ECONOMIC RESEARCH & CORPORATE DEVELOPMENT

Financial Market Outlook

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Expect the unexpected

Allianz

EXPECT THE UNEXPECTED

The future usually begins before you have prepared for it. This saying certainly applies to 2009, which brought us two completely different semesters. In the first half of the year most economies in the world were still on a downward slope, grappling with the consequences of the banking crisis that destroyed large amounts of financial wealth and created cathartic uncertainty. Forecasters in both the public and the private domain adapted their outlooks to the steep slide in indicators and completely overshot on the negative side. A V-shaped recovery was seen as a crazy assumption, most forecasts resembled an L-shape (see Financial Market Outlook "No L on Earth", March 2009). Well, things turned out differently. In the months of the second quarter the uncertainty diminished, helped not least by the massive policy stimulus that was administered on a global scale. The dramatic decline in world trade and international exports came to a halt, the banking system stabilized and some depleted inventories had to be replenished. So, quite unexpectedly for the majority of observers, the major economies turned the corner and embarked on a clear recovery in the second half of 2009 despite rising unemployment. This once again illustrated that cyclical forces in the economy are hard to forecast and that economists tend to overstate all structural and fundamental problems in cyclical downturns.

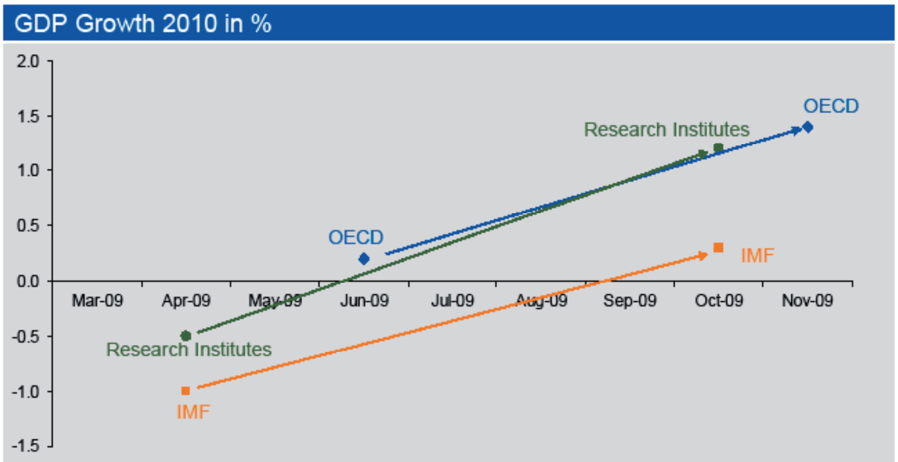
So what does this imply for 2010 and the years thereafter? Well, for the beginning of 2010, that seems quite clear, the global economy will retain its recovery momentum. And for 2010 as a whole, we can expect the fiscal injections and the lagged effects of monetary stimulus policies to keep the economies afloat. So, the outlook for 2010 is not bad and many forecasters have been forced to correct their gloomy forecasts for the coming year (see chart for Germany). Of course, some accidents could happen on the way. Political tensions could flare up again in the Middle East, propelling oil prices upward despite abundant supply. The dollar could tumble, intensifying the problems for non-dollar exporters and creating uncertainty about future trade and capital flows. Renewed doubts concerning the viability of sovereign debt accumulation could surface, and not necessarily be confined to smaller states. So, there are plenty of sharks in the water. Fortunately, there could also be some upside surprises. Oil and commodity prices could fall due to moderate demand and high levels of supply and stocks. Furthermore, if no major disruptions occur, the economies may pick up quicker than expected, as we have a habit of underestimating the momentum in cyclical ups and downs.

Contrary to the outlook for 2010, there is more consensus among economists about the medium-term outlook. With the reduction of fiscal stimulus and presumably also monetary stimulus in 2011, growth will slow down. Tighter financial market regulation and continued deleveraging of private households in various countries also justify more moderate mid-term expectations. These factors will take away some of the momentum created by the continued thrust of emerging markets as well as the development of new markets which always spring up after big recessions.

The situation on the financial markets, always subject to surprises, may look as follows: Despite the fears of many investors that we have already reached excessive valuations on stock and corporate bond markets, the continued cyclical recovery could further boost these markets and frustrate the bears. But once the end of fiscal pump-priming and monetary super-accommodation comes into sight – and this could well be before the middle of the year – markets may become more sober and could enter a soft patch. This would be exacerbated if government bond yields were to rise on the back of a revaluation of sovereign debt by investors on a global scale.

All this is a way of circumscribing that the volatility on markets will remain very high and very active management of assets will be of essence. We are in a Keynesian policy regime – our "Yes, we Keynes" situation – with an enormous policy influence that is not sustainable. This stop-and-go in economic policies may trigger a stop-and-go on financial markets. Financial investors should not get carried away even if the stock market recovery continues forcefully in the near future. Protection is the name of the game.

Economic Forecast Revision for Germany



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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

NO DUTY TO UPDATE