Alphabet Soup

Macro Themes into 2010

ECU
The ECU Group plc

'V', 'W' U', 'L' or something more complicated?

Robust V-shaped recovery, W-shaped 'double-dip' with a bounce followed by renewed weakness or a long, shallow U-shaped period of under-performance? Worst of all, are we in for an L-shaped non-recovery (with stagnation following recession).

It's all alphabet soup. Policy makers are mostly in the 'U' camp, along with the IMF, which predicts global growth in 2010 of just 3.1%, after a 1.1% decline in 2009. That's pretty pathetic, given an average growth rate of almost 5% between 2003 and 2008. Next year's 3.1% forecast is all the less impressive for being made up of a 5.1% growth rate in the emerging economies and just 1.3% in the so-called 'developed economies'.

The drags on growth are clear. Once policy stimulus wears off, the cold reality of getting debt levels down will be a sobering experience for individuals, companies and governments. Policymakers know this and, having failed to predict the recession, they simply can't afford to sound the all-clear too soon. But there's a chance that the current upswing is stronger, and will last longer than the gloomy consensus. And I wouldn't rule out the subsequent slowdown falling a good way short of the return to last year's depths that some seem to fear.

My one caveat is that the price of this rosier outlook is that the same old global imbalances that ultimately dragged the global economy to its worst crisis in a generation are being rebuilt. The policy of exceptionally low interest rates combined with quantitative easing, may just work. If it doesn't there is no 'Plan B' other than to do more of the same.

So policy-makers sound cautious and act aggressively. For that reason if for no other, there's a chance that world economic growth will be closer to 5% than 4% in 2010, with the advanced economies growing at a rate of over 2%.

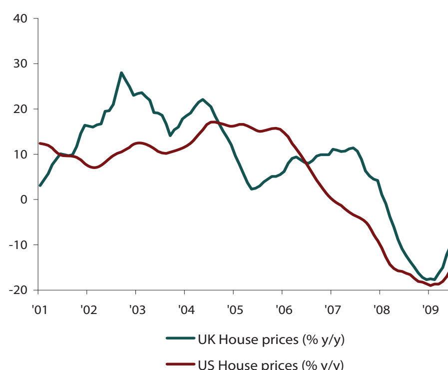
Better than expected growth (for now), more sustained than expected stimulus, and the realisation that were growth to disappoint, even more monetary reflation would follow will shape market trends into 2010. The big economic winners are those who benefit from easy money without being shackled by the legacy of the credit bubble. These winners include Brazil and a large part of Non-Japan Asia. For them, the trick is to benefit from easy money while managing the asset bubbles that come with it.

Market winners include gold, equities and the currencies of any economy which chooses higher rates over keeping its currency competitive. The big losers are the dollar, the yen, and eventually, government bonds. Reasonable targets for the first half of 2010 include gold at US$1250/oz, S&P at 1,200, EURJPY at 150, parity between the US and Australian dollars, and renewed Renminbi appreciation.

The shape of things to come

Academic work on the nature of economic recoveries that follow housing or equity crashes can be summed-up as concluding that

Anglo-Saxon Reflation



while asset markets can bounce sharply in the early stages of recovery, economic growth takes longer to return to trend. Low rates and cheap valuations help asset prices to jump but impaired balance sheets and a weakened banking sector hold back loan growth, boost savings, discourage investment and hamper the recovery in demand. This is the core economic scenario going forwards and is at the heart of most major institutions' (relatively gloomy) forecasts.

'This time will be different' is a lethal statement. But circumstances have allowed a more vigorous policy response than in previous cycles because ultra-low rates have not caused either major currency weakness or inflation. The US policies of quantitative easing and effectively zero interest rates have only resulted in the dollar's trade weighted index reversing most of last year's safe-haven rally. That's no crisis. And core inflation is running at 1.5%. And that, in turn, means that they have been able to finance huge budget deficits without sending borrowing costs up. The yield on a 30-year US Treasury is only 4.25%, 0.75% below the average yield seen in the last decade. The yield on the 50-year UK Gilt is even lower.

The economic recovery is very fragile and a W-shaped cycle with a further relapse next year is a definite possibility. However, the policy reaction and the fact that it has not been derailed by a sell-off in government bonds, a currency collapse or a serious bout of inflation, means that relative to a core assumption of several years of sub-trend growth, I want to err on the side of a sharper and somewhat longer initial bounce at the very least.

I also suspect we will see a more sustained bounce in asset markets even if that ultimately creates unsustainable valuations. Credit is cheap but heavily rationed. Some firms (banks, the very wealthy and the best-rated companies) can take advantage of very low interest rates. The rest of us can scarcely get access to credit at all and if we can, the terms are onerous. That is the ideal recipe for asset bubbles. If credit is rationed, you don't get the demand pressure which kick-starts growth or causes inflation. But the money has to go somewhere. In 17th Century Holland, when the central bank first realised that it could lend more

money than it held in the form of gold in its vaults (creating fractional banking for the first time), the availability of easy credit to the wealthy merchants of Amsterdam provided the impetus needed for the great tulip bubble. Who knows? Perhaps it fuelled the boom in Dutch art as well. Nowadays we are more prosaic and cheap credit is going to drive high-end house prices and an M&A boom as companies (like Kraft) take advantage of low rates and tight credit spreads to bid for competitors (like Cadbury). If you can finance acquisitions at such low rates (Kraft issues debt at less than 1% over Libor) it is easy to make the maths work.

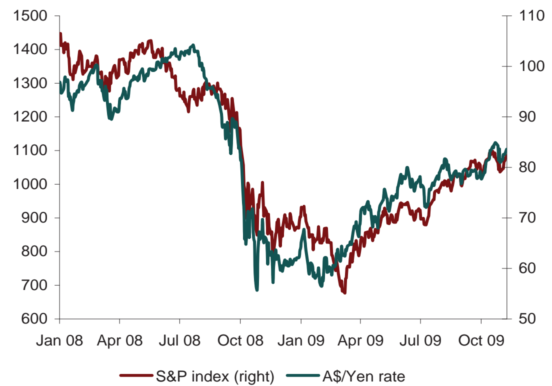
Don't discount the US consumer or rely on Germany

The performance of the US economy — the main driver of global demand — is critical. The end of 'cash for clunkers' and waning impact of tax breaks to buy homes could see demand for cars and homes tail off. Rising unemployment is eroding the bounce in consumer confidence. It is vital that the initial boost to growth from easier fiscal and monetary policy is big enough to create employment and get a more self-sustaining cycle of income growth, demand growth and employment growth back on track. US companies are still running exceptionally low stock levels and capital spending has remained very weak — non-residential investment was still falling in Q3, albeit at a slower rate. As the economic clouds lift, there is scope for both investment and stocks to recover which would help create employment. On current trends (simply extrapolating the improvement so far this year) employment growth will turn positive early next year. If employment and income growth are positive, this (allied to a partial reversal of last year's wealth destruction) could help the economy grow faster and for longer than people expect.

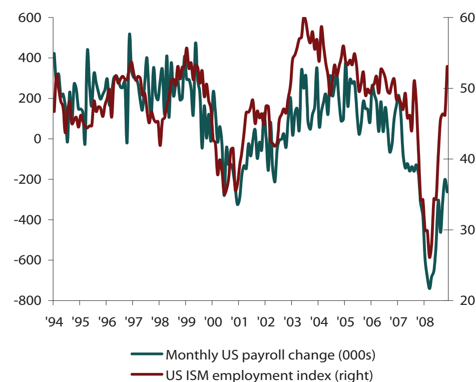
One thing we can't rely on is a revival in consumer demand at the heart of Europe. It is now 25 years since I first went to work in Frankfurt. The stores in Frankfurt at that time closed at midday on Saturdays so I had to set my alarm clock to get up and find food. I was young and had better things to do on a Saturday morning (sleep). Things have moved on of course, but as recently as 1999, I was told in a (large) sports shop in a hundred yards from the ECB that they didn't take payment using credit cards. The German economy is not geared up for people shopping in the way that Anglo-Saxon economies are. To be fair, Europe now is much more than just Germany but the Irish and Spanish economies share a collapsed property market so it is no surprise that the latest retail sales figures for the Eurozone show an annual fall of 3.6%, in volume terms.

The UK, on the same measure, has sales growth of 2.4%, and that is considered to be very weak. The UK economy was still in recession at the end of Q3, although the quality of statistics is questionable. Surveys are more reliable than the official statistics and point to a similar bounce to that seen elsewhere. In an economic recovery led by asset markets and wealth effects, the UK has the potential to bounce strongly even if it suffers in the medium to longer term from the scale of fiscal retrenchment that will be needed. Growth forecasts range from a little over 1% in 2010 to closer to 2%. But it's the prospect of an average

Reflation Trades



US Payroll Trends Improve



CPI inflation rate that is close to 2% (nearly twice the eurozone rate) which catches my eye. I am optimistic about UK growth on three levels. Firstly, the economy is driven by house prices and these are recovering. Secondly, the financial sector is being recapitalised and while this is a PR disaster, it will help the economy in 2010. Thirdly, sterling's fall will help what is left of UK manufacturing.

The Dollar's demise

In 1984, the yield on a 2-year US Treasury Note was 8% above the annual 'core' inflation rate (excluding food and energy) and the dollar was appreciating rapidly. The mix of 'Reaganomics' and a monetarist Federal Reserve under Paul Volcker saw the dollar peak at a trade weighted index level of 164 on 25th February 1985. The pound fell to US$1.05, USDJPY reached 262 and the USDDEM rate reached 1.45, equivalent to a EURUSD rate under 0.64. An ounce of gold was worth US$284.

Today, Treasury yields are negative in real terms, as measured using the core CPI index. They turned negative in 2001 when

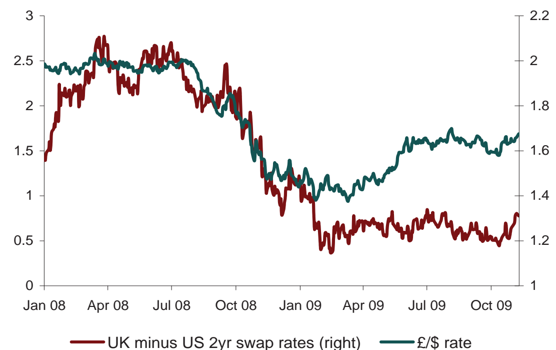
the Fed cut rates in response to softening economic data and the shock of the 9/11 attacks. Rates that were too low for far too long were the root cause of the credit and housing bubbles which burst in 2008. And the response to them bursting was to cut rates again, taking the 2-year real yield to -0.8% and the Dollar's trade weighted index to its all-time low (to date) of 79. The collapse of the global financial system sparked a rush to safe havens, benefiting the dollar and causing a severe shortage of dollar liquidity. The dollar bounced sharply even though rates remained low.

The policies the US Federal Reserve has put in place to tackle the weakness of the financial system are working. Bank lending has not recovered but quantitative easing and the maintenance of near-zero rates have seen the inter bank loan market normalise and credit spreads narrow. Equity markets have been able to recover and as both the lack of dollar liquidity and the search for safe havens has faded, the level of US interest rates has once again become a major factor in driving the dollar's value.

Today, two factors drive currencies on a day-to-day basis. The first is the ebb and flow of investor appetite for 'risk' in asset markets. So, on any day when equity markets retrace part of recent gains, the dollar is likely to benefit. Since days when equity prices fall are usually accompanied by buying of government debt and therefore falling bond yields, this is counter-intuitive. But the pattern is well established. The second is the level of rates. US rates are not the only ones which are low. That may seem obvious but no G7 central bank is set to raise rates soon. The Reserve Bank of Australia and the NorgesBank are the only major central banks to raise rates so far this year and the Australian dollar is up by a whopping 45% against the US dollar since March.

The Dollar's Demise

Rates Driving Currencies



Into 2010

For much of the last 18 months, currency trends were driven by risk appetite, the Yen and Dollar benefiting the most when equity markets were falling, but also suffering when they bounced. These correlations still hold but are getting weaker as the crisis passes. What matters more going forwards will be how relative macroeconomic and interest rate trends evolve.

The first being distinction to make is between the G7 currencies and the rest. G7 economies are saddled with debt and are seeing a major re-allocation of economic power away from them. As long as US interest rates are effectively at zero, the G7 currencies will tend to under-perform those outside the G7 where monetary policy is being tightened. Within the G7, currency trends will depend to a large degree on shifts in expectations about the timing of exit from near-zero rates. On that score, the biggest scope for a surprise may be in the UK and, on a 6-month view, sterling is (just) my favourite currency within the G7. Firstly, the MPC has an inflation target and not a balanced inflation/growth target like the Fed. Secondly, UK inflation will be the highest in the G7 next year on most forecasts. Finally, sentiment surrounding the UK economic outlook is more pessimistic than elsewhere. I don't really share the pessimism. A weaker currency is helping manufacturers; BOE policies are helping to get lending up and running, albeit slowly; the UK economy is more sensitive than others to both house prices (which are going up courtesy of low rates and limited supply) and the financial sector (whose government support is causing a huge populist backlash, but that's another story). This crisis has been a public relations disaster for the UK and some of that is reflected in the value of the currency.

At the other extreme, we are moving to a position where the mantle of 'most unattractive currency' becomes a close contest between the yen (where rates are staying at zero for the long haul) and the dollar (where they will stay at zero until recovery has solid foundations and by which time the US will have a growing current account deficit again).

What could this mean in practise? I think we have seen the low in USDJPY at 88 and, as the yen replaces the dollar as 'funding currency of choice', we should see a move towards (though not through) USDJPY 100. EURUSD is breaking through 1.50. The ECB will tighten long before the Fed, and the previous high at EURUSD 1.60 is a medium-term magnet. GBPUSD was trading

above 2 when EURUSD reached 1.60. That won't happen again for a while, but GBPUSD 1.80 is not impossible. And outside the G7, the AUDUSD exchange rate seems set to breach parity early in 2010.

Interest rates - the new normal?

Have neutral rates shifted in this cycle? Not necessarily. There will be a long period of below trend growth and that allows sub-neutral rates because inflation is not a threat. But I don't think that rates can stay permanently below nominal GDP. The new 'normal' for rates is a function of the premise that growth will be constrained for a long time by the need to reduce debt levels. Rates can only stay low if growth is sluggish. Strong growth, if it makes people question the 'sluggish growth for a long time' premise, will send market rates sharply higher.

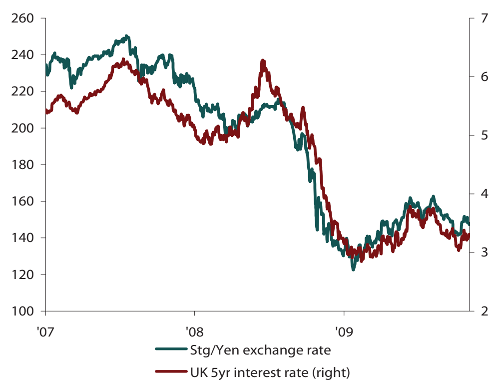
I don't expect any G7 central bank to raise rates in the first half of 2010. Even further out, I doubt we will see rates above 2% in the US, Eurozone and UK until well into 2011. And I can't at this point envisage any rise in Japanese rates until there is some fundamental change in their economy. That won't stop bond yields moving higher however. The gradual tapering-off of QE can see 10-year Treasury yields, which have been in a 3.25-3.75% range in recent months, head to a range of perhaps 3.75-4.25%. A similar 50bp rise in European yields takes Bunds to 3.5-4%, and Gilt yields can reach 4.5% long before rates actually rise.

1994 re-visited

Rising bond yields are a source of fear for central bankers. Extraordinarily low policy rates in the US are fuelling an asset bubble in emerging markets and putting currencies outside the G7 under upward pressure. We've been here before. In 1993, the Fed kept rates too low for too long and then surprised the market by raising rates in early 1994. The upshot was a 230bp rise in 10-year bond yields and the seeds of an economic crisis were sown in many emerging economies. The emerging market bubble is bigger now than it was in 1994 and the risks are consequently greater. This is one reason the Fed is so desperate to make sure that policy tightening — when it happens — is not a surprise. We can expect an orchestrated process of changing the language of public comment. But that just ensures central bank timidity, itself the fuel for the asset reflation. I can't see how this fails to support non-G7 currencies. It is important to understand the difference between those economies where economic reform has dramatically reduced vulnerability to higher US rates (like Brazil) and those where capital inflows have boosted trade deficits to unsustainable levels, but perhaps the most straightforward investment opportunity is to ignore conventional currencies altogether. As we become more concerned about the valuations of emerging market currencies, the one currency which has no government standing by to impose taxation and limits on capital inflows, is gold.

USDJPY against US 2-Year Swap Rate

Sterling/Yen and UK Interest Rates



The Price of Gold (USD/oz)