Smith & Williamson Investment Management

outlook

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World

Crisis management

In Europe, the ratcheting of contagion risks to Spain and Italy moved the eurozone debt crisis to a new dimension. The realization that the existing bail-out funds were too small to meet the funding demands of these substantial economies, combined with concerns that the implied losses for the global banking system would result in a seizure of the global interbank system, placed the eurozone leadership under enormous pressure to deliver a coherent rescue plan. After much prevarication, the European leaders convened an emergency summit that produced a package that did just enough to allay concerns over a rapid and disorderly default, but which didn't do quite enough to convince the markets that the structural eurozone fault lines were being addressed. Consequently, if the peripheral economies continue to contract (which is highly likely) we will once again see markets test the resolve of the eurozone leaders.

Meanwhile, the ongoing negotiations and brinkmanship between the Obama administration and the Republicans over the extension of the debt ceiling and deficit reduction programme will in all probability be resolved at the last minute. However, the process has injected another tier of uncertainty on an economy that is struggling to gain momentum. The hope over the coming weeks is that once US debt default fears dissipate and the manufacturing sector supply chain disruption unwinds, the US economy starts to reaccelerate.

Considering the systemic risks being encountered by the equity markets, their resilience has been admirable. Global equities have remained range bound for most of the year and have been supported by strong corporate cash flow that has delivered dividend growth, stock buy backs and M&A activity.

US

Budget brinkmanship

In the US, media and market attention has been resolutely focused on the progress of the negotiations between the Obama administration and the Republicans regarding an extension of the debt ceiling and imposition of budget cuts. Failure to produce an extension of the debt ceiling would see the US default on its bonds and endanger its AAA rating. This would have enormous ramifications and is such an undesirable outcome that the bond market is assuming that despite last minute brinkmanship a settlement before the August 2 deadline is inevitable. There is also an indication that the deficit reduction negotiations are making progress. The target is to reduce the deficit by between $3.7tn-$4tn over a 10 year period. This would entail reform to the Medicare, Medicaid and Social Security schemes and changes to the taxation regime. If this were to come to fruition the US will be embarking on a fiscal austerity programme similar to that of the UK.

A second successive weak payroll data series has once again raised concerns over the health of the economy. There is an active debate as to whether the US is suffering from a temporary dip as a consequence of the supply chain disruptions caused by the Japanese tsunami or a more sustained slowdown. The former assumes that once manufacturing capacity starts to ramp up later in the year the US should be able to resume a c 3% growth trajectory. The latter view assumes that corporations are seeking to boost their productivity by reining in payroll expansion. The Federal Reserve has acknowledged that after two doses of quantitative easing recent economic data has been disappointing. Should unemployment move back towards 9.5% (currently 9.2%) the Federal Reserve is likely to consider another dose of monetary stimulus.

UK

A gradual shift towards Nominal GDP targeting

The 0.2% initial estimate of second quarter GDP growth confirms the view that the UK economy is struggling. Over the past 3 quarters GDP has hardly moved and is perilously close to double dipping. The combination of negative real disposable income, fiscal austerity, deleveraging and relatively high unemployment is creating a shortfall in aggregate demand. The additional uncertainty generated by the eurozone crisis has seen regulators tighten bank reserving requirements which inhibit lending.

The recent minutes of the MPC indicate growing confidence in their forecast that once the utility price hikes impact CPI later this year inflation is likely to fall back sharply next year. Expectations for interest rate increases have been pushed out to the middle of 2012. In fact if the MPC forecasts are correct then disinflation not inflation will be recurring theme by mid 2012 inferring rate hikes might occur even later. Faced with the scenario of moribund demand and disinflation the MPC are likely to come under increasing pressure to inject further stimulus into the economy via another dose of quantitative easing. Vince Cable the Business Secretary has openly requested such a move. We may be witnessing a subtle but significant shift in the remit of the MPC from narrow inflation targeting to Nominal GDP targeting.

The equity market has displayed resilience to the variety of macro concerns. However, it remains confined to the 5700 – 6100 range established since last December. The catalyst to break out of this range will either come from signals of more quantitative easing or a pick up in corporate earnings revisions.

Europe

Taken to the brink

The last few weeks have seen concern over the scale and scope of the eurozone debt crisis escalate significantly. After a brief respite reflecting relief that the Greek parliament had voted to accept a new round of austerity measures the focus rapidly turned to Italy and Spain. Bond yields in both countries soared in a matter of days. This reflected concerns that the combination of weak nominal GDP growth, a lack of credibility regarding their austerity programmes and rising bond yields would suck them into a solvency vortex. An additional concern was that the complex interdependence of the global banking system to peripheral sovereign debt raised the spectre of another 'Lehman' style banking crisis. All of this took its toll on bank stocks which fell precipitously.

As the crisis unfolded the leadership structure in Europe has once again proven to be wanting. The apparent lack of willingness to confront the systemic risks raised serious questions over the sustainability of the euro itself. With markets staring into an abyss the EU leaders eventually convened an emergency summit to outline a rescue plan. The plan announced a restructuring of Greek debt that reduces the Debt to GDP ratio from 170% to 130%, imposes a 21% haircut on private sector creditors and extends debt maturity from 6 to 11 years. However, the plan notably excluded Ireland and Portugal from any debt restructuring and also missed the opportunity to mention the establishment of a Eurozone bond and gradual transition to a fiscal union. Consequently, although the plan has done enough to allay immediate concerns and buy some time, the failure to address the core structural flaws leaves the eurozone vulnerable to another pulse of pressure from the markets.

Asia

China

China continues to confront rising inflation and property prices by raising bank reserve ratios and increasing lending rates. While most of the rise in inflation is due to surging food prices, the authorities are anxious to rein in loan growth in order to curb speculative property building. M2 money supply growth has fallen from 19.7% in December to 15.9% in June. The lagged correlation between money supply and CPI inflation indicates that Chinese inflation could start to decline in a couple of months. This does not preclude further interest rate hikes but it does suggest that Chinese tightening has almost run its course. We think China will deliver between 8.5-9% GDP growth this year.

Japan

The triple whammy of an earthquake, tsunami and nuclear reactor melt down came as a heavy blow for an economy that was showing tentative signs of recovery. It now looks as though GDP will contract 1-3% in 2011. For 2012 the rebuilding stimulus should then produce between 2-3% growth. Initial concerns that supply-chain disruption would be significant now look overdone. After the G7 initiated a concerted intervention the yen weakened by 8%. However it has subsequently started to rally – possibly reflecting a repatriation of capital.

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