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Market Tactics

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INVESTMENT RESEARCH
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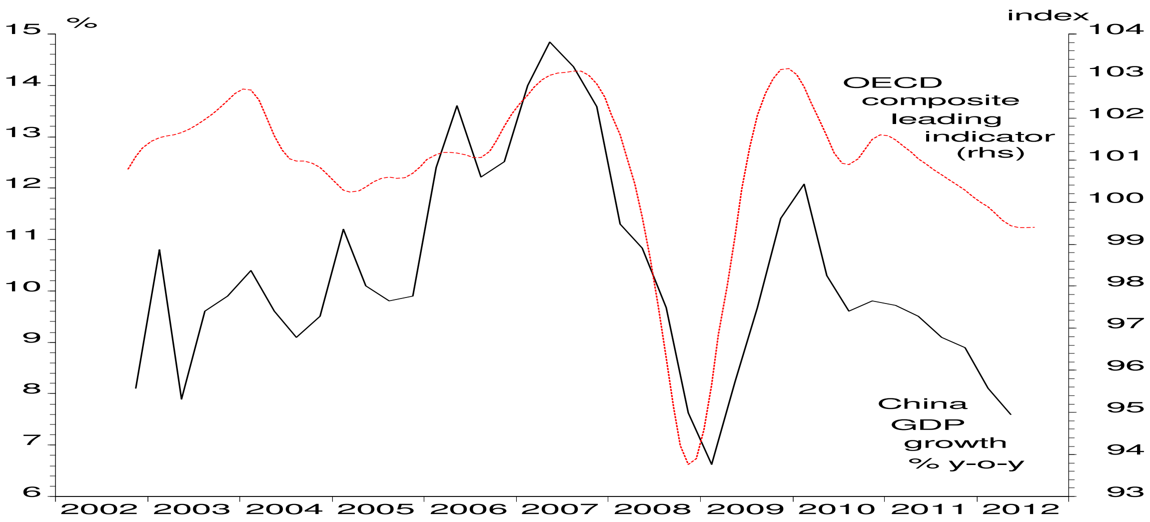
A medium term outlook with just a little less uncertainty.



Source: DATASTREAM

Medium term forecasts from Consensus Economics Inc show that over the next 5 years the US, the eurozone and China are expected to grow by an average annual rate of 2.7 percent, 1.2 percent and 7.6 percent respectively. As the National Institute used to say, a forecast, be it short-term or long-term, can convey a sense of precision that is not intended.

Taking the relative magnitudes then as the key feature, there is not much here to disagree with. If anything, the feature reflects what is widely understood about the broad economic backdrop. This is, that due in large measure to Fed policy, the US economy is expected to grow at a pace not far short of its long term, post-war, growth rate of 3 percent, that the eurozone is expected to grow modestly at best and that China is expected to grow as the authorities intend, notably slower but more balanced.

So what might the message be?

First, if China's adjustment to a slower growth rate is running its course, the loss of global momentum attributed to it is likely to be running its course too. GDP for the third quarter is due tomorrow and the consensus expects growth of 7.4 percent. The OECD composite leading indicator for China shown in the chart has been flat lining for the past three months after having fallen continuously for the preceding 18 months. Given the six-month lead time, this should be indicative of stability ahead for the economy.

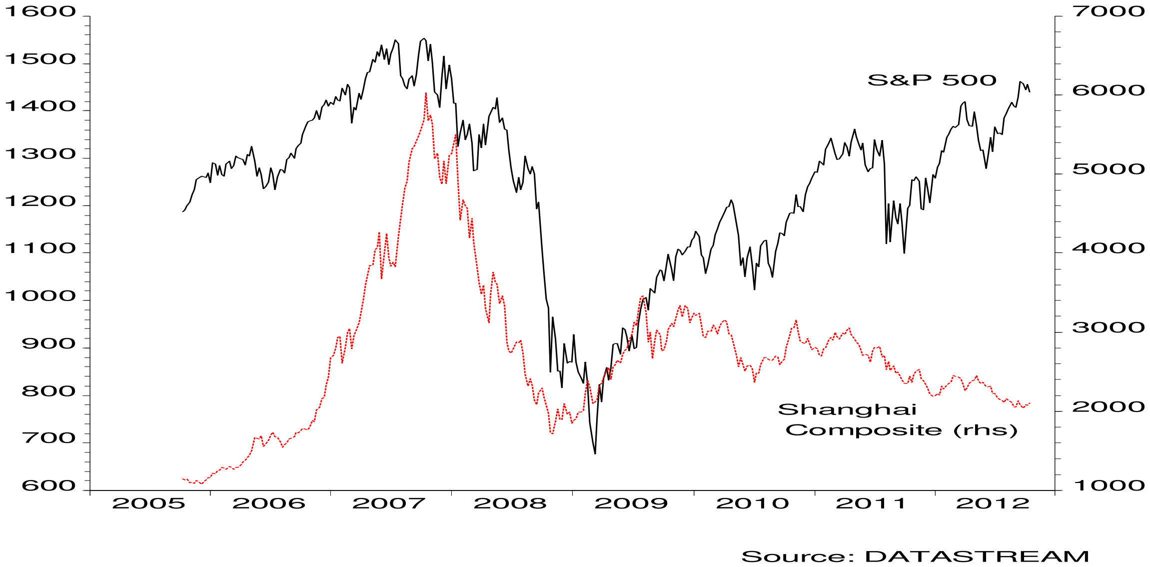
However, China's adjustment to slower more sustainable growth does mean it will be far less instrumental in supporting the global economy as it did in the period following the financial crisis. That much we know already.

Second, in contrast to China's slower growth, a Bernanke-led Fed wants faster growth. Given that high unemployment is viewed as more cyclical than structural, faster growth is the answer to more job creation and a lower unemployment rate. So the Fed is going for it and the consensus forecast for the US is consistent with its commitment to supporting the economy.

There is more to it though. As the Chairman said at the recent World Bank-International Monetary Fund gathering in Tokyo, stronger US growth is good for the global economy. As he put it in defence of the Fed's actions: 'Assessments of the international impact of US monetary policies should give appropriate weight to their beneficial effects on global growth and stability.'

While it was aimed at the critics from the developing world, the point applies generally. The consensus forecast of 1.2 percent growth expected for the eurozone over the medium term is likely to be conditional on the 2.7 percent growth expected for the US. Not only that, the latter in turn is conditional on Fed policy. Anything less than the Fed's all-out effort and the eurozone would likely be unable to muster even the paltry growth forecast by the consensus.

Third, the consensus numbers suggest that the leadership of the global economy has swung back to the US. The reality is the US never lost its leadership. Although China's big stimulus following the financial crisis was undoubtedly a boon for the global economy, its adjustment to slower growth and to a policy effort directed at stabilising rather than stimulating its economy is what likely lies behind the performance and de-rating of the equity market. Wall Street, on the other hand, has continued to lead the way in reflecting both the Fed's determined efforts to support the economy and a corporate sector that has been able to deliver on earnings. The Shanghai Composite, meanwhile, has gone the other way.



Might the prevailing uncertainties be diminishing? If China's adjustment to slower growth is running its course, then not only is the loss of global momentum attributed to it doing so as well, but the de-rating of the equity market could be running its course too.

For the eurozone, a policy framework intended to facilitate the adjustment to full integration is not only developing but the ECB has introduced a formal procedure, through its Outright Monetary Transactions, to assist the adjustment. Time will tell if the latter gives rise to an environment less fraught with instability and uncertainty but the very announcement of it and the ECB's commitment to it appear to be doing this already.

This leaves the US. For Congress, which needs to get on with fiscal policy, the question is; does it want to be blamed for a recession? Certainly, Mr. Bernanke won't take the blame.

According to Bloomberg both the Democrats and Republicans are discussing 'fallback plans' that might mitigate, if not avert, the fiscal cliff. It is accepted that a comprehensive fiscal adjustment programme cannot be achieved before year-end. However, it is also acknowledged that an effort is required not only to enable a programme of budget cuts to be deferred to 2013 but to take the edge off the uncertainty it has created and the adverse influence on the economy. The talk is of US$60 billion to US$100 billion cuts in federal spending.

To sum it up, this is a more progressive investment backdrop than existed a few months ago. If uncertainty depresses demand, reducing it even marginally should encourage demand to be more responsive to the stimulus already provided by the major central banks. That has got to be good for earnings – the medium term consensus forecasts may even understate the outlook for growth – and supportive of equity markets. This is aside from the current earnings season in the US and Europe. It is early days but if the results prove to be better than expected, as they appear to be thus far, Wall Street can only continue to go one way.

IMPORTANT NOTES

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