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Asset Management

Viewpoints

FROM CHAIRMAN JIM O'NEILL

The Market Battle Between Data and QE.

This past week was a bit more sober for markets after the fun and games of the previous week. A number of disappointing data points from around the world reminded us all about the background which economic and monetary policy is trying to change. As a result, much of the debate is about whether aggressive monetary policy can positively influence the real economy in many challenged advanced societies (US, Japan and Europe) in addition to the ongoing debate about the inflationary consequences. I shall reflect on both in this week's Viewpoint. I might add that those debates came against the background of the St. Leger race last weekend, which optimists argue heralds the end of the 'sell in May and go away' phenomena. Those less positively inclined point out that given the size of the equity rally since late July, has the past St Leger rally already happened? After my own personal travel calm of the summer, it is starting to ramp up and I am paying the price. I am off on a frantic dash to Australia, Hong Kong and Singapore this week which gives me plenty of airtime to ponder stuff.

Soft, Albeit Stable Data in September – So Far.

This past week was an important one in terms of an up-to-date read on global cyclical momentum, with the release of the September Philly Fed in the US, flash PMIs in China, the Euro area and the US, as well as the regular Thursday US jobs claims, which post QE3, are now even more important for markets.

China's flash PMI was a touch better although still weak. The Euro area flash PMI was disappointingly weak, with a large deterioration in France offsetting a notable bounce back in Germany. The flash PMIs don't include all countries, which is a shame because post the August Euroland easing of financial conditions, it will be interesting to see whether Italy, Spain, Greece et al show signs of a bounce. We will have to wait until the final PMIs are released in just over a week. In the US, a better than expected Philly Fed, including healthier components, was accompanied by an unchanged flash PMI at 51.5. Yet again, positive surprises in housing data were published but unfortunately, once again, the weekly job claims disappointed.

One continued marginal positive eye-catcher was the UK with the latest CBI business survey showing further signs of hope. The all important PSBR was released Friday showing two contradictory messages. Firstly, the 2011/12 fiscal position improved a bit more than previously, with a deficit of 7.8%, instead of 8.4% of GDP, down from 9.5% in 2010 (which means fiscal tightening had been tougher than previously thought). Secondly, the planned improvement for 2012/13 has stalled. Whether that is a major problem or not, given the better than expected starting place, is an open issue in my view.

World Imbalances Improving.

I have often thought that one way of thinking about the many challenges various countries face is that they have been forced, since the 2008 credit crisis, to shift their balance of payment current account positions. In particular, large deficit countries have to adjust to requiring better domestic savings and less dependency on external capital – which in a credit-starved world – is less available. To accommodate this, by definition, current account surplus countries will also need to adjust. These adjustments are to some extent unavoidable and a less negative way of thinking about the world economy's future. Any evidence

that those adjustments are under way is constructive. In this regard, this week's news that the Q2 US balance of payments current account deficit narrowed to around $117.4bn, some 3% of GDP is especially encouraging. It continues to improve despite the recovery (albeit a gentle one). Pessimists argued, for much of the post-2008 environment, that most, if not all, of the current account improvement would be purely temporary and a reflection of the weak domestic demand in the US. Yet here we are after Q2 with the deficit at 3% of GDP, way down from the dark years of 6-7%. Some long-term students of the US balance of payments argue that due to relative demographics and savings patterns, the US could cope with a 3% current account deficit. Of course, for the US to be closer to full equilibrium it would be good to see the deficit staying in the vicinity, if not improve more, with unemployment closer to 5% than above 8%. But it is not to be dismissed.

In the same vein, this week Greece reported a current account surplus for July, yes a surplus. For the year as a whole, their deficit stands at Eur 6.5bn, which is down from a deficit of Eur 13.8bn in the same seven months of 2011. Now of course Greece is a long way off full employment equilibrium, but you get my gist.

Protests Aboard!

The past week could also perhaps be characterised as a week of protests; whether it be Catalonians in Spain, Portuguese against austerity, Indians against – what looks to me as though it is very – positive change, Chinese against Japanese ownership of some small islands, many Middle Eastern people against a variety of things, and Manchester United fans against failing penalty shooters. Many market participants are quick to cite the protests as yet another reason to worry and doubt the sustainability of markets. In a way, protests are a by-product of change, especially when it reflects the kind of adjustments that have to cope with changing global imbalances.

Japan's Issues Getting Bigger?

When it rains, it pours. While the China–Japan dispute is not good for China, it could be a bit of a mini disaster for Japan. Given Japan's need for external markets to play a persistently key role in helping Japan, risking a closure of its biggest export market and FDI destination doesn't strike me as a good option. If this weren't enough, the dispute has flared up in the week when the government appears to have taken the decision to phase out all its nuclear energy production, guaranteeing dependence on imported energy. Japan's balance of payments future does not look healthy to me, and yet, the Yen remains at ridiculously expensive levels. To top a gloomy week off, the Bank of Japan (BOJ) 'surprised' markets with another of its, what I would call 'token', QE moves announcing plans for more asset purchases. The response? Renewed Yen strength! The BOJ needs to borrow Ben Bernanke or at least some of his and his colleagues' vigour. Japan needs some serious (positive) nominal GDP targeting.

China – Where it is Also Pouring.

The best thing to be said about the past week is that the President-elect, Xi, re-appeared in public. The China A-Share market endured another dismal week (more on this below). Their flash PMI was at best, a hint of stabilising weak momentum and they appear to be far too excited about the dispute with Japan. Against this background, the global mood about China and its economic future is rapidly souring. With the planned leadership changes around the corner, but the exact timing unknown, and persistent rumours of disputes at the highest levels, the resolve of even the most China-friendly optimists is starting to be challenged. In this context, I have to admit that I have developed some doubts about the idea of owning China A-shares against being short the Aussie dollar that I mentioned a couple of weeks back. I thought of it in the context of 'new China' versus 'old China' which I strongly believe is the reality of the issue the markets are having to deal with now and not something more akin to a 'hard' versus 'soft' landing. Think of '7-ish' GDP growth instead of '10-ish', and of rising retail sales relative to production, or of long Mexico/short Australia kind-of-theme, etc. But what I hadn't thought through, until the day China A-shares rallied nearly 4% on the back of unfounded rumours of a new infrastructure package, is that the aggregate China A-share index is dominated by 'old China' names. What I really mean is to be long China consumer-facing equities, or perhaps even long China specialist stock-pickers against being short 'old China' for which I think the 'expensive' Aussie dollar is a good, liquid proxy.

In this context, ahead of my trip to Australia, I note that their Resources Minister stated last week that the global boom in resources is over. I look forward to hearing more about that.

Other Tidbits.

Before I finish on the QE3 themes I raised at the start, the following nuggets caught my eye this week:

1. The Italian Economy Minister Grilli was quoted as saying a single Euro zone IMF seat is inevitable. Nice to read, can we get a move on please.

2. Israeli PM Netanyahu said that a clear 'redline' should be set for Iran over which it cannot cross. Interesting.

3. China Construction Bank said it is looking to buy into a European banking presence. Not all see gloom in Europe then?

4. Bangladesh, one of our Next 11. My ex-colleague, Pranjul, sent me a short paper that she had written with others outlining that Bangladesh has demonstrated you can execute change for the good-of-many with a low level of GDP per capita. This is a message aimed at an Indian audience I presume, given Pranjul's current role at the Indian Planning Commission.

5. Ahead of Sunday's Liverpool versus Man United game, there is an outbreak of friendly banter between the two proud clubs. Let's see if it survives the result.

QE3/QE Infinity.

So back finally to the two big US issues related to Fed policy.

Following the Fed's decisions, inflation 'breakevens' from the US bond markets implied a sizeable jump in medium to long-term inflation expectations. Traders and investors concluded that, at a minimum, the Fed is taking more inflation risk by opening itself up to an undefined time of asset purchases, and raising the goal of faster unemployment reduction as a stated purpose. To a large extent, given that my own interpretation of the Fed's move is that it is a step towards nominal GDP targeting, this reaction is understandable.

Three points lead me to question the simplicity of the market reaction. Firstly, the markets' view of inflation is exactly that. Whether it is accurate or not, time will tell. If it is not corroborated by a rise in the University of Michigan's 5-10 year Inflation Expectations Survey (a closely watched indicator at the Fed), I know which one I will favour. Secondly, it seems to me that the Fed is implicitly encouraging a rise in short-term inflation expectations. In this regard, if the one year Michigan Survey rises and the five year doesn't, the Fed will be happy and not too concerned about the TIPS market's view. Thirdly, it is interesting that oil (and some other commodity) prices fell since the Fed move, partly in circumstances where US policymakers were once again threatening to turn on the taps from their strategic reserve. And then surprise, surprise, Saudi Arabia makes noises about boosting supplies. Could those actions be more related to the timing of the Fed's move than first thought? It wouldn't be the first time.

Related to the second point is the growing issue of whether QE3/QE infinity will actually positively impact the real economy. I encouraged this topic to be the theme of our bi-weekly GSAM 'CIO' call. There were many sceptical voices that argued US growth cannot pick up on a sustainable basis until the corporate community starts to invest and employ more and Washington gets the fiscal impasse resolved. Before the Fed's latest move I would have sympathised with this, but the style of the Fed's QE3 makes me have more hope for two reasons. Firstly, by choosing to engage in further support for the mortgage market, the Fed is deliberately helping a sector of the economy that is already improving anyhow. Secondly, and linked to the nominal GDP targeting notion, unlike past QEs, the Fed isn't going to stop until it sees positive real economic results. Or at least that is what they told us.

Anyhow, lots more time to ponder all these things. At least I'll be able to watch Sunday's big match before I disappear off to Australia. Have a good one.

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