

## Economic Review

By Andrew Hunt

Q4/06

### About Andrew Hunt

Sparinvest works with Andrew Hunt, independent economist of Hunt Economics. In his market comments he gives a precise and unreserved analysis of the economic development. As we at Sparinvest do not claim to be able to predict the economic trends, we pass on the market comments to illustrate the degree of uncertainty within the economic future, which at the same time emphasizes the importance of thoroughly diversified portfolios. ■

### Market comments

Conventional wisdom would have us believe that bond yields have tumbled over the last four months in the USA and elsewhere as the financial markets have come to discount what the consensus believes will be a relatively soft landing for the US and global economies. We, however, suspect that this explanation for the rally in bonds is unconvincing, since not only have yields on government bonds fallen, so have yields – and ‘spreads’ – on corporate and other higher risk bonds. Usually, when an economic slowdown approaches, markets begin to discount the increasing likelihood of corporate defaults with the result that credit ‘spreads’ rise (i.e. corporate bond yields rise relative to government bonds) but this has clearly not occurred and we therefore suspect that the bond markets have been driven by something other than economic fundamentals.

In fact, we find through reference to the relevant flow of funds statistics that the rally in bonds has probably simply been due to massive capital inflows into US and international bond markets by Asian central banks, Asian private sector investors, European commercial banks and Japanese investors. These flows appear to have been driven not by US ‘fundamentals’ but rather by specific factors within the donor countries, including rising Asian savings and the impact of Japan’s stalled economic recovery. However, as these flows have impacted the US debt markets, they have exerted a stimulative impact on the US economy and even on the country’s formerly distressed mortgage market.

During the summer months, the US economy did slow as a result of rising mortgage rates, high capital gains tax demands and high energy prices. However, since September, energy prices have retreated, the tax bills have been paid and mortgage rates have fallen back as bond yields have declined. Hence, the factors that were leading the US to slow have now substantially reversed and these events, coupled with what is still a relatively strong labour market (wage inflation in the US remains relatively robust) lead us to suspect that the flow of US data over the coming months will tend to be stronger rather than weaker, a factor that while perhaps supportive for equity earnings in the near term, may prove problematic for what are now very expensive bond markets.

In addition, we would also expect the recent run of ‘good news’ on inflation to come to an end. Since the middle of 2006, Chinese manufacturers have been conducting what amounted to a fire sale of their large stocks of inventories. China’s albeit modest tightening of credit conditions in the second quarter appears to have acted disproportionately on the manufacturing sector, with the result that many companies in the sector have become short of working capital. These cash flow issues have obliged companies to liquidate inventories at heavily discounted prices, a course of action that though detrimental to Chinese manufacturing sector profits, has been extremely helpful to western inflation trends. The ‘glut’ of cut-priced Chinese exports has resulted in sharp falls in clothing, consumer

electronics and IT goods in the US and elsewhere, to the obvious benefit of the reported inflation rates in the importing countries. Unfortunately, such inventory cycles can, by definition, only be temporary or finite in nature. We estimate that China's inventory disposal cycle will end sometime in the late first quarter or early second quarter of 2007, with the result that China will cease offering such large price discounts, an event that can be expected to impact Western inflation rates adversely.

Given the probable strengthening in US economic data in the near term, and the likelihood for 'negative news' on inflation by the end of the first quarter, we suspect that bond markets may suffer a reversal in the first half of 2007, and that any correction in the debt markets may also tend to lead to a compression of price earnings ratios in the equity markets as well.

Although equity markets are by no means expensive according to conventional valuation techniques at present, they are clearly 'betting' on an early reduction in US rates in 2007. However, poor inflation news and any revival in the economy could force a significant change in view that may cause some negative sentiment in the markets, particularly if the Federal Reserve Chairman provides an aggressive or hawkish policy statement in his annual mid February policy address to Congress.

If the flow of economic data does force a rise in bond yields, and perhaps even an unexpected policy response from the Federal Reserve, then we would envisage that this 'second round' of tightening will finally cause the highly indebted, and perhaps financially over extended, US household sector to finally pull back their levels of expenditure. Such a rise in the US savings rate would then cause a significant slowdown in the US economy, but we suspect that this would be an event that would not occur until the latter half of the year. Thus, while we find ourselves agreeing with the consensus that the US will ultimately slow, we suspect that the timing of the slowdown – and hence the eventual reduction in interest rates that will accompany it – will be delayed until late in 2007. Moreover, and unlike the markets, we would expect yields and perhaps even policy rates to rise in the first half of the year before declining later in the year, thus contributing to a series of events that could unsettle financial markets around the second quarter.

Elsewhere in the global economy, we suspect that Japan's economic renaissance has lost momentum. Although the economy will likely produce slightly better economic data in the near term, it is now clear that the Bank of Japan's 2006Q1 tightening of monetary policy was premature; the recovery in credit growth and consumer spending has aborted and the economy, although clearly not headed back to a recession, appears to have lost its former buoyancy. Within the smaller Asian economies, we find that domestic demand, and in particular domestic investment trends, are subdued as a result of what must be considered as over-tight monetary regimes and weak profitability trends, factors that lead us to suspect that these markets may continue to under perform their peers, although they may gain some support in the near term as China's inventory cycle turns from being contractionary to expansionary for regional growth.

In Europe, we are continuing to witness modest signs of an economic recovery in Germany and France's domestic economy is continuing to gain strength, as are the Scandinavian economies. However, all is not well in Southern Europe. Years of low productivity growth and high rates of wage inflation have taken their toll on Italian and Spanish competitiveness with the result that we expect these economies to struggle over the next few years

– and to exert a constraining influence on the Euro’s external value over the medium term vis-à-vis the Yen and the US dollar. While we suspect that there will be relatively few ‘big’ currency moves over the next year, the currency markets may prove rather more volatile in 2007 than they have over recent years as market participants switch erratically from worrying about Japan’s stalled recovery to the US’s current account deficit and then the Euro’s structural problems.

In summary, we suspect that 2007 may prove a little more volatile a year than its predecessors. In the near term, signs of a recovery in growth in the US could be expected to lead to a sell off in bond markets but some support for the USD, and to perhaps some downward pressure on equities in the second quarter. Thereafter, we would expect the global economy to weaken to the benefit of bonds but the detriment of the USD and earnings expectations in the equity markets. ■

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