AEGON Befektetési Alapkezelő

Monthly Outlook - May

Péter Kadocsa: The financial crisis has come to an end…

The last few weeks have seen an increasing number of reports and opinions variously published and aired stating that the "crisis" has come to an end - that we can already see the light at the end of the tunnel. Although it might well be too early for such proclamations, it does seem likely that the period of the financial crisis that saw banks and countries threatened with bankcruptcy is indeed nearing the end. At the peak (or should we say low-point?) of the wave of credit expansion that swept the entire developed world over the past decades, two years ago the financial crisis arrived, leading, in the recent period, to capital-market panic and to a deepening economic downturn, and to all the attendant effects evident to every one of us. During the course of last year, the financial crisis, widely dubbed the “subprime crisis”, worsened into a credit crisis as a result of enormous bank write-downs which weighed heavily on the economy in the form of a reluctance of the banks to lend to each other, an increase in the costs of funding, and a narrowing of the credit market.

The last six to eight weeks have seen a favourable turn in the equity markets, causing some relief for the holders of risky assets: by mid-May the majority of the international stock indexes had made up the losses of the first quarter. Could this be the start of a sustained recovery? Are we in the early stage of a bull market, or is it just a “bear-market rally” – a temporary correction in an otherwise falling market?

The world’s governments and central banks are making concerted and strenuous efforts to resolve the crisis and to mitigate its negative consequences. The world’s largest economies are trying at the price of huge budgetary deficits to breathe life back into the economy. Besides tax breaks and demand-stimulus packages, the world’s largest central banks have tried to reduce “the cost of money” through unprecendented monetary easing. Next to the almost zero interest rates of the American Fed, the Japanese BOJ, the Swiss SNB or the Bank of England, the ECB’s 1% base rate appears positively high. The commitment of the central banks is clearly reflected in the fact that besides rate-cutting, they have been resorting to less usual instruments – namely, by inflating the central banks’ balance sheets they have been busy pumping additional liquidity into the financial system. And it seems to be working. The market is starting to believe that the economic recession can be stopped through the "pressure of money".

That the financial crisis is petering out is suggested by the apparent normalisation of the interbank market: the interest on 3-month interbank USD loans is at a 5-year low, but more important still is that the difference between this interbank rate and the interest rate stripped of counterparty risk with respect to the same maturity has dropped back to below the levels seen before the Lehman collapse. This is clearly indicative of the stabilization of the US banking system, which over the long term will have a positive effect on the real economy. As the high-point of this stabilisation process, following the better-than-expected first-quarter results of the US banks, the Fed published the results of its “stress test” aimed at assessing the state of the American banking system. Despite the fact that at first glance the shock parameters do not appear extreme (which could perhaps be justified in the case of a stress test), according to the findings of the report nearly half of the 19 banks examined are in need of additional capital.

There is, of course, another side to this coin, which in the last few weeks has, typically, come to be at the focus of attention. According to this the risks have been thoroughly assessed, they are of manageable proportions, the solution has been provided in the form of a capital injection, and if necessary the state will intervene to help. According to the US Treasury Minister, America should be able to avoid a “lost decade” of the kind suffered by Japan, as the banks’ future profits will lead the banking system out of the present situation. Of course at this point the naysayers will chime in saying that if the government had only ensured that the price of raw materials for automobile production had fallen to zero, and if it had bought a couple of million unsold cars, then today the Detroit car manufacturers would also be profitable. But let’s not be cynical – after all, a stable and viable banking system that can once again supply the economy with loans is an essential prerequisite for any turnaround in the real economy.

Positive (or less negative) news has also arrived with regard to the real economy, though from a European perspective at least, it is difficult to speak of a recovery yet. Certainly, in the BRIC countries, and especially in China, we can see the beginnings of a recovery driven by internal demand, but this will require further attention to ensure its sustainability – and besides, this recovery has to a large extent been priced in over the last few months. The often one-sided interpretation of mixed macro-economic news and indicators arriving from the developed world can easily cause disappointment. The mood of investors quickly changed thanks to the reduction in risk, although a rapid "V-shaped" recovery in the midst of a protracted deflating of the credit bubble cannot realistically be expected. There’s precious little point in the central bank’s creating liquidity if it only partially trickles down to the economy, and if in a deflationary environment businesses continue to be burdened with high real interest rates. Besides this, the latest US retail data suggest that growing unemployment is being accompanied by an unprecedented fall in the net worth of households, and that despite the measures aimed at stimulating consumption, this may yet hold back consumption for a long time to come. Although the financial crisis has perhaps reached an end, the recession has remained with us. Signs of stabilisation may be apparent, but the recovery is not yet here. Thus it appears that we are currently witnessing a significant bear-market rally of the kind that often occurs on falling markets, and which is telling investors who hold risky assets that for the time being, at least, they had better be careful.

Prepared by AEGON Magyarország Befektetési Alapkezelő Zrt. (1091 Budapest, Üllői út 1.)
Péter Kadocsa – Chief Executive Officer & Chief Investment Officer
Supervisory authority: Hungarian Financial Supervisory Authority

All information contained in this document is intended for information purposes only. AEGON Magyarország Befektetési Alapkezelő Zrt. accepts no responsibility for any investment decisions made on the basis of this publication and for the consequences of such decisions, nor for any possible shortcomings or inaccuracies in the data in this document.