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INVESTMENT PUBLICATIONS HIGHLIGHTS

August 2011

"A Less Friendly World: Cutting Our Global Forecasts" by Jan Hatzius and Dominic Wilson, Goldman Sachs, August 5, 2011

Developed markets growth, principally in the United States and Europe, is expected to be weaker than forecast, with growth no better than trend. While aggregate global growth forecasts still appear quite healthy, it is easy to imagine worse outcomes and the outlook is fragile. The point of maximum risk for the global economy comes in the next six to nine months, given the situation in Europe and tightening in emerging markets economies. While not the base case, the odds of a recession in the United States and further Federal Reserve asset purchases have increased significantly.

As recent data have come in softer than expected from the United States and Europe, Goldman Sachs has downgraded its global GDP growth forecast to 4.0% for 2011 and 4.4% for 2012, down from 4.1% and 4.6%, respectively. Much of the weakness over the next six to 18 months will come from the developed world, as emerging markets demand should remain relatively healthy. Given the expected weakness from the United States, it is easy to imagine worse outcomes for the world economy in the coming months with the point of maximum risk for the global economy coming in the next six to nine months. While not the base case, the odds of a recession in the United States and further Fed asset purchases have increased significantly.

Developed markets growth, particularly in the United States and Eurozone, will be weaker than forecast with growth no better than trend. In the United States, weak economic growth will be insufficient to help bring down the already elevated unemployment rate. The growth outlook for the Eurozone is similarly weak, as sovereign pressures have begun to weigh on larger, core countries like Italy. A stark divergence between the prospects for core economies such as Germany and the struggling periphery remains, and monetary policy in the Eurozone should remain loose as concerns about inflation in the region subside.

There are a few key areas that have weighed on global growth over the last few months. The first is soft underlying private demand, especially from the United States. As domestic final sales in the United States weakened in the first half of the year, the demand outlook from consumers became much more fragile than initially anticipated. At the same time, the ongoing sovereign debt issues in Europe have broadened to include core countries like Italy. This will impact the growth trajectory. Purchases of sovereign bonds by the European Central Bank will provide some relief, but fail to address the underlying solvency issues. Finally, since March it has become apparent that the global energy market is more constrained than initially believed and oil prices remain elevated despite downgrades to growth forecasts.

Against this backdrop of weakening growth, there are three distinctive dynamics of the current cycle. First, in a post-bust environment of deleveraging, it is proving difficult to raise unemployment and push growth above trend. Second, fiscal adjustments are proving difficult given that the public sector has absorbed many of the problems of the private sector. Policymakers face a difficult balance between trying to ease worries over debt sustainability and simultaneously trying to boost growth. Finally, the cyclical positions of emerging markets and developed markets countries are highly divergent, which complicates the global recovery. Large emerging markets countries are trying to constrain demand while large developed markets economies are struggling to sustain it.

As the economic landscape has begun to take a turn for the worse, there are implications for equity and bond markets. Earnings forecasts for major developed markets indices are beginning to come down. Many companies that enjoyed a tremendous rebound in earnings over the last few years will find it difficult to maintain their impressive earnings growth in the face of renewed global economic weakness. Bond yields globally should remain low, with less growth, less inflation, and lower policy rates helping to anchor yields. Commodities, however, remain constrained. Despite lower global growth forecasts, much of the marginal demand in commodities is now coming from the relatively healthy emerging world. Risks remain to the downside however, should China or any other large emerging country stumble as a result of weakness in the developed world or inflation.

"Take a Deep Breath" by Martin Barnes, BCA Research, August 12, 2011

Events in world stock markets and the level of investor panic over the last few weeks have drawn similarities to the financial crisis of late 2008. Of course, investor sentiment does not drive the global economy; fundamentals remain important and the picture is not uniformly bleak. For investors with a long-term view and a firm grasp of valuations and their history, market action like last week could provide attractive opportunities. That being said, investors should gradually build exposures and expect range-bound markets; hedging downside risks through assets like Treasuries and gold is also advisable.

Events in world stock markets over the last few weeks have drawn similarities to the financial crisis of late 2008. Violent moves to the downside, tremendous intraday volatility, rumors of bank failures, and fears of a recession in the developed world have placed investors in a panic. If investors start pulling out of risk assets because of the prospects for a recession, a self-fulfilling collapse could ensue. But all is not lost, and investor sentiment does not drive the global economy. For investors with a long-term view and a firm grasp of historical valuations, market action like that of last week could provide attractive long-term opportunities.

Global economic fundamentals have certainly deteriorated, as momentum has slowed and concerns over sovereign debts have worsened. In addition, the drop in asset prices will have wealth effects that could further hamper the recovery. However, the outlook is not uniformly weak. There are some pockets of good news in the markets, and one or more of them could serve as a catalyst to help the market break out of its malaise.

First, lower oil prices will provide relief to consumers and energy-intensive businesses. Second, lower real yields on bonds will not reignite a borrowing spree, but will at the margin encourage risk taking and lower the cost of debt for parties like U.S. homeowners. Third, while developed markets economies show slowing growth, emerging markets economies like China continue to grow at a healthy pace and authorities have plenty of ammunition left should the pace tail off. Finally, corporate profits remain high and balance sheets are in great shape. Profit growth will undoubtedly slow, but proper policy action will support confidence.

Economic data could continue to deteriorate in the months ahead, and therefore investors should not be complacent about the downside risks. However, conventional recessions are caused by tight money, while balance sheet recessions are triggered by credit booms turning to bust. We are well past the credit boom, and monetary policy is exceptionally easy. The deleveraging cycle will impact growth, and obvious drivers of a rebound are limited. On the other hand, slow growth remains more likely than a recession.

A key question investors will want to answer going forward is how much of the current weakness coming out of the developed markets, in particular, the United States and Europe, is currently priced in and whether there are opportunities in risk assets. Given that memories of the recent bear market are still fresh, investors remain skittish and inclined to fear the worst.

A few words on valuations and momentum are worthwhile. Since World War II, the average pre-recession decline for the S&P 500 was 21.6%. At the time of writing, the market had declined 14.1%. If we are heading into a severe bear market, it is not too late to sell. However, if we are heading into a recession, then the decline is well advanced. Despite the strong growth in global earnings, global equities trade at less than 13 times trailing earnings, which is the low end of their historical range. Meanwhile, the dividend yield compares favorably to the average developed world bond yield. In the United States, for example, the S&P 500 yields 2.1%, just below the ten-year Treasury, yet the 30% payout ratio is at a historical low. Normalizing the payout ratio to 50% would take the S&P 500 dividend yield to around 4%.

Valuations will not dictate the market's direction in the short term, but one has to be fairly pessimistic about earnings and multiples for bonds to outperform stocks in the years ahead. Investors choosing to add risk are probably best off averaging in, as market timing will be difficult in what are likely to be volatile markets. This advice is driven by a macro view, as we believe modest growth is more likely than a recession. If a moderate recession ensues, however, the recent sell-off may have already incorporated some of the pain. Looking ahead, weak growth and lingering imbalances are likely to weigh on sentiment and asset prices for several more years, and risk assets are likely to trade within a broad range. This argues against a typical buy and hold type strategy; investors are better off buying when sell-offs are overdone and reducing positions when optimism becomes excessive. ■