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Investor reaction to market stress set to change

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Since late April investors have, according to most surveys, built up major money market positions and, as reflected in the current low yield levels, significant long positions in US Treasuries and German Bunds. This flight to safety was triggered in April and May by investor concerns over eurozone sovereign and bank risk and, more recently, by increased expectations of a slowdown in the US economy.

Investor behaviour in the past three months has followed a typical pattern of risk reduction, with capital flows into what are perceived to be the safest assets – i.e. G3 government bonds. A relevant question, however, is whether this perception of safety is likely to change and whether investor capital flows will be directed differently in future times of market and economic stress.

In the US, recent data have shown a clear deceleration in demand and activity, with particularly weak data from the housing sector, while consumer spending has slowed against a background of poor monetary and credit conditions.

This trend was confirmed by the recent downgrade of the Federal Reserve's forecast for real gross domestic product growth. While the probability of renewed recession remains low, a number of factors imply that the medium term growth prospects for the US are less favourable. Key constraining factors are the weak outlook for consumption assuming US savings will be re-built, the poor labour market with unemployment staying well above the historic trend, and the lower level of leverage in the banking system, which will restrict credit expansion and make improbable any near term recovery in the housing market. A central case has to be a sustained period of sluggish US real GDP growth.

One obvious conclusion, as evidenced by US policy statements at the last G20 meeting, is that the US administration will move slowly in tightening fiscal policy while monetary policy will remain easy. So far this calendar year, the reported US Treasury budget deficit is annualised at US$1,300bn. The gross US government debt to GDP ratio will exceed 100 per cent in the short term and total US debt, on Office of Management and Budget data, could reach US$18 trn by 2020. Net interest payments to total revenues are likely to be over 15 pct by 2013.

In addition, individual state budget deficits could exceed US$140bn this year with states and municipalities struggling to expand revenues amid high unemployment and poor real estate conditions. It is clear that local government defaults and debt restructurings will increase in the near term. Note the widening of spreads in the municipal bond market. The US will show fewer of the signs of a safe haven in the future, particularly if no progress is made in addressing the US budget deficit and if a renewed trend of US dollar weakness emerges .

Europe and Japan, too, are losing the characteristics of a safe haven. Although the eurozone has taken robust action in reining in fiscal deficits and investor concerns over bank risk should be allayed if the stress tests are handled professionally, substantial longer term problems exist there. Like the US, bank de-leveraging will lead to poorer credit conditions. In many eurozone economies, the lack of labour market reform will lead to higher trend levels of unemployment, constraining fiscal revenues. Most models point to major differences in competitiveness within the eurozone, which will require a reduction in unit labour costs in many countries.

Given the need for fiscal restructuring, the weaker eurozone countries are likely to experience a sustained period of near recession. Exports have been the driver of the German economy but the export outlook could deteriorate if the euro strengthens further and demand elsewhere in Europe is weak.

In Japan, while growth this year, led by exports, could reach 3 per cent, many structural issues are becoming more serious. After the US and the UK , the cyclically adjusted government primary balance is the worst among the OECD countries. Gross government debt to GDP will reach 200 pct in the near term . Although the Japanese government have made a number of statements saying that the fiscal position has to be addressed, there has been little firm action.

Moreover, the ageing Japanese population could struggle to maintain current savings rates, implying that Japanese budget financing will be reliant on foreign investors. If deflation in Japan switches to - albeit modest - inflation, Japanese savers could accelerate their foreign investment.

In contrast, most emerging economies are characterised by high domestic savings, strong budget positions supported by revenue growth, high levels of official reserves and, despite a recent moderation in sentiment indicators, high trend levels of real GDP growth. By 2014 , government debt as a percentage of GDP among the developed economies in the G20 will approach 120 per cent; the corresponding figure for the emerging economies in the G20 will be less than 40 per cent.

The key characteristics of a safe haven in times of market stress are perceived minimal default risk and negligible risk of market and credit downgrades. In the medium term, the safe haven characteristics of the G3 are deteriorating while those of the emerging economies are improving. The classic investor reaction to market stress is likely to change significantly.

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