

Global markets still vulnerable

Early indications for the start of the first quarter suggest that the economic environment has become even more challenging, notes **Peter Hensman**.

The inauguration of Barack Obama and the opportunity to set out the detail of his economic and financial policy agenda stood out as the biggest hope as a catalyst for change and rejuvenation of market prospects in the early months of 2009. But, as often occurs, it appears to have been better to travel than to arrive. The expectation that a new policy initiative could break the gridlock provided a more favourable environment than the actual announcement of the initiatives could support. While Obama may be maintaining high opinion poll ratings, markets have been less favourable in their early assessment of the performance of the new administration.

Two events stand out. First, there was the discord over the fiscal stimulus package. Although President Obama hoped to gain cross-party consensus on the scale and structure of the public sector effort to boost the economy, only three Republican senators could be persuaded in the end to back the plan to spend nearly US\$800 billion of taxpayers' money. The bipartisan effort to stem the economic crisis has not lasted.

Second was the Financial Stability Plan announced by Treasury Secretary Timothy Geithner. Despite his acknowledging that the response to the crisis under the previous administration had been reactionary rather than proactive and had consistently underestimated the scale of the problems faced, the plan set out on February 10 seemed to represent a continuation of past efforts.

Instead of taking the opportunity to 'kitchen-sink' the problems exposed by the credit crunch and completely removing bad assets from bank balance

sheets at the expense of severe dilution of existing capital holders, efforts continue to centre on attempting to forestall the impact of market illiquidity in the hope that some sort of recovery will kick in. Further disappointment was evident in the lack of detail in the proposals that were announced.

What remains clear is that the hyperactivity among policymakers looks set to continue as efforts are made to prevent the downturn from becoming more severe. The bewildering array of new and ever-larger policy initiatives, as well as the associated explosion in acronyms, can only be expected to increase.

Investors will need to continue to monitor these efforts closely. As has been the case in Japan in the last 19 years, it is possible that aggressive, short-term cyclical rallies will occur. However, it seems unlikely that a sustainable recovery will occur until the longer-term problems of the over-leverage of economies are tackled.

One theme that has entered the psyche of the market has been the perception that the economic problems in China are not as significant as elsewhere, especially as the more centralised (and less democratic) regime is able to act decisively to stimulate activity. The short-term focus of some is that the Chinese A-Share Index has risen some 24 per cent in the year to February 20 and is thus the best performing equity index by some margin. The National Bureau of Statistics Purchasing Managers Index for China rose to 45.3 against 41.2 in December, while loan growth accelerated to 18.8 per cent year on year in January. These factors (data sourced from Bloomberg) have created a cacophony of noise

that the US\$586 billion fiscal stimulus package announced in November has already led to a recovery in activity in China.

While this idea is possible, there is reason for caution. First, the rally in the A-Share Index so far this year appears to lag that of the Hong Kong China Enterprises (H-Share) Index. Measured over the last three months, the returns on the indices are nearly identical. Also, there is the suggestion that the pressure placed on banks by the government to lend to businesses has encouraged managers to speculate in financial markets, rather than use the funds in their businesses, as was perhaps intended.

Furthermore, several banks have indicated that much of the increase in lending is the result of discounting of trade bills that companies were previously able to finance in markets. But is this not similar to the re-intermediation of financial transactions being witnessed in the rest of the world? If so, is there really a reliable indication that the fiscal stimulus is feeding rapidly into a reacceleration of the Chinese economy?

Unfortunately, markets are likely to continue to be the best lead indicators of their own future trends, as the failure of the monetary transmission mechanism means that the traditional markers of changes in market fortunes are not working properly. Given that policy efforts seem focused on preventing market mechanisms from clearing, it seems appropriate to remain cautiously positioned while recognising that market sentiment could change very rapidly were a significant policy initiative to be unveiled.

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