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Market Update – Comment by Robert Parker

Robert Parker
Vice-Chairman of Credit Suisse's asset management business

Overview

- US economy expected to form a base during the third quarter of the year.
- Eurozone data pointing to a first half real GDP contraction of 4% to 5% annualised.
- Japan remains the weakest of the developed economies.
- Inflation continues to moderate globally,and monetary policy expected to remain easy.
- Following recent rally, equity markets are technically overbought and could see a short term setback.
- Risk that US Treasuries could sell off during the second half of the year on the back of economic recovery and heavy new issuance.

Update on the Credit Crunch

In March/early April, credit trends were generally positive:

- US dollar libor fell further to 1.15%, while Euribor also continued to fall and is now below 1.50%.
- The Markit CDX spread for North American investment grade narrowed to 189bps compared with 217bps at the end of February.
- On the back of the G20 announcement of further IMF funds for emerging markets which are under stress, spreads on the Markit 5 year EM Index rallied sharply to 553bps, compared to around 850bps at the end of February.
- High yield spreads also narrowed with the crossover index ending March at 922bps, compared to 1046bps at the end of February.
- Investor demand remains evident in the investment grade bond market, with strong primary market demand and an improvement in secondary market liquidity.
- Indicators of stress in the CP, ABS and MBS markets have all shown signs of slowly easing.
- Given the improvement in equity markets, the VIX has stabilised at around 40. However, one has to question the sustainability of the current rally in equities given that in 2006/7 the VIX averaged 15–30.
- Total bank write-downs currently stand at US$916bn, while insurance sector write-downs stand at US$221bn.
- During March and early April, banks have seen strong rallies in their share prices. Ongoing restructuring at banks which are partially government owned continues, with the focus on cutting costs, selling non-core assets, de-leveraging and strengthening capital ratios. In addition, a number of lending banks have reported profitable starts to the year, while some are also passing regulatory stress tests (e.g. Barclays).
- The hedge fund industry is starting to recover, albeit from a significantly smaller client base. Industry concentration has continued, with leading hedge funds now regaining client inflows. Write-downs and de-leveraging in private equity continues.

US recession appears to be moderating…

The US economy remains in recession, but there is mounting evidence that the pace of the downturn is moderating. We could see the economy forming a base during the third quarter of this year.

In February, housing indicators improved, with private housing starts increasing by 22.2% m-o-m and new house sales rising by 4.6% m-o-m. There is evidence that the inventory of unsold houses is being cleared at lower prices and the housing affordability index has improved sharply. The Case Shiller national index is likely to show y-o-y declines during the second quarter of 20% to 22% and during the second half of the year housing activity should show a slow trend improvement. In addition, the decline in mortgage borrowing rates has seen a sharp increase in mortgage re-financings. During the second half, we expect real residential investment growth to be marginally positive.

Consumption has been another major problem for the US economy, but the decline in consumption is now moderating. The University of Michigan consumer sentiment index recovered to 57.3 in March and the trend since last October is now flat. Likewise, the expectations sub-component of this index has recovered to 53.5, up 5.9% m-o-m and broadly flat since last November. Retail sales have improved by 1.7% outright over the past two months, and the y-o-y decline has moderated to 8.6%. Retail sales excluding the auto sector have risen by 2.3% outright since last December. The largest increases in the sub-components of retail sales have been in basic consumer goods, e.g. spending at gasoline stations has risen by 6.3% since December, purchases of clothing and accessories are up 8% outright over the same period, while health and personal care expenditures have risen at an annualised rate of 4.3% over the past six months.

While the low level of interest rates and trend lower energy and food prices are supporting consumption, any recovery is likely to be muted given the rise in unemployment (currently 8.5%), the slow pace of personal income growth at only 1% y-o-y and the improvement in the savings ratio to 4.2%. During the second quarter real consumption may only be slightly positive and for the rest of 2009 is unlikely to increase by more than 2% annualised.

In contrast, there has also been a further deterioration in the downtrend in exports. In January, exports declined by 21.4% y-o-y, while the corresponding figure for export volumes was minus 17.8%. The poor export picture is a function of weak global demand and there is no evidence that the value of the dollar is having a major negative impact.

Other data paints a mixed picture. For example, industrial production in February declined by 11.2% y-o-y and is now down 6.8% outright since last October. However, durable goods orders improved by 3.4% outright in February, while the ISM index has now risen for three consecutive months, although at 36.3% in March it remains in recessionary territory. It remains likely that the ISM manufacturing index will remain below 40 for April and May but, during the third quarter, it could improve towards 50.

…but inflation is improving

Although February recorded a slight m-o-m increase in the headline Consumer Prices Index (CPI), it is still only up 0.1% y-o-y and since last July it has fallen by 3.5% outright. The core CPI has stabilised at 1.8% y-o-y. A major factor in declining inflation has been the Import Price Index, which is down 12.8% y-o-y and 23.5% outright since last July.

The Producer Prices Index (PPI) declined by 1.6% y-o-y in February and has declined 6.6% outright since last September. Excluding food and energy, the core PPI has improved only slowly, with the y-o-y increase easing to 4% compared with 4.7% last October.

Given capacity utilisation at close to 70%, the expected rise in unemployment to over 9% by the third quarter of the year and downward pressure on wages growth, it is premature to forecast any upturn in inflation. A central case scenario is that over the next six months the headline CPI will remain close to zero and that the core CPI will ease to less than 1.5%.

Fed policy expected to be maintained

Although the Federal Reserve may have to review its policy of 0–25bps on the Fed Funds rate during the first half of next year, we do not anticipate any change in interest rates this year. Action in buying US Treasuries, ABS, MBS and corporate paper will continue with the Fed balance sheet probably exceeding US$3.5 trillion by the third quarter.

The central case remains that US real GDP growth will contract at an annualised rate in excess of 4% during the first quarter and by a further 1% during the second, but then subsequently see moderate growth of 1% to 2% during the second half of the year.

No evidence of a base in European economy…

Economic data releases in the Eurozone continue to paint a bleak picture and there is no evidence that the region's economy is forming a base.

The key area of consumption remains a major negative. Consumer spending remains weak with retail sales by value showing a 1.1% y-o-y decline, while sales volumes have fallen by a similar amount. Both consumer indices have fallen sharply since December. As is the case in the US, there is clear evidence of consumers switching to basic products. Real consumption across the Eurozone is likely to contract at least during the second and third quarters of 2009 given the rise in unemployment and downward pressure on wages.

Exports is another weak area for the economy. The downtrend in exports has continued with German exports reversing by 18.4% y-o-y. The volume of overseas new orders has collapsed by 40.2% y-o-y and by 37% outright since last August. Plant and machinery orders have declined by 42% y-o-y. The key negative factors are the decline in overseas demand and the cancellation of major investment projects which have hurt the capital goods sector. Eurozone historic strength in CEE and the Middle East has been adversely impacted by the downturn in these two regions. In addition, the over valuation of the euro is a further negative factor.

At the same time, sentiment surveys remain subdued. The IFO index in March decreased to 82.1, down 22.5% y-o-y. The only slight positive is the improvement in the future expectations sub-component of the IFO index, which improved to 81.6 in March compared with a low point last December of 76.9 – however, the index is still down 16.6% y-o-y.

However, as with other regions, inflation in the Eurozone continues to be subdued. The German cost of living index in March showed a y-o-y increase of only 0.5% and is flat over the past three months. Wholesale prices have declined by 5.7% y-o-y and since last August are down 8.6% outright. The strength of the euro and the low level of commodity prices are reflected in a y-o-y decline in import prices of 6.4% and an outright fall of 10.6% since last August. There is a high probability of the headline German inflation rate going negative during the second quarter and for inflation in the region to approach zero.

Overall, Eurozone data is consistent with a first half real GDP contraction of 4% to 5% annualised. The recent cut in the ECB reference rate to 1.25% allows scope for a further cut to 1% during May/June, but the policy focus in the next three to six months will not be on interest rates but on liquidity injections.

…or in Japan

The story is much the same in Japan. It remains the weakest of the developed economies and there is no evidence yet of demand and activity forming a base. Activity indices remain negative. The leading economic indicator has shown a 32.6% y-o-y decline, while the index of overall business activity has fallen by 8.5% y-o-y and since August has decreased by 7% outright. The Tankan survey for the second quarter was reported at -59, compared with -44 for the first quarter of the year and +5 for the first three months of 2008.

Mirroring Europe, consumption remains subdued. Expenditure for all households rose slightly m-o-m in February, but is still down 1.8% y-o-y. Tokyo department store sales (NSA) collapsed by 10.6% y-o-y in February, while total retail sales are down by 5.8% y-o-y. Similar to the US and Europe, there is a clear switch in consumer spending to basic goods, while the overall trend in consumption is likely to remain muted given increased unemployment, part-time working leading to lower earnings growth and a sharp increase in the savings ratio.

Elsewhere, industrial production and exports both remain in the doldrums. Industrial production in February declined by 37.7% y-o-y and since last September, production has reversed by 35% outright. New orders continue to collapse and since September are down by 23.7% outright. Although, as forecast, the yen has weakened slightly, exports remain on a sharp downtrend, down 46.9% y-o-y. The weakest export sectors are capital goods, the electronics sector and autos. Given the high level of spare capacity, investment spending also remains on a downtrend.

As with elsewhere around the world, inflation is the one piece of good news for the economy. Tokyo consumer prices in March rose by only 0.2% y-o-y and national consumer prices have shown a y-o-y decline of 0.1%. Since last September, the National index is down by 2.2%. Import prices rose m-o-m in February, reflecting the slight weakness in the yen and the moderate upturn in the commodity prices, but are still down by 24.3% y-o-y. The appropriate forecast for the next three to six months is for the National CPI to be between zero and minus 1%.

Bank of Japan policy in response to the downturn in the economy since last October is now to increase liquidity injections into the banking system and to carry out quantitative easing. A further fiscal stimulus package of 2% of GDP is being finalised. Given the extent of a contraction during the fourth quarter of last year and the first quarter of this, the economy should stabilise during mid 2009, but any upturn will be limited. Second half real GDP growth this year should average zero to +1% annualised and, with inflation remaining negative, policy will continue to be easy.

Market implications

Despite the sharp rally from early March, the medium term case for equity markets to recover is still intact, i.e. initial evidence of economic recovery, cheap valuations (i.e., P/B, P/E, P/CF and Q ratios), high investor cash positions and the high level of insider buying. At the same time, equities are being supported by uncompetitive money and bond market yields and no hedge fund overhang.

However, the next couple of months could well see an equity market setback given that the technical situation is overbought in the short term and given the impact of weak corporate earnings for the first quarter to be announced in April/May. Strategy should focus on re-buying on the expected setback.

With bonds, the key theme in March and early April has been bond market divergence, with the US Treasury and Canadian markets rallying given the impact of quantitative easing, the bund market trading sideways and the Australian and Japanese markets selling off.

Although technically the US Treasury market could rally in the near term, the major risk is a market sell-off during the second half of the year given heavy issue supply and signs of economic recovery. Given weak Eurozone data and a potential European flight to quality, bund yields should rally back below 3%. Although yields on the weaker Eurozone markets are arguably over-discounting default risk, credit spread pressures should persist on trend given the extent of the economic downturn in economies such as Ireland and Greece and given the size of projected budget deficits. In Japan, fiscal expansion and new issuance volume should result in further yield curve steepening on trend.

The investment grade corporate bond market is seeing a significant improvement in demand and supply and the recent rally should be maintained. Similarly, the rally in emerging debt for those economies with robust trade and budget balances without external financing problems should persist. Although the high yield market rallied last month, risk reward remains unsatisfactory given the trend increase in defaults to 15%+ and the decline in recovery rates.

Within foreign exchange, the arguments for sterling forming a base are its under valuation, the likely sharp improvement in the trade and current account position, the restructuring of the banking system and evidence that the recession is forming a base. The negative arguments for the yen are its continued over valuation, weak macro economic data, the relative over valuation of the equity market discouraging capital flows, weak corporate earnings amongst the exporters and capital outflows in response to a higher domestic savings rate. Over the next three months, yen/US dollar should move to 105–110.

The negative factors for the euro are its over valuation, the weakness of the smaller economies, Eurozone bank exposure to CEE and the probability that Europe will exit the recession after the US and the UK. Strategy should focus on selling euro on temporary bouts of strength.

The fourth quarter of 2008 saw an indiscriminate sell-off in emerging currencies. Although the recent rally in emerging currencies has been widespread, investors are likely to become more discriminate, with capital flows moving into the under valued but well managed economies, viz Asia and in Latin America, Brazil, Chile, Peru and Colombia. In CEE, capital flows should discriminate in favour of Poland.

Turning finally to commodities, prices are likely to consolidate at current levels although stronger evidence of the Chinese economic recovery should support industrial metals. Given reduced systemic risk, low inflation and low volatility in the US dollar against the euro and the yen, it is difficult to identify positive factors for gold. It is also worth noting that India is no longer a gold importer, which could hold back prices further.

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