Monthly Letters – By Sebastian PARIS-HORVITZ
Investment Strategy

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Bet on growth and liquidity

Highlights

- Global economy is growing.
- Initiated by manufacturing, the rebound is broadening.
- Economic policy support remains critical.
- Implementation of "exit strategies", aimed at reversing extremely accommodating policy stances, is starting.
- The lack of international synchronization amongst these policies could lead to more volatility in the markets over the coming quarters.
- The return to growth and abundant liquidity, plus reasonable valuations, justify favoring exposure to risky assets.

In the economic literature, the type of crisis that we have just weathered is referred to as a "sudden stop". It means that, unlike the usual cyclical fluctuations (which entail periods of growth followed by recessions, generally short-lived), this kind of crisis is characterized by a paralysis of the economic system that could lead to a significant loss of wealth and plunge the economy into a dangerous phase of extended sub-optimal utilization of its production capacities. In a nutshell, we are confronted to the exceedingly rare possibility of falling into a state of depression. Ricardo Caballero, an economics professor at MIT, vividly compares this type of crisis to a cardiac arrest. But, while the medical procedure one follows to try and revive a patient whose heart has suddenly stopped beating is extremely strict and well defined, the procedure that will successfully resuscitate the economic body threatened with cardiac arrest is far from having achieved this level of scientific exactitude. Obviously, it would have been preferable had the arrest never happened in the first place, and had the patient avoided the excesses that lead to this kind of situation. But it happened and has to be dealt with.

The action that has been taken so far by economic policymakers in concerted fashion across the globe has paid off. We think we are hearing heartbeats consistent with a resuscitated economy.

Today, some observers are wondering about the magnitude of the public stimulus plans, and are already talking about the need to tighten the belt again as new excesses are supposedly beginning to appear and bubbles are beginning to form. Obviously, once again we would like to see the crisis end in a reasonably balanced fashion: gradual economic adjustments accompanied by smarter financing. It just so happens that both the strength and the weakness of our economic system lie in a frequent lack of moderation. However, with regard to the adjustments we are seeing—which are of historic proportions—it seems a bit premature to start talking about the dangerous rise of exuberance. In fact, although the global economy is in a rebound, it is nonetheless functioning at levels well below those seen before the crisis. Worse still, unemployment has stubbornly stayed on its upward path. Indeed, for some countries it has reached record highs. As for the prices of the so-called risky financial assets, seeing them go back up is rather reassuring. Whilst the uptick seen in these past eight months is surprising, it is also rather good news and a positive sign for the future, in the sense that it restores our faith in the long-term resilience of the economic fabric. In addition, is it really so easy to detect signs of excessive valuation? In our humble opinion, the answer is no. In a recovery scenario, and without asking for the moon in terms of growth, we don't see signs of excess in either equities or corporate bonds. On the contrary, we think that valuations are still relatively attractive right now. Naturally, in an economic relapse scenario—a hypothesis that cannot be ruled out entirely, but one that we think is relatively unlikely at present—risky assets would be the first to suffer.

Overall, and despite the Cassandras, we feel that a reasonable degree of optimism is warranted at this point. We are back on the growth track, even though it is still shaky, with many economies—and especially the developed ones—plagued by private sectors that still have not quite overcome the shock of the financial crisis or the recession. However, adjustments are being made and they look promising to us. Accordingly, despite the strong rebound in markets and the recent correction, we still think it is advisable to recommend that over-exposure to the most risky assets be maintained. Indeed, against a backdrop of a return to growth and abundant liquidity, it makes sense to think that equities and corporate bonds will continue to behave well, even if it would be unreasonable to hope for a return of the kind of rally we have seen over the past eight months.

Growth is winning

In September, whilst we saw here and there some signs of a brief halt in the economic recovery, in some countries and regions at least, the latest published surveys are indicating that the recovery dynamics are firmly in place. Whether we are talking about manufacturing or services, in a vast number of countries the most reliable indicators have reached levels that suggest the pursuit of a robust expansion over the coming months. In the United States, the manufacturing ISM leading indicator jumped to 55.7 in October, which is the highest level we have seen since November 2005. In France, the PMI survey (55.6) is the highest it has been since late 2006. The recovery dynamics are there, that's for sure, even though growth has not returned to every corner of the earth, as attested to by the recent contraction in the UK's GDP in Q3 (-0.4%qoq). Moreover, despite the rebound in activity—industrial production is up by more than 11% stateside for Q3—available capacities remain massively under-utilized in light of the brutal recession. For this reason, employment—which often lags the economic cycle—should continue to suffer in the months ahead, even though we expect to see a slowdown in the pace of job losses, at least in countries like the United States, where the adjustment has already been substantial.

The recovery dynamics are supported by a rebound in global trade (albeit a very gradual one, so far) and are contributing to restore growth in a rising number of emerging countries. China remains in first place, with GDP growth through Q3 of 8.9%yoy, although the quarterly growth rate for Q3 was much more moderate, following the explosion in Q2 (GDP growth of around 20%qoq a.r., versus 10% in Q3). As is the case in numerous countries, particularly in the advanced economies of the world, Chinese growth is also mostly being driven by support from public policy, which has taken over for the private sector and its relatively lacklustre demand.

Exit strategies start

As the good news of the return to growth gains ground, so does the debate on whether or not it is time to phase out the stimulus policies in place. In fact, the pace at which certain countries get back on the economic growth track and the nature and magnitude of the recessionary shock will determine both the rapidity and the rhythm with which the change of track should be carried out. For this reason, the economic policy shifts will not occur in synchronized fashion. Twice already, the Bank of Australia has raised its key interest rate (bringing it to 3.5%). Norway has also begun its rate hike cycle, and we are fully expecting that other central banks will take this road as well, especially in the emerging world. Within their respective regions, Brazil, South Korea and Poland should be among the first to adjust their key rates upward. Overall, their monetary policies should become less accommodating over the next six months. Conversely, for the G3 it is difficult to imagine rate hikes over this time frame. Indeed, with deflationary pressures to still present and given our growth forecasts for them—which remain fragile at this time—we don't see any of them hiking their key rates before early 2011. However, we expect to see the first measures aimed at soaking up some of the excess liquidity that has been unleashed. This will have to be done to avoid jeopardizing financial stability and possibly triggering inflationary pressure. Yet again, this process is expected to be gradual, because another cardiac arrest would be fatal. On the budgetary side, the adjustments will be even much slower. Public expenditure should continue to support growth throughout 2010, even though the amount poured in will be less than in 2009 for a number of countries.

Markets are hesitant but still buoyant

It is often said, when trying to capture the ability of Mr. Market to anticipate the economic future, that he "buys the rumour and sells the news". After risky assets staged an extraordinary rally beginning in March, it is legitimate to wonder if everything has not already been priced in. It is always impossible to answer this kind of question. Nonetheless, looking at a multitude of ways to measure the valuations of risky assets, it is hard to find a worrisome anomaly. Our calculation of the risk premium for MSCI global equities, whilst it is down from the heights reached last spring, remains high nonetheless (7.0%). The one-year P/E forecast, based on analysts' forward-earnings estimates, is hovering around 12-15 times, which is consistent with the view that the market is not extremely pricey—indeed, it suggests that valuations are relatively attractive for a rebound phase. The same can be said for credit, where implied default rates reflected in current spreads remain at levels that seem rather higher relative to our expected actual outcome. Overall, in terms of valuations we are getting a pretty reassuring message. At the same time, we feel that the key factor in favour of staying relatively more exposed to risky assets is the pursuit of the economic recovery dynamic and the persistence of very abundant liquidity. Accordingly, we read the market downturn of late October-early November as a correction that does not call into question our general diagnosis of the financial and economic environment. As a result, we maintain our recommendation to overweight risky assets. On the other hand, we also think it is the right time to recalibrate some bets. In particular, within equities, the relative value of some defensive versus cyclical stocks, and in particular utilities, leads us back to the latter.

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