2009. In reality, it will take more than emerging market demand alone to turn the tide convincingly and will still need to be supported by broader based consumer spending, especially in the US.

The problem remains that the de-leveraging of the consumer has still not been completed, and is likely to continue for some time to come. This will inevitably have an impact on retail spending and recent data in that regard has, at best, been mixed. Whilst unemployment remains on an upward path and house prices continue to fall, the 'feel good' factor is unlikely to emerge, leaving consumers to increase their saving rate and reduce debt.

The key therefore, is whether a 'V' shaped recovery emerges or whether it develops into a 'W' or even a 'U' shaped pattern. The current equity market pricing in of a 'V' shaped recovery is fraught with risk since there is little room for disappointment given the rises already seen.

The markets are also preoccupied with the deflation versus inflation debate. If we are to see a 'V' shaped recovery, then the danger is that the Central Banks will hold off tightening fiscal policy for too long, allowing the inflation cat-out-of-the bag. The fact that the Federal Reserve is implying rates will be on hold for some considerable time to come suggests that they are more cautious on the prospects for recovery than the market. The recent action by the ECB also suggests that they believe we are still far from returning to 'normal' market conditions. In any event, Central Banks still see the inflation threat as less dangerous than the risk of prolonged deflation and so their policies will continue to be weighted to prevent the latter.

On the positive side, whilst the credit markets and financial system may still have a long way to go before they are fully repaired, they are probably out (or soon to come out) of intensive care. However, confidence in

credit markets will only be completely restored once bank lending returns to normal.

In conclusion, whilst we believe that the current rally in equities will stall, due to the fact that they have factored in too much of a recovery too soon, they should find traction again later in the year as some of the short term froth is blown away from valuations. We believe that the slow and painful process of recovery will begin sometime in 2010 (relating perhaps most closely to a 'U' shaped pattern), suggesting that there will be a renewed interest in equities in the final few months of 2009.

On the Fixed Income side, we believe that there may be some modest retracement of yields in the shorter term as the appetite for equities diminishes, but that the bull market in Government and Government Guaranteed Bonds is finally coming to a close. On that basis, we continue to favour keeping Government maturities relatively short given their lower volatility, but we will also maintain our search for selective high quality Corporate Bonds given their attractive yield spreads.