ECONOMIC RESEARCH & CORPORATE DEVELOPMENT

Financial Market Outlook

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2010 – Moving along

Allianz

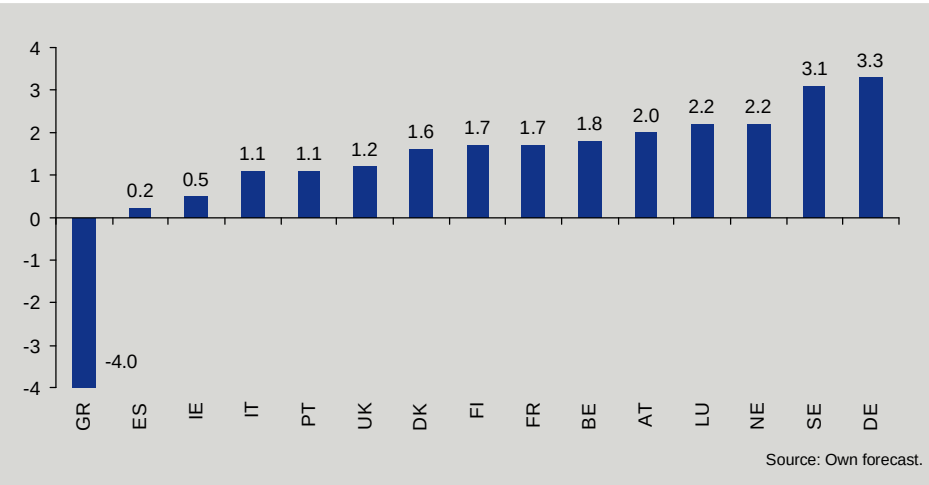
2010 – MOVING ALONG

The year is marching on. It is still too early to draw any conclusions, but from an economic perspective, 2010 has been largely in line with expectations thus far. The global economy has continued on the path to recovery following the crisis, and has actually made far better progress than international organizations like the IMF predicted at the end of last year. The IMF particularly underestimated the German economy, which at the end of 2009 was still forecast to grow by only 0.3% this year.

We had expected that those economies with less pressing debt problems would manage to shake off the crisis and report stronger growth than the economies that were stuck in a debt rut. 2010 confirmed this forecast, evidenced by the high growth in China, not to mention Germany's growth advantage in the euro area. At the moment, the economic disparity in the euro area is extremely pronounced. Countries in the midst of a consolidation effort in the state and private sector are lagging in terms of economic recovery. In the US, the much-needed savings drive, particularly those implemented by private households, are increasingly taking its toll on the economy. The US economic recovery has lost considerable momentum and the country will not be the growth engine of the global economy for the foreseeable future, which was to be expected. However, this does not mean that the US economy is necessarily about to lapse into a new recession.

Economic outlook in Europe varies

Real GDP growth 2010, in %



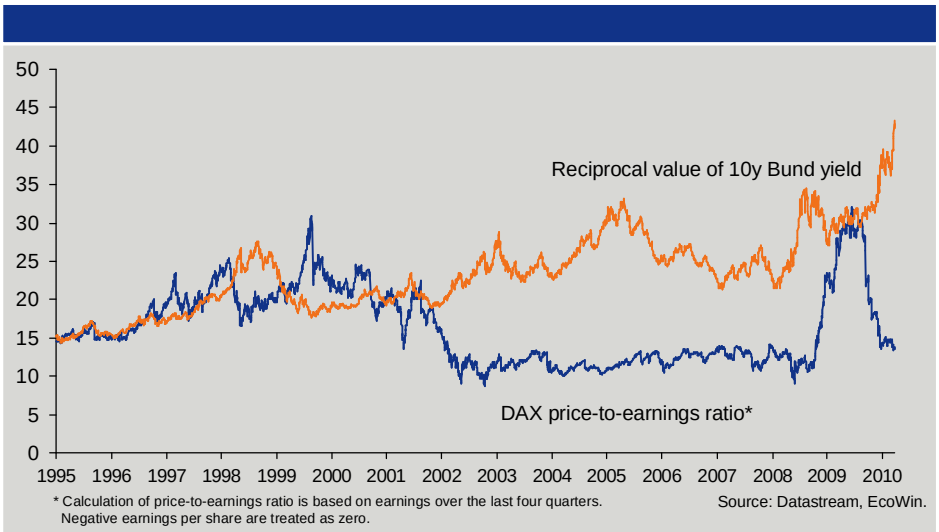
Source: Own forecast.

Although economic developments have not exactly been spectacular, the financial markets have shown no sign of settling down in 2010. Although there have not been any major changes in economic data, we have seen a swift change in focus in the markets. While the euro was the center of attention in the spring, the focus over the summer has been on the dollar. Risks were acknowledged more readily on the markets than opportunities. The stock markets were relatively weak in the spring, when the US reported positive economic data but the European markets were dominated by the debt issue and a mixed bag of economic data. Then, when the summer came and Europe reported some progress concerning consolidation and stronger economic growth, due to less favorable economic data from the US, the stock markets stagnated again.

This would appear to be driven by a mood of marked risk aversion among investors. The 2008/2009 financial crisis has had a sustained impact on investor behavior, with institutional investors in particular facing a dilemma: they have to generate decent return on investments, but the zero interest rate policy of the central banks means practically no interest on low-risk investments. Consequently, institutional investors cannot completely turn their backs on riskier assets. Many investors have evidently adopted a strategy of inching their way towards risky investments every now and again, only to make a sharp exit as soon as new signs of uncertainty emerge. An environment characterized by this sort of investment behavior is hampering any marked upswing on the stock markets, even though the solid earnings trends reported by the corporate sector would certainly support a rebound.

Nevertheless, we doubt that investors will maintain their reluctance towards equities in the long term. Although the renewed drop in yields on German and US government bonds signals that risk-aversion has increased again among investors, this trend has made it even more difficult to achieve satisfactory returns. The yield on German 10-year government bonds is at a historic low, despite strong growth in the German economy and the fact that calls for higher wage hikes are a clear argument against any deflationary risk. With nominal GDP growth of around 5% this year, a nominal yield of 2.3% on 10-year German government bonds appears far too low from a fundamental perspective. The question as to when the markets will have a change of heart and the government bond "bubble" will burst remains open. At the moment, it would appear unlikely that German government bonds will lose their safe haven appeal any time soon, especially since German public finances are developing better than planned. Consequently, the next few months are not expected to herald any yield surge. But as potential gains on the bond market now seem exhausted, investors could well start turning to shares again, especially as corporate earnings are expected to remain solid. The P/E ratio at the stock market is much more favorable than that of the bond market (see figure).

Bunds very expensive



It is unlikely that the markets will remain fixated on risk scenarios and largely ignore the more probable scenario - a moderate upward economic trend with no deflation.

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