ECONOMIC RESEARCH & CORPORATE DEVELOPMENT

Financial Market Outlook

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Yes, we Keynes*

Allianz

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So here it is, the turn of the cycle. It is earlier than most expected and – somewhat ironically – it is occurring at a time when a string of forecasts has been published e.g. by the IMF, the EU Commission, research institutes and the German government that predict no real recovery until the second half of 2010.

Of course, the green shoots of recovery are still feeble. But they are becoming more numerous. The first indicator to improve after the fierce drop in demand was business expectations. Whether you look at the purchasing managers' indices – with the very marked rebound for example in China – or other sentiment indicators like the ifo-Institute and the EU surveys, you can see that some confidence is returning in the corporate sector. The turnaround can also be seen in analysts' economic expectations, in rising stock markets and in declining corporate bond spreads. It is evident in the stabilizing housing market in the US, a drawdown of inventories and rising base metal prices. Even the indicators of the financial crisis like credit spreads for banks or money market rates are improving.

So how could this happen? Actually it is not a big surprise. There was bound to be a rebound in the economy after the drastic decline of orders and production in the winter months. The timing was questionable, but the turnaround as such was not. For three reasons:

1. Underlying this recession has been a very strong and very sudden negative demand shock. This is what Keynes described in his general theory after the world depression. The main shock occurred in the fall of 2008. Companies had already become concerned about future demand prospects due to the slowdown in the US and exploding oil prices when suddenly the unexpected escalation of the financial crisis threatened corporate financing and future economic perspectives in general. Production lines were cut, investment projects shelved and employment reduced. The economy went into a tailspin confirming the negative expectations of the corporate sector in the first place. The economic decline and the uncertainty about the future aroused the animal spirits of the corporate world, as Keynes might have said, and this retreat exacerbated the problems the economies were facing. The present decline can be described as a massive cyclical downturn triggered by the fear about the financial crisis. All this played together with the structural or fundamental problems, like excessive private household debt in some (but not all) important economies and disequilibria in international trade.

2. In a Keynesian situation, no surprise, Keynesian policies will be effective. And indeed, we have had such policies, actually enacted quite aggressively by monetary and fiscal authorities and through bank rescue packages. These demand policies come at the price of higher public deficits or excessive money supply that will have to be corrected in future years, but they do work as a stimulus in the short run. This is particularly true in the present situation, as the expansionary combination of monetary and fiscal policies was accompanied by an unprecedented fall in oil, energy and other commodity prices. This made inflation go down and it strongly boosted the purchasing power of private households.

3. The third reason for a likely rebound in the economy is that forecasts themselves are often pro-cyclical. In the midst of a deep recession, when important business

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indicators are still depressed, it obviously is difficult to see what could turn the economy. But nonetheless: It happens. And by the way: How can forecasters, who by and large all failed to make a call on the huge recession, be so sure that recovery will have to wait until the middle of 2010? Especially in an extremely volatile situation, where indicators can give guidance for two or three months at best.

So what is the outlook for the next quarters? If, for a moment, we take former recessions as a point of reference, then as a rule of thumb, about 50% of production losses during the recession can be made up for within two quarters of a recovery. And usually in a recovery phase it takes roughly the time span of the preceding recession to offset the production losses in full. Applying this rule of thumb leads to favorable growth rates for the upcoming quarters. But of course this recession is different. It is characterized by the financial crisis, which, according to conventional wisdom, will curtail the momentum of the recovery. Credit will not be flowing abundantly to corporates and private households, as banks are still shoring up their capital and reducing risks. Taking this into account, we expect a significantly longer recovery phase until the production losses have been recouped. But even then we would expect production in the OECD area to grow by an annualized 3% in the second half of 2009 versus the first half. How about inflation? Given weak pricing power of the corporate sector, it seems pretty clear that price Inflation will remain rather low for the remainder of this year, at least assuming commodity prices stabilize on their present levels. Experience tells us that it usually takes a couple of quarters until price inflation reacts to a post-recession demand recovery. This leads us to forecast a gradual increase of headline inflation in the course of 2010, going up to around 2% in the EU and the euro region and about 3% in the US.

Of course there are risks. As in any rebound situation, a big concern is the lagged rise in insolvencies and unemployment. Looking at former recessions, insolvencies and unemployment kept rising for about half a year or even a full year after demand had reached bottom and started recovering. Higher insolvencies and higher unemployment do not prevent an economic recovery from happening, but they do make it vulnerable with respect to possible exogenous shocks. Such shocks are hard if not impossible to forecast, but some candidates that come to mind are renewed shock waves in the financial sector causing doubts about the stability of the banking system, adverse developments in commodity prices, widespread protectionist tendencies or natural catastrophes. Such disturbances could always put an early end to the recovery.

This creates a challenging environment for economic policies. On the one hand it is necessary to nurture the seeds of the recovery by expansionary policies, on the other it is important to take steps towards more balanced budgets. Consolidation of public finances is obviously of essential importance for future generations but, if done too early in the cycle, it may cut off the green shoots that have just appeared on the surface. But actually this risk of premature policy contraction does not seem very acute, as the expansionary measures will be effective throughout 2010 and there are still discussions about yet further stimulus packages, not least in the US and in Germany.

So what does Keynesian reflation mean for financial markets?

- First of all, stock markets again got it right at an early point in time. But given the natural fragility of an early economic upswing, stock markets will not embark on

an unbroken climb despite the pickup in GDP figures. After the gains of recent weeks, some temporary setbacks and a pause for the markets seem plausible. But in general, this stock market rally is not what you might call a dead cat bounce or a "trash rally" which would end in tears for anyone who has significant stock exposure at present. The point in time to become careful about stock investments will come when the fiscal expansion subsides and fiscal consolidation issues move to the forefront in many countries. This will be a drag on world growth.

- Concerning interest rates, we should be on the watch. It is not only the recovery in demand and the expected moderate reflation of our economies, but also the surge of public bond issues that has to be expected for the coming quarters. This has to be absorbed by capital markets. As there is still a high degree of risk aversion, this has not yet led to rising interest rates, but once this risk aversion subsides, the premium on government bonds will also disappear. The implication is that this is not a good time to invest in long-term government bonds. On the contrary, it seems sensible to realize some gains and shift into corporate bond markets or real assets which are still overshadowed by the crisis.

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