GLOBAL SPECULATIONS

Unsettled start

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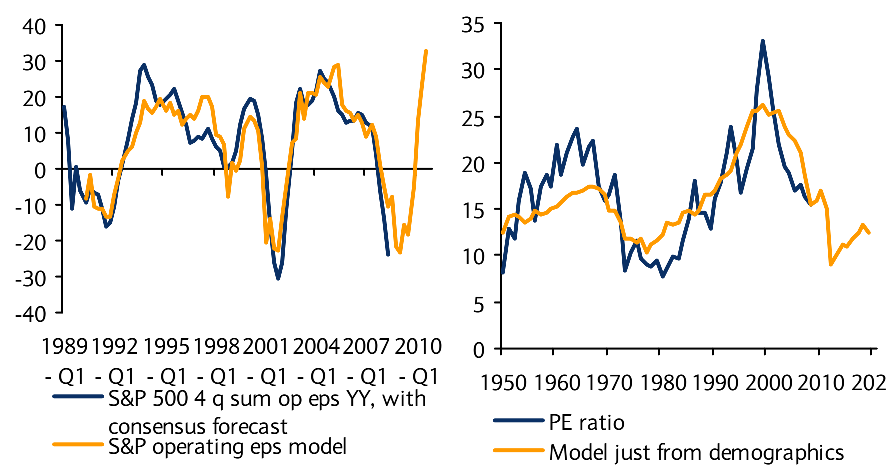
Markets have had an unsettled start to the year, buffeted by a variety of risks. We offer some views on the three main risk themes, relating to China, fiscal concerns and bank regulation. We note that the overall background liquidity and growth environment is still very constructive. We conclude that some rotation away from China-related assets is sensible in the light of their relative valuation and the gradual shift in Chinese policy. However, the balance of risks, in our view, does not merit a more aggressive re-allocation of exposures. The global economy continues to recover and the developed world remains a long way from policy tightening. With private sector de-leveraging continuing apace, a sustained rise in financial asset risk premia is unlikely until much later in the year.

It has certainly been an interesting start to the year. Markets have been forced to grapple with the implications of a number of disparate themes that have unexpectedly pushed their way to the forefront of the newsflow. Investors have been shelled with fresh information at a time when their protective armour, in the shape of the risk premia embedded in asset valuations, has grown rather thin. Unsurprisingly, the net result is a somewhat messy correction to preceding trends. The overall situation probably requires some re-examination of underlying strategies.

The first point to be made is a reiteration of our comments on valuation in December's Global Outlook. By the end of last year, most asset classes were trading close to fair value. To quantify this point for equity markets, our modelling assigns a current fair value PE ratio for the S&P 500 at 15.5. With consensus earnings growth estimates now almost in line with the output of our top down models, this analysis suggests that fair value for the S&P 500 is in the 1180-1190 region. This level is just 6.3% above today's price and just 3% above the 1150 high prints for the index so far this year.

Figure 1) US profit growth and fair value models

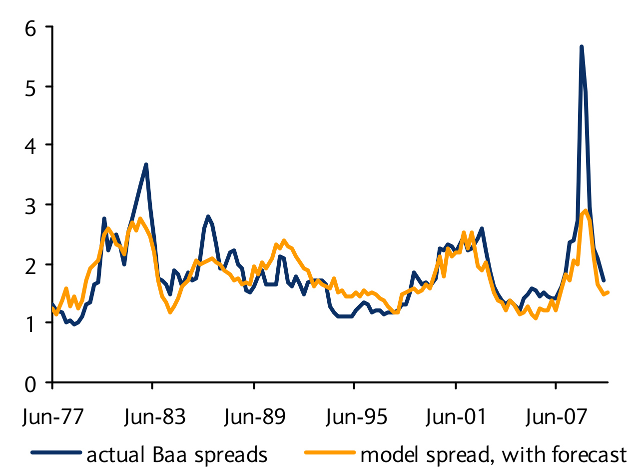


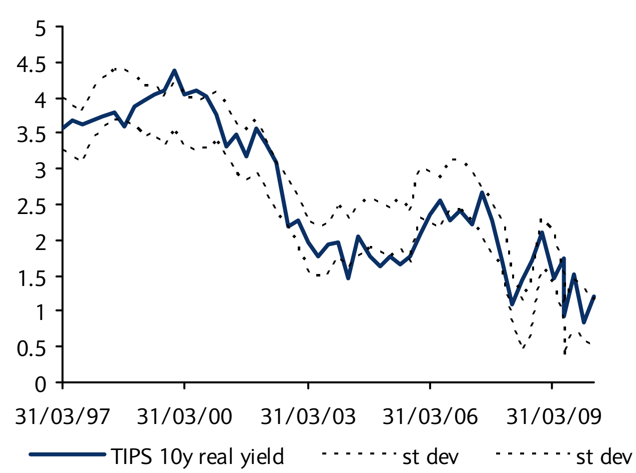
Source: Barclays Capital

However, so long as the exceptionally benign liquidity conditions of ultra low short-term rates and extensive private sector de-leveraging remain in place, history suggests that equity valuations are biased towards exceeding fair value. The 5 point expansion in World ex-US forward multiples during 1993 is a case in point. Thus for the first half of this year, there are certainly grounds for believing that markets can temporarily stray into overvalued territory. Conversely, the historical record is pretty unequivocal that once a tightening in liquidity starts to take place, equity markets' de-rate and valuations decline. This is because investors demand an extra cushion of risk premia to counterbalance the possibility that the tightening programme is overdone and results in an excessive hit to corporate profits. Thus the most plausible picture for equity markets this year was a small move up to fair value, followed by a liquidity-fuelled push above fair value, periodically interrupted by outbreaks of nerves about potential liquidity tightening. Ultimately, our central view is that any rally would eventually give way to a de-rating phase later in the year once the main central banks indicate that they are preparing to tighten policy.

As far as the fixed income asset class is concerned, our view continues to be grounded on the belief that the current background environment of low short-term rates and private sector de-leveraging is compatible with a phase of very low real yields and contracting credit spreads. Once monetary policy begins to be tightened, real yields can be expected to recover, a trend that would be reinforced once private sectors return to the position of net borrowers. Similarly, a recovery in the business sector's net borrowing requirement would herald the end of the credit spread tightening trend, ushering in a phase of tight but stable spreads. So far, real yields have conformed to the expectation of our modelling, with 10-year US real yields trading in a 1-1.4% range since the start of November. The range has been clearly defined by fluctuations in US data, the phase of positive data surprises pushing tightening expectations and real yields higher in December, before receding on the less upbeat data flow in January. As far as the de-leveraging trend is concerned, total business loans, visible in the weekly data for US banks' asset and liabilities, continue to decline at a relatively steady annualised pace of minus 18%. Credit spreads have also continued to contract, in line with our model output. Talk of a renewed bubble in the credit markets is misplaced, in our view, our models suggesting that the de-leveraging of corporate balance sheets justifies spreads tightening further from today's levels. The real yield and investment grade spread models are displayed below.

Figure 2) US investment grade spread model, TIPS 10-year real yield model

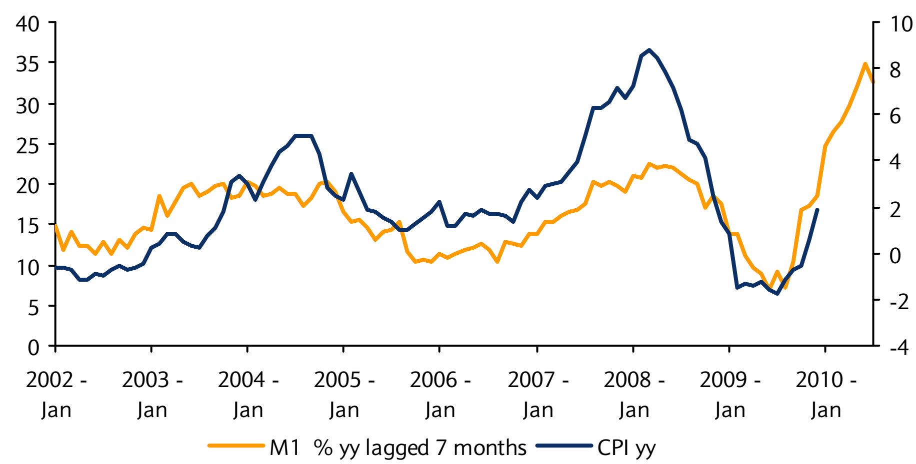




Source: Haver, Barclays Capital

Clearly, the risks surrounding this analysis lie in the direction of a tightening in liquidity conditions that would push interest rates higher across the curve. As we discussed in the last *Global Outlook: Beyond the recovery trade,* December 2009, such developments might be precipitated by unexpectedly faster economic growth, an inflation scare or a fiscal scare. Interestingly, elements of all three of these concerns are visible at present. However, somewhat confusingly, they are occurring in China and Europe, rather than the US. The latest spate of Chinese data showed an economy growing very strongly at the end of last year (real GDP 10.7% y/y) with inflation rising at a stronger-than-expected 1.9% (consensus 1.4%). As our China economics team discuss in their latest analysis *Continued strength in economic growth with increasing inflation risks,* 21 January 2010) the recent news from China offers some limited upside risks to our growth and inflation expectations for 2010 (9.6% and 3%, respectively). Perhaps more to the point, the dramatic surge in Chinese bank lending at the start of this year threatened a further sharp acceleration in growth and inflation. Reportedly, over CNY1trn in fresh loans were extended in the first two weeks of the year, almost 15% of the full year's target of CNY7.5trn. The implications of this development are highlighted in Figure 3, which illustrates the tight leading correlation between M1 growth and Chinese CPI.

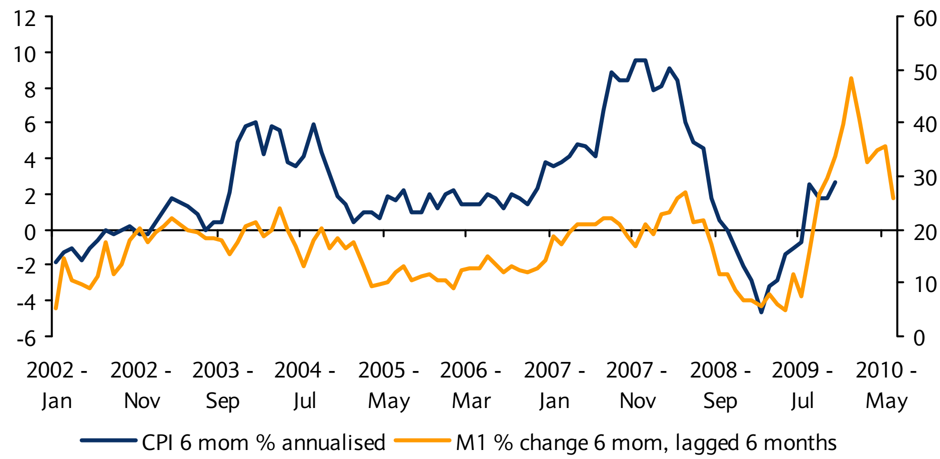
Figure 3) Chinese M1 growth % y/y, lagged 7 months, CPI % y/y



Source: Haver

The credit restrictions, increases in reserve requirements and slight increases in t-bill rates are therefore all understandable policy reactions to the renewed surge in bank lending. However, it is important to understand the objective behind these measures. The Chinese authorities are attempting to prevent a further acceleration in credit-fuelled growth that would threaten a severe and more prolonged rise in consumer and asset price inflation. Broadly, the objective might be categorised as stopping the economy accelerating above trend. This is a very different ambition to slowing the economy below trend. The picture is elucidated if we look at shorter-term measures of money supply and credit growth. Figure 4 shows the six-month annualised rates of change in M1 and CPI. As you should be able to see, somewhat slower credit growth in the second half of last year suggested that any inflation spike would tend to be temporary, with inflation decelerating in the early summer of this year. So the surge in bank lending at the start of this year, if sustained, represented a threat to this outcome, which is presumably why the authorities reacted so fast.

Figure 4) 6-month annualised % change in Chinese M1 and CPI

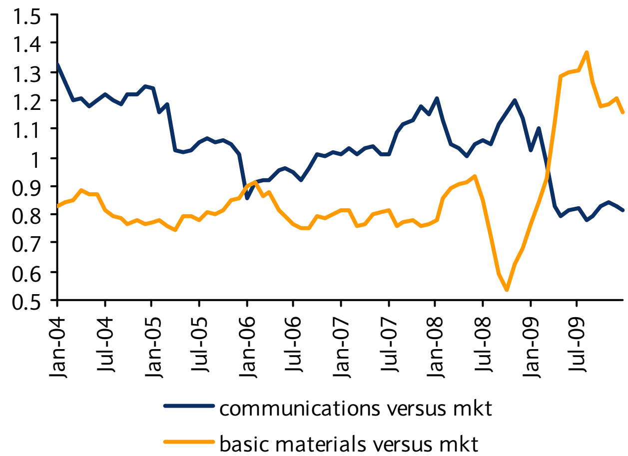


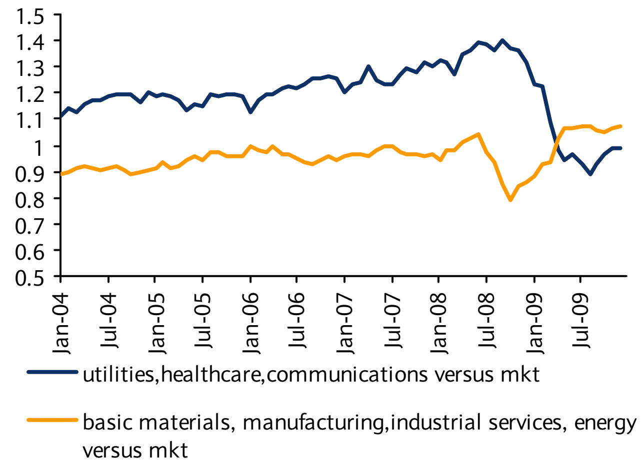
Source: Haver

So although we can probably classify events in China as constituting a mix of upside growth and inflation surprises, along with an earlier-than-expected tightening in liquidity conditions, it is not the type of development that should raise the probability of a sharp economic slowdown to any great degree. Rather, we would view the economic data as revealing upside growth risks that have been partially offset by the policy changes. As our Chinese economists note, the balance of risks is still slightly to the upside for growth, suggesting there that are some further limited tightening risks. All of which suggests that the rest of the world should not be overly concerned about recent events in China. To be sure, had there been no Chinese policy reaction to the acceleration in credit and growth, it would have been logical to expect upward revisions to global growth, commodity price and headline inflation forecasts, developments that on balance would have shortened the period of time in which policy and liquidity settings in the rest of the world remain at very easy levels. However, since the Chinese authorities are clearly prepared to take measures to prevent growth accelerating further, the actual outcome should be for little change in underlying medium-term economic assumptions, which are still for a very strong outcome for global growth this year. In this respect, one could argue that the implication might very well be for tighter Chinese liquidity conditions at an earlier-than-expected juncture, but also for a reduced risk of similar developments in the rest of the world. So from this perspective, a continuation of the range-trading in Chinese local equity markets seems appropriate, as does less overtly bullish performance from the commodity sectors of global equity markets, but with very little attendant implications for broader equity markets, where six-month prospects are for a combination of easy liquidity conditions and stronger growth.

One might argue that some rotation in equity exposure away from those sectors most closely related to China is probably due in any case. The underlying point is that if Chinese authorities are tightening policy, we should anticipate Chinese-related equities to be in a sideways trend, passively de-rating in compensation for the change in economic risk. Currently, Chinese equities and China-related equity sectors are priced at a premium. As the left hand panel in Figure 5 should hopefully illustrate, valuations for the basic materials sector (we are looking at European markets here) have soared relative to the market average, whereas the more mature and less cyclical sectors such as communications and telecoms have seen valuations decline relative to the market. More broadly, as the right hand panel in Figure 5 should demonstrate, valuations for the most cyclical equity sectors such as commodities, energy and industrial services are at six-year high valuations relative to market averages, whereas the more stable and higher yield sectors such as utilities, health and telecoms are trading close to six- year low valuations versus the market average.

Figure 5) 12-month forward PE ratios (consensus), euro area equities, versus overall market averages, basic materials, communications (left hand panel) average of utilities, health, communications and basic materials, energy, industrial services (right hand panel)



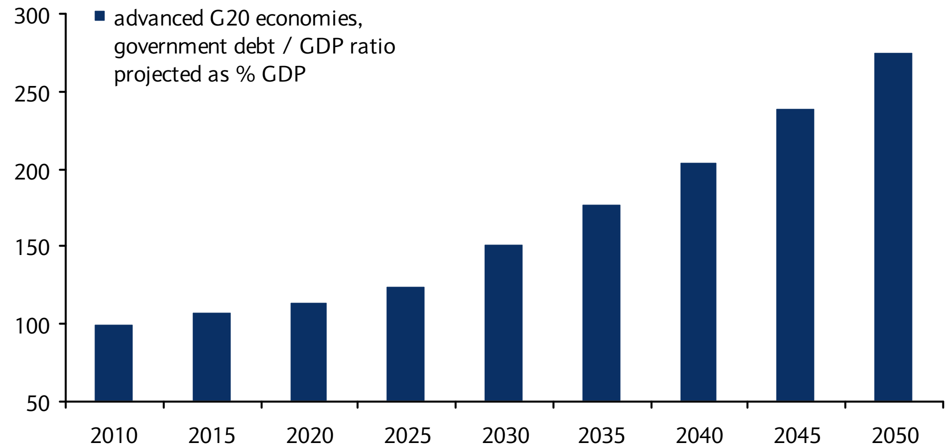


Source: Factset aggregates

There would therefore seem to be some sense in rotating exposure, away from the expensively priced China-related areas. We particularly like the idea of moving basic materials to telecoms, the latter being high yielding (Stoxx telecoms yields 5.75%) and still modestly exposed to an improving economic cycle. Overall, we do not really see events in China as a reason to drastically reduce equity exposure. Economic developments outside China are certainly compatible with the recovery story, but equally we have had no sign at all of any acceleration that might provoke an early end to the benign liquidity conditions. To judge from a wide variety of indicators, we remain in a reasonably sweet spot in cyclical terms, with inflation pressures still muted, growth recovering and an eventual policy tightening still a fairly distant (ie, Q3 at the earliest) prospect. Along with valuations that are close to, but still slightly below, fair value, there seems to be little reason to move to underweight in equity exposure. We would add on this score that the de-leveraging of the corporate sector informs us that coincident equity price volatility is likely to fall further and remain low for some time. Coincident equity risk is therefore declining, a point that needs to be borne in mind when considering valuations. So the upshot of Chinese developments is to adopt a slightly more defensive equity allocation, specifically rolling out of sectors and markets that are closely linked to China, into the higher yielding and lower beta sectors.

The second main source of negative newsflow over the past few weeks has been Greece. This story is a small subcomponent of the much larger theme of fiscal risk. Broadly, with government debt profiles subject to very severe structural deterioration over the next couple of decades due to the aging of the boomer generation into retirement, there is very little room for error in medium-term fiscal policies. According to work by the IMF and OECD, advanced economy government debt/GDP ratios are likely to increase by 50% of GDP over the next two decades (and by 175% of GDP over the next 40 years) due to aging. The starting point for this particular trend is, coincidentally enough, 2010.

Figure 6) Advanced G20 economies, government debt/GDP profiles due to aging



Source: IMF

The financial crisis has increased advanced economy government debt/GDP ratios by over 20% of GDP over the past three years. For the economies with the largest deficit/GDP ratios, such as Greece, Portugal, UK, Ireland, and the US, the implication is for a severe fiscal tightening extending over a period of several years. While there are plenty of successful examples of such tightening, it is undeniably a difficult political task. And since the medium and long-term trajectory for government deficits is for a relentless deterioration driven by demographics, investors are likely to be less forgiving of any recalcitrance than usual. In short, the costs of not offering a convincing fiscal restoration plan – and then sticking to it – are substantially higher than might usually be the case. The inexorable grasp of demographics eliminates any freedom of manoeuvre. So across all asset classes, we have to be cognisant of a risk of government bond yield spikes if investors start to lose faith in the political processes that lie behind a successful fiscal tightening.

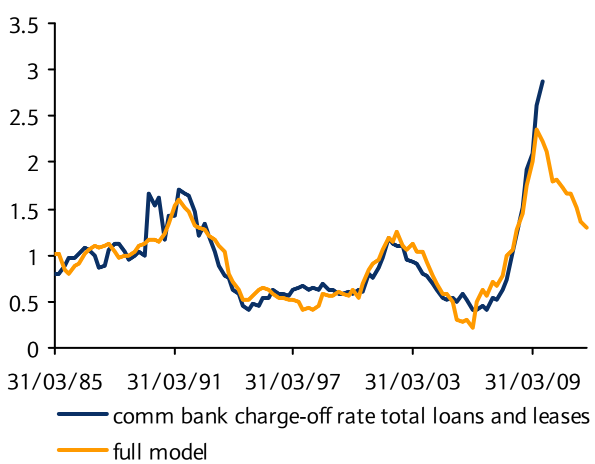
So far this year, investors would seem to have reacted negatively to the news regarding Greece and remain unconvinced on this particular fiscal trajectory. However, outstanding Greek debt is around €300bn and this year's financing requirement is just €53bn. The sheer dimensions of the Greek problem are relatively small, even if the political environment does not seem very friendly for fiscal rectitude. The Greek situation, on its own, seems unlikely to provoke wider global market repercussions and dealing with the problem, on a worst-case scenario, is well within the capabilities of the EU and IMF. The greater risk, in our view, centres on a loss of confidence in fiscal discipline in the larger US and UK economies. It is certainly plausible to construct a scenario under which a lack of a clear general election winner in the UK, in combination with similar political trends in the US, cause investors to lose faith in the fiscal process. Needless to say, such a development would have very bad global economic consequences.

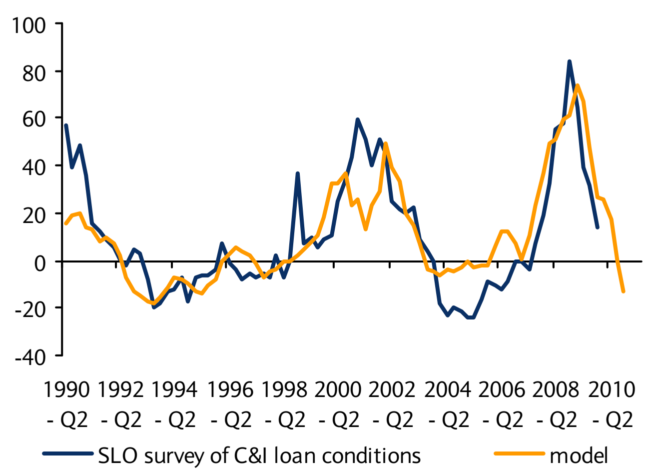
On this score, to judge from the tenor of political debate in the UK, both parties are now making fairly reassuring noises on the fiscal outlook. This was not the case late last year, when market suspicions were aroused by the pre-Budget report and by some electoral rhetoric about maintaining public investment levels. Subsequent policy pronouncements by the current government have swung more towards future spending cuts and it now seems reasonably clear that both main parties are committed to such an outcome, merely differing on the timing of implementation. In particular, the risk that the election might be fought on a "maintain spending/cut spending" political divide seems to have faded. Gilt spreads have been stable to somewhat narrower against Bunds since early December and UK CDS spreads have declined slightly since mid-December, despite the continuing blowout in Greek risk premia. Overall, as far as the sovereign debt risk is concerned, we are more relaxed than was the case a month or so ago, the Greek situation notwithstanding.

The third main source of negative news concerns the intensification of the regulatory assault on the banking system. Investor concerns on this front seem to be particularly inchoate. Thus far, most of the measures that we know about – whether they are tax hikes, changes in liquidity regulations, or changes in capital ratios – all tend to point to a reduction in the trend for bank profits. The most recent US initiative to curtail bank prop trading points in a similar direction, although the relevance of the measure tends to be confined to a handful of banks. It is difficult to draw any major macroeconomic conclusions from these trends. To be sure, banks will seek to restore lost profitability. On a medium-term view, this probably argues for an overall increase in the cost of bank credit, although much of the effect on the economy might be muted by further disintermediation of the banking system. However, with the non-financial private sectors actively repaying bank loans at present and the credit markets engaged in an aggressive easing of credit conditions, these concerns have little immediate relevance to the economy.

Furthermore, the Q4 results for US banks do tend to support the conjecture that loan-loss rates peaked in Q3 last year and that the underlying credit quality of bank assets has finally turned the corner. This is of greater economic relevance, since it does point to an eventual easing in bank lending conditions. The risk is more that this natural rhythm in the credit cycle is interrupted by uncertainties generated by a rapidly changing regulatory environment. Such an outcome is not an economic game-changer, although it would tend to dampen the normal operation of cyclical dynamics. More broadly, an apparent breakdown in international co-operation regarding bank regulation and a greater politicisation of the process does make the overall operating environment for banks rather less certain. This increase in uncertainty could weaken the standard cyclical response pattern of the banking system to an economic recovery, although it would be very unlikely to obliterate it altogether. So from a macro perspective, we would suggest that the implications of our bank loan loss and bank credit condition models, displayed in Figure 7 below, are still generally correct, but perhaps somewhat muffled by all the regulatory background noise. There is an issue here for bank equity prospects, but that was a sector we suggested avoiding in the last *Global Outlook* in any case. Meanwhile, the increased regulatory emphasis on de-risking banks is probably a structurally positive trend for bank debt.

Figure 7) Bank Models – US bank loan charge-off rate, Senior Loan Officer survey terms and conditions for C&I loans





Source: Barclays Capital

To summarise, our asset allocation views have evolved in the direction envisaged at the end of last year, with events pointing in the direction of a slow reduction in exposure to risk. The main change in our view has been to accept the inevitability of something of a temporary stalling in the bullish trend for China-related plays, notably commodity-related sectors and markets. To a degree, these assets had been displaying a bit of a China premium in their valuations and had run well ahead of less Sino-centric markets and sectors. So we like the idea of shifting out of energy and raw materials sectors into sectors like telecoms, where yields are attractive and some correlation with economic growth is still visible. However, we do not believe that any of the Chinese tightening, sovereign debt or banking regulation risks has much in the way of immediate negative consequences for the global economic trend. They are certainly risks, but the key point is that the background liquidity environment, generated by the combination of low short-term rates and private sector de-leveraging, should tend to erode financial asset risk premia over the medium term and contain any spikes in the short term. And – at least as far as the US and Europe are concerned – the trend in recent economic data has been towards a longer, rather than shorter, prospective phase of easy liquidity. We feel it is therefore too early to entirely disengage from pro-cyclical investments and would tend to stick with core exposure to industrial and technology equity market exposures, keeping away from fixed income duration exposure. Simply put, we view current equity market price action as corrective and the recovery in government bond prices as demonstrative of the expected range-trade. The major risk to global asset prices comes from a sharp improvement in US employment or a significant loss of faith in fiscal dynamics in the large economies. Ironically enough, the news so far this year points towards lower risks on these matters.

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