

A Greek tragedy

May 2010 // Market commentary

The biggest question for investors arising from the European debt crisis is whether it is primarily a risk aversion event (albeit deep and protracted) or a larger macroeconomic shock that has the potential to derail the global economic recovery. On balance, we think the current dramas represent a risk aversion event, with the sharemarket correction unlikely to be sustained. To become more cautious, we would need to see how fears of Greek default could cause a renewed global credit crunch and stalling of the global profit rebound.

Europe isn't the only issue investors have to deal with. There is also, the potential for a China slowdown as tightening measures take effect, and questions about the sustainability of the US economic recovery mean that sharemarkets have a fairly large "wall of worry" to climb. None of these issues should prevent global markets from ending the year modestly higher, but they can all add significantly to market volatility.

The main factor keeping us relatively optimistic on the outlook for sharemarkets is that the recovery in corporate profits has further to run. We are still in the sweet spot of the earnings cycle as firms with plenty of excess capacity see demand and revenues grow off a fixed cost base. This has been apparent in the 1Q reporting season with most S&P 500 companies exceeding analyst expectations. Our favourite indicator of the US profit cycle, the Conference Board's quarterly survey of CEO confidence – which tends to lead annual growth in S&P 500 operating EPS by one to two quarters – decreased marginally from 64 to 62 in the March quarter (50 is a neutral reading), but is still at high levels. Consensus expectations are for 30% growth in S&P 500 EPS this year and the CEO confidence reading suggests that this is on track to be achieved.

US recovery remains on track

The US economic recovery is looking more entrenched, with a range of economic indicators now on the upside. The ISM index of manufacturing activity is signaling a robust expansion, consumer spending has strengthened and housing indicators are showing tentative signs of recovery.

"Markets are struggling and prone to volatility. The reason is mostly to do with fears that the final leg of the global financial crisis is about to play out in sovereign debt markets."

Even so, it is unrealistic to expect anything better than a sluggish recovery from the worst recession since the 1930s. Most economists are looking for US GDP growth of around 3.5% this year, about half the growth rate that would normally be expected after such a large recession (the US economy grew by over 7.5% for six quarters following the 1980s recession). The poor shape of the financial system remains a significant constraint on the strength of the recovery.

The current US outlook of a sustained but moderate economic recovery is the best case scenario. Markets are struggling and prone to volatility. The reason is mostly to do with fears that the final leg of the global financial crisis is about to play out in sovereign debt markets.

A Greek tragedy

One lesson from the past 18 months is that concerns about liquidity and solvency can quickly cause broader contagion and large-scale risk aversion. While some of the more pessimistic commentators are likening Greece to Bear Stearns and have cast Portugal in the role of Lehman Brothers, we don't think European government debt problems are about to generate a renewed global financial crisis. The Lehman collapse effectively triggered a run on the global financial system, drying up liquidity and creating large scale insolvency for financial institutions. The ensuing credit crunch devastated the global economy causing both corporate profits and sharemarkets to plunge.

The current situation in Europe, while serious, seems unlikely to have investors questioning the viability of the global financial system. The magnitudes of the potential losses are fairly well known and the European Central Bank (ECB) and European governments seem to have learnt the contagion risk lesson and seem determined to shield their banks from PIIGS-related write-downs for as long as possible. The €750 billion European Union/IMF funding package and willingness of the ECB to buy government bonds effectively covers the liquidity requirements of the high debt euro-area countries.

“The current situation in Europe, while serious, seems unlikely to have investors questioning the viability of the global financial system.”

It is not a complete solution, however, as it does not deal with the solvency issue – the willingness and ability of high debt euro-area countries to repay their borrowings. For example, the scale of the Greek fiscal contraction (11% of GDP in three years) required by the rescue package will place enormous pressure on the Greek economy and society. Greece faces an almost intolerable burden in fiscal cutbacks and debt servicing costs. Even if successful in eliminating the primary fiscal deficit, Greece is likely to have a government debt to GDP ratio of around 150% in three years' time. On the optimistic assumption that this could be financed at a 5% average interest rate, interest payments alone will account for 7.5% of Greece's annual economic output. Investment markets are therefore likely to continue speculating about the likelihood of an eventual

debt default or restructuring. The question of whether Greece exits from euro is also open given the choice of painful deflation to restore export competitiveness by staying with the euro, or less painful currency devaluation by leaving the euro.

“Unfortunately, the issues surrounding potential euro-area defaults are not likely to disappear anytime soon...”

The fiscal positions of Portugal and Spain are somewhat better than for Greece, but the concern is that neither country has a dynamic enough economy to grow its way out of debt problems or a political culture that will accept large deficit reductions.

It is hard to make a confident prediction as to how the crisis will play out. The best case scenario is if the bailout package successfully calms fears about a near-term Greek default, while Portugal and Spain make credible commitments towards deficit reduction and economic restructuring. The worst case scenario is that the pain of deficit reduction becomes too great, triggering a default and an exit from the euro.

Unfortunately, the issues surrounding potential euro-area defaults are not likely to disappear anytime soon and will be a continuing source of volatility for global investment markets.

However, the crisis may open up an attractive entry point to higher risk assets. Risk premiums might rise for a while, but cash rates won't and this will anchor discount rates. The crisis seems unlikely to seriously derail the global recovery in corporate profits.

Look for opportunities when fear and uncertainty seem as high as they can get.

China: Looking for a slowdown

While the euro-zone concerns are currently grabbing the headlines, the issue of a China slowdown remains in the background. China's economy barely slowed during the GFC, registering growth of 8.7%. Add to that a 30% increase in bank lending, a 40% expansion in industrial production and growth of 46% in construction last year, and it is little surprise that there are concerns about overheating. China's authorities have responded so far with three increases to bank reserve ratio requirements and a monthly credit quota. Their goal is to slow annual lending growth to 17%.

China's economy always looks like a high wire act and there is a risk that policy tightening could trigger a hard landing. With inflation still low and credit growth slowing, a soft landing seems the more likely outcome. The greater risk is that the economy does not slow by enough this year, forcing more aggressive policy measures and increasing the risk of a hard landing in 2011.

Australia: Cyclical headwinds ahead

Our last report nominated the theme of 'less pain means less gain' for the Australian outlook. Having missed the deep recession of the rest of the world, Australia lacks the cyclical upside of other economies. Sharemarkets have so far subscribed to this view with the S&P/ASX 300 returning -0.5% over the first four months of the year compared to +4.1% for the MSCI World share index in USD terms.

While most economic indicators remain strong, we are probably moving through the peak in the economic cycle. After six RBA interest rates rises since last October, and with several more to come, monetary policy will soon start to bite. The sustained high Australian dollar is a further headwind and many of the fiscal stimulus measures put in place to combat the GFC are now winding down. There is also the prospect of a slowdown in China and a potential reversal in commodity prices to consider.

Enhanced Asset Allocation

For clients who are interested in strategies which are designed to take advantage of current market valuation levels to add incremental return potential over the strategic asset allocation policy of a portfolio, contact your Russell representative who can provide more information about Russell's suite of Enhanced Asset Allocation strategies.