ECONOMIC RESEARCH & CORPORATE DEVELOPMENT

Financial Market Outlook

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No summer break on financial markets?

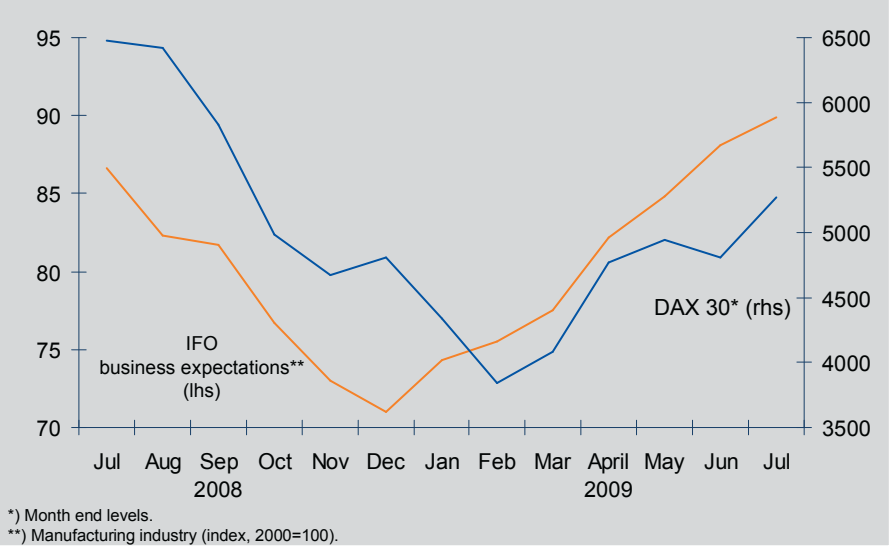
Allianz

NO SUMMER BREAK ON FINANCIAL MARKETS?

Does the amazing stock market rally of late once again signal a departure of financial markets from the real economy? Are the stock markets going crazy? Since early July the FTSE has jumped roughly 18% and the DAX by almost 20%. Given the preponderance of forecasts with very negative GDP figures this year and no substantial recovery in 2010 this seems hard to explain.

But the financial markets are not alone in taking heart again; green shoots of confidence are also budding in the corporate world. In most countries business expectations and stocks are tracing a similar path, with corporate expectations even slightly in the lead. Hard data such as new orders and production are starting to confirm this picture.

Stock market and business expectations



Although the real economic improvement is still fairly weak, the data tells us that a Keynesian scenario of a quick recovery has become more likely. Business activity will continue to recover, especially as inventory stocks have been run down and need to be replenished. The downbeat scenario of a protracted recession with deflationary tendencies, "The 30ies reloaded", has lost most of its scare. This scenario has been averted by the massive policy reactions prompted by the crisis. Of course, it will take a number of years to work off the structural problems like property bubbles, excess household borrowing or fiscal debt. But from a cyclical point of view, the important thing is that the paralyzing uncertainty created by the possibility of a great depression scenario is waning. This is what financial markets are pricing in.

The upward momentum is being propelled by the fact that many actors missed the rally and are now jumping on the bandwagon to prevent excessive underperformance against the benchmark. Proponents of an L-shaped development will have been off the mark with their stock and bond market forecasts.

So what might happen in the rest of 2009?

- The tendency towards real economic improvement should continue.
- The abundant and cheap liquidity provided by central banks stimulates investment demand
- With low central bank interest rates and a phasing out of the fear factor, investors will reconsider riskier types of investment that promise higher yields.

These factors suggest that the upswing on the stock markets will continue. It may even go into temporary overdrive. However, the climb will certainly be interrupted by temporary disruptions and corrections. There are various downside risks – like rising oil prices or renewed banking problems due to loan losses. The market will remain volatile, opening options for buying in times of downward correction. Our best guess for the year's end is that we will be almost back at the pre-Lehmann levels that prevailed when the bank went into default around the middle of September 2008 and the tailspin on markets began (with a little time lag). That means approximately 1100 for the S&P 500, 5000 for the FTSE and 5800 for the German DAX.

In a medium-term horizon, markets are, of course, no one-way street. After the relief over the cyclical recovery, structural problems may return to front stage again. De-leveraging of banks and households balance sheets cannot be accomplished overnight. And high public sector debt is a new challenge arising. Therefore, the economy could again lose momentum in the course of 2010. In that case disappointment on the capital markets could end the period of stock revaluation and cause some setbacks.

But until then the cards will be reshuffled several times. Meanwhile, 2009 stands a chance of turning into a good year for the stock markets. After a more than dismal start, this is without doubt a positive message. Interest rates on the other hand should have seen their lows for this year and show an upward tendency. For tactical asset allocation, stock markets seem more promising than bonds, despite the fact that they have already run part of their course.

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