



Second Quarter Analysis

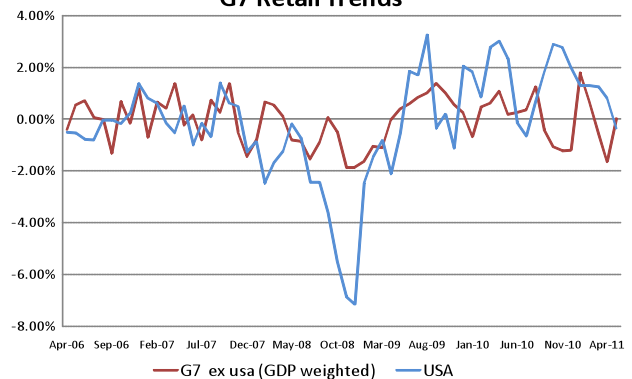
by Andrew Hunt

Weak growth is 'new normal'.

At the beginning of the year, and largely a result of the US Federal Reserve's Quantitative Easing regime, the sheer amount of 'money' that was attempting to access global financial markets gave cause for a considerable degree of optimism. Despite this, it is now abundantly clear that the global economic recovery has come to an end. Although there has been a tendency to blame the recent signs of economic slowdown on special factors, such as Japan's tragic earthquake, we believe that the genesis of the recent slowdown predated this event by several months, if not quarters. Furthermore, rather than the periodic bouts of strong growth that we have seen over recent years, we believe that this current weak growth environment is the 'new normal' situation for the global economy.

In fact, it is now clear that the periods of seemingly rapid growth that occurred within the developed world during the two years following the Global Financial Crisis were largely the temporary results of special factors. These included an inventory rebuild in 2009 and the effects of the unsustainable fiscal expansions by Western governments that occurred following the G20's interventions. Now, as these fiscal experiments have begun to reverse and inventory levels have been restored, the momentum in the 'production side of the global economy' has slipped. Moreover, consumers are also being obliged to slow their spending habits. In the household sectors of the developed world, we find that higher food and fuel prices have eroded the already weak income streams bulk of the populations – and this at a time when many of them know that they need to save more in order to address their still weak balance sheets.

G7 Retail Trends



Depression in Europe's periphery countries?

In Europe, these trends have naturally been exacerbated by the ongoing Euro crisis, which in some cases such as Spain, Ireland and perhaps even Italy, has forced the economies into depression-like situations. The use of the 'depression' word may seem unduly alarmist but with Spanish unemployment at over 20% and retail sales falling 6% per annum (to quote just two examples), we feel that the term is warranted in the Euro Zone periphery. Hence, as a result of these factors, we consider that developed world retail spending – in volume terms – probably peaked 8 months ago and that global industrial production growth probably disappeared around the same time.

BRICs go slow.

Even in the much-hyped BRICs economies, we are now finding signs of a slowdown. It is apparent that the exceptional growth in these economies over the last 3-5 years was in fact largely due to large, foreign capital-initiated domestic credit booms. In short, we in the West transferred so much money to these economies that their own domestic monetary authorities effectively lost control of their credit systems. Hence, credit growth rates in these economies accelerated to extreme levels – particularly in China. The result of these credit-fuelled booms has, of course, been higher rates of inflation. Higher inflation, coupled with currency strength (a by-product of the intense capital inflows), has clearly eroded the countries' competitiveness, with the result that their traded goods sectors have been struggling for some time.



Moreover, as inflation rates have increased, the local authorities have been forced into attempting to tighten their own domestic monetary and fiscal regimes. Initially, their actions appeared relatively ineffective but as the global economy has deteriorated, these tightening measures seem to have gained traction. Brazil and India are showing the first signs of a slowdown while in China we are confident that an economic hard landing has occurred, despite the still relatively upbeat message offered by some of the economic data. It seems to us that industrial production growth in China may only be around 5% year-on-year and even this seems to be heavily reliant on continuation of the current domestic public sector housing boom.

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.

Naked swimmers revealed

In this stagflationary environment where global volume growth is clearly weak but inflation rates are still relatively high (a result not only of high commodity prices but also the BRICs' inflation problems and the rise in sales taxes in the West), it is natural that the weakest systems are being 'found out'. As Warren Buffet noted during the LTCM / Emerging Market Crisis of 1998, "when the tide goes out you find out who is swimming naked". At present the tide is clearly ebbing and thus revealing where the weak spots are. The periphery of Europe has been an obvious casualty but so too have some of the other more vulnerable economies, such as Australia which seems finally to be succumbing to a recession following years of unsustainable credit-driven growth.

This is clearly not an attractive backdrop for risk assets and for those interested in capital preservation, at least in nominal terms, this weak economic environment should be ringing alarm bells. However, we must note that ever since the global authorities embarked on their first 'monetary experiments' as far back as the second quarter of 2008, financial markets have shown that they can rise almost regardless of the fundamentals. For example, in mid 2008, when the world had already entered into its worst recession for generations, asset markets apparently boomed on the belief that the omnipotent authorities would somehow save the situation, which, of course, in reality they did not.

In our view, this year, markets have repeated this triumph of optimism over reality by ignoring the slowdown and inflation problems noted above. We suspect this has been largely because of the pressure caused by massive inflows of money into the financial system. As a result of the Federal Reserve's and others' monetary policy actions, effective borrowing rates for would-be speculators were at times negative during the second quarter. (At their low, USD borrowing rates for intra financial sector 'repo' credit dropped to minus five basis points.) This allowed a disconnect to form between the booming financial sectors and the struggling real sectors.

Expect headwind for risky assets

Unfortunately, these easy money policy chimeras are now coming to an end. By mid August, we suspect that the Federal Reserve's quantitative easing experiments will be over, the Treasury Department's rather intriguing underfunding of its deficits at the expense of its cash reserves will be over and the sheen will have worn off the EU's latest proffered bailout for the struggling periphery. With the BRICs still constrained by their own problems, we suspect that the global liquidity cycle will therefore begin to turn down towards the end of this quarter, thereby creating a headwind for asset prices.

Indeed, as the Federal Reserve finally exits its QEP, the US Treasury will begin to issue bonds once again (something it has avoided in recent months despite its large deficits). We may find not only that liquidity tightens but that nominal bond yields rise as well, something which the equity markets may take a dim view of in light of their own concerns over the outlook for slower earnings growth ahead in the weaker global economic environment. In the currency markets, this phase of 'risk off' investing may lead to a preference for the former 'liability' currencies of USD, Yen and perhaps even the GBP. Overall, the next quarter or so may provide some interesting times for investors.

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