



First Quarter Analysis

by Andrew Hunt

Western money heads East

Perhaps pleasingly for economists, although probably not for anyone else, the global economy appears to be becoming ever more divergent and complicated to analyze. On a positive note, household spending is beginning to strengthen in many of the emerging markets. This, we suspect, is not primarily as a result of their superior growth prospects – or other perceived long-term advantages – but because there has been a significant easing in their domestic monetary policy settings, brought about by massive investment-capital inflows from the West. Western monetary policies appear not to have generated strong economic recoveries in their domestic economies. In fact, domestic demand trends seem to be slackening at the margin in the West, as household incomes come under pressure. However, the extraordinarily lax monetary policy conditions in these developed countries have both financed and encouraged unprecedented levels of capital inflow into many emerging markets. These immense inflows have, in turn, obliged local central banks to become more expansionary themselves. Hence, we are seeing an upturn in domestic demand in these countries. From the point of view of global growth, this domestic renaissance in the world's most populous nations can, of course, be welcomed. However, the individual central banks in many of these countries – and particularly in the fashionable BRIC economies – are only too aware that this type of expansion can turn inflationary relatively quickly. In fact, inflation rates in the BRICs are already moving up and these countries seem set

to attempt to tighten their monetary regimes over the course of 2010, an event that may lead their currencies to appreciate but their growth rates to moderate.

Monetary policies to tighten...

There has also been much talk of a tightening of monetary policies within the Western economies of late. In some senses, the mere announcement of an intention to tighten by the European Central Bank, the Federal Reserve and the Bank of England actually represents an important first step in the tightening process. These central banks evidently wish to tighten – not necessarily because they believe that their respective economies are recovering strongly but because they wish to put an end to some of the abuses of their monetary generosity. For example, the Federal Reserve's purchases of Mortgage Securities produced relatively few benefits for the US's struggling household sector but, inadvertently, it provided funding to Hedge Funds. Meanwhile, the ECB's generous lending facilities were diverted into cheap financing for Southern European countries' overly lax (and counterproductive) fiscal policies.

However, we suspect that – in reality – the central banks will not be able to change their extraordinarily expansionary policy stance this year and in fact many have already moved back towards a more relaxed rhetoric. In the USA and the UK, the ending of last year's massive fiscal policy injections, and in some instances rising tax burdens, has led to a sharp collapse in disposable income growth which already appears to be sapping

About Andrew Hunt

Sparinvest works with independent economist, Andrew Hunt, of Hunt Economics. In his Economic Review, he gives a precise and unreserved analysis of world economic developments. As we at Sparinvest do not claim to be able to predict economic trends, we pass on Andrew's Economic Review to illustrate the degree of uncertainty about the economic future, which also serves to emphasise the importance of maintaining thoroughly diversified portfolios.

the household sector's ability to spend. The US housing market is widely assumed to be suffering a 'double dip' and the latest retail sales figures have tended to be disappointing. A similar pattern appears to be emerging within the UK and the prospect of a more generalized 'relapse' in these economies should ensure that both these central banks remain generally accommodative, even though this year's inflation rates seem set to be substantially higher than those experienced last year.

Deflation in Japan

In Japan, meanwhile, deflation remains firmly entrenched and the domestic economy continues to languish – despite the recent slight improvement in the country's exports to Asia. With the current lax fiscal policy stance apparently reaching the limits of its sustainability, the Bank of Japan has been obliged to become more expansionary, despite its internal reservations over the use of Quantitative Easing Policies, and we can expect this central bank to remain expansionary for at least the next 12 months.

The Greek/Euro Crisis

The European Central Bank has, of course, suffered a traumatic period of late as it has attempted to deal with the implications and fallout from the Greek Crisis. In practice, the Greek, Spanish and Portuguese economies should not have joined the Euro when they did and, as a result of their mis-timed entry and subsequent behaviour, they now find themselves in intractable, uncompetitive positions which we believe simply cannot be solved through fiscal retrenchment and enforced cost deflation. Ultimately, we believe that Greece's public and private sectors will be forced to default on many of their existing debts and the outlook for Spain is only marginally better. However, at present, political forces within the Euro Zone are preventing these necessary defaults and this political impasse is threatening – in a very real sense – to tear the Euro project apart at its core.

Faced with its own potential imminent unemployment, the ECB has been obliged to supply yet more liquidity to the Euro Zone financial system and further guarantees about the outlook for short-term interest rates. We strongly believe that this situation represents a *de facto* re-imposition of the ECB's former quantitative easing policy regime. Therefore, although we expect Euro Zone economic growth rates to remain lacklustre – if not depressionary in the struggling peripheral countries – we

also expect local monetary conditions to remain relatively accommodative and the currency to become steadily cheaper, to the benefit of some of the region's exporters.

Mixed signals for investors

For investors in financial markets, this situation poses something of a quandary. Many emerging markets are experiencing faster rates of economic growth. But in some cases this growth has already started to become inflationary, thereby creating the potential for adverse policy actions by the local authorities, although we doubt that they will be able to slow their economies significantly in the near term. In the West and Japan, we expect to witness the opposite situation of persistently slow growth but continued easy monetary regimes, against a background of modestly higher inflation rates.

For the currency markets, we would suggest that tighter monetary regimes in the Emerging Markets and also in the commodity currencies such as Australia, Canada and New Zealand should lead to further gains for these currencies against the major currencies. We should caution, however, that the BRICs economies – and particularly Brazil and China – are already beginning to look quite uncompetitive, a factor that may limit profit growth in their manufacturing sectors this year, despite their superior growth rates. Amongst the major currencies, the Bank of England and the ECB clearly now have preferences for weaker currencies and we would broadly expect them to have their wishes granted.

Weight of money is supporting asset markets

For global financial markets, these various cross-currents of continuing slow growth in the developed world and higher inflation in the Emerging Markets, coupled with the ongoing situation within the European single currency system, argue for continued nervous trading conditions over the next few months. However, ultimately we suspect that both bonds and equities will gain in price terms from the continuing relaxed stance of the major central banks, although this may leave the markets looking expensive relative to their 'fundamentals' and therefore vulnerable to any reversal in the central banks' policy stances in 2011. Just as occurred during much of 2009, the immense weight of money that is being generated in financial markets by the major central banks' easy policy regimes may support asset markets for much of this year, even as growth and inflation trends ultimately disappoint many observers.

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