

## ***“There is still work to do”***

- Recent rally is not the beginning of the next bull market
- Many financials will require more capital rather than more liquidity
- There is no one ‘global fix’: solutions may be governed by the cultural histories of countries
- Global industrial production has deteriorated sharply due to a fall in demand
- Growth expected to gradually begin to reappear in 2010

**Neil Dwane, CIO Europe at RCM, the specialist global equity company within Allianz Global Investors, comments on the year to date and gives his outlook for the rest of 2009:**

### **We are not at the beginning of the next bull market - yet**

“The recent rally in equities has to be put into context. January and February were a much worse start to the year than anticipated. Hopes and expectations pinned to Obama’s inauguration have been disappointed. Markets want to believe that politicians and central banks will effect a reflationary rescue of the current dire circumstances. The market has rallied quite aggressively, and technically it could still rally another 3% to 5%, but we do not believe that this is the beginning of the next bull market, because there has not been, as yet, a capitulation-type event which historically signal the bottom of the market.

### **Financials will require more capital, not more liquidity**

“The missing piece of the jigsaw is a plan from the US to stop further deterioration in financials. We think that \$1 trillion is definitely heading in the right direction, however, closer reading of the plan suggest that there is further disappointment for the US, and therefore global financials, ahead. To date, we have a plan to buy toxic-assets, effectively a liquidity plan, rather than a solvency plan. We still believe that many financials, particularly the more distressed ones, require more capital. Banks choose what assets to sell to the US Treasury, and if they are paying a price that is less than what the bank has already written down the assets to, the bank has no economic interest to exacerbate further losses.

“On a global basis, politicians are starting to put in place better and longer-lasting policies. Germany, for example, has found a way to nationalise private banking entities like Hypo Real Estate, to alleviate the potential damage to financial markets. In the UK, there is now a structure that allows banks to take insurance on balance sheet losses. However, this insurance is still very expensive and dilutive to existing shareholders. Financials are clearly still part of the problem and however low their share price may have dropped, we believe they are still not, at this stage, worthy of consideration for equity investment.

### **Reflationary policies**

“Reflationary plans take time to work. Looking at the stimuli, many EU countries are putting similar amounts of money into infrastructure and other positive developments. It is not just Obama who is building wind farms and high-speed rail links. There is a commonality of interests and the scale of the stimuli is similar, between 3% and 4% of GDP.

“Despite the plans which the G20 outlined last week, we believe solutions to this global crisis will be governed by the cultural histories of countries. China has its own ideas and is very constructive, the UK and US have a very clear view of spending and printing money, while Germany is keen to hunker down and work its own way out of the crisis. While there is a lot of debate about quantitative easing, history suggests that it is successful, but that it also generates inflation. We have seen the effects on the US dollar, Sterling and the Swiss franc recently, with substantial weakness following the announcement of quantitative easing policies. RCM believes that there will be no aggressive quantitative easing from the ECB, as Germany has not forgotten that its policy of the 1920s was followed by hyperinflation.

### **Global industrial production**

“There has been a fierce deterioration in global industrial production so far this year. The world’s second largest exporter, Japan, has seen exports fall 50% year-on-year. This is not just a credit-related issue, but a collapse in demand. Many companies are now running their businesses for cash, to survive, rather than to invest for the long term. On the other hand, there has been some resilience in other areas, such as better data for European consumer spending and US housing seems to be bottoming. However, although we are now settling down a bit, the level of activity is significantly lower than in previous years. In Japan, year-on-year GDP is settling at between minus 10% to minus 12%.

“Given the collapse in industrial production and global trade, we would expect this economic performance to stay with us over the next two to three months. Going forward a focus will be to look out for signs of a slowdown of this deterioration. Obviously, mathematically, Japan’s exports can’t continue to fall 50% year-on-year! We now have global interest rates at around 0% and monetary policy usually impacts on the economy with a lag of 12 to 18 months. Therefore somewhere in the second half of 2009 we should begin to see the impact of cheap money on the economy, which should potentially improve the rate of decline into 2010.

### **Conclusion**

“The economy still looks set to be tough. Markets have now priced in a lot of the bad news and the consensus seems to be that there will be a snapback in economic growth in 2010. It seems widely accepted that the worse 2009 is, the faster the recovery will be in 2010. We believe that part of the rallying and ebbing in equity markets will be driven by the fact that markets are still too optimistic about the growth prospects. We would be more comfortable with the image of an extended L-shape into 2010.

“Globally, there is no quick fix. However, if a certain level of inflation is factored in, the risk-reward scenario is looking attractive, given the performance of equity markets in recent months. Bond investors are now questioning how aggressive they should be in their buying, when they will be able to buy bonds in the coming months from most governments around the world. Obama is looking to issue \$2.5 trillion worth of bonds over the next months. From a European perspective, money markets and bond markets presently yield virtually nothing. We believe, income can now be found in the equity markets, with dividends now exceptionally high and valuations looking attractive.

“Looking into 2010, growth will begin to reappear, but on a muted level, probably more markedly in emerging markets. The threat of inflation or the threat of bond supply may cause people to worry about financial assets and consider diversifying back into real assets – including equities.”

**- Ends -**

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