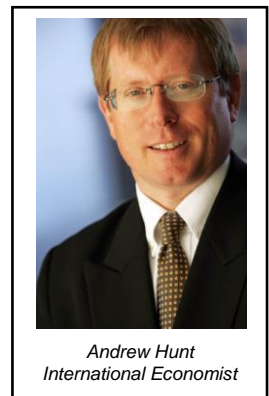


Has Everyone Got Too Positive?

As is often the case at a time during which financial markets are generally performing well, many forecasters' predictions for the global economy have been revised up to more positive views. Where problems exist such as Europe's growing fiscal crisis or the rapidly accelerating rate of inflation in much of the developed world, these seem to be being largely ignored by what have become known as the "Teflon Markets". Perhaps unsurprisingly, we take a more cynical view of the current state of the global economy and we would attribute the recent seemingly universal and all-encompassing buoyancy in the equity, commodity and many other risk markets (including fine wine, art and even classic cars) not to an improvement in the global economy per se, but rather to a renewed credit boom within the financial system itself.



Although rates of credit growth with regard to lending to the real economies in the USA, Europe, UK and Japan remain remarkably weak or even mildly negative, we find that credit growth between financial institutions is booming at the current time. In particular, we have (albeit partial) evidence that the securities repurchase markets – a highly collateralised but very short term component of the credit system that is used extensively by the investment banks and their clients - are expanding rapidly at present with exceptionally low rates of interest on offer (at times, even negative rates have been witnessed) as the commercial banks draw on the funds still being provided to them by the US Federal Reserve and some other central banks and utilise them to lend not to "real" households and companies, but rather to the investment banks and their leveraged clients. This activity has in turn released a new tide of 'market liquidity' into the financial system that has lifted all of the boats in the investment universe, including some of the seemingly unlikely ones noted above.

This situation is highly reminiscent of the scenario that occurred during the mid-2000s, at least prior to the global financial crisis and it would certainly appear to be exerting a similar impact on asset prices today, almost regardless of the state of the global economy. As we now all know to our cost, the global economy was not in an overly healthy position in 2006 and it was clearly vulnerable to the financial shock that was subsequently to envelope it. Unfortunately, we are not certain that the situation is in reality any better today: the financial markets are booming as indeed they were in 2006 but underlying economic conditions may not be as bright as commonly supposed.

In the USA, for example, although it is noticeable that employment growth and wage income growth rates have picked up, it is also true that household cash flow is coming under pressure despite the improved labour market as a result of rising consumer prices (food, fuel, rents and most significantly of all, import prices have all increased sharply of late) and an unwinding of many of the Bush



and Obama Administration's previous fiscal stimulus programmes. Consequently, the US faces an unfortunate combination of rising rates of reported inflation but weakening household incomes, a situation that could yet give rise to a period of stagflation rather than 'Goldilocks Growth' in the economy. Also of note in the USA is the recent sharp deceleration in profit growth that has been caused by rising input prices and the reduction in the budget deficit from its 2010 peak levels. Given these events, we are not as convinced that the US economic recovery is quite as 'on track' or solidly based as the optimists would have us believe and in the UK, which faces similar issues, the situation appears even more precarious. At the very least, we would expect the bond markets in these countries to soon begin to behave poorly as inflation rates accelerate and the once dominant Quantitative Easing regimes are unwound.

In China, which has long been the darling of investors, it is clear that although the authorities may be understating the true extent of the inflation problem in the economy, rising prices and the loss of international competitiveness that these imply are beginning to undermine the economy's prosperity. Although continued strong infrastructure spending by the public sector will likely underpin headline growth in the near term, rising domestic inflation rates and an ongoing slowdown in the export sector as a result of the country's declining competitiveness may ultimately be of more importance to policymakers and investors alike. Indeed, we suspect that China's policymakers will soon be obliged to step up their recent bias towards a tighter monetary and fiscal stance for the remainder of the year and this will presumably result in higher interest rates in the near term and notably slower growth in the economy next year and perhaps beyond.



Japan's economy has recently suffered a traumatic series of events but, over the medium term, we would expect the reconstruction effort to add around 2% to GDP per annum, an event that may benefit some companies within the economy. Unfortunately, we are also aware that the Japanese central bank is also at pains to point out that it believes that trend sustainable growth in Japan is only around 1% a year and therefore we expect that the Bank of Japan will err towards a tighter monetary stance and firmer currency in the near term so as to depress 'non-essential spending' in the economy so as to make 'room' for the reconstruction effort. This too could pose a threat to bond prices.

In Europe, an area in which investors seem determined to turn a collective blind eye to the region's problems, we expect continuing and worsening banking system and fiscal problems in Iberia, Ireland, Greece, and most of all, Italy, to continue to not only depress growth in these areas but also to continue to pressure the bond markets as the supply of government debt continues to increase. We would expect Euro Zone bond yields to continue to rise over the medium term, particularly now that the European Central Bank has embarked on what we believe to be a premature series of interest rate hikes. In fact, we wonder if the ECB's tightening, and the currency's reaction to that tightening, may have created intolerable levels of stress within parts of the Euro System which could, if left unchecked, create the preconditions for the Euro Project's demise. Indeed, we suspect that if the ECB does not relent and allow or encourage the external value of the EUR to decline, the future of the single currency will be in doubt despite the much-hyped existence of the European Financial Stability Fund.

In this awkward, complex and seemingly deteriorating environment, we would expect bond yields to rise significantly over the next quarter or so to the probable benefit of the USD and JPY, although not to the emerging market currencies or the EUR. However, it is also our concern that if bonds do indeed weaken in price as we expect, then the higher yields will tend to undermine not only credit growth and economic conditions further, but they will also begin implicitly to reduce the amount of collateral present in the all important securities repurchase markets. If these markets were then to stumble as a result of a lack of 'bond' collateral, just as the CDO markets did as the

value of property-related collateral declined prior to the 2007 credit debacle, then we could easily foresee a situation in which weakness in the bond markets could spread to the asset markets and financial system in general. We would therefore suggest that while at present markets remain in a decidedly 'risk on Teflon mode', if bond prices do begin to decline rapidly as stagflationary pressures mount in the global economy and the Federal Reserve nears the end of its Quantitative Easing phase, then investors should turn more cautious in favour of liquidity holdings in the USD and JPY.

Andrew Hunt
International Economist
London

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Helen McKenzie at helen_mckenzie@tyndall.co.nz or visit us at www.tyndall.co.nz
Phone: 09-377 7220 / 021-608 849

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