

Issued by the Office of GPC EMEA – Chief Investment Officer

Contrasts and conflicts

- **Contrast the volatility in credit markets and stability of equities**
- **Central Banks remain reluctant to help too much**
- **Continuing disconnect between profit forecasts and economic outlook**
- **Liquidity- still a nagging problem**
- **Soft commodities – somewhere to hide**
- **Japanese equities- too early to venture-in but worth watching**
- **If you believe the statistics- September is not typically a good month for equities**

We maintain our caution that it is too early for investors to take on too much risk in current market conditions. Global money markets are still struggling to come to terms with continuing volatility. Central banks are also showing a reluctance to give the markets the interest rate cuts they crave. Volatility continues in the credit markets, whilst equities have consolidated. We worry that equity markets are being a little too sanguine about current events.

Fed chairman Mr Bernanke, in a speech last week, delivered a more sobering message than some in the markets had hoped to hear. Given that the US central bank is really the only major central bank minded to helping the markets through interest rate cuts, everything that Fed chairman says takes on more importance. Mr Bernanke stuck to the line that the central bank is not there 'to protect lenders and investors from the consequences of their financial decisions'. His comments knocked the notion on the head that the Fed will cut the Fed Funds rate before its next official meeting on September 18. Indeed the market may be asking too much to expect the 75bps of cuts the market has already priced through until the end of the year.

We still see little scope for other central banks to cut interest rates. This week we expect the UK MPC, the ECB and the Bank of Canada to leave rates unchanged at their regular meetings. In the UK, the medium term economic dynamics still argue for potentially further interest rate increases; however recent data has shown a moderation in both price and wage inflation. In Europe, the ECB has been very active providing liquidity to the money markets, hence it is likely to leave rates unchanged for the moment. However the underlying strength of the European economy may still warrant rate increases in the future. In emerging markets the trend is still for higher rates. Whilst the central banks in Bulgaria and Thailand left rates unchanged last week, rates went higher in the Czech Republic and are due to go higher in Mexico and Poland in the next few weeks.

Whilst equity markets are generally stable the problems of the short-term credit markets continue. Investors continue to avoid the commercial paper market that provides short term funding for institutions and companies. Outstanding Commercial paper fell another \$63 billion in the last week, bringing the total decline over the last month to \$244bn or 11% of the outstanding. Investors who would typically buy commercial paper have instead parked their cash in the treasury market which has driven down yields on 3 month T-bills to 3.8%. Worries over the liquidity conditions also led to a further wave of the sell off in the financials in the equity market. The global financial sector is down about 10% from its year high in mid May. We continue with our view that in general the valuations of the banks are not compelling enough to warrant a purchase at these levels.

There is a clear disconnect between the continuing volatility of the credit markets and the stabilization in the equity markets. What will be important is how the daily onslaught of credit issues changes the risk appetite of the financial sector to provide lines of credit to fund

the future growth of the global economy. A de-risking of commercial bank balance sheets would provide a meaningful drag on growth and lead to re-coupling of the equity markets to the downbeat mood of credit.

There also appears to be something of a disconnect between the economists' concerns about the outlook for global growth and company analysts positive profits outlook. The latest data from IBES shows that the consensus estimates of profits for corporations around the world made by brokerage analysts are still on the rise. Earnings upgrades outnumber downgrades in every region of the world. Meanwhile David Rosenberg, our US economist, has cut his fourth quarter GDP forecast to 1.4% (annualised) and he writes 'we expect that in the coming months we will see the debate shift from whether there is going to be a soft landing or hard landing (in the US economy) to whether we are going to see a mild recession or a severe one'.

To our mind, soft commodities continue to provide a good investment opportunity. We continue to search for assets that have little relationship with the current woes of the market. Soft commodities provide such an investment opportunity. Put very simply, even if the US economy goes into recession we still have to eat, so the demand for soft commodities such as wheat is less likely to get hit than other hard commodities such as copper and nickel. The Merrill Lynch commodity team believes that agricultural commodities will continue to perform well in the current environment. The supply side in the agriculture sector will likely continue to face significant constraints including water and land shortages as well as climate change. From the demand side, the use of agricultural commodities in the bio-fuels and the economic growth of the emerging countries as well as their changing tastes are putting upward pressure on the growth in demand.

We keep looking at Japanese equities and try to find sufficient reasons to buy after such a poor performance year-to-date (-4.1%). When you contrast the performance of Japanese equities (+2.4% over a year) with the rest of Asia ex-Japan (+11%) and emerging Asia (+42%), the difference is enormous and yet the Japanese companies have been benefiting from opening up of China and the generally good growth of the region. The equity market has been overwhelmed by the recent domestic political turmoil and the weaker economic data. Given our hesitation to take on risk in portfolios, now would not be the time to jump in, but is worth keeping an eye on this market.

Key economic data this week includes industrial confidence surveys in China, Europe, Singapore, UK and US. The beige book of regional industrial confidence is published in the US. The industrial surveys may start to reflect some of the turmoil of the markets in August and hence will be viewed by the markets as a sign post of the damage the crisis may have inflicted on economic growth.

An interesting data find from Mary Ann Bartels, our Technical analyst, states that the **Dow Jones Industrial Average (DJIA) has fallen in 16 of the last 25 Septembers.** Also, September is the only month to show an aggregate negative return from the DJIA over the last quarter of a century.

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