

## Strategy & Economics

Richard Jeffrey

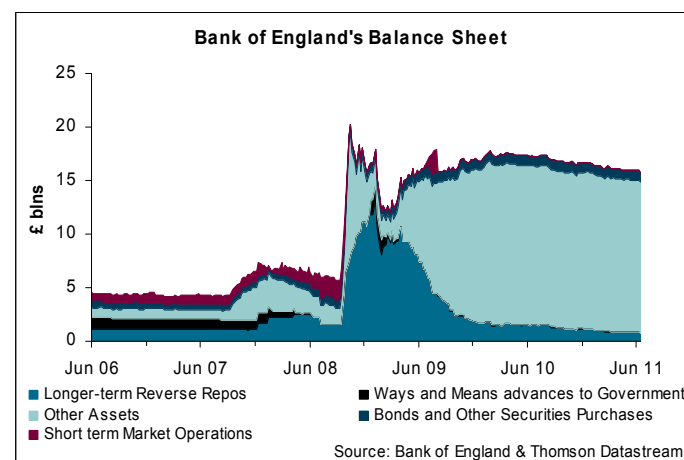
[richard.jeffrey@cazenovecapital.com](mailto:richard.jeffrey@cazenovecapital.com)

+44 (0)20 3479 0202

 7<sup>th</sup> July 2011

### The economic backdrop

In the midst of the 2008/09 recession, we suggested that the ensuing recovery phase was likely to be characterised by two features: sub-trend growth in economies saddled by still excessive levels of debt and shorter economic cycles. Initially, as

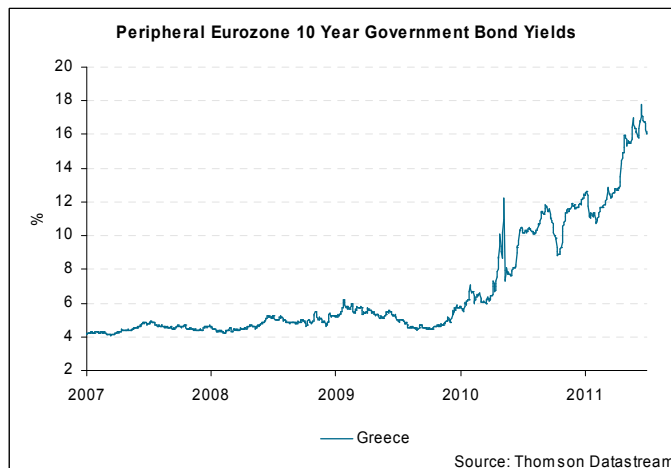


world manufacturing activity kicked in, it seemed as if growth would exceed our rather downbeat assessment prospects. However, the strength of the early upswing was misleading and almost entirely the result of companies rebuilding inventories. Since then, the pace of growth has slowed, in a development that has taken many economists and strategists by surprise. In part, this has reflected the impact of rising commodity prices (especially, but not only, oil). Against the backdrop of relatively low wage growth in western industrialised economies, rising inflation has had a widespread deflationary impact on demand. When quantitative easing was first introduced by central banks desperately seeking a solution, we cautioned that it was likely to have more impact on asset prices and wider inflationary trends than on real economic activity. We would argue that trends in commodity prices have been the proof of

this. Indeed, these trends can be seen as providing evidence that quantitative easing is essentially self-defeating, if not counter-productive. Even in the absence of QE, however, it was to be expected that growth trends would eventually prove disappointing. In effect, during the credit boom, households and governments (and also some companies) increased consumption spending on the basis that this would be justified by future income growth and/or capital gains from rising asset prices. However, neither proved of sufficient strength to support the colossal amounts of debt that built up during that period. So, borrowing could have but one effect: that is, rather than being a one-off boost to consumption, it merely brought forward spending that otherwise would have taken place at later time; that later time being, of course, now.

Nowhere is this more true than in Greece, which has dominated both newspaper headlines and market sentiment in Q2 2011. A government reshuffle prompted by the failure of the incumbent party to establish a 'unity government' with the

opposition and a subsequent positive confidence vote, led to a narrow passing of an additional €28bn medium-term austerity package. It is arguable that this new austerity plan will be unachievable given the depth of the ongoing recession in Greece. However, at the current time, there remains sufficient political will to continue to push through austerity measures, but at a cost of increasing social unrest and it is possible that, for all the protestations over terms and conditions of the bail-out from Germany, Finland and other EMU politicians, it will eventually be Greece that opts itself out of the rescue plan. At the moment, this is not our base case, but it is a scenario that is gaining traction. For now, the medium-term plan has allowed the release of a €12bn disbursement from the EU and IMF bail-out funds, staving off the crisis until the next IMF compliance check in September. Before then, the



Eurozone needs to agree a second package to cover the funding gap that still remains. An agreement that there now needs to be some private sector involvement (PSI) in any further (and necessary) bail-out for Greece has so far delayed negotiations. Positively, French and German banks have indicated that they would be prepared to rollover a

reasonable proportion of shorter dated debt, while the Institute of International Finance (IIF) has announced that buybacks of Greek debt and resulting right-downs could be acceptable. All have certain conditions attached, but these proposals could well represent a step in the right direction. The nature of any PSI currently hinges on the ECB and ratings agencies. At the moment, Greek banks are able to borrow liquidity from the ECB using Greek government debt as collateral. This process will continue so long as the Greek government is not considered to be in default. At the time of writing, two of the three major agencies had hinted that they would consider current proposals for PSI as a credit event and rate Greek bonds as in 'selective default'. Whatever the outcome of ongoing negotiations, it now appears that there is a general and growing acceptance that the volume of Greek debt must be reduced if a disorderly default is to be avoided.

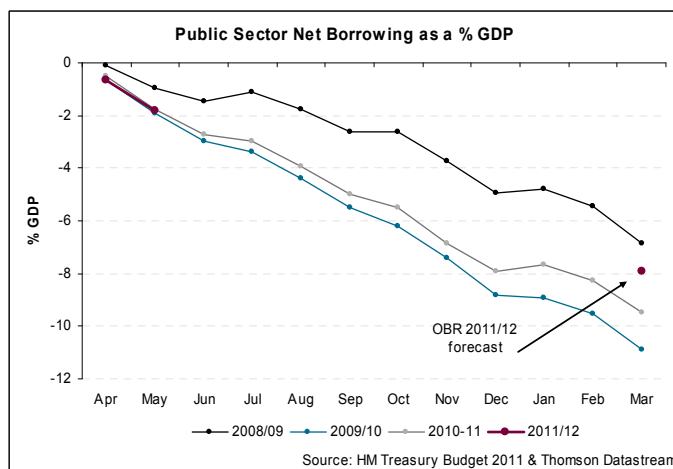


Outside Greece, the global economy has shown signs of slowing over the second quarter. This has been particularly true in the US, where recent real and survey data have been disappointing. Private payrolls, which had increased by an average of 240k over the three months from February to April, rose by just 83k in May. Job numbers can be volatile from month to month, but when combined with a slowdown in industrial output and a weakening in retail sales numbers, it appears that the US economy is experiencing a softening in economic activity. Disappointment in economic data has fed through to forecasts and Consensus Economics have shown downgrades to expectations for US GDP in 2011 to

2.5% in June from a high of 3.3% in February. More positively, the ISM manufacturing PMI for June surprised on the upside, increasing to 55.3 from 53.5 in May, giving some hope that the softness has been due to temporary factors of high oil prices and disruptions to the supply chain caused by the earthquake in Japan. It is still hoped that, as these factors fade, the nascent recovery in the smaller companies space will show signs of regaining some momentum.

Elsewhere in the US economy, both monetary and fiscal policy are likely to see more headlines over the summer as the debate over the raising of the debt limit comes closer to Tim Geithner's stated deadline of 8<sup>th</sup> August, which if reached would lead to a government shutdown. It remains unlikely that the US would actually default on its debt, given that tax receipts would be sufficient to cover any debt payments, but already fragile global sentiment would probably be negatively impacted. The debt limit debate comes at the same time as the end of the Federal Reserve's second round of quantitative easing (QE2). It currently seems unlikely that there will be a QE3, but we have been in a similar position to this before. Approximately 12 months ago, the global economy began to show signs of a slowdown until Chairman Ben Bernanke announced QE2 in August 2010 and we would therefore refrain from ruling out any further monetary expansion altogether. The most likely scenario is that the Fed will maintain its current level of monetary support and that Congress will agree to raising the debt limit, but with significant spending reduction conditions attached. It is highly likely that any fiscal austerity measures will be postponed until after the presidential election in 2012 and we therefore expect fiscal policy in the US to remain accommodative over the near term.

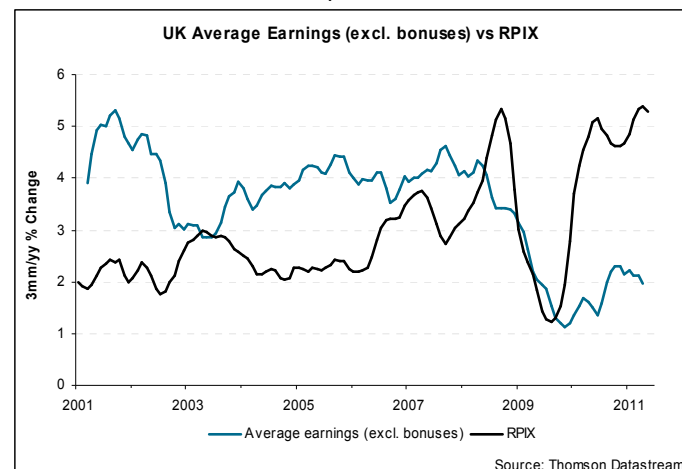
Looking back at the UK, austerity measures are already beginning to look difficult to achieve. Low growth, high inflation and persistent high unemployment mean that the countercyclical automatic stabilisers which provide support during downturns, increasing the deficit, and then reduce the deficit in times of economic growth have remained a drag on deficit reduction. In fact, due to higher debt interest payments and tough comparisons with the one-off banks' bonus tax last year, government net borrowing in the current fiscal year has so far exceeded borrowing last year. This should improve as new measures begin to take effect and the bank levy begins to bring in additional revenues, but some slippage in the scale of the deficit reduction plan is anticipated. Whatever, the outcome on the actual deficit reduction figures,



reduced government expenditure is likely to provide a negative contribution to GDP growth over the medium term. On the other side, monetary policy is now expected to remain unchanged into 2012 despite the continuing rise in inflation.

The weakening outlook for growth in the UK means that any chance the Bank of England had to raise interest rates seems to have diminished and we now feel that it is unlikely that the voting pattern on the MPC will change until past the end of the year.

Elsewhere in the economy, expenditure continues to look weak. Consumer sentiment has fallen through 2011 and expenditure, with the exception of goodwill surrounding the Royal Wedding in April, has remained subdued. Retail sales fell by -1.4% in May and early indicators for June suggest that the trend is for a reduction in household expenditure. As we have highlighted on a number of occasions, the gap between consumer price increases and average earnings growth continues to act as a squeeze on households' real purchasing power. Utilities price increases mean that CPI inflation is expected to rise to 5% over the summer from an already high 4.5% in May. It therefore



remains extremely difficult to envisage a positive domestic consumption environment. More positively, one of the offsets to lower domestic consumption has been lower import growth and, over the first four months of 2011, the deficit has seen a reduction of £2.8bn. In fact, the reduction in the net trade deficit in Q1 2011 contributed +1.0% to first quarter GDP. Contributions to Q2 and beyond are likely to be somewhat smaller, but we continue to expect net trade to make a positive contribution to GDP for 2011. The other area for the economy which may see positive growth would come from a pick up in business investment. Corporate activity has so far been almost entirely within M&A, meaning a transfer rather than a creation of wealth. However, high cash balances on corporate balance sheets combined with very low levels of investment over the recessionary

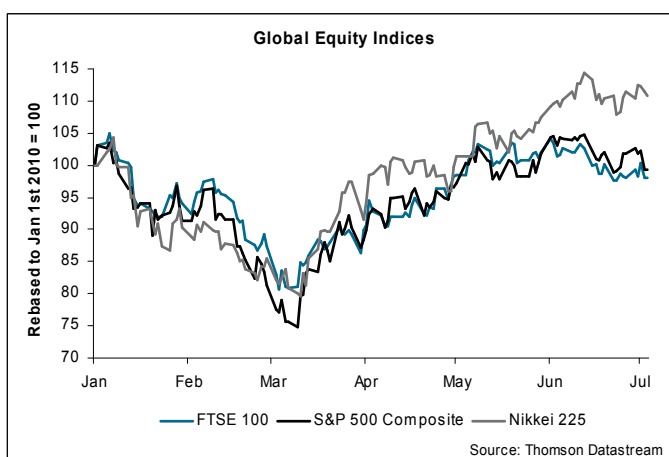
period should mean that we see a pick up in capital investment spending over the second half of the year. Overall, this means that we continue to expect low, but positive growth in the UK in 2011.

## Markets

### Equities

Equity markets saw a difficult quarter on the back of a weakening macroeconomic outlook combined with continuing high uncertainty surrounding the Eurozone debt crisis and ongoing political unrest in the MENA region. A sharp rally in the final week of June after the successful passing of the Greek austerity package meant that the quarter was marginally positive overall for equities. The FTSE All Share returned +1.9%, slightly outperforming both the Euro1st 300 and S&P 500, which returned +0.8% and +0.1%, respectively. Market rotation towards defensive stocks away from cyclicals continued to be the overriding trend. Commodity cyclicals were the weakest style grouping, returning -4.8% relative to the FTSE All Share, while growth defensives were the strongest grouping, returning +5.8% relative to the wider market.

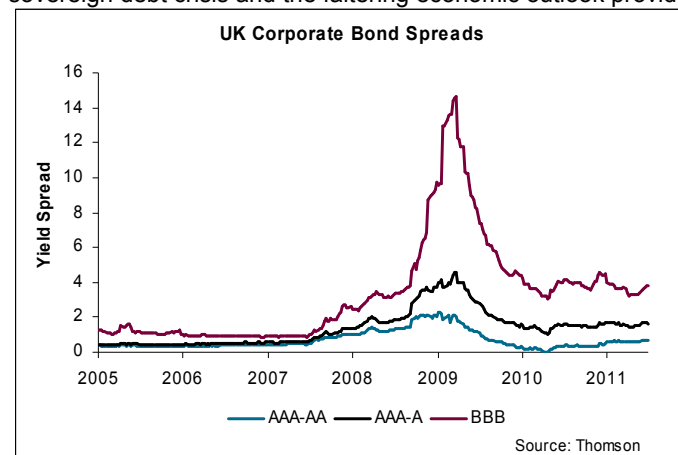
Given the weakening global macroeconomic picture combined with a continued inflationary outlook, we would maintain our favour for developed market over emerging market equities. Within the developed market space, we would continue to look for exposure to faster growing areas of the global economy, thus avoiding western consumers, particularly those in the Eurozone periphery and the UK. Germany and northern Europe remain the areas with the strongest growth outlook, while the US may see a reacceleration over the second half of the year making these the most attractive investment areas on a relative basis. The international exposure of the UK equity market continues to make us feel more positive on the outlook for UK equities than we do for the domestic economy. Equities currently look fairly valued on an historical basis, but given the poor return offered by fixed income and the increasingly



inflationary outlook, we would continue to favour equities over bonds. In the current environment of high uncertainty, we feel that our defensive bias will prove to be the correct one.

## Fixed Income

Government bonds saw a positive quarter, particularly in short to medium term maturities. The 10 year gilt yield fell to 3.4% from 3.7%, while two year yields are now below 1.0%. It is likely that the uncertainty surrounding the Eurozone sovereign debt crisis and the faltering economic outlook provided some support for 'safe-haven' government bonds and



for as long as Greece continues to remain at the forefront of market news, we would expect government bond yields to remain low. However, we continue to view current yields as unattractive on both an inflation outlook and excess supply basis. The Debt Management Office is set to sell £162bn of gilts this year after £165bn last year. This is at the same time as the US Treasury will have to sell a glut of Treasuries to catch up on the current lack of debt issuance as a result of reaching the debt limit. With the Federal Reserve now no longer a large buyer of Treasuries, it is difficult to see further upside to government bonds. Aside from sovereign debt, selective issues of corporate bonds continue to present opportunities, particularly further up the risk scale in high yield bonds. Corporate bond spreads

have widened over the second quarter due to the outperformance of government bonds and we see scope for a narrowing of spreads over the second half of the year.

## Currencies

Expansionary monetary policy relative to other economies has meant that the dollar has underperformed the majority of other major currencies over the last twelve months. Now that QE2 has ended and we do not currently anticipate a QE3, we feel that the downward pressure on the dollar may ease. When combined with higher uncertainty over the global economic outlook, we feel that the dollar may begin to experience some positive momentum as investors seek the safe-haven status of the reserve currency. We therefore maintain our view that the dollar is likely to strengthen over 2011 as a whole. The outlook for the euro is rather more difficult to call given the range of pulls and drags from differing areas of the Monetary Union. So far, the positive growth outlook for the core combined with an increasing interest rate environment has outweighed the struggles in the periphery and the euro has remained relatively strong against other major currencies. Meanwhile, sterling continues to look vulnerable against a backdrop of low interest rates, a poor economic growth outlook and an extremely high government budget deficit.

This document is issued by Cazenove Capital Management Limited (Cazenove Capital), a firm authorised and regulated by the Financial Services Authority. Nothing in this document should be deemed to constitute the provision of financial, investment or other professional advice in any way. Past performance is not a guide to future performance.

This document may include forward-looking statements that are based upon our current opinions, expectations and projections. We undertake no obligation to update or revise any forward-looking statements. Actual results could differ materially from those anticipated in the forward-looking statements.

Cazenove Capital Management Limited Telephone: +44 20 3479 1000 [www.cazenovecapital.com](http://www.cazenovecapital.com)  
Registered Office: 12 Moorgate, London EC2R 6DA Registered in England No. 3017060