Markets adjust to new order

The US economy continues to show signs of resilience. **Sachin Patki** hopes that this same resilience will help the economy recover in the next three quarters.

As the financial world reorganises itself post an event equivalent of the Ice Age, we see a potential change in the ranking order in the financial markets for the developing nations.

Emerging markets from Asia, South America, Eastern Europe and the sub-continent have substantial market capitalisation today. Governments of most of these emerging market countries have also set progressive economic policies into place with a focus on developing human capital, and the chances of economic recovery in these markets being sustained are high.

The key items that caused a global meltdown have been seen as outputs of markets that have been big on regulations but low on their implementation, along with structural deficiencies of not enough corporate governance and supervision. This has resulted in many voices arguing in favour of shifting away from the dollar-centric economies in the world, where most central banks maintain large amounts of reserves in US dollars. And a lot of these funds end up financing the US trade and budget deficit, leading to unrealistic risk-adjusted returns and interest rates in the US.

The US dollar also gets indirect support from overseas holders of its currency and in turn treasuries, corporate bond issuances and in some cases equities. If these holdings are diversified into other currencies, it is likely to provide the market with lower volatility and save corporations a lot of hedging costs.

The US economy continues to show signs of resilience, especially from consumers in the areas of spending and future outlook for the economy. This is happening at a time when the unemployment rate continues to rise and deflation remains a real risk in the economy. Hopefully, this same resilience will help the economy recover in the next three quarters, which will be decisive for the monetary policy of the Federal Reserve. Though the key Fed Funds rate may not rise much, the Fed may let the longer-term treasury yields rise to reduce the risk of longer-term inflation in the economy that can seriously derail any longer-term growth. Aside from this, the economic policies of the Obama administration will help decide how quickly the economy will return to normalcy.

The Eurozone lags behind the timelines for the US economy, although the European Central Bank (ECB) has hopes for the economy to improve faster with record low interest rates and billions of euros worth of intervention funding to corporations and local bodies. With consumer and industrial confidence still low and rising unemployment rates, the only area of hope comes from retail sales, which were not as bad as expected in May 2009. Consumer sentiment needs to seriously improve over the coming three quarters for any recovery to find deeper roots and provide the sustainability needed for longer-term growth to happen.

The key risk is that of inflation, and given the ECB's focus on this topic, we may see the euro interest rates rise ahead of those in the US. This may in turn give a floor to the euro as it looks to rally from its current levels near 1.4000, with a clear break above 1.4250 and giving it the momentum to test 1.4480, 1.4635 and 1.4850. Failure to break above 1.4250 will indicate lack of buying support and take the currency lower towards 1.3780, 1.3570 and 1.3100.

The euro/yen seems to have reached the near-term top as it looks to test the support at 130.10 and 126.75, which may provide it with the support area. A reversal back above 1.3500 indicates that the euro has some further upside possible against the yen.

Economic releases from the UK continue to show weakness in the employment market, but pockets of recovery in the manufacturing area. Retail sales continue to be negative, with property values still sliding lower. With the Labour government not being seen to do enough, the GDP is expected to fall by 4.3 per cent this year as per the OECD. This is compared to a fall of 4.8 per cent in the Eurozone and a drop of 2.8 per cent in the US. While growth may take root with government schemes

like 'scrappage' and intervention to replace private equity in corporations, this will come at a cost that may be too high and take too long to pay off by taxpayers. Inflation may derail longer-term real growth and the monetary policy may reverse ahead of the fiscal policy reversal.

The sterling looks to find a top near 1.6560 and may see the downside being tested at 1.5950, 1.5540, 1.5380 and 1.5270. If it holds on a weekly closing basis, it may attempt the range of 1.6200-1.5450. The dollar/yen looks very toppish and may see some deeper correction towards 94.35, 92.70, 91.10 and 89.45. A failure to break the downside level of 92.70 would indicate a test of up to 98.25 and 100.10.

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Views expressed are the author's and not necessarily those of Mashreq. Data and comments are as of July 7, 2009.