ECONOMIC RESEARCH & CORPORATE DEVELOPMENT

Financial Market Outlook

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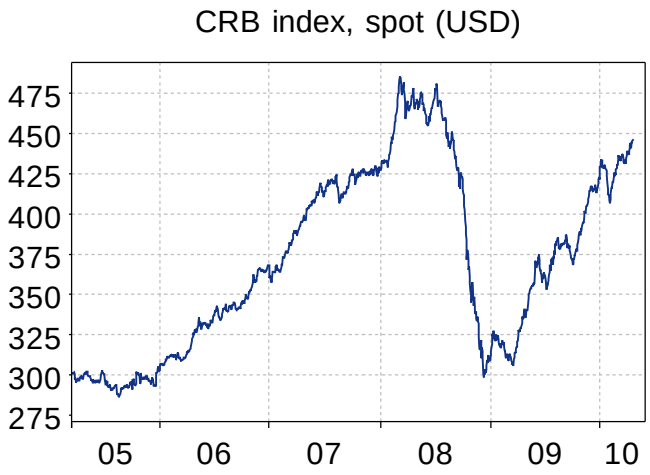
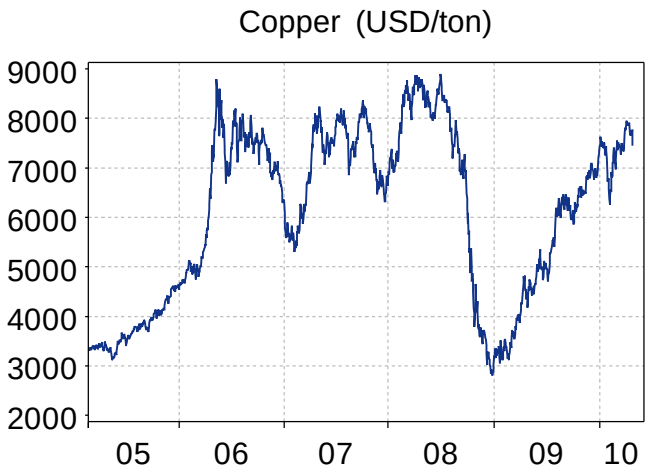
Resilience to the Greek shock?

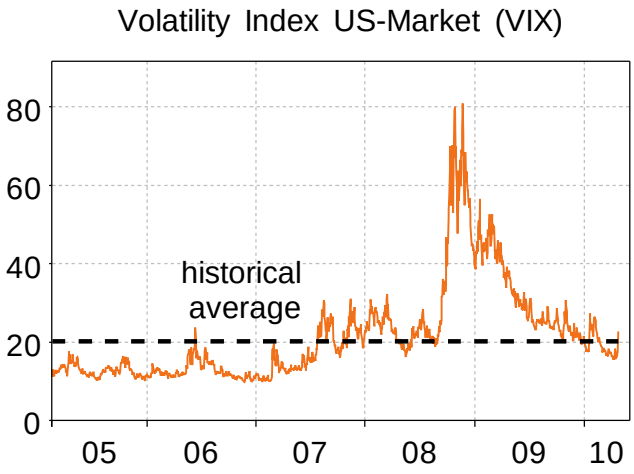
Allianz

RESILIENCE TO THE GREEK SHOCK?

For many weeks, financial markets seemed to be shaking off the threat of a Greek default and an imminent global public debt crisis. While spreads on government bonds of debt-laden EMU countries were exceptionally high, this did not affect emerging market spreads – even in those countries with elevated risks. Corporate bond spreads were also continuing to drift down. Market-to-market contagion – as seen in the financial market crisis 2008/2009 – was not evident. On the contrary: in recent weeks equity markets had been leaping from one annual high to the next, clambering back towards pre-crisis levels. Enthusiastic investors were driving up commodity market prices, copper was flirting with an all-time high. This did not look like the "new normal" everybody is talking about. It was also striking that many markets saw volatility fall sharply. Volatility readings for the US and German equity markets dropped below their historical average.







Are the markets relying too much on low interest rates and abundant liquidity and overlooking major problems of public and private debt? Will the "Greek shock" cause a lasting downturn on the markets? We believe that markets may not be that wrong after all and that some fundamental improvements have warranted market advances. The markets are not completely out of sync with real economies. Expectations had been overly pessimistic. That was being corrected, driving prices upward. One expectation was that the US and other industrial economies would take years to reach the level they had before the crisis. Well, the US will have achieved that at the end of 2010; growth should be around 3% this year. And the emerging markets are thrusting ahead despite Greece. For the European economy the recovery period may be longer, but activity indicators imply that momentum is building up here as well. In this environment profits have improved more quickly that had been expected. As a matter of fact, reported profits in the second quarter of 2010 have already reached pre-crisis levels for some of the leading stock indices.

Of course, the current high (cyclically-adjusted) price-earnings ratio in the US is frequently cited as a critical factor for a continued rebound in US stocks, as earnings expectations could be sorely disappointed. Although there are profit risks, it is also true that, after the exceptionally savage recession, there is considerable potential for a bounce-back in earnings. US labor productivity has been rising steeply in the course of the economic recovery, with unit wage costs falling sharply (at the end of 2009, down by around 5% on a year earlier). The share of (non-financial corporate) earnings in value added in the US has recently edged back marginally above its long-term average. Thus, with profit margins picking up again, any expansion in production in the upswing will prompt a surge in earnings. And, in this context, some optimism is justified. Economic indicators in the industrial countries are signaling that the economic recovery is regaining momentum again. The US labor market is finding its feet – a key prerequisite for further growth. In most industrial countries business surveys show sentiment increasingly upbeat. World trade has evidently got back into its stride nicely. In the course of this year industry will make up significant lost capacity. As a result, investment demand is also likely to gradually spring back to life. What is more, a boost will still be coming from monetary and fiscal policies that, in a misjudgment of the cyclical recovery now in train, are failing to correct their expansionary course. Sounds familiar?

What could spoil the party? The global sovereign debt crisis is one spot on the risk charts. The fiscal picture in a number of countries is indeed grim, although the current exorbitant levels of borrowing are due not least to one-off effects (spending to shore up the banks and on stimulus packages) and the revenue losses and additional expenditure triggered by the automatic stabilizers. With the appropriate discipline on the spending front, most countries will be able to rein in their new borrowing significantly over the coming years, but it will dampen growth for some years to come. We are most concerned about developments on the commodity markets in recent weeks and months. The trend is pointing in only one direction, and that is up. This eats into purchasing power, drives up production costs and clouds the corporate earnings outlook, particularly in industrial countries with a low commodity base. However, in our view the current level of commodity prices is not yet a drag on the economy. Only if prices were to continue to rise steeply throughout the whole of 2010 – something we do not think particularly likely – would this become a serious risk for the recovery.

Putting these risks to one side, the performance of the economy and the stock markets could again surprise on the positive side in 2010. Stocks may again notch up double-digit increases.

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