

Global Strategy Weekly

Next leg in Ice Age equity de-rating nears as key leading indicators top out

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The topping out of some key leading indicators suggests it is time to become more cautious. The inherent vulnerability of the global economy leaves us still happy to overweight government bonds *for the near term*. We look at a key difference between Japan and the US viz their exploding debt situations – demographics. And finally, we heartily agree with the IMF's thoughts that Central Banks' inflation targets are too low.

■ In a post-bubble *Ice Age* world, equity investors have to watch the cycle far more closely than before. One of the key lessons from Japan was that prior to their bubble bursting, equity valuations were dominated by movements in bond yields and hence there was only a very loose relationship between equities and the economic cycle.

■ But after the bubble burst and as *The Ice Age* unfolded, the close positive correlation between bond and equity yields broke down as equities suffered secular de-rating - driven by 1) the unwinding of unrealistic market-wide long-term earnings expectations in a low inflation world, and 2) a rise in the cyclical risk premium, as Japan's own version of *The Great Moderation* gave way to highly volatile economic cycles.

■ Japan enjoyed some impressive 50% equity market rallies during their lost decade, driven by strong policy induced cyclical recovery. The secret was to exit as the cycle started to top out as this preceded the equity market dropping to new lows.

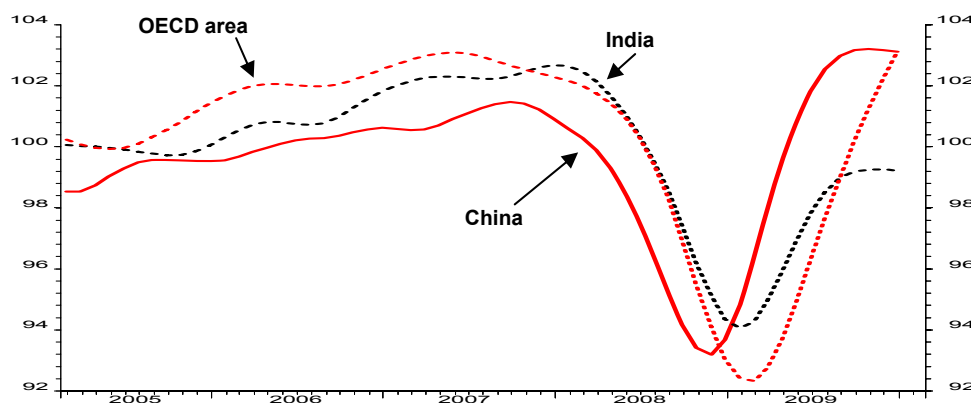
■ Early last year the safe re-entry back into risk assets was signalled by a clear upturn in leading indicators. So too now should investors be concerned that the leading indicators are topping out. The recovery in the leading indicator for China seemed to precede that of the composite for the OECD and similarly China has now topped out *ahead* of the OECD composite (see chart below). Indeed, other emerging economies such as India (below) and Brazil are also seeing clear warning flags of cyclical caution.

Global asset allocation

%	Index	Index neutral	SG Weight
Equities	30-80	60	35
Bonds	20-50	35	50
Cash	0-30	5	15

Source: SG Cross Asset Research

China's leading indicator has already topped out ahead of OECD area



Source: OECD, Datastream

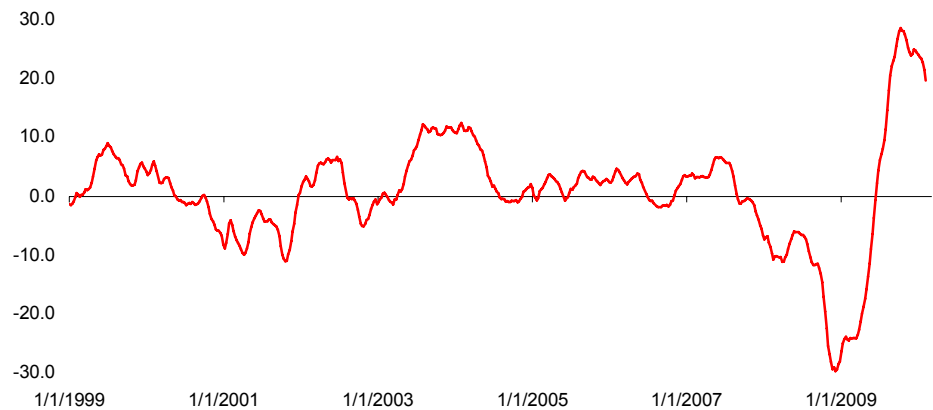
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In a post-bubble world it is far more important for equity investors to follow the cyclical ebb and flow of the economic cycle. We know from the Japanese experience that the post-bubble equity market synchronizes extremely closely with the economic cycle. But, while in a post-bubble world massive cyclical gains can still be made in a structural bear market, how does an investor know when it is time to get out of equities?

Certainly my former colleague, James Montier, derided the notion of investing on the basis of forecasts as they inevitably proved so inaccurate. It would not be *too* unfair to say that market and economic forecasters tend to hug the consensus and typically lag events. That is especially true at cyclical turning points. That is why it is useful to monitor proprietary leading indicators. These are especially useful in predicting economic turning points and allow the investor the opportunity to pile into or withdraw from cyclical risk assets.

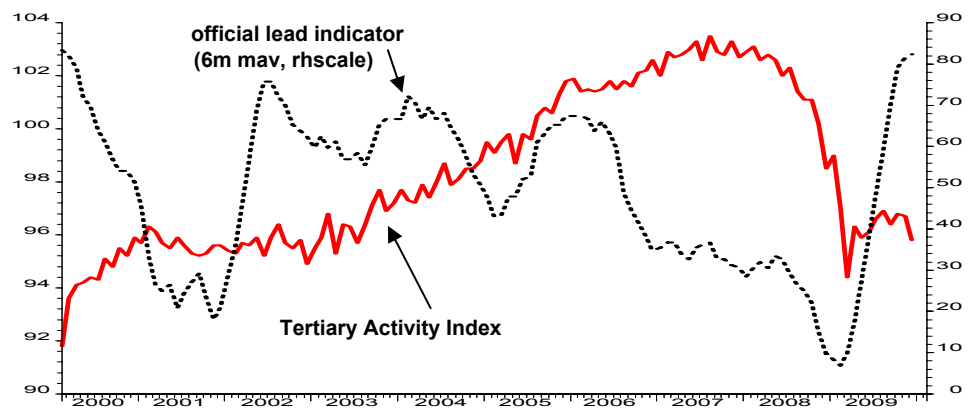
US Economic Cycle Research Institute (ECRI leading indicator starting to decline rapidly)



Source: Datastream, ECRI

We monitor a variety of such indicators and until recently they have all been giving an unambiguous green light to participate in risk assets. That has now changed. We noted on the cover the OECD leading indicators for China and other emerging markets have now topped out. But also in the US, some leading indicators have started to dive quite sharply, albeit from very elevated levels (see chart above). In Japan too, we note a topping out action (see below). Recent hard data in Japan such as the closely watched Tertiary (non-manufacturing) activity index has been surprisingly weak, suggesting their anemic recovery is already stalling.

Japan's official Cabinet Office Leading Indicator (6m mav) and Tertiary Activity Index



Source: Datastream

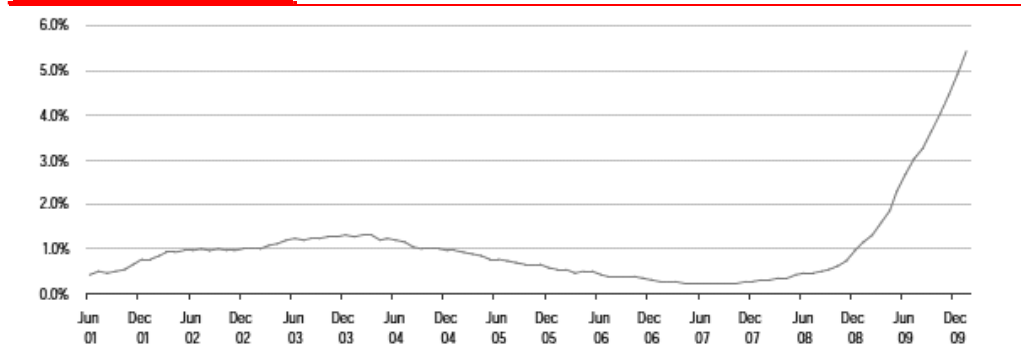
Some more bullish commentators, while accepting that leading indicators are topping out, point to the extreme strength of the recent peak as suggestive of still more positive growth surprises in the pipeline. I think this is wrong. I was always taught that it was turning points that were accurate and hence should be watched closely, and not the magnitude of any directional movement to either the up- or downside.

I was recently sent a set of questions by a journalist in advance of an interview I had agreed to do. I winced slightly at the question “Do you expect more banks to go under in the near future? How big is the risk that we might see a second wave of problems in the banking sector?” For obviously this is still, even now, a pretty sensitive subject.

Since I expect the global economy to lapse back into recession, there will inevitably be further waves of write-offs and problems for the banking sector ahead. But, even without a relapse, massive problems lie ahead. In that context I was grateful to the excellent Financial Times Alphaville website for flagging up a must-read report on the impact of defaults on commercial real estate loans in the US banking sector - [link](#). The report published last week by the Congressional Oversight Panel is truly scary. Even a quick read of the two-page executive summary will leave your head spinning - [link](#). The key point is that **“The most serious wave of commercial real estate difficulties is just now beginning.... (The panel) is deeply concerned that commercial loan losses could jeopardize the stability of many banks, particularly the nation’s mid-sized and smaller banks, and that... will contribute to prolonged weakness throughout the economy”**.

With the above in mind it was particularly worrisome when this week Moody’s reported that loan delinquencies on US commercial mortgage-backed securities rose *at the fastest rate on record* in January (rising 52bp to 5.42% - see chart below). Yikes!

Total delinquencies as a percent of outstanding balance – CMBS conduit and fusion universe



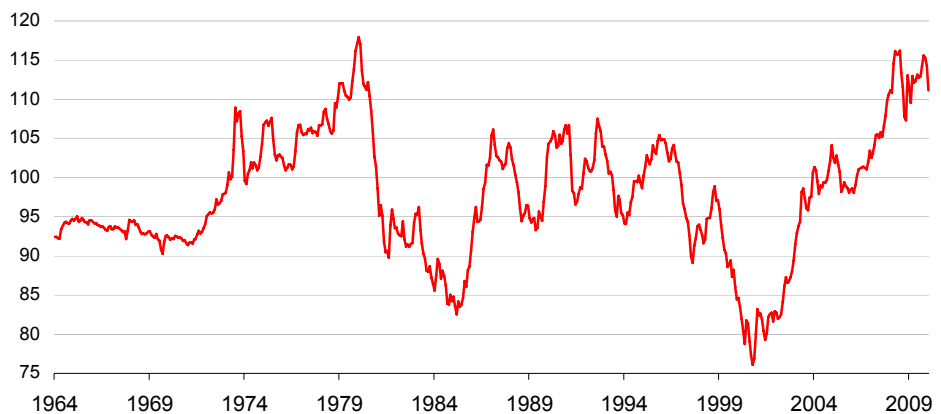
Source: <http://www.housingwire.com/2010/02/15/cmbs-delinquencies-and-special-servicing-hit-record-highs/>

The answer to the journalist’s question is that banks are still going bust like it never went out of style. In the US the Federal Deposit Insurance Corp (FDIC) seized another 15 struggling banks in January. That compares with 140 in 2009 as a whole but only 25 in 2008 and three in 2007. The 15 seized in January 2010 also compare with *only* six in January last year - [link](#)!

No wonder small and medium-sized companies in the US are still locked in the grip of a massive credit crunch (see NFIB survey – [link](#)). No wonder the US economy is nowhere near as strong as large-cap surveys, such as the ISM, suggest. And there should be no wonder if as soon as the massive fiscal and monetary stimulus wears off, the global economy lapses back into recession.

A word on the euro: we noted last week that the one-size-fits-all interest rate regime had led to a disabling loss of bilateral competitiveness for the so-called PIGS (Portugal, Ireland, Greece and Spain), within the eurozone due to rapid inflation -this in very large part through no fault of their own. Not only are the PIGS' real exchange rates uncompetitive *within* the currency zone but, on top of that handicap, the entire eurozone is suffering from an excessively strong euro exchange (see chart below).

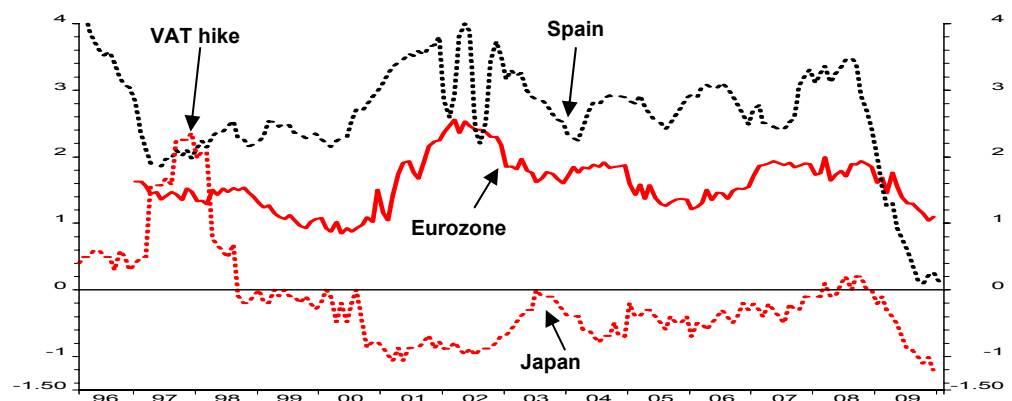
BIS-calculated real effective euro exchange rate: The recent weakness of euro in long-term context is hardly noticeable! It probably needs another 25% decline



Source: [BIS](#)

It could be reasonably argued that the eurozone authorities should welcome a large decline in the euro. With growth in the eurozone looking particularly anemic, these are desperate times. Looking at the chart above, a dollar/euro exchange rate some 25% lower, nearer parity, seems far more appropriate. The end game for The Ice Age was always competitive devaluation and the US and UK have embraced this strategy to revive growth and export their own domestically generated deflationary impulses. Eurozone core CPI inflation currently is a dangerously low 1%. Albeit not quite as desperate a situation as Spain or Japan, this surely is too close to outright deflation for comfort (see chart below).

Core CPI inflation (deflation). Eurozone is too close to outright deflation



Source: Datastream

After all didn't Ben Bernanke in his famous November 2002 'helicopter money' speech highlight that *"it's worth noting that there have been times when exchange rate policy has been an effective weapon against deflation. A striking example from U.S. history is Franklin*

Roosevelt's 40 percent devaluation of the dollar against gold in 1933-34" (*Deflation: Making Sure "It" Doesn't Happen Here* – [link](#)). In the Ice Age, it is the nation that devalues last which suffers the deepest deflation.

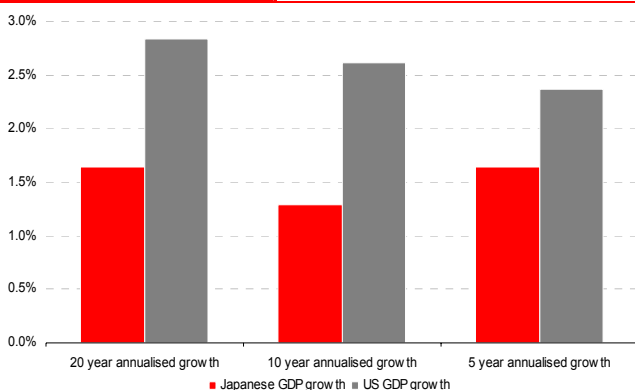
Eurozone politicians should stop bleating that the euro is too strong and blaming the deflation-leaning ECB for eurozone stagnation. **The politicians should take matters into their own hands and instruct the ECB to intervene to drive the euro lower.** In almost all developed industrialized economies, the politicians and *not* the central bankers decide foreign exchange intervention. And that is also the case in the eurozone, where politicians can direct the ECB to intervene "after consulting" with it (n.b. consulting does not mean agreeing, see article 219, para 2 of the Lisbon Treaty – [link](#) see p101).

In this context a recent paper by Olivier Blanchard, the IMF chief economist, comes at a particularly interesting time. His suggestion that policymakers should be targeting 4% inflation rather than 2% is controversial but spot on in my opinion – [link](#). For with inflation rates now running at such low levels, the risk is that a further 'shock' will tip the global economy into *outright* deflation. There is nothing sacrosanct about current targets. New Zealand, for example, the market leader in inflation targeting, raised their target from 0%-2% to 0%-3% back at the end of 1996 – [link](#). But the problem for the eurozone, unlike the UK, is that the inflation target is set by a deflation leaning central bank rather than the politicians.

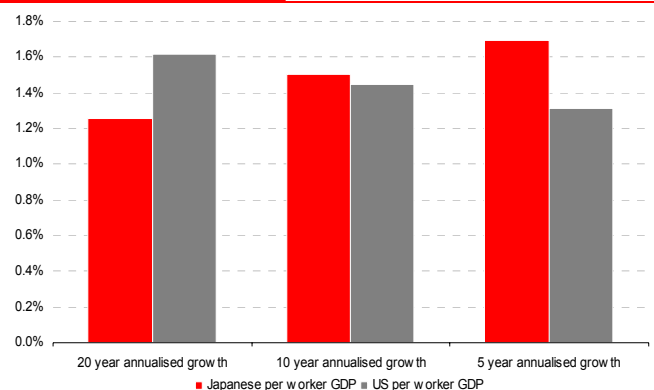
Finally, a quick work on Japan. I had quite a large number of responses to the Richard Koo article I posted about the need to continue to fiscally stimulate *throughout* the private sector's de-leveraging process. Many readers rightly commented that the alternative to a relapse into recession is ending up with a wholly untenable Japanese-style public debt situation.

My colleague Dylan Grice's view on this is interesting. He believes that Japan's private sector de-leveraging process was concentrated in the 1990's. But over the last decade the semi-deflationary, low-growth environment is very much down to the rapid deterioration in the demographic situation. Hence when we contrast the terrible GDP growth Japan has suffered over the last decade (see left hand panel below) with the situation *per head* (right hand panel below), **it is clear that the Japanese economy has in fact been performing perfectly well.** Its outsized public sector debt/GDP ratio may be a *consequence* of poor demographics. In contrast, the US demographic outlook shows a continued expansion of the working age population through this century (Europe is similar, but not as bad, as Japan). So maybe Koo's prescription may not result in the US hurtling off into a Japanese-style debt debacle, maybe!

Real GDP growth: Japan is a story of consistent under-performance (data to end 2008)



Real GDP growth per worker: Recent weak Japanese growth due to demographics (to end 2008)



Source: Datastream, SG Cross Asset Research

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