

2008: WHERE NEXT FOR GLOBAL MARKETS?

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Stock markets have seen extreme volatility as investors grapple with a range of possible outcomes for the global economy. Much vaunted 'decoupling' scenarios predicated on the fact that the world has become less dependent on US growth have come under pressure. At the same time, many investors expect further fall-out from the credit crisis as its effects spread out into the wider economy. Furthermore, US economic data has become almost universally gloomy.

Can the US Federal Reserve (Fed) avoid a damaging recession that not only impacts the US, but which some investors fear may extend to the rest of the world? A largely unprecedented 75 basis points reduction in interest rates, between official meetings, was designed to bring stability back to financial markets and address the deepening problems in the US housing sector. Is economic growth and demand from China, India and other emerging markets sufficient to ensure a 'soft landing' for the global economy? With inflation indicators still pointing upwards, rising food prices and oil at \$90 a barrel, does the Fed have any more room to manoeuvre without compromising its remit to manage inflation?

The Investment Clock model used by Fidelity's Asset Allocation Group currently attaches greatest likelihood to the global economy being in the 'stagflation' phase of the cycle – an environment of rising inflation and weak growth. The conditions for equity markets may seem bleak, but the downward revisions to earnings growth forecasts brings a dose of welcome reality and value back to many shares, presenting attractive opportunities for fundamental investment managers.

While it is impossible to predict exactly what 2008 may bring, for the time being, volatility looks like it is here to stay. In this paper, we consider the root causes of some of the current uncertainties in global markets and then outline some of the possible scenarios that may unfold.

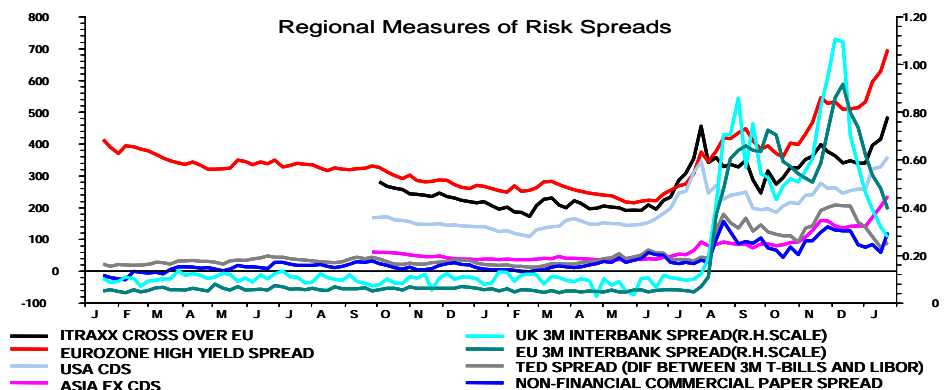
FROM SUB-PRIME TO THE WIDER ECONOMY

The recent five-year bull run in equity markets was supported by historically low interest rates, plentiful liquidity and more liberal lending practices on the part of financial companies. This access to 'easy money' provided the foundation for a prolonged consumer and housing boom, most notably in the US and the UK, which contributed strongly to economic and corporate earnings growth.

Recent developments in collateralised debt instruments, where groups of mortgages or other loans can be packaged up and sold onto the bond markets, have provided a lucrative source of earnings for banks. Unfortunately, these instruments have also encouraged them to pay less attention to creditworthiness, and we have seen a sharp rise in housing repossessions in the US. As the problems became apparent, wholesale money markets dried up, to the extent that a leading UK mortgage lender, Northern Rock, struggled to finance its operations.

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The banks quickly removed the easy access to consumer credit as wholesale bond markets re-priced the risk of these products (see chart below¹) and the effect the crisis was having on their own balance sheets became clear. Initially, investors de-rated stocks in the financial sector and the wider equity market was not as harshly hit. However, fears of fresh write-downs from financial institutions and downgrades of bond insurers or 'monolines' (who face a higher cost of insuring investment grade companies) have been unnerving markets more generally. Money market funds, for example, could become forced sellers of vast quantities of monoline-insured securities should they lose their AAA ratings. Some financial companies may face another round of write-offs, which would further reduce their ability to extend credit to businesses, causing a vicious spiral to develop.



The problem is that America no longer has a crisis in the sub-prime portion of the mortgage market; it has a problem in mortgages generally. The number of Americans who fell behind on mortgage payments rose to a 20-year high in the third quarter of 2007² and data releases are likely to show that US home prices fell last year for the first time since the Great Depression. Many US consumers have spent beyond their current income by borrowing on credit, and the fall in the value of their homes may make them reluctant to continue this pattern in the future.

The extent of these problems is now being felt in the broader US economy, with the building industry (which makes up 15% of US GDP)³ expected to cut its output by half, with the loss of between one and two million jobs. The slowdown in the property market is also hitting many other industries, for instance makers of durable goods and DIY stores. Much will depend on whether, and to what extent, the US consumer keeps spending.

IS THE US IN RECESSION?

Many commentators have warned that the US economy is on a knife edge, even though the Fed has cut interest rates four times since last summer, bringing its main borrowing cost down to 3.5%. The last cut of 75 basis points took place between scheduled meetings and was partly a response to the volatility in stock markets as well as fears over further problems in the credit sector and the housing market. It remains to be seen whether this reduction in rates will be enough to avoid a recession.

Bond markets have been pricing in the likelihood of a more serious slowdown in US growth for some time, using each piece of bad news as further justification for their gloomy forecasts. Equity investors, the argument goes, have only just woken up to the reality of a slowdown in the US and wider global economy.

The Philadelphia Federal Reserve survey of regional manufacturers showed that business confidence and new orders both fell sharply to recessionary levels. The survey also showed that producer prices spiked higher at the same as employment weakened. House prices, specifically, continue to weaken, with the nationwide median home price falling to \$207,800 from \$218,900 in October 2006⁴. This housing weakness, combined with credit restraint, is predicted to cause a material slowdown in the US economy.

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Certainly, the recent news has overwhelmingly favoured the bond market bears and much of what we have seen in equity markets in January could be put down to equity investors finally 'falling into line' by revising down their expectations. Where we go from here though and how the authorities and markets respond is critical. The recent volatility could ultimately be seen as a 'necessary' correction in a transitional market, rather than signalling the start of a bear market.

CONSIDERATIONS FOR THE REST OF THE GLOBAL ECONOMY

The outlook for the rest of the world has been the subject of intense debate over recent weeks, with most of the arguments focused on the 'decoupling' question. Decoupling challenges the idea that the world economy has only one engine of growth in the shape of the US economy.

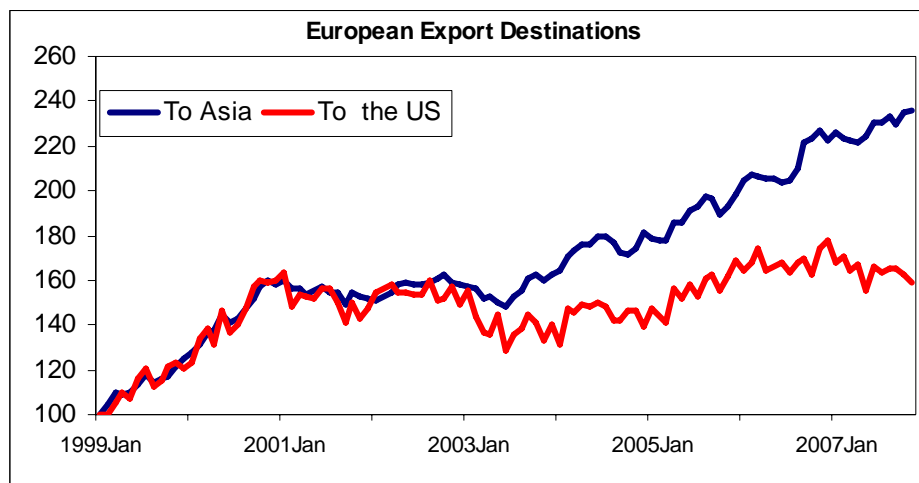
Certainly, the idea that 'when US sneezes, the rest of the world catches cold' is ingrained in popular economic thinking. But how relevant is it in an age when developing economies, such as China, Russia and Brazil, have recently assumed much larger importance? Surveys from the IMF point to the fact that developing economies were responsible for over 50% of global GDP growth in 2007⁵. Merrill Lynch⁶ believes that this contribution will jump to 75% of global GDP growth next year. So the 'de-couplers' argue that, even if the US were to slip into recession, Europe would be partly insulated by the fact that a large and increasing amount of its exports now go to emerging markets, notably China, Brazil and India.

SO CAN DECOUPLING SAVE THE GLOBAL ECONOMY?

China is at the centre of the decoupling thesis. With its huge labour supply of 1.3 billion people and its growth record of 10%p.a. for the last 20 years, China is seen as an unstoppable force on the global economic stage⁶. It has also had a ravenous appetite for raw materials. In 2007, China accounted for 9% of global oil consumption and 25-30% of demand for copper, nickel, zinc, aluminium, lead, steel, iron and coal⁶. In this sense, commodity-driven emerging markets have decoupled from the US and re-coupled with China.

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China is certainly an engine of growth, but what about demand? Sceptics would highlight that it exports 36% of its GDP⁶, mostly to the US which as we know is slowing. Merrill Lynch⁶ believes that European exports have now de-coupled from the US (see chart below left)⁷, yet German exports remain tied to the US consumer. The reason is that Europe is providing the machines and chemicals for China's manufacturing, which China uses to make and sell consumer goods back to developed markets, particularly the US. So, Europe still depends on the US to the extent that Asia depends on the US! It is also why materials and industrials have been the best-performing sectors during the last five years of unprecedented global growth.



Bear Sterns⁴ expects slower US and EU growth to materially set back China exports and profitability in

the near term. China's exports as a proportion of GDP have expanded dramatically from 20% in 2002 to 35% in 2006, so softer external demand will have a larger impact on China than it would have done five years ago. In Bear Sterns' view, much of the growth in China's domestic jobs and incomes, as well as local investment, has actually been a function of developed world off-shoring. Given their estimates that 25%-30% of China's workforce is directly export related, a slowdown in external demand could provide a headwind for consumption growth. From a global demand point of view, Bear Sterns believes that China and India are yet to generate sufficient final demand to offset any reduction in US and EU consumption. China's reported household consumption in 2006 was only 11% of US consumer spending that year, while India's was even lower at 5.6%.

Markets may already be factoring in some of these risks. Emerging markets are down 19% year to date in US dollar terms according to MSCI indices and, on this basis, it seems debatable whether they are the 'safe havens' that their supporters would have investors believe.

COULD CHINA ACTUALLY BE THE BAD GUY?

The consensus view, at least for the time being, is that China is now a rare bright spot among economies and is helping to keep global growth afloat.

However, an alternative view, from Merrill Lynch⁸, is that unless China takes urgent action to slow its economy, the developed world will be pushed into recession by the combination of a rising oil price and inflation-fighting G7 central banks. The reasoning behind this view is that China's peg to the US dollar (albeit with modest RMB appreciation) is keeping them unfairly competitive relative to the rest of the world. China's domestic fuel prices are heavily subsidised with prices ultimately controlled by the authorities, which means that high energy prices (partly caused by Chinese demand) are not being felt domestically, so the Chinese economy keeps rolling on.

The interest rate cuts in the US have fuelled a liquidity boom in emerging markets at the same time as the dollar has weakened. By pegging both exchange rates and commodity prices, emerging market governments have tried to keep growth high and limit the 'pass-through' effect of higher raw material prices to their domestic economies. This practice is effectively exporting inflation to the rest of the world in the shape of higher oil prices. China and other emerging market governments need to cool off the demand in their economies, or increase domestic commodity and fuel prices, to materially improve the inflation outlook for developed economies.

ARE EQUITY MARKETS NOW DISCOUNTING THE WORST?

It is fair to say that the economic backdrop for equity markets is poor right now but the more critical question is how much of this is already priced in? The issues of a US slowdown, housing weakness, and the likelihood of a consumer slowdown are substantively discounted in equity prices, though the process may not yet be complete. Similarly, stock markets are now discounting an earnings recession. It might be argued that the recent volatility partly reflects investors becoming more realistic about just how damaging that earnings recession will actually be.

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Generally speaking, companies have resisted calls to gear up at the top of the cycle. As corporate earnings have risen to lofty levels, the multiple equity investors apply to them has fallen. With a PE of 15.8x, global equities are on their lowest trailing price/earnings ratio for 17 years. Scepticism over the sustainability of earnings has been slowly but steadily discounted in equity prices for several years. What the recent volatility suggests is that this scepticism has turned to outright fear.

European equities look cheap on both an historical basis and relative to European bonds. The average PE ratio on 2008 consensus earnings is only a little over 10x⁴ – even if consensus estimates are marked down there is little potential for further multiple contraction. So, investors should not necessarily factor in a sustained bear phase on the back of the recent correction.

In the short term, we are likely to see 'bottom fishers' looking to pick up bargains after the sharp falls in equity markets. For those investment managers prepared to take a longer-term view, these periods, disconcerting as they are for investors, often provide the opportunity to generate considerable alpha. Well-established trends of globalisation, competition and technological change will continue to provide favourable market conditions.

COMMERCIAL PROPERTY PROSPECTS TIED TO ECONOMIC OUTLOOK

The outlook for commercial property markets is tied very closely to the outlook for economic growth in their respective domestic economies. As global growth estimates are revised down and access to cheap borrowing dries up, the outlook for this asset class has naturally become more clouded. In the UK, investors in commercial property have already been factoring in lower returns going forward - the market performed very poorly from the early part of 2007, when REITs were introduced very close to the peak of the cycle. However, there are pockets of growth and brighter outlooks in markets in Asia and in certain parts of Europe; these areas can continue to provide relatively attractive investment opportunities.

In Asia, the general expansion of the regional economy is helping to improve real estate fundamentals in the region: demand exceeds supply in most markets. There is strong potential for growth and the market exhibits a relatively low correlation with the US and Europe. Urbanisation and off-shoring are increasing the demand for industrial and logistical space; growing labour forces support demand for office property; while younger more affluent populations and higher spending are creating demand for retail and hotel space.

FIXED INCOME MARKETS AHEAD OF THE GAME?

Bond markets were expecting the Fed to cut interest rates significantly, although the timing was perhaps a surprise. The 75 basis points reduction in the Fed Funds rate is the first unscheduled cut since September 17, 2001 and the largest single cut since August 1982. According to one school of thought, the volatility we saw in equity markets could be attributed to equity investors simply catching up with their fixed income counterparts, who have been much more focused on the worsening macroeconomic backdrop. For months, as share prices have held up, fixed income markets have been signalling that the

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credit cycle has most certainly turned. The US yield curve has been pricing in the sort of significant rate cuts typically associated with economic distress for some time now, and the Fed's most recent move proved that they were right to do so. More is expected too, with some analysts anticipating another 50 basis points at the Fed's next scheduled meeting.

In the UK, consensus forecasts expect the economy to slow and the Bank of England is expected to lower base rates by between 50 and 75 basis points over the coming 12 months. While growth concerns have dominated the economic landscape in the UK and US, rising inflationary pressures have kept Eurozone interest rates higher. Despite the hawkish tone of the European Central Bank, the bond market is pricing in a 0.5% reduction in rates in the next six months.

Corporate bond markets are experiencing deteriorating credit fundamentals, given the notable rise in financial risk. Healthy balance sheets and central bank easing are positives, though many areas of the market remain dislocated, housing adjustments are ongoing, company earnings trends are deteriorating and issuance is likely to dampen the likelihood of a strong rally. However, credit spreads on investment grade debt now discount much of the bad news already, having priced in a significant rise in defaults. Capitulation trades in equities are a signal that long-term investors look for to re-enter the credit market and on a medium term view, we should see performance pick up from this very low point in the credit cycle as the banking system recovers. Asset-backed securities (ABS) have experienced some of the greatest corrections as the market has indiscriminately de-rated the asset class. However, the ABS sector is wide and varied and there is value to be found in selected highly rated names.

RETURNING TO EQUITY MARKETS, WHAT MIGHT BE THE FOCUS FOR 2008?

In 2008, we can expect sector rotation. Traditionally defensive sectors, such as healthcare, food and pharmaceuticals, finished 2007 strongly and may continue their strong run amid the current uncertainty. On the other hand, we could see some mean reversion from some of the crestfallen banks, although they are likely to remain under pressure. In the same vein, property companies and even certain retailers might offer potential, albeit more speculative, value.

Sector calls can go badly wrong, of course, particularly when market leadership swings back and forth; it may pay to focus more attention at the company level in what is likely to be an environment with marked differentiation between winners and losers.

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In 2008, investors will have to search for earnings. The long-established small and mid-cap rallies have now petered out and, over the coming year, there will be more opportunities across the market cap scale, requiring the need for more discrimination on the part of investors. Identifying those companies with strong, visible and better-than-expected earnings will be crucial. At present, due to narrow market breadth and limited liquidity, some investors are finding more opportunities in large-cap growth companies.

CONCLUSION

Diversification across asset classes and internationally should remain the foundation of any investor's portfolio. Stock and bond returns remain negatively correlated with each other even over short periods.

Investors looking to reduce risk in their portfolios should avoid the temptation to make large moves into and out of equities; far better to reduce risk by gradually increasing exposure to other uncorrelated asset classes such as bonds. Given the difficulties associated with market timing, equity exposures may best be considered with a long term view away from the tumult of day to day moves.

Investors may need to become accustomed to volatility as this is likely to remain a feature. In 2007, for example, the FTSE All Share moved more than 1% in one day on 30% of trading days. In 2006, this happened on only 13% of trading days⁹. Within equity markets, stock selection will become critical in an environment where identifying better-than-expected earnings growth will become much more difficult.

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Notes 1. Source: DataStream, as at 24.01.08. 2 Bloomberg, as at 06.12.07. 3. US National Association of Home Builders. 4. Bear Sterns, Vantage Point 2008. 5. Based on Purchasing Power Parity measure, source: IMF Survey, 'Emerging Markets Main Engine of Growth', 17.10.07. 6. Merrill Lynch, 'Decoupling: Can the world wean itself off the US consumer?' October 2007. 7. Source: European Central Bank, as at end 11.07. 8. Merrill Lynch, 'China in a box: oil vs. USD' 09 November 2007. 9. Source: Fidelity, DataStream, as at 31.12.07.

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