ECONOMIC RESEARCH & CORPORATE DEVELOPMENT

Financial Market Outlook

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Risks in the wings

Allianz

RISKS IN THE WINGS

One year ago, in the midst of the crisis, some professional forecasters suggested that the guild abstain from growth forecasts as economic developments were deemed too unpredictable. Now, at the beginning of 2010, any such qualms have been set aside. The world economy has experienced a relatively synchronized recovery since the middle of 2009, with the exception of some smaller countries. Purchasing manager indices in most countries are substantially above the 50 point level, signaling solid economic expansion.

Are we therefore already in a stable and self-sustained economic recovery? The answer is no. There still exist at least two risks scenarios with a significant probability:

- a double-dip recession
- a marked pickup in global inflation

Which factors can trigger these risk scenarios? A host of factors are presently under discussion, with an assortment of transmission channels. In our view, four main risks top the bill:

- the occurrence of geopolitical risks
- a renewed surge in energy prices
- a bursting of the bond market bubble
- a sovereign debt crisis

In the following, I would like to classify these risk factors according to our scenarios.

Firstly, the occurrence of geopolitical risks (potential hotspots 2010: Middle East, Iran, Korea, Pakistan, Yemen) poses in principle a threat to any economic upswing. The Iraq war in 2003, which postponed the economic recovery after the bursting of the New Economy bubble, provides empirical evidence. As any nascent recovery, the present one is also fragile. With a savage recession just behind us, economic expectations are not robust and susceptible to sudden shocks. In the case of a political shock, expectations in the corporate sector would probably deteriorate sharply. Economic policy, already strained by the stimulus programs of the past, would once again be faced with the challenge of preventing a slide in demand and output. A double-dip recession would be the upshot. Although geopolitical risks represent a real risk to the economy, it is practically impossible to quantify the probabilities. But history teaches us that they are not negligible.

Secondly, copious liquidity in financial markets is promoting asset price bubbles. The oil price – the most important representative of the asset class commodities – has more than doubled since the end of 2008 in spite of subdued capacity utilization and constrained demand. If monetary policy maintains its expansionary stance too long, the oil price could climb to new highs. This would be a major drag on the economic recovery. Higher inflation rates would reduce

the purchasing power of households, which is already under pressure from the income losses caused by the weak labor market. As a consequence, a renewed surge in the oil price could also lead to a double-dip recession. Less probable is that such a bubble would trigger a continuous inflation process. The oil-price bubble would burst fairly rapidly in the face of declining domestic demand. The probability of a premature surge in oil prices (e.g. breaching USD 120 a barrel) depends to a large extent on the stance of global monetary and fiscal policies in the present economic environment. We estimate a probability of 5% to 10%.

Thirdly, a less visible bubble – the high valuation of long-term bonds – is possibly already a reality. A 10-year government bond yield of 3-3½% can only be fundamentally explained by low inflation expectations, low key interest rates, weak economic growth and moderate bond issuance in the medium term. The present loose monetary policy is not consistent with low inflation expectations and the swelling flood of government bonds in the course of 2010 provides fertile ground for a setback on the bond market. An acceleration in economic growth could prompt monetary tightening and fuel inflation expectations. A violent market reaction cannot be excluded. All in all, a bursting of the bond market bubble would probably happen in the context of a stronger than expected upswing and rising inflation rates. A bond market crash would mean that long-term US and EMU yields would rise by at least 100–200 basis points. We assess the probability of such a development in 2010 as quite significant (20–30%). Therefore, the bond market has to be watched quite closely.

Fourthly, in recent weeks fears of a sovereign debt crisis have intensified. Besides Greece, several other countries are also on the fiscal sick list. If a bigger industrial country were to encounter Greek-like difficulties, this could trigger a surge in capital costs for a wide range of countries and probably also for many corporates. Financial markets could take fright. Tremors on the financial markets would undermine corporate sector expectations. The economic recovery could take a knock. In our view, a sovereign debt crisis of a major industrial country will be avoided. Neither Italy nor Spain are in a situation comparable with Greece. Countries like the UK and the US, with deficit ratios above 10% in 2010, will experience serious consolidation slack in their economies, but the situation will be manageable. In addition, we expect that the pressure on Greece – especially from the EU – will lead to substantial consolidation efforts.

One question inevitably arises: If so many risks are lurking in the wings, why is the continuation of the recovery still our most likely scenario? We must keep in mind that the early stage of an upswing is often endangered by disruptive elements. After a recession, the perception of risks is generally higher than normal. This is why the strength of an economic upswing is often underestimated. Given buoyant demand in the emerging markets and the strong impulse still coming from monetary and fiscal policy, and with financial markets functioning normally again, the chances for an ongoing economic recovery are still high. Growth in most industrial countries will probably top 2% in 2010, while global growth will reach 3%.

Against this backdrop, what are the strategic implications? What to do in the recovery? On the investment front, circumspection remains the name of the game. As the upswing gathers momentum and earnings reports regain some sparkle, we recommend moderately overweighting in equities. In this context, a

hedge against big risks may be appropriate. Until interest rates start picking up, presumably later this year, one should remain underweight in government bonds. With regard to currencies, a neutral stance is appropriate as long as international currency parities jostle to rearrange themselves in the post-crisis world. We do not recommend currency bets at present. One could adapt Churchill's comments on policies to currencies: "Each one is dreadful, apart from all the rest."

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