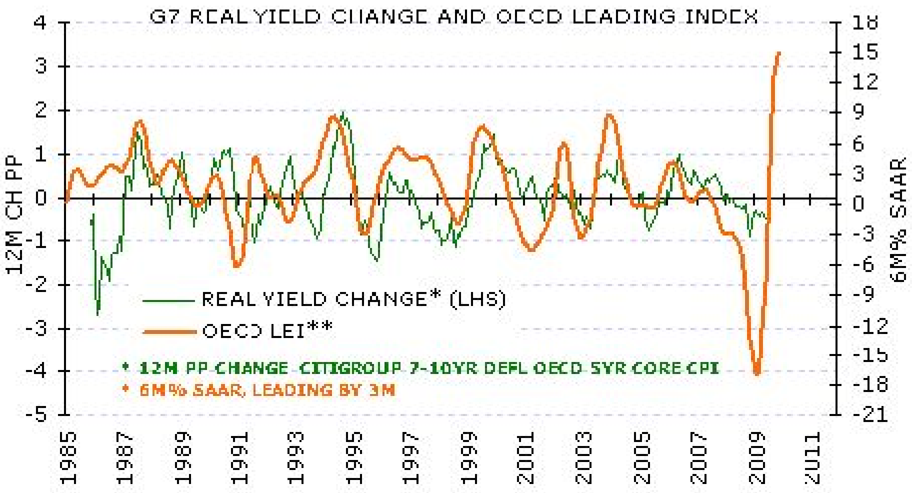
January 2010

Market outlook
Let’s start a new decade

Table of content

Ten years ago, the Millennium Bug was a common obsession. As the clock struck 12, and a new millennium began, planes were envisioned as falling from the sky, supermarkets as running out of supplies and the banking system as going into meltdown. Well, thank goodness, none of that happened but, unfortunately, another meltdown was on the way: people would have been better off not investing in equities as it was a dreadful decade for equity investment.
So far, the year-end rally is spilling over into the New Year. At the start of 2010, we are all hoping for a better decade, especially given that the conventional wisdom in Europe is quite depressed by the prospects for the new decade. If, in 1999, the overriding popular fear was the silly Millennium Bug, 10 years on you can take your pick from the following challenges: deleveraging, the looming pension crisis, global warming, etc…. Western countries face huge competition from the emerging powers. Chinese mercantilism is a growing problem. Westerners have the choice of simply sitting back on their welfare and pension entitlements or of responding with creativity, innovation and determination. The technological changes over the past decade are a kind of new industrial revolution and winning countries have to exploit it to the full. **The west has to overcome two challenges at the same time because they are closely tied: the maintenance of financial stability and the search to improve their sustainable growth path.**

In 2010, the macro should shift from recovery expectations to recovery delivery and sovereign financing will prove the main risk. There is the growing likelihood of economic recovery turning out better than expected; the flip side would be tension on the sovereign bond market. Investors are still underestimating the favourable feedback loops that kick in during recoveries. Leading indicators continue to surprise on the upside. The headline manufacturing index rose to 55.9 in December, its highest level since April 2006. The last couple of days-weeks are maybe a good preview and template of what 2010 could look like: a combination of better-than-expected but tension-ridden leading indicators and exit strategy-related fears. Equities have, up until now, benefited from a sweet-spot environment, given that bond yields have not reacted to an astonishing set of leading indicators. Usually, when the leading index is a strong as it is now, bond yields are sharply higher, as shown below.



Source : Morgan Stanley

Equities are entering a tough and crucial transition phase. Most of the monetary stimulus is becoming to wane, while investors may shift their focus to the exit-strategy issue. The public debt issue may overshadow the sustainable recovery of profits for a while.

Risks are numerous for 2010: declining sovereign credit quality, exit strategies, the US dollar, regulation and politics…. Typically, rising bond yields go hand-in-hand with stronger growth and hence earnings upgrades. **Earnings will rise next year and we are not afraid of a double dip unfolding in 2010. Earnings will even continue to surprise on the** upside. Equity multiples are low enough to withstand rising bond yields, but only to a certain level. The uncertainty is all about how investors will weigh the negative against the positive. Will they focus first on the positive surprises associated with the economic recovery (earnings upgrades), or on the flip side of stronger growth (a higher discount rate)? The conventional wisdom is assuming a strong start of the year for the equity market before a rollover in the second half.

Paradoxically, a stronger-than-expected recovery would create a temporary tailwind for the equity markets. The reflationary process is not a free lunch. We are not so concerned by the exit from extraordinary monetary-policy stimulus and the possible effect on interest rates but, rather, by the lack of willingness on the part of the public authorities to unwind the public deficit in an orderly manner. While the bond vigilantes tend to be sanguine when things go sour, they tend to wake up when things start to look up. Bond yields and the US dollar started to creep up on the back of a strong NFP in early December. Recently, we have seen that bond markets play their role of adjuster when there is a lack of political will to act seriously. We wonder if, in 2010, the financial markets will punish other selected countries, the UK, especially.

People continue to be obsessed with, on the one hand, the over-leveraged American consumer, in spite of current evidence of private-sector demand for credit also beginning to pick up (as we will see later) and of the future belonging to the emerging world (China, in particular). Although it is too early to talk about a bubble on emerging assets, there is an incipient one. An underlying fundamental long-term story, and also an important financial aspect tied to US monetary policy, should not go unnoticed. The emerging run will not come to an end as long as investors are convinced that the major economies are not yet ready to implement an exit policy. Two factors are critical when assessing this risk: the prompt improvement in labour market conditions and the recovery in demand for credit in the private sector. The last set of data is showing signs of improvement on both fronts.

Last month, we mentioned the problems correlating bonds, commodities, currencies and equities. The fact that equities can rise in spite of an ever-weaker US dollar and ever-higher commodity values consoles us.

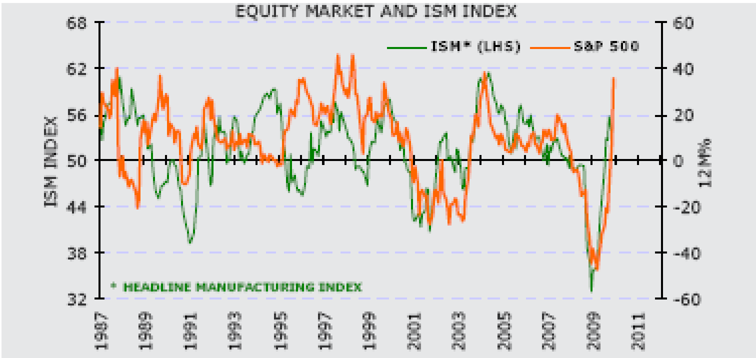
The US greenback bounced back in December after having reached a 40-year, trade-weighted low. Although this may be nothing more than a short-term trade after a prolonged period of weakness, we find it interesting to highlight the backdrop of this turnaround. The US dollar bottomed out on the back of stronger-than-expected non-farm payrolls. A bearish view on the US currency is based upon the belief that the US economy is unable to recover on a sustainable basis. The November payroll report marked the end of the downward adjustment of expectations for the US currency. The labour market is improving and consumer surveys suggest that households are beginning to notice this. There is still some scope for a consensus forecast of 2010 growth in the US and the euro zone.

2009 proved to be a perfect cut-and-paste of 2003. Will 2010 mimic 2004, which was a positive year for equities, albeit also a very bumpy one?

Dexia Asset Management

Macro and profits

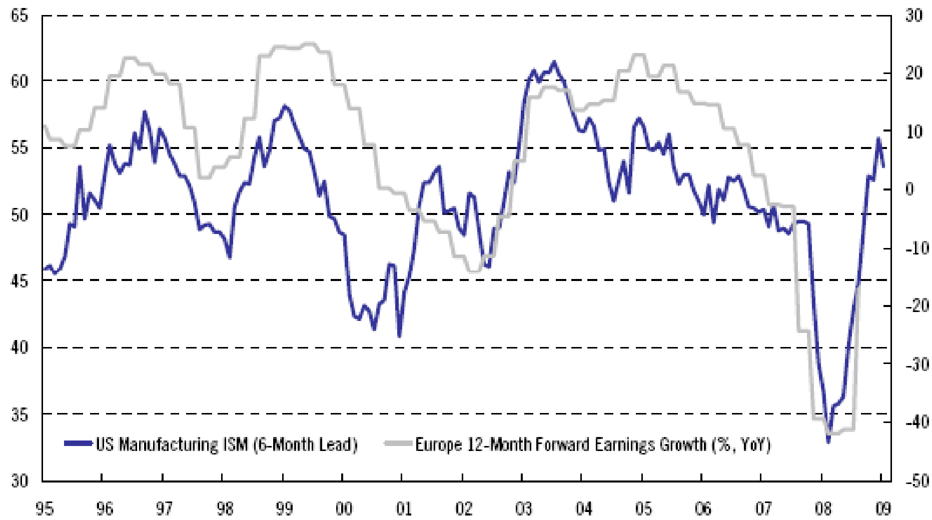
Looking back, it would appear that the ISM is the only thing that counts. It actually transpired that equities bottomed soon after the ISM (as shown below), and the relative sector performance from the ISM throughout this cycle followed the historical pattern.



Source: ISM, Standard & Poor's; Morgan Stanley Research

This is why it is important to see the ISM as a leading indicator for any disappointment down the road. It may be argued that this indicator is not representative of the broader economic outlook and that it is just correcting a dramatic phase of destocking and a tumble in global trade volumes. However, the ISM, an accurate forecaster of earnings growth over the past 20 years (cf. below) can also help predict earnings.

US ISM and Europe 12-month forward earnings growth 1995-2009

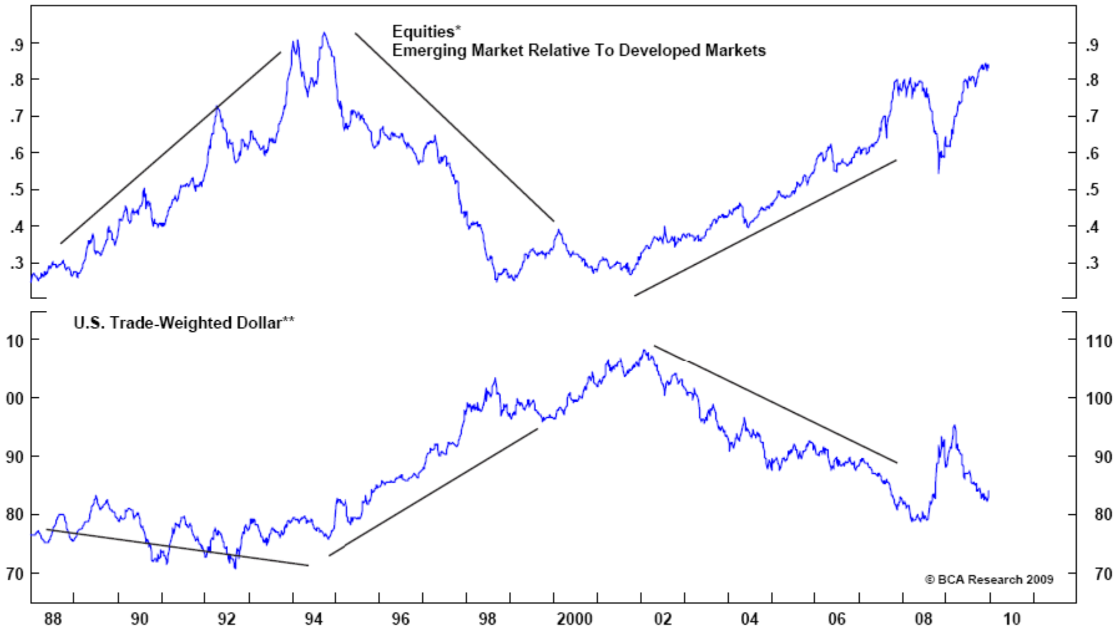


Source: Citi Investment Research and Analysis and DataStream

ISM movements suggest that double-digit earnings growth for 2010 is a likely outcome. Our belief is that earnings revisions will continue to go up and that analysts are lagging behind, paying too much attention to corporates which are also lagging behind. We believe, too, that there can be positive surprises in top-line growth. Companies will face increasing pressures to invest, especially in the wake of growing Chinese pressure.

The emerging-market trade and the dollar correlation

2009 was a year of weakness for the US currency; today, the emerging markets are hogging the limelight. This is why it is important to look at both. Historically, there has been an inverted correlation between the performance of the emerging markets and the US currency.



* Shown in common-currency terms. Source: MSCI Inc. (see last page).
** Source: J.P. Morgan Chase & Co.

This time, more than ever, the emerging markets have rallied explosively on a weakening dollar, suggesting that borrowing in US dollars to buy emerging market stocks has become a crowded trade. This is potentially setting the stage for a countertrend move in both the dollar and emerging market stocks. We are sick of saying that a falling dollar is not per se sustainable or self-destructive. Maybe the level reached late November was the tipping point.

Follow-up on sovereign risk

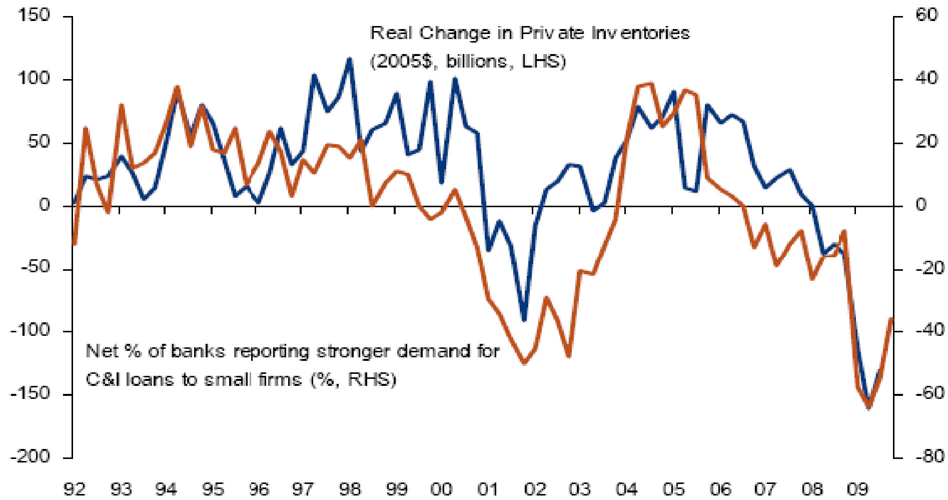
We first mentioned the sovereign issue three months ago. People are reading too much into the Greek issue as the beginning of a domino effect or harbinger of default. It is interesting to note that the spreads of other "weak European sovereigns" have not widened nearly as much. Ireland and Greece, although initially thought of as being in the same boat, are actually two different situations. **It is a credibility issue – which has to be priced correctly – more than a sovereign issue.** Spreads on government bonds have been reset accordingly. While Greece has obviously done very little in the past two years to deal with its budget problems, Ireland is in the midst of a severe belt-tightening exercise. Moreover, while Portugal has had to endure a deflationary burst almost since Day One of its entry into the Euro, Greece has been enjoying the benefits of the European Union with precious few of the inconveniences. Greece is by no means a potential new Lehman case. The EU won't let Greece down, especially as Greek bonds are mostly held by European banks. At the very least, credibility cannot be taken for granted. Greece was in the eye of the storm as the Greek people were not prepared for austerity, meaning that the financial markets had to do the job and force the country into accepting tough measures, which it ended up doing. It might be politically easier for the present government to have austerity imposed on it from the outside than from the inside. We are more concerned by the UK situation.

The sovereign issue, more than anything else, could bring about a premature end to the sweet spot. It will trigger some volatility down the road but, paradoxically, could also extend a lax monetary policy. All in all, the public-debt overhang is preventing investors from blindly playing a normal economic recovery. **It won't derail the equity recovery but will create some volatility, i.e., opportunities. From an equity angle, we are inclined to further geographic bets to play the sovereign fear and thus favour global diversified companies against pure domestic ones.**

Credit demand

In 2010, the financial markets may reacquaint themselves with one or other of the traditional economic laws, e.g., the eviction effect. Economic recovery is making economic agents more competitive about borrowing. So far, however, one key element is missing: credit demand from private agents has been anaemic enough to avoid this risk, this could change in 2010. One of the primary uses of commercial and industrial (C&I) credit is to finance inventories. The drop in inventories may, to a certain extent, be due to tight credit; it is also due to big recessions causing big reductions in inventories. As a result, the demand for loans to finance inventories has also declined. This would suggest that, as long as inventories continue to contract, business credit demand will remain weak. As inventories grow, we suspect that the demand for C&I loans will improve and that C&I loan growth will resume.

Correlation between inventories and loan demand



Source: Bureau of Economic Analysis, Federal Reserve, BofA Merrill Lynch Global Research

The spread between orders and inventories is increasing. In other words, orders are rising faster than inventories can keep up, which implies that, down the road, production will have to ramp up. The first post- Black Friday indications are rather encouraging. Once again, all eyes should now be focusing on labour income growth, which has also started to show some signs of life.

The improvement in consumer and credit conditions in America should reinforce the USD.