

IPS View: Climbing the Wall of Worry

One of the more striking features of the year so far is that equity markets are up even though there is, on the face of it, plenty to worry about. The Eurostoxx 50, for example, is currently up 6% for the year even though it fell 9% from its peak following the tragic earthquake in Japan. In fact, all the major indices that we track have made gains for the year except, perhaps understandably, Japan.

At this point we would normally ask ourselves: what can go wrong? In fact, we think the more relevant question today is: what is *already* going wrong and why is the market ignoring it?...

When we look at the issues facing the world right now we see the law of 'Unintended Consequences' hard at work. The global economy is a complex, inter-locking system. Policy prescriptions that make sense for one part can create havoc elsewhere.

As an example, we put forward QE2. The aim of QE2 was to help kick-start the US recovery at a time when it seemed it might falter. This has ostensibly been a success. However, just as an interest rate policy set for the economic heart of Europe has created havoc at its periphery, so a cheap dollar policy set with an eye on US inflation and unemployment is creating problems in the wider "dollar-zone". This area encompasses export focussed nations, most notably China, that peg formally or informally their currency to the dollar. The net effect has been a de facto interest cut for countries that were already booming. This in turn has pushed up the price of food and commodities and so has helped create an oil price shock, rising interest rates in Europe and revolution in the Middle East. Each of these we think is a reason for real caution.

- **Oil:** The point here is that oil shocks should be taken seriously. A recent paper by the Dallas Fed on the role of energy prices in business cycles points out that, for the US, "Every recession in the post-war era, except in 1960 and 1970, followed an oil price shock the previous year". This would be particularly true if central banks start to raise rates into a rising commodity price environment. Unfortunately, this is what has started to happen in the Eurozone.
- **The Eurozone:** there is continuing denial about the solvency issues for Portugal, Greece and Ireland. As the Economist puts it in their current issue: "They're bust. Admit it." In spite of this, most efforts are still centred around addressing the liquidity needs of these countries rather than facing up to the unsustainability of their financial positions. Greece and Ireland are putting in place heroic budget cuts to try to put their houses in order. The problem is that this austerity is dragging down growth and raising the ultimate debt burden – expected to peak at 160% of GDP for Greece and 125% for Ireland. The last thing these countries need is rising short term rates. Yet the ECB hiked rates last Thursday.
- **Revolution in the Middle East:** a continuing civil war in Libya puts strain on the world's oil supply. Obviously, the extent that this will spread to other countries is unknown and probably unknowable. That said, it is worth remembering that the world depends on Saudi Arabia as a safety valve for oil production. The discontent in neighbouring Bahrain is therefore particularly important. Any disruption that happened to the flow of the world's largest oil supplier would be potentially catastrophic.

The question is, then, how have equity markets managed to rise this year? Behind the negative headlines, we believe leading indicators of economic performance remain strong and point to a continuing solid global recovery. Last week's data flows continued this trend and momentum also remains strong. It is worth remembering that the "double-dip" concerns that hit markets around the summer last year were driven by a slowdown in these leading indicators: extrapolating this slowdown pointed to a real risk of recession. The business cycle is then, to our eyes, still in place and the outlook is for the upswing to continue.

The question is, then, what to do? As we continue to think the global recovery has legs we remain positioned to profit from it. We are, however, clearly concerned by the long list of things that can go wrong. An oil and rising rate driven slowdown, for example, could easily lead to a sizeable sell-off in equity markets. Our current focus is therefore on finding assets that can protect capital in a rising rate world. We also continue to watch events closely and we are ready to cut our risk quickly should our concerns continue to escalate.