

## Viewpoint

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**Viewpoint is our regular research bulletin for private investors. This review of topical investment issues is written by our chief economist, Peter Bickley.**

### Bear market rally or bear market over?

During the long bull market (happy days, remember them?) all you really needed to do was avoid the temptation to panic out during the many periodic setbacks; until, of course, the day came for a 'periodic setback' to mature into the start of this nasty and oh so unkind bear market. It's the same, only upside down, during bear markets too; every time stock markets rally there's a dilemma: is this one just another short term trading opportunity and pitfall for the unwary or is it the start of something bigger?

Since the dog days of early March, when Viewpoint number 95 was doing its best to keep cheerful, stock markets have been in a better mood. Across the asset class divide, bond markets have weakened. Commodity prices have picked up and Oil has trended back above \$50. Gold, the world's favourite 'safe haven' play, seems to have parted company with its perch. Arriving here from Mars and seeing all this you would be convinced that confident recovery is in the air.

Out there in the real economy, though, it's grim. What we sensed at the time is confirmed in the data – during the final quarter of last year normal commercial life crunched to a halt. There was nothing slow-motion about this train crash. Not since 1974 have we seen anything quite so brutal, so life-threatening, so downright frightening – and the general run of data is hardly any more encouraging into 2009. So there is a mismatch between the apparent day to day reality and what asset markets are saying. Our Martian might wonder whether the markets have taken leave of their senses; after all that's something for which markets are renowned.

This presents a conundrum, a defining characteristic of which is an absence of simple answers. For all the blather you read and hear from those with opinions to express (including, I suppose, economists at wealth management companies) none of us knows just when stock markets will roll over from their well-established bear trend into a state in which 'buying on the dips' is no longer as financially masochistic as my efforts to punt on the Grand National. Mistrust any who claim otherwise, whether they are telling an optimistic or a pessimistic story. But bear in mind too that the extreme reluctance of strategists to be caught making strategic calls may have a lot to do with a history of false dawns on the way down.

Let's face it, the easy call is that the rally in risk assets is just that: a rally rather than the long awaited trend change. The loss of confidence that drove us down to the recent lows was triggered by an apparent vacuum at the policy-making nerve-centre, a vacuum that has subsequently been addressed. But before we are too quick to write this one off as a 'mere' rally we should pay it some respect; not only has it been impressive, it has been a real class act. Six weeks ago everything looked black and nowhere could you find the slightest motivation to go out and buy equities yet those who succumbed to the gloom missed a substantial opportunity to claw back some of last year's losses.



'Mere' rally or not, it does teach two important lessons. The first is that the days of easy money are over; even when markets do turn decidedly for the better, sustaining and rebuilding capital will need a lot of concentration and hard work. The rising tide will not lift all the boats. The second lesson is as old as the hills but warrants (constant) repetition; when no one has a shred of a good word to say for an asset you probably want to buy some.

This feels a bit limp-wristed; having asked the question up front I'm dodging a direct answer. But then I am an economist... What I can do is help the Martian understand how this mismatch between financial markets and real life on the ground can actually make sense, so perhaps taking us a little closer to an answer.

Everyone knows that stock markets are anticipatory, sensing changes in the real economy before they are at all apparent. Actually there's an element of paradox there: markets do not exist independently, they are merely reflections of the actions of many individuals, namely us. It is one of life's more challenging mysteries that collectively we can anticipate something that as individuals we cannot but this is a mystery that drops a few veils if we understand how markets react to data.

It all hangs on what you mean by 'recovery'. The natural understanding is of things getting better but for markets that's definitely not it. Think instead of things still getting worse but maybe rather slower. While the pace of decline is accelerating, a familiar condition since October, there can be no confidence. When we are in circumstances that are so unfamiliar as genuinely to warrant the liberal deployment of 'unprecedented', when policymakers are – understandably enough – making their responses on the hoof, it is reasonable that market participants will shun assets with 'risk' in their title.

But just as any epic journey starts with the prosaic routine of getting out of bed, any recovery must start by tackling that pace of decline. And that's the signal to markets that the end of the world may not, actually, be nigh. One or two more foolhardy politicians have talked of 'green shoots', to much derision. Whisper it softly but they might be right.

Here in the UK the household savings rate has improved from almost nothing to 5%, well on its way back to normality. Retail sales have not imploded, even if retail margins have. Indicators such as the Purchasing Managers' Indices have unexpectedly tickled higher, albeit still deeply in negative territory. This is a long way from making a case for betting the ranch. Unemployment will keep on rising, corporate earnings will be grizzly, the headlines alarmist. Quantitative easing has not yet had time to show it can work. The macro-economic nadir has not yet arrived; it may, though, no longer be impossibly far off.

Peering out into the fog nothing is clear, certainty does not exist out there. The building blocks for a more optimistic view do, though, exist – and that's even after taking fully into account previous attempts to come to the same conclusions. Humility is big in the mix these days.

By the time the economic news finally troughs out the bull market in stocks will be well under way. 'Less bad' nuances in the emerging data are sketchy and may not sustain – but they have the feel that at least parachutes have been deployed. I think they deserve to be taken seriously. I suggest that absent yet another lightening strike from left field the bear market hit bottom at 3512.09 on 3 March 2009. Markets will continue to struggle and it is likely to be right to continue trading rallies rather than reverting to 'buy and hold' for some time yet.

This, though, is what transitions out of bear markets usually feel like; uncertain, nervous, challenged by setbacks and generally pretty miserable. But with the worst surely behind us, that opening question is now getting too close to call. Equity bears – don't push your luck.



## Emerging Markets

I've written a lot about emerging markets over the years and I'm sure there will be more to come. This is a story that will last for decades; this is as structural as any strategy can ever be. Sadly, EMs took a pasting during 2008, nixing my argument that they ought to provide a relative safe haven as developed world markets fell (an argument that was playing out very nicely until early summer). Understandably this has rattled people's nerves somewhat; since October the EMs have been rebuilding credibility with significant out-performance. So yet again the question of strategy v tactics arises; can this out performance continue?

One place to start is with a brief post mortem; why did they fall so much last year? Essentially two reasons: first, it did become evident that some of us had overestimated the economies' ability to ride out developed world recession, partly because as the year wore on the scale of the recession started to go exponential and partly because the EMs' ability to sustain endogenous growth was a tad less than hoped. The judgement was not wrong but clearly a bit premature; they are not quite there yet. Second, global investors spent the second half of the year in a complete blue funk and there was a panicky withdrawal to home base. Paradoxically, the EMs' previously superior performance also counted against as fund managers looked for profitable sales. This sort of behaviour creates what we generally call a contrarian opportunity, one that has played out well for those who kept their nerve at the bottom.

Looked at this way, last year's reaction seems to have got completely out of hand. True, there are earnings downgrades in EMs but they are a lot less than in developed markets. Domestically (with the notable exception of many E Europeans) monetary transmission mechanisms are working a lot better than our own and monetary expansion, unhindered by any inflation issues, is effective. As a corollary, the banking systems are relatively robust and are indeed likely to expand rather than contract. So the cyclical drivers all look favourable for EMs versus developed markets.

Meanwhile the fundamental or more structural drivers remain in place. Many EMs offer exposure to commodities of either the hard or soft variety and there is no give in our strategically positive thinking on these asset classes. But much more important is the absolutely basic point that investors in risk assets ought naturally to go where the growth is and that – for us sitting here in the UK – is certainly not at home. Indeed the performance disparity between the economies of the dynamic emerging countries and the tired old West is set to get even wider, significantly so.

So there's a pretty uncompromising message here. Much of last year was torrid for enthusiasts for the developing world which means much of last year was torrid for me too, given my pernicious habit of following my own advice. Put it behind you; the underlying logic that drove the investment in the first place has not gone away even if it did suffer some stress last summer. If anything the logic now is even stronger.

On the Global Investment Committee we have the benefit of input from highly qualified experts on all asset classes. For the emerging markets that expertise is located in Frankfurt. Happily the country-specific thinking from my friend and colleague over there is a perfect fit to the old Tilney Strategy Group output. She strongly favours China, Taiwan and South Korea within a generally positive view on emerging Asia. Within Latin America, Brazil and Mexico are preferred. Eastern Europe has really got it wrong in spades and is generally to be avoided; Russia is performing well but is too lawless and risky for our taste. As for India the positive long view is tempered by significant near term concern over the triumph of politics over economics and we are therefore somewhat wary. Otherwise, business as usual.



## Japan

Just when you might be feeling it's safe to venture out again (I hope you are, because I think it is) here's the next spanner heading quietly towards the gears, Japan. Japan is looking really scary. If Japan were a normal company, you would be asking whether it should continue trading. Japan is in a 'debt trap'; let me explain.

Government debt stands at near 200% of GDP. Japanese interest rates are very low, 10 year Government debt yields 1.4%, so maybe this isn't too much of a problem. But even at 1.4%, debt of double the size of the economy costs 2.8% of GDP to service. Put another way, 2.8% of nominal GDP growth is needed just to stop the debt getting bigger (through compounding). Unfortunately Japan does not grow at anything remotely resembling 2.8% nominal and nor will it on any sensible forecast. So debt service costs already substantially exceed economic growth and that's even before taking into account the high – and rising – current budget deficit. Even worse, a beleaguered Government has proudly announced a fiscal stimulus package costing a further 3% of GDP. I may sometimes be mildly critical of UK fiscal management over the past 10 years but Japan is in a different league.

Meanwhile the economy isn't just failing to grow fast enough, it's not growing at all. In 2009 it may shrink by a massive 10%. So think about the debt/GDP ratio; with the numerator rising fast and the denominator collapsing, the ratio goes exponential. We could be looking at 250% on a two to three year view – and rising. This is not sustainable and may be already past the point at which it could be averted. So what happens?

At some point the deficit becomes impossible to fund; there will be no buyers for Japanese Government Bonds. Already Japanese households are drawing down on their savings to finance retirement; this is one of the world's fastest ageing societies. When bond investors walk away this will be the clearest indicator that the Japanese Government finances are about to implode.

Guessing how this will play out is tricky but the customary responses are hyperinflation and a trashed currency. Whilst this is a Japanese problem only, Japan is (for now) the world's second largest economy. It is hard to imagine that the global economy and its financial markets would simply shrug this off.

For Japan to go pop is such an extreme scenario that predicting it may seem absurd. There are policy actions that could avert or at least mitigate the event or its fallout but these are conspicuous only by their absence. None of this seems even to be being thought about. The logic is simple but scarily robust; once we stop agonising over the banks this is where we should focus.



### Peter Bickley

Peter has been in the investment business since 1970. Initially working in private client stock broking he spent 12 years running a large private sector pension fund before joining Tilney in the pension fund team in 1991. In 1993 he became Head of Research. He is now our Chief Economist and is also a member of the Deutsche Bank Private Wealth Management Global Investment Committee, responsible for the direction of Deutsche Bank's dynamic multi asset-class investment process. Peter is a popular writer in the media and is noted for being probably the only UK Investment Strategist to run an alpaca farm in his spare time.

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