- Germany: Recession over?
- Capital market: Running out of opportunities
- Equity euphoria: Remain defensive

part

partners' view

January	February	March	April	May	June	July	August	September	October	November	December
1/09	2/09	3/09	4/09	5/09	6/09	7/09	8/09	9/09	10/09	11/09	12/09

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Politics and business

US balance of trade deficit has contracted significantly, US monetary policy remains unchanged, and the recession in Germany seems to be over.

The deficit in the American trade balance declined from about $60 billion to roughly $26 billion (see graph) because of reduced energy prices (cheaper imports) and consumer frugality (reduced consumption results in reduced imports). However, this trend is unlikely to continue because further easing cannot be expected, especially as regards energy prices.

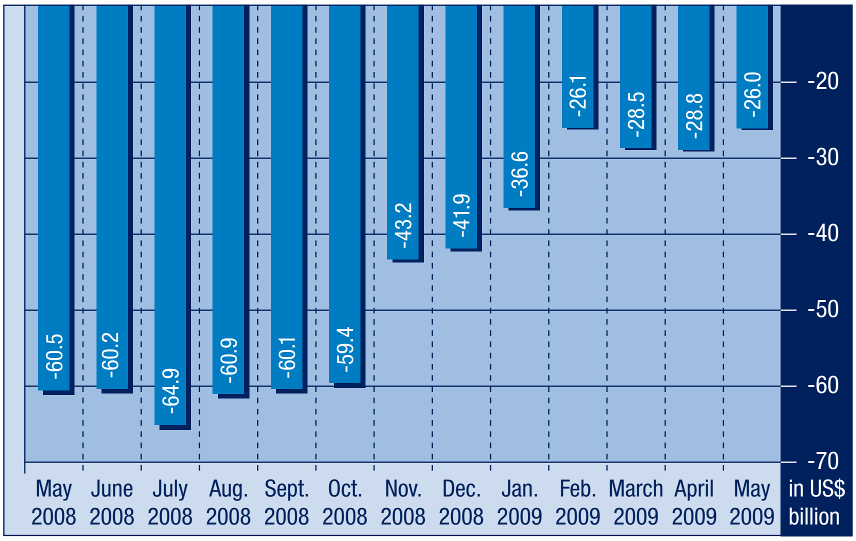
Cautious optimism

At its most recent meeting in mid-August, the Federal Open Market Committee voiced cautious optimism with respect to the growth outlook. Since inflation remains within the expected range, the low interest rate approach in monetary policy was not changed. This can also be understood as a support measure for the mortgage market and the ailing real estate market. The Committee once again emphasized that the low interest rate policy will remain unchanged for an indefinite period of time. But the day will come when the Fed's monetary policy decision may cause foreheads to perspire, because sooner or later – depending on whether the economy kicks in or inflation picks up – the American central bank will have no option but to gradually increase lending rates. It is quite certain that this scenario will materialize. In the second quarter of 2009, production growth advanced by 6.4 percent, the greatest gain in six years. We owe the postponement of interest rate hikes to the inflation situation. Last July, consumer prices declined more steeply than ever since 1950. Despite predatory discount pricing to woo consumers, retail sales did not rise as expected but instead even contracted slightly.

The recession is over

According to initial growth estimates, the recession in Germany is history. After a fat decline of 3.5 percent in the first quarter, economic growth in the second quarter of 2009 already seems to have rebounded to 0.3 percent. In June, the German industry posted a surprisingly vigorous 4.5 percent gain in new orders, and exports also surged unexpectedly by no less than 7 percent. At the same time, inflation is negative again for the first time in 22 years, at minus 0.5 percent. Politically speaking, the timing of this recovery is ideal because Bundestag elections are scheduled for September. Angela Merkel's administration thus stands a good chance of succeeding at the polls. For the financial markets, however, these latest assessments could also mean disappointment, because the bourses have already priced in the upside to a great extent. And in the wake of the terrible news from the German mechanical engineering industry, it might be justifiable to view this newfound optimism with a grain of salt.

US balance of trade



Source: Bureau of Economic Analysis

Currencies and interest rates

Virtually no upside potential left in capital market. Greater risk tolerance not recommended.

Even though much has been said about the volatility of the dollar, the greenback has remained fairly stable versus the euro. Since the end of May, the American currency has traded with a narrow range (see graph). The periods of significant volatility (October 2008, December 2008, and March 2009) seem to be over.

Hardly any alternatives

While the CFOs of capital-seeking companies were quite generous just a few months ago when they pegged the coupons of new issues (partners' view 5/09), they are now testing the limits of the capital markets. On the one hand, the names of borrowers are becoming more and more exotic (even Ford, most recently), and on the other, coupons are dwindling and maturities expanding. Bonds that have already been issued are riding the trend and are also becoming more expensive which means that yields are declining. For example, Holcim's 9-percent euro-denominated issue, floated at 100 percent in March 2009, is currently trading at 118.75 percent with a yield of merely 4.4 percent, not even half of what Holcim was prepared to pay on the issue date. This is a crass misjudgment, because extrapolated across the five-year maturity, the cement manufacturer is overpaying debt service by some CHF 175 million.
Even though the money market is not really an alternative to fixed-income papers, the bond market now seems to be clearly overpriced. Profit-taking in this domain is advisable. In particular, investors should review their bond portfolio allocations and reduce the overweighted financial borrowers.

US dollar / euro

Desperately seeking ideas

Where should surplus liquidity go? Usually, shifting assets means increasing risk. But neither a downgraded credit rating nor a prolongation of maturities is advisable. Additionally, an increase of exposure in equities is not recommendable from the point of view of a lack of alternatives or excessive cash positions: stocks will not become more appealing to investors just because they have ample liquidity. Forex bonds are one investment option, but only with appropriate risk tolerance and existing foreign-exchange allocations.
As a rule of thumb, investors should hold about 70 percent of their assets in their reference (domestic) currency. Those who have already exhausted their foreign-currency quota and also have some exposure in precious metals (gold, silver), currently have no genuine options but to hold cash. Alternatively, they can benefit from rising interest rates with floaters (automatic interest-rate adjustments twice a year) without incurring a price risk. In view of the most recent gains, greater emphasis should be placed on capital preservation again.

Financial markets

Euphoria is rampant, risk tolerance is rising. In this respect, it is not surprising that the equity market continued to move up.

The massive decline of the VIX volatility index (see graph) once again suggests that investors have become more risk-tolerant. It is metric for the American equity markets which indicates how nervous investors are and tells us that for the moment, we are in quiet waters.

The rally fuels the rally

This maxim sums up the current situation on the international equity markets. The fact that rising prices attract new buyers, which in turn leads to further uptrends in prices, is a well-known stock market phenomenon. In this context, psychological factors play an eminent role. Investors are generally irritated when they miss a rally and their anger grows the more stock prices rise. Fundamental analyses are ignored because many investors believe that the markets are right. But this would assume that the economy will quickly recover, that inflation is not a topic for the time being, bank balance sheets are sound, and the swine flu more likely an advertising blitz on the part of the pharmaceutical industry than a genuine threat. These are quite a few traffic lights that have to be set to green to justify a continued stock market uptrend.
Now that the rally in emerging markets has progressed vigorously for quite a while, the time might have come for a breather. Investors who have not yet bought into this dynamic market would be best advised to wait for a consolidation phase.

VIX volatility index

Source: Bloomberg

Staying defensive

The price rebound has resulted in "natural" growth of the equity quota. Investors who do not want to be too aggressively exposed in the event of a possible setback should focus new commitments mainly on defensive sectors (pharma, med-tech). The fact that even the defensive nature of Nestlé does not rule out price slumps was duly noted by investors when the company presented its quarterly figures. Conversely, the executives at Roche and Novartis beamed when they published their semi-annual reports. Both stocks are worth buying.

Last but not least

"Nothing is so urgent that it cannot become more urgent with procrastination."
Unknown author

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