

# The United States of Europe?

## Market Commentary



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 VENTURA

- » Europe's latest rescue plan a good start, but still a wide gap between talk and action
- » United States to avoid recession but outlook remains lacklustre
- » China downside risks switch from inflation to property, but moderate slowdown for 2012 most likely outcome
- » Global and Australian shares approximately 25% below fair value
- » Strategic tilt against the AUD remains
- » Global government bonds on the radar for a tilt but catalysts for higher yields not yet in place

It's all so familiar - a financial crisis, plunging share markets, dithering policymakers and fears of global recession. This time it's European sovereign bond markets rather than U.S. banks at the epicentre. Europe's fractured leadership makes it difficult to put a comprehensive rescue plan in place. The agreement reached in late October is a step in the right direction, but the gap between talk and action is large. The difficulty will be in the details of the plan (of which there are few) and the implementation.

### Euro-zone:

#### Welcome to the Hotel California

If the euro is to survive, Europe needs to develop a more centralised fiscal structure where debt burdens are shared and countries have less say over their own spending and taxation decisions – in effect, a United States of Europe.

Inevitably, Europe is on a path towards closer integration. The only questions are how long it takes and how deep a crisis is required to force through the necessary changes to create an effective fiscal union.

The European leaders summit in late October went part of the way towards addressing the issues. The challenge is the big gap that can exist in Europe between the announcement of grand plans and their implementation. There is a possibility that this plan will stabilise bond markets by convincing investors that Europe's leadership is committed to solving the crisis. It's also possible that a vicious circle is falling into place that will accelerate events. The euro-zone desperately needs economic growth to help ease funding pressures.

*"In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could."*

*Rudiger Dornbusch*

### United States:

#### No recession but not much joy either

We are not in the camp that thinks the U.S. is headed towards recession but we wouldn't describe ourselves as particularly optimistic either. The biggest risk is that Europe drags the U.S. down through the banking system. Absent this, we expect a return to unspectacular 2-3% GDP growth through the first half of 2012.

The best description of the U.S. economic outlook is 'malaise'. How will the economy escape this low growth/ high unemployment purgatory? We think the housing market could eventually be the trigger for a sustained economic revival. New houses require whitegoods, furniture, carpets and curtains. They require infrastructure in the form of roads and utilities.

We expect eventually, possibly in 2013, oversupply will turn to undersupply and a rebound in housing construction will provide the kick start to the rest of the economy.



## China: short term comfort/long term concerns

China's economy appears to be slowing, but only mildly and growth remains relatively strong. Most forecasters are confident that China will slow only modestly in 2012. In particular, the government's plan to build 35 million low cost dwellings (social housing) by 2015 is seen as minimising the downside growth risks. The consensus expects China's GDP growth rate to slow from 9.1% this year to 8.5% in 2012 – a very soft landing.

The main risks for China are inflation, weaker export demand due to the slowdown in the rest of the world, and the potential collapse of some property development firms amid credit restrictions and rising non-performing loans. The property development issue plays into fears that China's property market has been in a bubble and is now in danger of bursting.

The longer term issues are whether China can sustain its exceptionally high growth rate of fixed investment spending and how it will increase the share of consumption in GDP. China's leaders aim to increase the consumption share of GDP to 50% over the next 10 years. This will require faster wage growth (which will be inflationary), and reforms to address the structural reasons for the high household savings rate (pensions, health care, education costs, financial regulation). These changes will be difficult to achieve, require significant economic reforms, be costly and most likely dampen growth for a period of time.

## Australia: Optimistic forecasts under pressure

On 1 November, the RBA cut the cash rate by 25 basis points, taking it down to 4.5%. This move was widely anticipated after the release of the September quarter inflation figures, which increased by only 0.3%.

The debate has now shifted to whether this rate cut will be a one off, or whether the RBA will continue monetary policy easing in light of the continuing turmoil in Europe and worsening growth outlook in Australia. Many forecasters remain convinced that the slowdown in the economy this year is temporary and that growth will bounce back strongly in 2012. The hawkish economists are focused on the \$82 billion the mining companies say they will spend on expansion this financial year (equal to over 5.5% of GDP). This is why they continue to see stronger economic growth in 2012. In contrast, the financial markets are pricing in about 100 basis points of further easing over the next 12 months.

The truth is likely to be somewhere in the middle - the rationale for lower RBA interest rates is growing, but it is not nearly as strong as the market believes. Another rate cut seems likely if employment continues to trend lower following the slowdown in GDP growth we have witnessed in the first half of 2011.

## Strategic tilting views

We've had a tilt against the Australian dollar in place since December 2009. It was initially a low-level tilt and was upgraded to a medium-level tilt in May this year as the AUD surged towards 110 US cents. Our catalysts for AUD weakness are RBA easing, more risk aversion from events in Europe and weaker commodity prices.

Global government bonds have been under discussion for a tilt. U.S. 10-year Treasury yields at around 2% fit our definition of an unsustainable extreme. However, there are some compelling reasons why yields could stay low for an extended period. We will continue to monitor this asset class closely and watch for a reversal of the factors that are holding yields at record low levels.

In terms of asset classes that might come onto the radar for a tilt, the most obvious is global equities. The issue for the share markets is one of time horizon. At 25% undervalued, global shares have a lot of upside potential on a five to ten year view. We would, however, need to see some catalysts, such as the policy moves in Europe, before making a tilt towards equities. Investment grade credit might also come under consideration if spreads continue to widen.

## Conclusion: Buckle up for a bumpy ride

The near term outlook is almost certain to be dominated by Europe. A lot of bad news from Europe has already been priced into asset markets. The wide gap between talk of policies to stem the crisis and the ability of Europe's leaders to take action means that volatility will remain high. There could be large relief rallies on policy talk followed by pullbacks as plans fail to be implemented.

We think a managed Greek default, a euro-TARP to recapitalise banks and ECB liquidity support are the minimum policy steps required to save the euro and prevent a regional financial collapse. The late October announcement in Europe moves part of the way towards these steps. The challenge now will be implementation and dealing with a deteriorating European economic outlook. Europe is not yet out of the woods, but there are at least signs that Europe's leaders recognise the size of the problem.