

“Savers will fund the global recovery”

- **Things will get worse before they get better**
- **Deflation - not necessarily an evil**
- **Western savers and saving nations, such as China, will pay for recovery**
- **Equity values are at historic lows, but volatility will persist**

Andreas Utermann, Global CIO at RCM, the specialist global equity company within Allianz Global Investors, provides his latest global outlook:

US bailout plans

“The situation is very complex, old remedies may not work and much more may need to be done. I think that the markets’ reaction to the US bailout plan – which lacked detail – was natural, i.e. sell on the news simply because the jury is still out on the potency and efficacy of this plan, and of similar plans in the other countries.

“A particular struggle will be the fact that the private debt to GDP ratio in the US and in the UK is simply too high. Historical evidence points to the fact that once the total private debt to GDP ratio rises above 130 percent, and it is close to 200 percent in the US and over 200 percent in the UK, you end up in trouble and real economic growth is only re-established once you get back down towards 130 percent. Actually to kick-start the economy you might need to be closer to 100 percent. Much of the fiscal and monetary stimulus that we are seeing will be aimed at reducing both consumer and corporate debt in order to try to re-inflate the economy. We expect this recession, particularly in the UK and the United States to be long and drawn out, and therefore the news this year will get worse before it gets better.

Inflation vs deflation

“About three years ago RCM took the view that inflation was going to become a topic for markets and that as a result of rising inflation expectations, Western central banks would need to increase interest rates and those central banks in the East and in the emerging markets which had fixed currency regimes would probably need to implement fiscal measures to try to arrest the increasing boom conditions. We thought that the strongest likelihood was that there would be a benign outcome, i.e. slightly higher inflation for some time in the region of 3 to 4.5 percent, perhaps cooling economies but not leading them into a downward spiral, and that a slightly higher inflation rate (when compared to the 1990s) would slowly erode the debt overhead.

“As it happened, in 2007 inflation did become an issue. In early 2008, central banks aggressively raised interest rates but did not manage to steepen the yield curve and we got pushed into the current recessionary if not depressionary environment. Clearly inflation is no longer a topic and disinflation and deflation are now the key threats. The central banks and the fiscal authorities are doing everything possible to arrest a depressionary style deflation.

“At present it is not clear whether the fiscal and monetary deflation that we are seeing needs to end up in prices. There is a strong likelihood that much of that can be sterilised later on. But more importantly it is also not clear to us that deflation is necessarily an evil. We can very well imagine a scenario where we have disinflation for some time, particularly in the Western economies, with slow growth but not of the depressionary kind.

“We don’t buy the argument that in deflationary times people stop spending because they expect prices to fall. There are many examples over the past 20 years where prices of a number of goods – consumer electronics, IT equipment and so on – have hit significant deflation every year but that has not stopped consumers from buying these goods. What needs to happen though, is that confidence needs to be restored. Some of the balances need to be restored and if that arrests the slide of negative growth then we could well have flat or slightly positive growth still with disinflationary forces at work.

“One of the consequences of course of this episode, if you are thinking longer-term, might well be a return to a different type of monetary policy by the authorities and the central banks. In particular a move towards inflation targeting and that of course would mean probably a slightly higher inflation rate in the longer run to avoid being too close to a disinflationary scenario sometime in the future.

Global imbalances

“Arguably, the global imbalances, particularly the over-consumption of the West and over-saving of the East, were root causes of this current crisis. This crisis will resolve those imbalances. So longer-term, the macro environment and financial markets will improve. The way this will resolve itself is simply through a transfer of wealth from the debtor nations to the saver nations. The same transfer of wealth is going to occur within economies as well, i.e. savers will be in a stronger position than debtors. However, both China, as a major saving nation, and savers in the Western countries, will have to finance at least part of what is required to get back to a more normal economic situation. The way that the Chinese will finance this is simply because the US dollar will depreciate and therefore the debt that they hold in US treasuries will be worth less to them. Savers in the West will be ‘punished’ and will need to bail out the debtors to a degree by paying higher taxes. This moral hazard has its problems but this is the only way that the current situation can be resolved.

Currencies

“RCM take the view that given what has happened in the US and what needs to happen in terms of fiscal and monetary reflation, in the medium to longer-term once the safe haven status of the US becomes less important and the global economy gets restarted, the dollar will continue its downward slide. It will not be a rout but clearly the dollar in three or four years will be worth much less relative to most major currencies than it is right now.

“Within the Euro area we observe big differences between some countries who are looking relatively healthy, such as Germany and France, and some of the peripheral countries, which are looking much less so. The latter have seen a significant deterioration of their unit labour cost in recent years and therefore their competitiveness has also declined. They can no longer depreciate their currencies because they are tied within the same currency. Sovereign bond spreads of peripheral countries relative to Bunds have therefore increased significantly.

“There has been speculation that this may lead to the break up of the Euro area, but we don’t believe that this will be the case. Yes, measures will have to be taken to rectify the situation and once more the ‘savers’, in this case the healthier nations, will have to contribute to the bailout of the periphery. A nation may even default, but this need not necessarily mean the break-up of the Euro area. We believe that the cost of any country leaving the Euro area, particularly in this current crisis, will be prohibitive.

The impact on asset classes

“We believe that in 2009 equities will continue to be extremely volatile. Within equities we prefer Asian and European equities, particularly when taking total currency considerations into account. We prefer growth stocks with strong cashflows, and the ability to grow the dividends as themes across all markets.

“We believe yield curves will steepen and corporate bonds relative to governments, particularly the longer maturities, are good value. But clearly the steepening will occur both through a sell-off at the long end and continued easing at the short end. We would steer clear of property and private equity at the moment. Current equity valuations are historically at

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very low levels, and we would use the volatility to gain exposure, particularly in the favoured areas, but we would not be aggressively overweight to equities at the moment. In particular one should stress given the risks that are still out there for the next 12 months, this would only really be appropriate for people with a very long-term investment horizon.”

- Ends -

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