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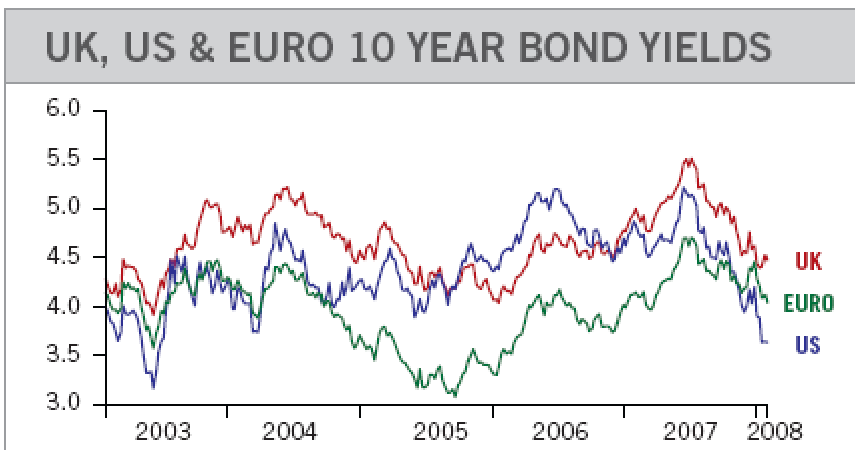
Pictet Asset Management

Monthly Global Outlook

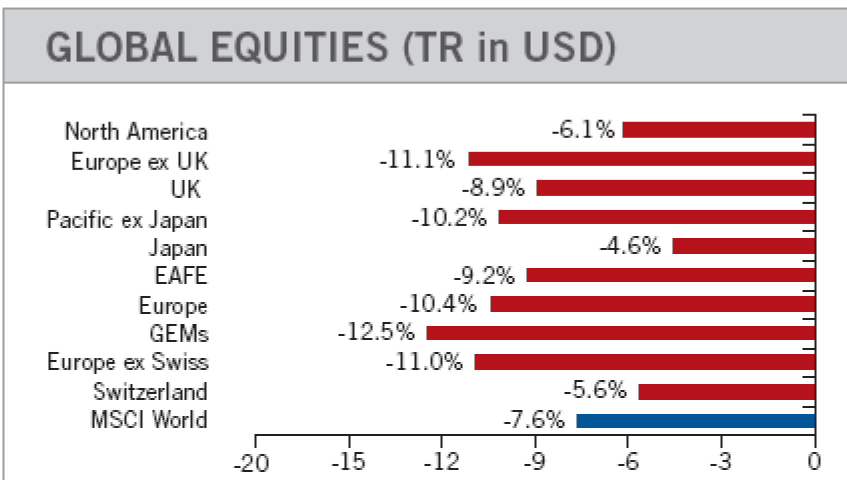
As U.S. bond insurers ran into new difficulties, fears over the wider implications of the credit crisis have spread. More banks made more write-offs, easily meeting worst expectations. One bank even managed to contribute a completely unrelated record rogue trading loss. The Fed cut rates by 125 basis points (bps), the biggest and fastest easing since 1990/1991. Markets are left deeply anxious over the prospect of a U.S. recession. Yet the economic indicators are mixed and equities look like a distinctly good value against bonds. Even if confidence remains brittle, a sharp rally looks possible.

Review

With gold and energy prices reaching record levels, financial markets made a wholesale retreat from riskier assets. Corporate bond spreads widened as fears over potential defaults grew, while government bond yields fell as investors sought safe-haven investments. Over the month, the MSCI World Index fell by 7.6% (TR in USD) while the MSCI EM Index dropped by 12.5%. In fixed-income markets, the U.S. 2-Year Treasury Yield fell by 65 bps to 2.13%, while 10-Year Yields closed at 4.25%, some 45 bps lower over the month.



January 1, 2003 to January 31, 2008 Source: Datastream



1 Month to January 31, 2008 Source: Bloomberg

During early January, the Fed chairman, Ben Bernanke, attempted to reassure investors by implying the Fed's readiness to take "substantive additional action" to support growth. However, the initial knee jerk recovery in markets was soon cut short by Citibank's further USD $18B write-down and 40% dividend cut, not to mention Merrill Lynch's subsequent net quarterly loss of USD $9.8B—each meeting investors' worst expectations.

While such subprime-related losses were shocking enough, new concern focused on the USD $3.1B element of the Merrill write-offs linked to hedges with bond insurers—in this case with ACA Capital, a guarantor that had recently lost its AAA credit rating and was raising funds to avoid insolvency. The market's sense of crisis grew as two other bond guarantors, MBIA and Ambac, after being savaged in the market, were forced to seek additional capital with their credit ratings under threat. In short, the business model of banks, dependent on the securitization and distribution of subprime and other loans, underwritten by bond insurance companies, has come center stage. The fear is that if such insurers fail, banks will be forced to raise further capital against the, now underinsured, bonds they have issued, adding to the stress of their balance sheets.

On Monday, January 21, with the U.S. markets closed for a holiday, selling pressure elsewhere reached a crescendo, as China's bank regulator suggested that exposure to U.S. subprime loans could force write-offs in China's banking sector. The ensuing sell-off spread from Asia into Europe and markets registered their worst trading day since 9/11. In an emergency meeting, the Fed responded by cutting the fed funds rate by 0.75 percentage points, a move reinforced by a further cut of 0.50 percentage points at month end, to bring the rate down from 4.25% to 3% in little over one week. Oddly enough, the subsequent revelation that Société Générale, the French bank, had lost EUR $4.9B on Monday and Tuesday that week unwinding rogue trades relieved the general anxiety, since it provided a possible—though unlikely—explanation for Monday's selling climax.

Outlook

Markets remain extremely volatile and sentiment indicators, at historic lows, reflect skepticism that the policy measures taken so far will be sufficient to restore confidence. Bears fear that even aggressive interest rate cuts will not offset the impact of falling asset prices and that consumers will retrench and attempt to rebuild household balance sheets stretched by the long consumer boom. This, some fear, raises the specter of a Japan-style deflationary spiral. Many commentators are convinced that the U.S. is already in recession, and expect a sharp drop in corporate earnings, which would hit employment levels, exacerbating a consumer-led downturn.

We doubt that the economic fundamentals are so bleak. While U.S. fourth quarter GDP came in lower than expected at just 0.6%, much of the drop reflected a rapid run-off in inventories; meanwhile the same report indicated a 2% rise in consumer spending over the quarter. Employment levels so far are also showing little sign of corporate retrenchment and export growth remains relatively strong. However the housing market remains in difficulty, with the stock of unsold homes still rising—a trough is only likely when the price expectations of buyers and sellers are aligned. Whether the U.S. is currently in a recession or not, the threat to growth remains high, as the travails in the housing and financial markets feed into the wider economy. Even though the Fed is likely to ease further—market expectations are for another 0.50% cut in rates over the next 2 to 3 months—the time lag before changes in monetary policy affects the economy is typically 12–18 months. During this period, confidence will remain vulnerable to further bad news from the rolling crisis in subprime and other credit markets.

Investing in foreign securities, especially emerging markets, will involve additional risks including social and political instability, liquidity, greater volatility, and less regulation.

The Morgan Stanley Capital International World (MSCI World) Index is an unmanaged index composed of more than 1,400 stocks listed on exchanges in the U.S., Europe, Canada, Australia, New Zealand, and the Far East.

The MSCI Emerging Markets (MSCI EM) Index is a free float-adjusted market capitalization index designed to measure equity market performance in the global emerging markets.

It is not possible to invest directly in an index.

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