



Market Observations - 8 February 2010

Maybe a wobble but maybe more – what we think

After a sharp rise at the end of 2009, stockmarkets have sold off over the last few weeks, and risk aversion seems to have risen. This might prompt investors to re-examine their stance on markets. However, we believe moves of this sort are inevitable and consistent with our scenarios for 2010. Properly diversified portfolios should be able to limit the volatility investors are exposed to and should also allow investors to take advantage if a sell-off opens up opportunities to buy risky assets at attractive prices.

Markets have been spooked by a combination of factors. Investors knew that 2010 would see gradual withdrawal of some of the emergency measures put in place by governments and central banks to support the economy through the crisis: the possibility of mis-steps along the way always threatened higher volatility in markets this year. But against this background, other risks are currently in focus. Investors knew that tougher regulation on banks and markets was a given, but have been alarmed that proposals made so far in the US, to limit banks' size and scope of activities, might be tougher than they anticipated; fears of protectionism are growing too. Renewed moves by China to prevent over-heating of its economy have increased concerns that demand from there – particularly for commodities – could slow. And (following Dubai a month or two ago) concerns over the deterioration of public finances have spread: to Greece for now, but awkward questions are raised about others – Spain, Portugal and even the UK – and over the exposures of banks across Europe to loans in the weaker peripheral economies.

These concerns are understandable, and there are risks that could develop into something much more serious, but we do not believe they change the outlook dramatically at this stage (of course, we would need to change our view if events take a turn for the unexpected). The global economy is recovering, albeit slowly and with setbacks along the way: that is to be expected after the scale of the crisis, but there are encouraging signs in labour markets, inventories, industrial production, housing markets and other key indicators. Support from low interest rates and government spending will be withdrawn, but only slowly.

Regulation will affect the banks but should not undermine good functioning of the markets. China will dampen growth, but it will still grow and be a source of demand for raw materials: slowly, it may be a market for higher value exports too, if consumer demand there is unleashed. Greece and other countries must address their unsustainable deficits – a painful and extended period of austerity looks inevitable. But we do not believe the Euro (a political as much as an economic project) will fail, or that we will see the current strains in Greece result in sovereign debt default.

We expected a rise in volatility in 2010. Our central view has been (and remains) that investors can still make money in equities this year, but that the challenges facing markets would make it a choppier environment. After such a rapid rebound in equities in 2009 (punctuated by meaningful corrections in June and October), another pullback is no surprise. We had prepared for greater volatility, exiting our riskiest equity positions (call warrants) late in 2009 and more recently trimming exposure to Chinese equity and to banks. We were already concerned that bond markets may not be adequately pricing in the strains on public finances, and have been running very low allocations to gilts in particular.

This pullback may not be over yet: volatility could persist while investors worry about Greece, China and US jobs, and the question of whether policymakers will remove support too slowly or too fast will stay with us. But after a strong rise in equities, a correction is healthy and not a great surprise. There is a risk that one of the concerns currently driving markets could develop into a much greater problem, but this is far from certain. We should not be complacent, but at this stage the economy – sluggish though it may be, and with question marks raised by some data – does not look like being de-railed altogether. The rally in stocks since March had priced in much in the way of recovery and future growth: it's too soon to say that this pullback makes equities definitively cheap again, too soon to declare that the concerns on sovereign debt will fizzle out, but we should be ready to take advantage of an overshoot and a rise in risk aversion like this to add to equity positions for long-term investors as and when the current hysteria around the Euro and its troubles abates.