



# FIRSTRAND

Private Wealth Management

International Investment Centre

## Global Markets Monthly Update

May '09

### Global Outlook

As the market recovery continues, the question to ask now is, is this a bear market squeeze or something more substantial...

A bear market squeeze is a market rally that is usually triggered when cash holdings are high, yields are low and risk appetites bottom out. The attractive equity valuations then become compelling to the investor and money flows back into riskier higher yielding assets. When pessimism reaches its zenith (or nadir depending on your point of view) then a return to optimism is the natural progression. However, a bear squeeze is often a short-term rally as that is eventually undermined by continuing poor economic fundamentals. The position will become clearer after the upcoming season of economic performance indicator releases.

Looking back at markets' performance in April, the best-performing asset classes were also among the riskiest, with equities and high-yield credit recording double-digit returns. This has to be seen in the context of markets reducing the 'tail risk' they assign to calamitous outcomes in light of somewhat less gloomy macro news. But given the ongoing recession, it would be wise to employ a degree of restraint toward taking on too much risk at present.

However, regardless of the fundamentals (so it seems), the rally is now in its seventh week. So who is buying and what are they buying?

The marginal investor or the investor that has the biggest impact on any day appears to be the mutual fund manager, required to buy only equities and not to sell short. As Hedge funds have fallen massively out of favour and suffered

huge subsequent outflows, it appears with yields at all time lows, much of this capital has flowed directly to the Mutual fund manager. This perhaps says more about the poor health of the Hedge fund sector than it does about the current appeal of more traditional long-only funds.

And what are they buying? Well, it appears that they are betting on whatever did worst during the sell-off, financials and other cyclical stocks. The impressive rally in financials was sparked by news that Citigroup and Bank of America reported profits in January and February, followed by the huge (relatively speaking) profit reported by Goldman Sachs. As other banks followed suit financial stocks, which had been heavily sold, led the rebound.

The question remains, have the massive economic stimulus packages (including the various controversial 'Quantitative Easing' programmes) begun to bear fruit and generated a turning point in equity markets? Or will this be a 'W' shaped recovery with the current bear squeeze finally capitulating to the seemingly overwhelming raft of poor economic data that the markets are bracing themselves for?

Economic doom and gloom has been well publicised for many, many months now and the trend does not appear to be changing. Jobless numbers continue to rise, the threat of deflation lurks just below the surface and consumption continues to stagnate at the foot of the cliff that it fell off. So it isn't the amount of bad news that is the issue, it is how it is now being interpreted. There are always optimists and pessimists opining over the economic outlook, but recent news stories have produced some interesting and quite diverse interpretations. Take Japan as example. Recently reporting that it has now begun to run a trade deficit for the first time in nearly 30 years with February and March export figures half what they were in 2008, that's bad news. Yet others point to the decelerating drop in sales to China and the US, indicating the bottom is near, and that's good news! In fact many rates of economic decline are slowing across the board from consumption to asset values (eg house prices). Giving good cause for at least reduced pessimism.

## **Investment Implications**

### **Equity**

Having survived the reporting season and more recently and perhaps more impressively shrugging off the Swine Flu outbreak, the rally continues to gain credibility and an increasingly solid foothold. Investors will now be looking for consolidation of the past seven week's performance.

The next few weeks will determine whether the 30% rally in global equities from 9 March can be sustained. The next round of economic data will present a serious test. We remain wary until further proof of progress in the economic and business profits cycles can be provided. Our view remains cautiously optimistic, with some further increasing of risk.

## **Fixed Income**

As with equities there is a tipping point approaching. Where a continued rapid recovery was to hold, then this would suggest increased competition for funds which would put upward pressure on yields meaning prices fall. However, should this be a short-term recovery in a longer-term recession then bonds are likely to outperform equities as short-term rates are inadequate to meet target returns, until inflation pick ups. We will look to take equity like returns from good quality corporate issues whilst reducing the lower yielding government paper.

## **Property**

House prices in the US continue to fall. This is one green shoot that has stubbornly refused to grow. However, with credit markets increasingly opening up and lending standards softening, buyers may rapidly return. It may not be long before the trough is hit and prices start to rise. We remain underweight but consider the bottom may be near.

## **Alternative Strategies**

Whilst de-leveraging continues and bank losses mount Hedge Funds with exposure to low liquid assets will continue to struggle. Massive outflows in 2008 have slowed considerably and the best managers are reporting significant interest. Returns will be found with those managers that maintain a highly liquid portfolio and are flexible enough to roll with the market punches. We are maintaining a neutral weighting.

## **Currencies**

The US led the world into recession and is likely to be the first to lead out of it with some further period of deflation in the Euro zone likely to persist for some months longer. This possibly gives the US Dollar a better longer term outlook. However, with so many doubts about the US Dollar strength, (ie massive Chinese holdings can easily dictate the US Dollar exchange rate) investors are holding shorter maturities in USD bonds vis-à-vis EURO, suggesting that any return to a secular decline can be gotten out of quickly. We are still broadly neutral with a slight bias towards the US Dollar.

## **Conclusion**

**The world has looked a better place to be of late. The signs of optimism continue apace and in places real confidence is returning. The lag effect of some key indicators will likely show continued contraction and deflation for some time to come. But with a 30% rally under its belt the equity markets are looking far steadier. The 'R' word now might not be 'recession'... and might start looking more appropriate as 'recovery'.**

**Paul Clifford**

8<sup>th</sup> May 2009