Monthly outlook – August

Back to the future - every silver lining has a cloud?

The recession isn't over, just (possibly) about to turn w-shaped

The various market analysis firms are publishing their opinions thick and fast, to the effect that we are now very close to the end of the global recession. Equity market analysts, often rushing to 'outbid' each other, have begun to raise their forecasts for corporate profits, which (looking at just the numbers) really is good news, as this is something that we have only been able to dream of since April 2007. The buoyant predictions are partly due to the fact that 75% of companies that have posted results so far in this flash reporting season published figures more favourable than the analysts' consensus. So it comes as no surprise most of them have raised their year-end target for the S&P 500 index to around 1050 points, from its previous value of 900. Many base their predictions of an end to the bear market on the likelihood that the macroeconomic picture could improve in the second half of the year, as companies rebuild their inventories and the real-estate market stabilises. Certainly, appetites for risk and investor confidence indices are returning to normal levels, and based on their P/E levels many of the equities markets can be regarded as inexpensive (although many others, having risen unbelievably since the beginning of the rally, are downright pricey), and due to the low inflation there is no reason to fear a tightening of monetary policy.

There is a genuine possibility that the global recession will be drawn to a close around the end of 2009. However, many are being overly optimistic and, similarly to the expectations that accompanied the change from 2008 to 2009, they believe that 2010 will be a much better year. The recovery will be far slower, lacklustre and below-trend than this, as households, companies and financial institutions find themselves in a world where the opportunities for borrowing, lending and spending are more limited than they were before. Although the current flash reporting season is very encouraging, at every single company it is worth taking a closer look at the role played in the reported results by the savings in wage costs resulting from the mass layoffs, or by trading gains, or in many cases the funds generated from the sale of superfluous divisions or subsidiaries.

According to the professor of economics Nouriel Roubini, renowned for his almost prophetic abilities, the "perfect storm" has drifted an inch closer on a radar screen already displaying a cloudy global outlook, since a permanently large budget deficit and the accumulation of state debt, coupled with the excessive money supply pressure of the US Federal Reserve (the partial financing of state debt by the central bank) will also push up the expected inflation rate. The remaining ingredients of this cocktail, the rising yields on government bonds, spiralling oil prices, the profits that remain weak despite exceeding expectations, the continuing fall in jobs and the stagnation in growth, also give cause for concern.

At the end of 2010 or beginning of 2011 such a storm could tip the global economy, just as it staggers out of the crisis, back into what is known as a double-dip recession. This is the term used to describe the phenomenon in which an economy in recession superficially shows signs of recovery before suddenly plummeting into another deep crisis. Such a turn of events could have grave consequences, not only for the US, but also for the entire global economy. It's important to bear in mind, however, that the storm is by no means inevitable; but we should be aware that if nothing is done, then the likelihood of its occurring continues to rise. This can be avoided by elaborating, very quickly, an exit strategy in order to break out of the cycle of aggressive monetary and fiscal stimulation measures, which must be implemented early enough and effectively enough to curb any further growth in the Fed's already horrendously over-inflated balance-sheet liabilities. At the same time, the measures should not be so drastic as to cool down the economy. The negative impact of the latter is obvious, but the former deserves one more line of commentary: any further growth in the liabilities is extremely dangerous, because the point could be reached when foreign investors simply shut off the taps, and stop buying US government bonds.

The above is best evidenced by the outcome of the Sino-US Strategic and Economic Dialogue, also known as the G2 summit, held in Washington in the last week of July. At this event China once again voiced its unease with regard to this year’s expected USD 1,840 billion US budget deficit, as the East-Asian nation has bought more than USD 800 billion in US government bonds, making it the USA’s largest creditor. The high budget deficit must be remedied, and if insufficient foreign investors turn up at the latest bond issues (which are being held at far higher yields than at the beginning of the year), the central bank will have to intervene once again, leading to further growth in its liabilities and another increase in the quantity of cash in circulation, which in turn will add impetus to the weakening of the dollar. China (and many other countries besides) are none too happy about all this. It’s no coincidence that increasingly vociferous demands are being made for the world, led by the IMF, to find a new anchor currency to replace the dollar. Most recently the President of the United Nations General Assembly also called for the question of what should replace the dollar as the reserve currency to be put on the agenda.

The need to become independent from the dollar is well illustrated by the June announcement that four Arab states, Bahrain, Qatar, Kuwait and Saudi Arabia, intend to introduce a common currency. It is planned that the Khaleeji will be adopted in 2013. For the time being, however, the dollar may be sick but it would be premature to bury it, although in future it’s conceivable that the role of reserve currency will be taken over by another currency or currencies.

One of the great winners in the recovery from the recession could be the raw materials market, which in 2010, on the back of rising demand, could continue to grow at a far more spectacular rate than this year. The bull commodities market that is highly likely to result could be extremely beneficial to the exchange rates of the Australian, New-Zealand and Canadian dollars, which are regarded as a form of “raw materials currency”, since more than 50% of the above countries' export revenues are generated from the sale of raw materials in the global market.

AEGON Fund Management's total return derivative funds, as a consequence of their opportunistic strategy which facilitates the rapid exploitation of market trends, could continue to capitalise effectively on tendencies in the commodities’ market, whether directly (commodity futures market) or indirectly (forward currency market, equity futures market).

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