INDEPENDENT STRATEGY

Global

GLOBAL MARKETS

Halcyon days, ice age or deleveraging grind?

A soft patch?

***Figure A:* CRB spot index (1967=100)**

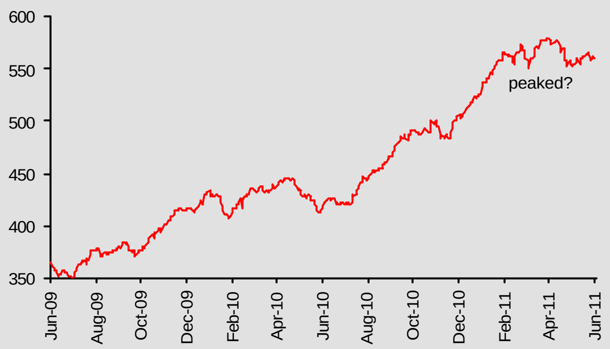


***Figure B:* Japan: industrial output and tertiary activity**

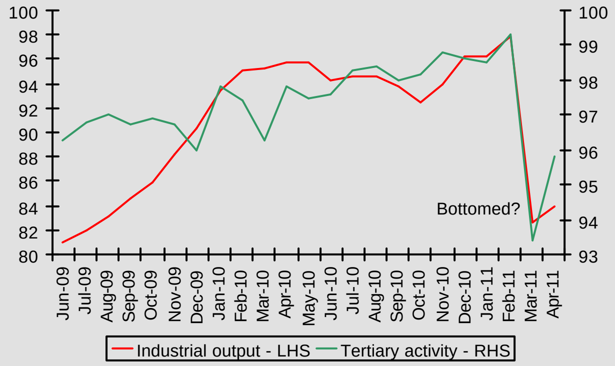
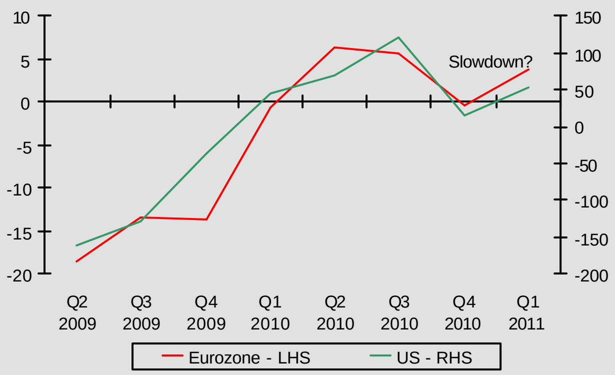


***Figure C:* Change in inventories (bn)**



Inset 1. *Source: Datastream*

15 June 2011

INVESTMENT CONCLUSION

There are three possible outcomes for the global economy and financial asset prices. The world economy may be in a temporary ‘soft patch’ that will soon give way to stronger growth and rising equity and commodity markets. Or it could be heading down into a deflationary spiral of recession, where only the safest government bonds and gold will perform.

Most likely (but not by much), the world is in a lengthy, post-stimulus grind of deleveraging. That means slow growth and volatility in financial asset prices.

We are flexibly positioned for the latter scenario. We hold defensive equities; long German bunds versus US treasuries; and long the safe-haven currencies of the Swiss franc and Singapore dollar versus selected EM currencies. We own gold, but have turned more cautious on most other commodities. Oil remains a long.

ANALYSIS

Three scenarios

Soft patch, deflation or the slow grind of deleveraging: one of these outcomes will be the fate of the global economy — and the major determinant of asset prices.

The ‘soft patch’ view attributes the slowdown at hand to a peaking of commodity and energy prices (Inset 1A); the Japanese disaster, where there will be a normal ‘S’ curve bounce back (and there is evidence that’s coming through — Inset 1B); and an inventory

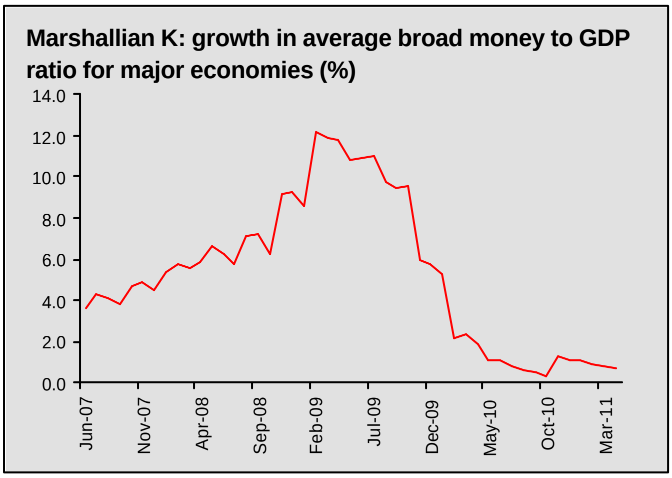


Figure 1. *Source: Datastream, Independent Strategy*

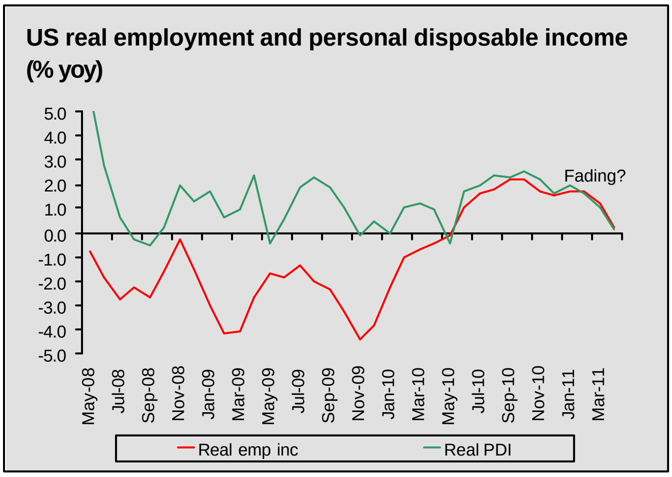


Figure 2. *Source: Datastream, Independent Strategy*

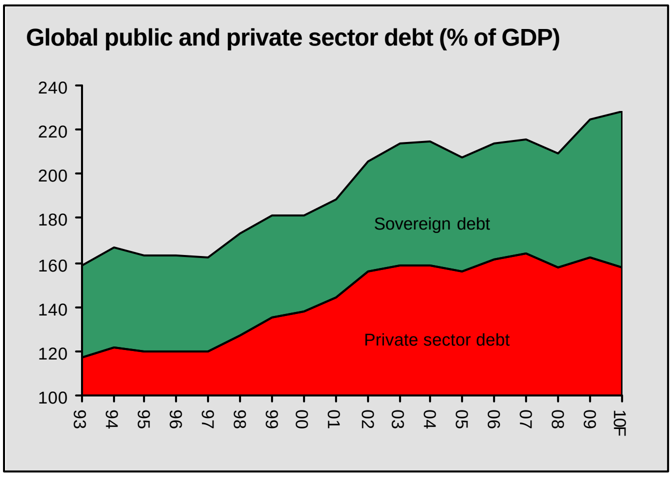


Figure 3. *Source: IMF, BIS, Independent Strategy*

cycle that will cause global manufacturing output to run below final demand growth for a while (Inset 1C).

As all these factors are seen as 'temporary', the second half of 2011 will see the global economy bounce back to ruddy health. This is the Halcyon Days outlook.

Deflation is the other extreme — a return to the Ice Age. Too much capacity remains idle. Debts are excessive. Inflation is absent — except for commodities. And bond markets are telling us of imminent downturn. So are the aggregates for credit and broad money — at least in the major economies (Figure 1). In a word, the world is retracing the path of post-bubble Japan.

The slow grind of deleveraging sits in between. It sees another five years of balance sheet restructuring in the private sector and ten years for the public sector. Our analysis of earnings from work points to insufficient household income gains and spending to drive real demand at anything but fairly low rates (Figure 2). Government won't help growth. And, in the long run, investment is driven by final demand from consumers.

The rolling sovereign credit crisis will be exported from the Eurozone periphery to the global core of the US and Japan. The impact of both will limit growth. But the world will not experience the Great Depression predicted by the deflation scenario — just the slow grind of growth being curtailed by putting right previous excesses.

These excesses have been getting worse not better as sovereign debt has been added to private debt to boost consumer demand, not productive investment (Figure 3). And yet investment is the only way of repaying it. The deleveraging scenario is one in which we see the mispricing of risk in emerging and developed countries as a necessary accident waiting to happen.

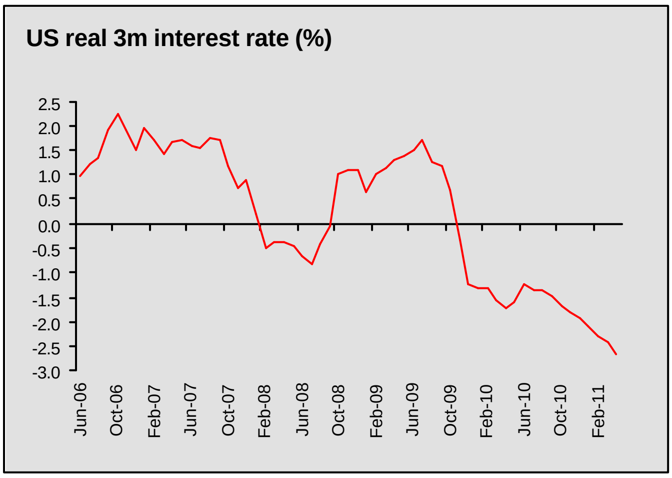


Figure 4. *Source: Datastream*

The deleveraging scenario is not a stable world, but one that bounces around the jar of possible outcomes like a trapped bluebottle. At times, deflation and depression will seem quite likely. At times, the global economy will seem healthy and dynamic. Inflation will stayaround 4-6% a year depending on the country — enough to erode debt slowly but also allow central banks to keep interest rates low (in real terms).

The pattern of the Fed's QE2 programme is not that clear cut under this scenario. QE2 has two components: printing money and underpricing it. The Fed will stop the former, but not the latter (Figure 4). Less money growth means less asset price inflation. But cheap money continues to make the dollar attractive as a funding currency for all sorts of speculative trades. The two variables will tussle for influence and asset prices will reflect this. Market volatility will remain high, so trends are difficult to discern.

The other scenarios (Ice Age and Halcyon Days) are trends set by extreme predictions and stable in their trajectory to hell or heaven.

The probabilities

All these scenarios are reasonable predictions. The probabilities of their occurrence are thus not normally distributed. At a guess, we would say the slow deleveraging grind has a 40% probability; the return to ruddy health 25% and deflation (for us lying on the far side of a joint US and Japanese sovereign debt crisis) gets a 35% probability.

The abnormal probability distribution of outcomes is something we have written about many times (see our report, *If*, 5 April 2011). The markets in their directionless uncertainty today reflect that reality. This dictates a very nimble portfolio rather than locked-in, irreversible strategies.

If you believe in a coming Ice Age of deflation, you would want to prepare for QE — not just 3, but to the power of "n"! You would own government bonds in developed markets and be short equities, oil and commodities. Emerging market assets would be anathema. Gold would still be a refuge, as the only currency central bankers can't print. The Swiss franc, euro and Singapore dollar would be safe haven currencies.

A return to ruddy health would have you do the opposite: bonds would be the most expensive asset on the planet and equities the cheapest, along with commodities. Inflation hedges would play a role. Gold crops up again. As the US economy would pave the way for others to trend, there would be a rebirth of the dollar at the expense of EM currencies, the euro and ultimately the yen.

Under the deleveraging scenario, the current weak path heralds the return to a low-growth path consistent with balance sheet restructuring. The euphoric burst of growth we saw for a short while was little more than a bounce-back from depressed levels, through massive, but unsustainable, policy stimulus.

INVESTMENT STRATEGY

As deleveraging is a scenario whose warp and woof is like the slow progress of a sail boat tacking across a watery landscape under a leaden sky, no single asset allocation provides a fast investment anchor. Currencies and most asset classes will wax and wane.

Take commodities. We are probably at the top of the cycle, because growth is past the peak and monetary stimulus will be less. Yet the top of the Matterhorn may still look flat to an ant living there. So may this cycle to most commodity investors. We see less demand from manufacturers going forward; a normalisation of weather patterns for crops and a waning of investor positions. With the exception of oil, we are growing more cautious on commodities.

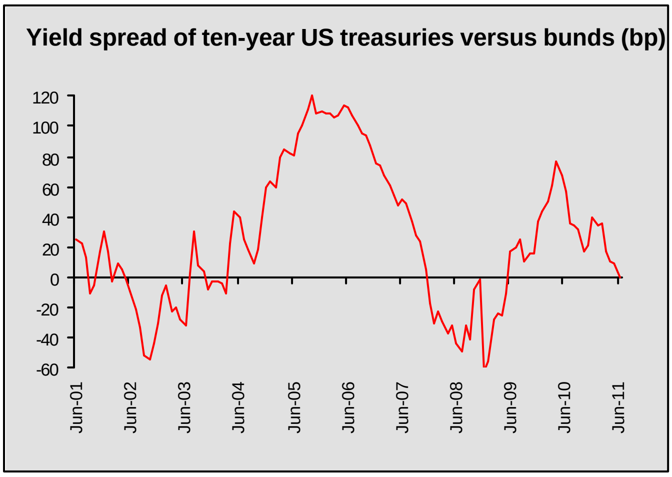


Figure 5. *Source: Datastream, Independent Strategy*

We still have long positions in defensive developed market equities. But the conviction level is low.

US and European core bond markets are way overvalued, but German sovereign ten-year paper has the same yield as US treasuries and that makes no sense (Figure 5). So a spread trade does.

We have flattened a lot of our developed market currency bets and are only marginally long the dollar. Safe-haven currencies such as the Singapore dollar, Norwegian krone and the Swiss franc (as well as gold) remain core holdings. We are short EM currencies

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such as the South African rand, Hungarian forint and look to go short the Brazilian real and Turkish lira when the tide turns (see our report, *EM currencies: the long and the short of it*, 31 January 2011).

The key to all these investment positions is that the instruments we own are all highly liquid and our positions are carefully bracketed by stop losses and return targets that limit any reversal of our scenario and lock in profits.

To add alpha to the portfolio we look to themes that are to a degree independent of the scenarios described above, in whole or in part, or are subsets of them with their own scripts but about which we have well-researched and deep convictions.

One such is our belief that the Irish debt crisis (and the country's ability to resolve it) has little in common with Greece or Portugal, or even Spain or Italy (see our report, *Europe: the conundrum of debt stability*, 26 May 2011). We are long Ireland and short the others.

Another is the mispricing of risk in emerging markets.

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