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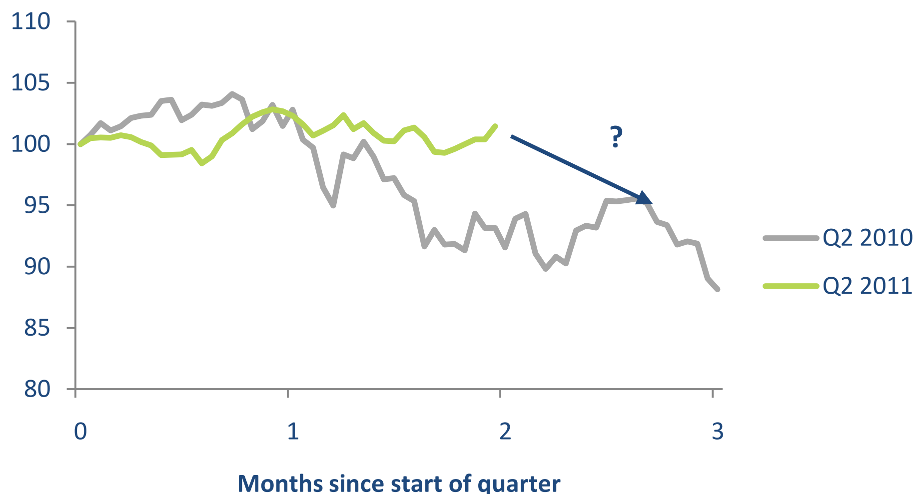
IPS View: Déjà Vu

In our April IPS View, "Climbing the Wall of Worry", we commented that equity markets were strong even though there were plenty of things – Oil, China, Greece – going wrong. In view of these concerns, we cut our exposure to equity markets at the beginning of May. Since then, a US growth-scare has begun in earnest and the issues facing investors look more and more like those of the second quarter of 2010. If so, that could be bad news for many investment portfolios: most equity markets lost over -10% in that period. We think that the fact these problems are more familiar second time around means that – so far – the impact has been less, as our chart below shows.



In this IPS View we look at how justified this resilience is and look at what would make us increase our allocation to equities again.

Reasons to be cheerful

In Q2 2010, the US slowdown and fears of another recession led the equity markets down. As another US slowdown looks to be underway the question is: how serious will it be this time? The case for optimism is that many of the factors that may have caused this growth-scare look to be temporary. The Japanese earthquake is the most obvious of these. The 13% fall in oil prices from their end-April peak is also likely to give some relief to consumers. Finally, and hardest to call, is the impact of the slowdown orchestrated by the Chinese authorities to address their inflation problem. We need some evidence that the measures put in place are beginning to bite. As they do, we think it quite possible the Chinese once again take their foot off the brakes. When they have done this in the past, the economy has rebounded quickly.

Our feeling is therefore that this is a pause in the recovery rather than the start of a new downturn. The risk though is that these shorter-term effects cause a more permanent slowdown in either consumer or business investment which has been the engine of the US recovery. We will watch both

carefully but, for now, we remain happy to run our client portfolios at lower than average exposure to equity markets. If the evidence for our more optimistic view grows we will look to add to our clients' exposure on a sell-off.

Some longer term concerns

First, commodities. If the world is booming then demand for commodities will continue to accelerate, which would be a natural brake on growth. This would mean that one of the main constraints to global growth would be, well, growth. In our view, a recovery that occasionally disappoints and remains below many commentators' expectations still remains most likely. This is one reason we have maintained our exposure to corporate credit as it is an asset likely to perform well in lower growth environments.

Second, Greece and the structural problem that is the Eurozone. Much has already been written on this (most recently Martin Wolf's excellent FT column) and we do not plan to add much here. We will just reiterate our core views: Greece is insolvent and the Eurozone faces the choice of allowing a default or proceeding with full financial integration. Default runs the risk of setting off a new bout of liquidity and insolvency crises. This clearly terrifies the ECB because, as with Lehman, the victims may be numerous and unexpected. As an example, Martin Wolf points out that the Bundesbank (separately from the ECB) is now owed €325bn mainly by the central banks of Ireland, Greece, Portugal and Spain. What would happen to this in the event of a default?

The alternative scenario is a genuine fiscal union where the problems of the periphery are ultimately socialised and absorbed by the rest. Though this looks like the preferred scenario for Europe's leaders, it is not clear that the political will is there from voters in the richer countries to put it in place. How will this play-out? We have no idea and we suspect the leaders of the Eurozone do not know either.

The implications for us are first to limit our exposure to the Eurozone. There seems little reason to risk a large portion of our client's capital to the region given the uncertainties and tail risk involved. Second, we are, as ever, ready for more volatility. Our client cash balances are therefore higher than normal in part to act as a buffer and in part to have the ability to profit from opportunities quickly as and when they arrive.