

# Gradual economic recovery

Investors can expect 2010 to continue with the gradual economic recovery and outperformance of risk assets, writes **Peter Hensman**.

Last year proved to be a year that demonstrated a remarkable turnaround in fortunes. While at the end of 2008 it was possible to recognise that an extraordinary degree of effort was being applied to forestall the unfolding financial crisis, what was less clear was whether, or when, this would prove successful. The recent confession from the Bank of England that it provided emergency loans to both Royal Bank of Scotland and HBoS in October 2008, because the bank believed both were potentially within hours of needing to stop withdrawals of customer deposits from cash machines, is just one of many demonstrations of the strain that the financial system was under. The legacy of the financial turmoil in 2008 will likely be evident for a generation and can be expected to have a significant bearing on market trends in the next 12 to 24 months.

The dominant theme behind the investment portfolios at Newton in recent years has been the belief that the over-indebtedness of the developed world represented a significant threat to the sustainability of growth in these economies. What was also demonstrated in 2009 was the determination of the authorities to avoid the inevitable debt deflation and returning the economy to solid footing.

The outlook for 2010 represents something of a conundrum. The fragile state of the developed economies and financial systems is likely to mean the policy backdrop remains extremely supportive. Arguably, the best mix for financial markets would be to see a continuation of the recent trend of moving toward some fiscal consolidation that in turn would allow monetary conditions to remain more supportive. Such a backdrop would be likely to see an extension of the trend evident in 2009, and it is the unintended beneficiaries of the loose policy stance where the largest risk-adjusted capital gains are made. With interest rates in these circumstances held lower for longer, the race to the bottom in currency markets would likely continue. The

benign neglect of the US dollar evident in the attitude of the US authorities is reminiscent of former US Treasury secretary John Connolly, who told his European counterparts in 1971: "The dollar is our currency and your problem." With few willing to countenance a large currency appreciation for fear of the impact on the performance of the export sector, the loose US monetary stance forces easier policy settings elsewhere. Absent a policy shift in the US, those who do raise interest rates are likely to be swamped by capital inflows that will support credit availability and go a long way in offsetting the tightening desired by the authorities.

With policy concentrated on growing the economy away from the problems associated with too much credit, equity markets and other risk assets are likely to be underpinned by reasonable valuation and positive earnings momentum. The US government bonds are also unlikely to produce the best returns in 2010, and neither are the negative returns feared by some as the consequence of an unsustainable debt mountain likely.

Inflation is unlikely to be a major issue beyond the first quarter. Despite the enormous money printing in 2009, the vast majority has simply been parked at central banks as the financial sector now chooses to operate with a higher level of liquidity than before the credit crisis. While commodity prices have been more resilient than might have been anticipated given the scale of the downturn in global activity, this is not necessarily an indication of larger future increases in overall price indices. Instead, this may well reflect a shift in relative prices that is arguably the converse of events of the late 1990s. Then, in the aftershock of the emerging market crises, commodity prices remained soft, despite a recovery in activity into the turn of the Millennium. The quid pro quo from this softer background for internationally-traded products was the underpinnings for the boom in non-traded

domestic prices in the developed world. The stronger underpinnings for the prices of globally traded products in the current environment is more likely to be a drag on prices of non-traded items in the developed world than the start of a cost-push inflation.

After the experience of the last 18 months, it would be foolish to suggest that this outlook is not without risk. Arguably, foremost amongst these is that this relatively sanguine view overestimates the ability of the authorities to control the near-term direction of markets and the economy. The current loose stance of policy is clearly intended to sustain some unhealthy underlying distortions to help achieve a more gradual adjustment process. There is a significant threat that this fails, and the return of risk aversion contributes to a downward adjustment in asset prices as market liquidity fails and a double-dip recession ensues. Largely ignored in many outlooks is the impact of Japan on the world economy. Despite nominal GDP being back at the same level as 18 years ago, Japan is still the second-largest economy and is the largest non-US holder of Treasury securities, as well as being a large holder of overseas assets generally. Should the new Democratic Party of Japan consolidate its hold on power in the Upper House elections in the summer, there is the potential for some significant policy changes that could have global repercussions.

None of the above considers geopolitical events that are always an unforecastable unknown. Despite the likely occasional events, 2010 can be expected to see the continuation of gradual economic recovery and outperformance by risk assets. The main threat to this is the unexpectedly early tightening of interest rate policy in the US, which would likely contribute to a reversal of dollar weakness.

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