

# Keep the dream alive. Hit the snooze button

## Equities and bonds rally in July

In early July 2010, global equity markets sold off 16% from their April highs to reach their lowest levels on the year. Since then equities rallied as investors took comfort in strong Q2 earnings and less concern surrounding the European Sovereign crisis. While it was a great risk reversal for the month, the bigger picture is that equity markets remain flat for the calendar year as the market attempts to find a direction. More times than not markets have been range bound, trading with the mentality of 'risk on' one day and 'risk off' the next.

At the same time that equity markets recovered in July, bond markets continued to post record low yields. The US two year treasury yield dropped to 55bps (a record since the Treasury started issuing two year notes), while the US five year treasury yield fell to 1.59%.

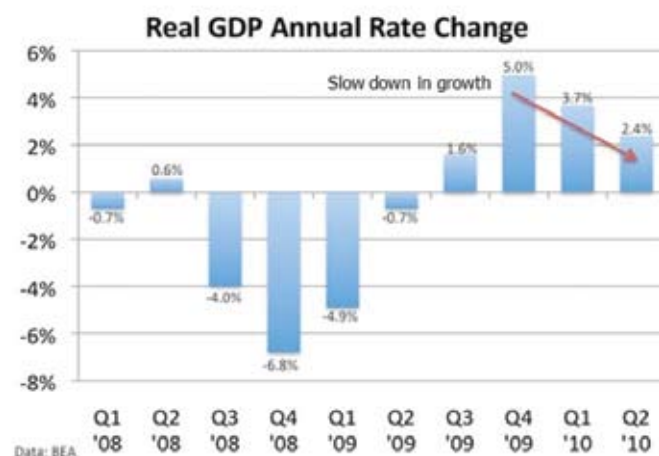
Is it odd that both equity markets and bond markets rally at the same time? Shouldn't investors expect bond yields to sell off as equities rally? Not necessarily.

The biggest question facing both equities and bonds is the outlook for the global economy in the second half of 2010. Will a recovery play out, as governments contemplate an early exit strategy, and allow the private sector to replace public austerity?

## US economic growth and more quantitative easing

US Q2 GDP grew slightly below consensus (2.4% vs. 2.5%) confirming that US growth is decelerating as the effects of fiscal stimulus have begun to fade. Increasing evidence that US economic growth is slowing not only means that low Treasury yields are justified, but also points to a continuation of their recent rally. The faltering US economy reinforces expectations that official interest

rates will remain low, and also raises the question of a return to monetary expansionary measures, such as quantitative easing by the Fed.



Adding fuel to the fire, St Louis Federal Reserve President Bullard wrote a lengthy research paper on quantitative easing and deflation risks. President Bullard argued that the Fed's 'extended period' language could increase the probability of a Japanese-style deflationary outcome within the next several years. However, 'the most likely possibility is that the recovery will continue...inflation will start to move up and this issue will all go away.' Not to be outdone by Bullard, Dallas Fed President Fisher stated that there is a fear that the US economy is 'sailing forward at suboptimal speed', and that further monetary accommodation will be like 'pushing on a string.'

## Does the US end up like Japan?

Lower nominal yields in the US should be driven by a shift to a lower long-term US inflation rate, as inflation-adjusted US and Japanese yields are comparable. However, the two countries have two different trade situations which should also affect the deflation risks.

Recent research by HSBC points out that the Japan's export industries suffered as China's share of global markets grew, contributing to deflationary pressures. In contrast, the US trade deficit created large foreign holdings of dollar-based financial assets. Ultimately, these assets create currency and credit risks for foreign holders. The only way to reduce these risks is to buy goods and services from the US. Hedging strategies simply transfer the risks to other foreign holders. This link between the US and its creditors should mean that the US is less exposed to long-term deflationary pressures than Japan. Ultimately, a strong dollar is in the long-term interest of US creditors.

Alternatively, the US could pursue inflationary policies to reduce the value of the dollar. Both sides will likely have to make unwelcome adjustments to manage this process over time. This analysis highlights that some of the deflationary pressures that affected Japan since early 1990s should have less impact on the US.

## Australia – A mixed bag of data

Australian employment data continued to surprise on the upside. Jobs created for the month of July increased by 45,900, well above consensus, while the unemployment rate stood at 5.1%. This immediately put the rate hike for August back on the table with the catalyst focused around the CPI number. However, headline CPI rose by only 0.6%, well below consensus of 0.8%, while the RBA trimmed mean fell YOY from 3.0% to 2.7%. As Q2 CPI surprised on the down side, the underlying inflation measures on a year-on-year basis fell back within the RBA's 2-3% target band for the first time in three years. This gave both the politicians (who are facing an election on August 20th) and the Reserve Bank some comfort to leave everything status quo. Indeed on August 3rd the RBA left rates unchanged at 4.5%.

As Australia becomes more prone to changes in Asia (especially China) and less reliant on the US and Europe for trade, its fortunes are tied to the economic growth in the region. As long as China and India continue to grow and their populations standard of living improves, Australia should remain the 'lucky country'.

The RBA will continue to safeguard against an upward breakout in inflation which will keep their feet hovering over the brakes of its economic vehicles – even if they do not actually touch them again. For the Australian market this presents a challenging period of being tempted to gobble up the few basis points of carry that the short bonds offer over the cash rate, versus worrying about Governor Stevens hiking rates preemptively.

It is worth mentioning that when Stevens started hiking last October, almost nobody expected it, and a number of Australian economists were actually calling for further rate cuts. Stevens has been ahead of the economic curve and the financial markets for the past 12 months, and betting aggressively on no hike would appear to risk too much for very little in return. Big directional gains in Australian short bonds can only come if the market perceives that the RBA has tightened too aggressively and that they may need to cut rates. With Europe appearing to be stabilizing and the United States now firmly entrenched in its snail like recovery, such a need does not look likely to occur.

## Investment implications

Kapstream expects equities and bonds to be range bound until the problems in Europe subside and the US can engineer some positive GDP and job growth. Investors should get used to low investment returns from both bond and equity markets over the next several quarters. Over the next six months, there are a handful of themes that could alter investments (for better or worse):

1. European financial sovereign risk subsiding. During the second quarter, sovereign tensions in European region led to a differentiation of government bonds. Some were categorized as 'risky' (Greece, Spain, Portugal) while others were deemed 'safe' (Germany, France). Policy measures implemented during the quarter, including austerity measures, ECB purchases of peripheral debt, and positive bank stress test results have led to greater stabilization. We are not totally out of the woods yet, but are cautiously optimistic.

2. Growth decoupling. The weakness in economic growth and the possibility of a double dip recession is fully reflected in the value of US treasuries. While Europe is on the mend, and the US struggles, Asia, including Australia, continues to enjoy reasonable economic growth. It is hard to imagine this scenario not continuing. The only risk to this decoupling is a policy action out of China or a slowdown in consumption of commodities.
3. Inflation vs. Deflation. As usual the bond guys are clinically depressed, concerned about deflation risks one minute and inflation risks the next. Central bankers seemed more concerned about a Japan style deflationary environment, however, given the amount of stimulus thrown into the system, the dominant fear that investors face is a spike in unexpected inflation due to the surge in liquidity and ballooning central bank balance sheets.
4. The more things change, the more they remain the same (snooze). 2010 is starting to feel like the year is going to end exactly where it began. Markets go up and markets go down, everything is driven by short term economic fundamentals and this time is no different. The danger is extrapolating too-pessimistic a view from the recent negative growth surprises. According to Nomura, the average GDP forecast error is 1.7% (1985-2010). The expectation for Q2 2011 is 2.9% according to the Bloomberg survey of economists. A one-sigma downside surprise would increase fears of a double-dip even if it would not actually coincide with a second recession. But, what if there is a one-sigma upside surprise or a 4.6% reading? Would the Fed tighten, viewing growth as sustainable? Would bond yields be closer to 4.5%?