



First Quarter Analysis

by Andrew Hunt

Global malaise continues

By any standards, the last six months have been traumatic for the global economy. The US economy has fallen into its worst recession for generations and by some standards, one might suggest that the decline has resembled a depression rather than a mere recession. In Japan, the economy has taken on a decidedly depressionary trend and even China, which many had hoped would prove immune to the global slowdown, appears to be suffering what is close to a technical recession at present. In Europe, the situation has been no better with Germany contracting at its fastest pace in the modern era, France in a more modest recession and the UK beset by both economic and financial crisis.

The cause of the global malaise has, of course, been the bursting of the global credit boom – especially in those major world economies where the private sectors had become remarkably dependent on credit for their finances and ability to spend. The last ten years were characterised by heavy borrowing, low savings and heavy (leveraged) acquisitions of assets (the yields of which were steadily declining). Now, however, the world has moved to an era of enforced higher saving, asset disposals and balance-sheet contraction – at least outside the state sectors. Indeed, it now appears that the government sectors of the world's economies are the only ones that are expanding. Unfortunately, in this new world of heavy government intervention, higher savings and a lower propensity to consume, we can expect corporate profits to undergo a major trend reversal that will likely keep the longer-term performance of equities under something of a cloud.

Positive effects of G20 interventions

In the near term, however, there is something resembling good news for the equity markets. Large tax cuts and

an increase in government spending are lifting, albeit temporarily, disposable incomes in the USA. This makes it highly likely that US consumer spending will expand, at least in cash terms, in the remainder of this year. At the same time, Japan's government is finally moving to stimulate its economy through fiscal means and this may break the descent of the world's second largest economy. In China, meanwhile, the government is presiding over a large fiscal expansion (of circa US\$50 billion) which will be directed at improving the nation's infrastructure. However, more important in the short term is likely to be the Chinese government's provision of \$500 billion in soft loans and subsidies to its producers. While these measures will do nothing to solve China's long-term uncompetitiveness and structural problems, the subsidies will at least provide the appearance of production growth in the near term - even if the majority of the resulting output will simply add to the already high level of inventories in the economy.

Given these events and the other fiscal and monetary stimuli being enacted by the G20 and others, we do expect the global environment to appear better over the next few months and this should be supportive for equity markets in the near term. Unfortunately, it is not clear that the global 'revival' will be sustained into 2010 and thus we expect the equity market rally to prove finite.

Trouble ahead in 2010

One of the casualties of the global slump has been labour productivity. However, given the current pressure on corporate cash flow and profitability, and the high level of inventories, we can expect unemployment to move higher over the coming quarters, with an obvious impact on household incomes. Consequently, when the Obama and other governments' tax cuts end in 2010, we can expect these weak income trends to cause a relapse in global demand and production. In some cases,

such as the UK, the authorities have already committed themselves to tax increases in 2010 and these will only increase the tendency towards economic weakness at this time.

Even in China, we can assume that the government's largesse will prove finite and it is highly probable that by late 2010 the production subsidies and cheap loans may be recalled, thereby forcing China's companies to cut production and to attempt to dispose of their – by then – bloated inventories. Therefore, although we foresee an improvement in the state of the global economy over the next few months, we do not expect this improvement to be continued into 2010. Instead, a substantial relapse in growth seems more likely as 2010 approaches.

Low inflation – the impact on bond markets

In this environment, we see little risk from price inflation, despite the increase in government indebtedness that will result from the recent government easing measures. We do expect that some specific sectors of the global economy may experience higher inflation in the medium term as a result of supply disruptions caused by the credit crisis – including the oil and gas sectors – but we doubt that this will become a widespread phenomenon. In some sectors, a lack of even basic 'maintenance capital expenditure' may cause disruptions to supply chains, leading to localised pockets of price inflation. In general, however, we expect the weak global trade, weak growth and high inventory situation in the global economy to keep aggregate rates of inflation either low or negative in the medium term.

This low inflation environment, coupled with the central banks' increasingly aggressive easing policies (which will include the central banks purchasing large quantities of long-term debt instruments), should provide a generally supportive backdrop for global bond markets. However, it is currently not possible to estimate accurately the eventual costs to the public sector's finances of the global credit crisis. We suspect that \$5 trillion may be too conservative an estimate and we could imagine sums very much larger than this amount. Therefore, we expect supply concerns to continue to constrain bond prices in the near term. Ultimately, we expect bond yields to drop further but in the near term their prices may prove erratic as the markets worry about the quantity of new supply that may be forthcoming from the governments.

In the corporate bond universe, we expect similarly challenging conditions. In the global credit crisis, many companies will suffer – or come close to – bankruptcy. In addition, a significant number of (leveraged) investors in the corporate bond markets may also suffer difficulties and be forced to liquidate their positions, to the detriment of specific bond prices. However, what is also clear is that there are many opportunities to acquire 'cheap assets' in the corporate bond markets and if one can avoid the pitfalls, positive returns in the long term should be possible.

Summary

Overall, the new global environment is a challenging one. While conditions may appear to improve over the next few months, we fear a global relapse in 2010 as rising unemployment and rising savings rates combine with smaller government fiscal injections – or outright fiscal tightening efforts – to cause renewed falls in demand in the global economy. We would therefore participate cautiously in the current equity market rally and be prepared to re-enter fixed-income markets as the global economy loses momentum once again.

About Andrew Hunt

Sparinvest works with independent economist, Andrew Hunt, of Hunt Economics. In his Economic Review, he gives a precise and unreserved analysis of world economic developments. As we at Sparinvest do not claim to be able to predict economic trends, we pass on Andrew's Economic Review to illustrate the degree of uncertainty about the economic future, which also serves to emphasise the importance of maintaining thoroughly diversified portfolios.

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