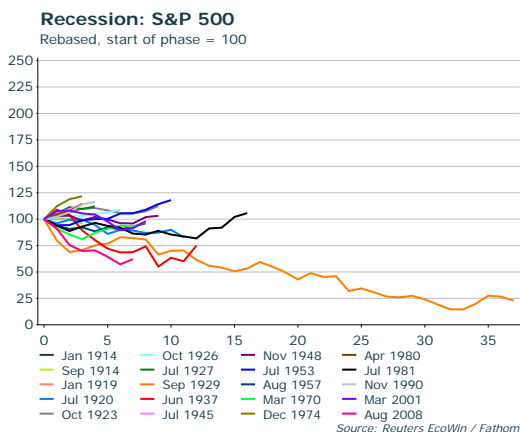




# Markets: priced for perfection?

## Introduction

Despite a recent bank survey<sup>1</sup> suggesting just 5% of investors expect a V-shaped recovery, a broad range of financial markets continue to behave as if just such a recovery is upon us. Even for those who are skeptical about a rapid return to normality, the contrarian trade remains compelling - after all many equity bear-market rallies have previously exceeded 20%.



So are markets just pricing in the 'green shoots' of a modest recovery or a full blown rebound and rapid return to normality? In our most recent G4 quarterly forecast, we outlined a fairly pessimistic outlook for both economic activity and asset prices. Our growth fan charts envisage a slow, moderate rebound in economic activity at best, as global deleveraging continues. Moreover, they imply that the stronger the uptick in the short run, the more likely a double-dip and/or ongoing sub-par growth become. Given that view, in this note we consider whether the markets are underplaying the short and medium term risks, and whether they are 'priced for perfection'.

## Stress markets – past the worst?

A number of markets – particularly those most affected by the banking crisis - are back to 'pre-Lehman' levels, but still remain in the 'post-Bear Stearns' range of stress. To that extent, the worst may be over but we are still far from the all-clear yet, and will likely have to get used to permanently higher risk and liquidity premia. Both interbank spreads and the VIX remain well above pre-stress levels, though well below post-

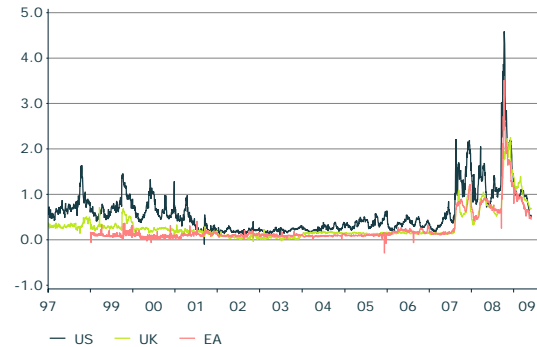
<sup>1</sup> Barclays Capital (as reported in the Telegraph June 4<sup>th</sup> 2009)



Lehman peaks. While not 'priced for perfection', these levels strongly suggests that markets are not expecting a return to turbulence any time soon, perhaps because the myriad of government interventions are felt to have been successful.

#### Interbank Spreads

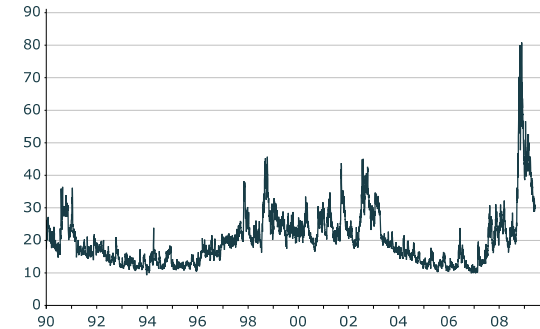
Percentage points



Source: Reuters EcoWin / Fathom

#### VIX Index

Close, USD



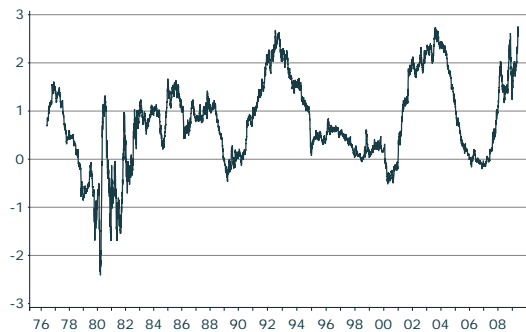
Source: Reuters EcoWin / Fathom

## Sovereign fixed income – underestimating the risks?

The US yield curve appears priced for a strong rebound in economic activity – much as after the past two recessions in the early 2000s and the early 1990s. Inflation expectations – as measured by breakevens – are picking up and have contributed significantly to the rise in yields. But expectations remain well-contained for now, as markets move away from pricing in a significant chance of long-term deflation. To some degree then, the US bond market currently appears to be pricing in a perfect recovery at target levels of inflation, despite the many macro risks to this scenario. Certainly, it appears that not many of the risks implied by our US bond yield fan chart are yet reflected in yields.



**US 10y-2y**  
Per cent



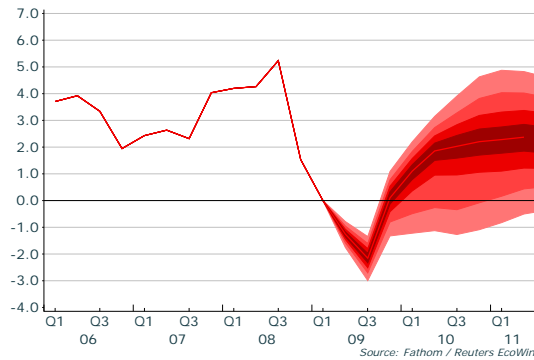
Source: Reuters EcoWin / Fathom

**US Breakeven Inflation Rates**  
Per cent



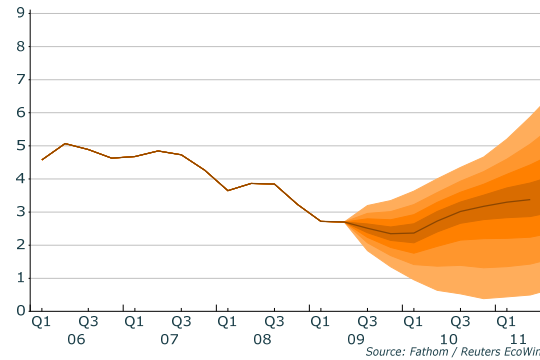
Source: Reuters EcoWin / Fathom

**US inflation**  
Annual percentage changes



Source: Fathom / Reuters EcoWin

**US ten-year bond yield**  
Per cent



Source: Fathom / Reuters EcoWin

To an extent, this story holds true in the UK as well, with record steepening but relatively benign breakevens. That said, the inflation forwards market is picking up more sharply than in the US, particularly at the longer end. The 20-year breakeven has now risen above 4½% and has been rising steadily for a number of months. This perhaps reflects the precariousness of the UK's fiscal position, coupled with fears about the long-term risks associated with quantitative easing. Nevertheless, we would still argue that our forecast fan charts allow for a larger degree of risk than is implicit in UK yields and that UK bond markets remain vulnerable despite the rise in yields to date.

**UK 10y-2y**  
Per cent



Source: Reuters EcoWin / Fathom

**UK Inflation Forwards**  
Per cent



Source: Reuters EcoWin / Fathom



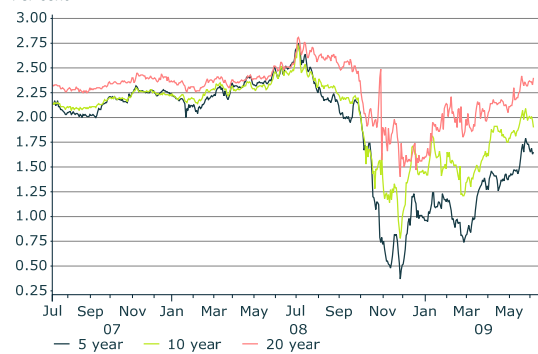
But perhaps European bond markets are the most complacent of all. The yield curve is discounting as sharp and permanent a recovery as in other parts of the world, despite a lag in the fundamentals of Europe as reflected in lower business surveys such as the PMIs. Moreover, if there is another leg to the banking sector collapse, it is most likely to arise in Western Europe, where exposures to leveraged Eastern European investments are greatest.

**EA 10y-2y**  
Per cent



Source: Reuters EcoWin / Fathom

**EA Breakeven Inflation Rates**  
Per cent



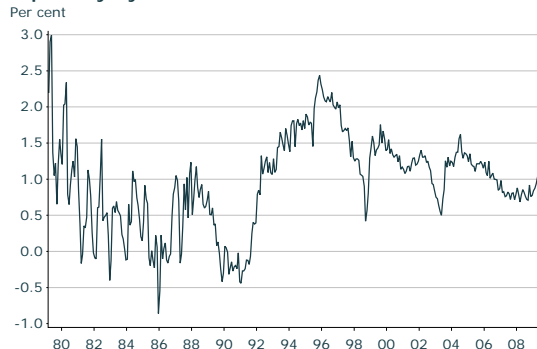
Source: Reuters EcoWin / Fathom

Japan's situation remains rather different to that of the other G4 nations. With deflation entrenched, there has been no turn around in breakeven rates, in part because the authorities show few signs of a return to radical quantitative easing. But despite this, the yield curve has steepened back to levels last seen in mid-2006, suggesting a sharp growth rebound is expected. As with other regions, the Japanese bond market appears to be placing much weight on the improving second derivative of output, as a harbinger of long-term recovery.

Fathom's forecast is less optimistic, suggesting again here that the bond market is getting ahead of itself in proclaiming a rapid return to growth when what we are currently witnessing is a reversal of some of the collapse (an arithmetic improvement in the 'second derivative'). We do not discount the possibility that growth may be strong for a few quarters – in fact our fan charts suggest it is reasonably likely – especially if Asian and emerging markets' domestic demand continues to improve at current (official) rates. But our concern is that the financial markets may be underestimating the possibility of a significant down side surprise, which could cause this steepening to unwind remarkably quickly.

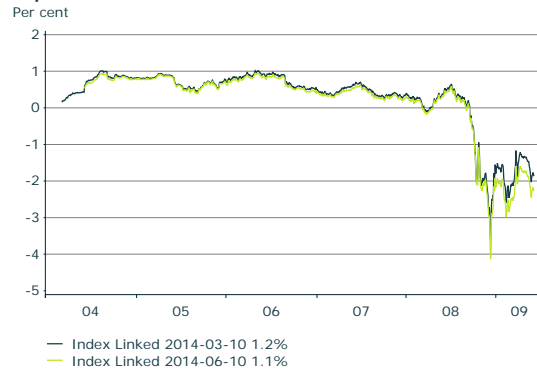


**Japan 10y-2y**



Source: Reuters EcoWin / Fathom

**Japan Breakeven Inflation Rates**



Source: Reuters EcoWin / Fathom

## Equity markets – happy days are here again?

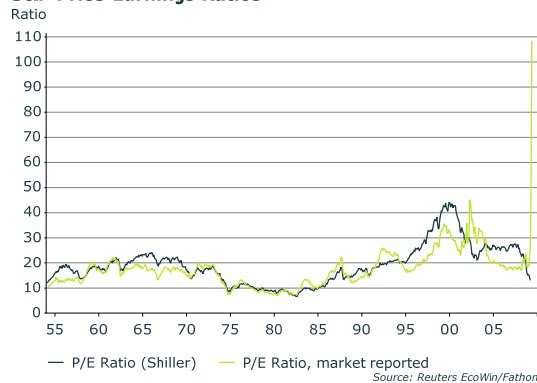
G7 equities have rallied 25-30% from their mid-crisis lows, though levels remain far from what could plausibly be described as 'exuberant'. Markets have rallied as the spectre of a complete global banking sector meltdown has receded. And, as such, the rally could, until recently, be described as the elimination of an extreme undervaluation rather than any fundamental optimism for the outlook. It also reflects the expectation that corporate and banking profits will rebound in the coming year: the actual P/E ratio has shot up whereas a version based on Professor Robert Shiller's smoothed 10-year earnings has not (though there is a month's difference between the two measures).

**Equity Markets**



Source: Reuters EcoWin / Fathom

**S&P Price-Earnings Ratios**



Source: Reuters EcoWin/Fathom

The profit share of US GDP has fallen, but remains at an elevated level. For the few remaining 'new economy' bulls this represents a massive buying opportunity, but we are less convinced. Unit labour costs have been rising sharply of late, as the traditional late-cycle rebalancing of the workers' share of income continues apace. That said, at some point rising

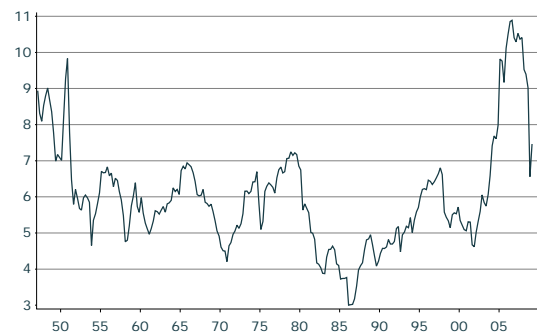


unemployment will bring that process to a halt and the profit share will bottom out. The question is, at what point will that happen.

We suspect this cycle is not so different from previous ones, that the fundamentals of the US labour market are basically unchanged, that low productivity growth will generate rising real unit labour costs for at least another 12 months and that the profit share will bottom out somewhere near past lows. Optimists will believe that job shedding at current rates will generate this turnaround sooner than in previous cycles, that faster capital depreciation motivates a higher equilibrium profit share and that, as a result, equity market valuations have reached or are nearing a bottom themselves. While we recognise this as a real possibility, our fan charts for growth and equity prices reflect a preference for the former view.

**US Profit Share of GDP**

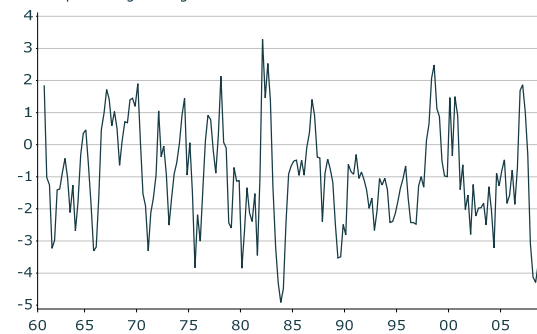
Per cent



Source: Reuters EcoWin/Fathom

**US Unit Labour Cost - CPI**

Annual percentage change



Source: Reuters EcoWin / Fathom

## Credit – back off the floor?

Rating agencies that forecast the coming 4-quarter default rate have already started to reduce their expected levels of high yield default rates, Moodys, for example, thinks a European default rate of 14.6% is likely in 2009, higher than the 12% of 2002, but lower than the rate suggested at the turn of this year. As result spreads have come in significantly, in both the US and Europe. US spreads are already at recovery levels last seen in 2003, after the peak in defaults had passed. If this cycle is like the last (and we suspect it will be significantly worse), then the market has got ahead of itself by around six months. In Europe on the other hand, and particularly amongst the lower-rated names, the market is still catching up. The markets appear to be markedly more cautious about European names than US ones.



### US High Yield Corporate Spreads



### EA High Yield Corporate Spreads



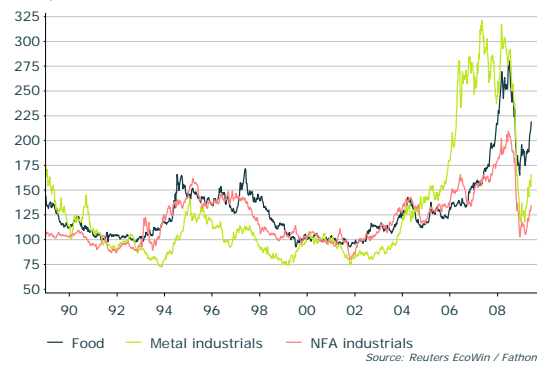
## Commodities – the global story

Commodities have rallied significantly, largely on the back of strong Chinese and Asian data. We take this information very seriously for the following reason. The most benign outcome for the world economy is one in which domestic demand in Asia and other emerging markets rises significantly over the coming months and years. This would allow over-leveraged economies in the West to reduce debt – both public and private – against a background of relatively strong global demand and therefore export growth. This would facilitate a relatively ‘benign’ global rebalancing of demand and net trade, and is not dissimilar to the adjustment the UK undertook in the early 1990s, when strong export growth helped ameliorate the deflationary impact of private and public sector debt reduction.

While we do not discount such a possibility, our concern is that commodity and other markets appear to be placing a high weight on just such an outcome – a higher probability than we would probably place ourselves, at least in the medium term. A variety of indicators, ranging from the Baltic dry index to the currencies of commodity-producing nations have turned up sharply, though it is fair to say none are yet approaching ‘exuberant’ levels. Nevertheless, all are consistent with a return to the happy days of 2003-5.



**Economist Commodity Price Indices**  
Index, 2000=100



**Brent Oil Price Futures**  
\$ per barrel



**Baltic Exchange Dry Index**  
US\$



## Conclusion

This note asks “are markets priced for perfection”? In our view, in the US, yes, broadly speaking. In EA, UK, it’s less clear.

Are they right? In our view, no. We would argue that many are excessively sanguine about the risks, and that much of the rally reflects relief that the worst is behind us. It might turn out the way markets seem to be assuming it will, but the risks are larger in our view than is consistent with market pricing, and our fan charts reflect that.

What is the evidence for that? First and foremost – the housing market and the level of debt, globally. Equity and, to an extent, bond prices are disconnecting somewhat from what we believe is the underlying source of the problem – housing – which has not gone away.

We have asked in the past, ‘who is now holding the housing market risk’? It started off as the shadow banking sector, then shifted into the banking sector proper, and now resides largely with governments. Risk metrics spiked one after the other to reflect that – CDS spreads, then interbank spreads and now to a large extent it is sovereign risk. A large spike in bond yields – driven by either or both real yields and breakevens – could yet provide a large jolt to other markets, especially equities. The US with its reserve currency status may ironically suffer least in such an event, but



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smaller debt-exposed economies such as the UK would see the largest adjustment in such a world.

It is not that we discount the stories associated with the 'second derivative' of output. GDP growth will improve in the coming quarters – it almost has to. We may well be past the worst in terms of quarterly declines in the US, UK and Europe – but we have doubts about the durability of any upswing, and our forecast fan charts reflect those doubts. There is a very good chance that structural headwinds will eventually outweigh the considerable policy-induced cyclical upturn – especially if China and the rest of the developing world do not come to our rescue. And, in our view, the greatest risk is that markets discover that sooner rather than later.