What will lead to recovery?

The recent spurt in the market activity makes **Peter Hensman** wonder if the market has finally turned. Or, is it another bear rally?

Equity markets have rallied strongly since the March 9 lows. Based on Bloomberg data the MSCI world index rose by more than 40 per cent from this nadir to the May 8 close. The scale and speed of this turn around has wrong footed many investors, fatigued by the onslaught of negative news and policy hyperactivity over the prior six months. Is this simply a bear market rally, or the start of a more prolonged rising trend?

There is little doubt that the economic backdrop remains extremely challenging, and although some data have improved, supportive figures are few and far between. Some highlight that the "second derivative" of activity has turned. Given that part of the positive for markets has been that sentiment became extremely depressed and hence the scope for upside surprises increased, without extrapolating the improvement in economic conditions, this is unlikely to be an ongoing support for the market. Nor does the "leaked" report that Citigroup had made operating profits in the first two months of 2009, that coincided with the market lows, seem a sufficient reason to expect a continued lift to market sentiment.

What is more credible as a driver of a continued improvement in market conditions is that the combined efforts of the world's authorities to stem the implosion of the global financial system have finally started to gain traction.

Improved market conditions should contribute to better economic conditions, as this turn in events is likely to mean that the risk of business failure and individual bankruptcies diminishes. Where businesses and individuals that hit hard times around the turn of the year could expect little assistance from financial markets or banks, the return of issuance in the high yield bond market and positively received rights issues means the risk of an economically disruptive failure is much reduced. As business and individual sentiment recovers, so should economic activity.

With valuations of risk assets still attractive, even allowing for probable earnings disappointments and dividend cuts, there is the potential for further improvement in market conditions as what was a vicious spiral turns virtuous.

What is unlikely to have changed is the desire of (and the imperative that will be placed on) the financial sector to reduce its level of gearing. The efforts of the developed world's financial and household sectors to repair their balance sheets are likely to mean that the underlying rate of recovery is relatively subdued.

What the authorities are likely to have achieved is the stretching of this process over a number of years, rather than the headlong descent that threatened following the collapse of Lehman Brothers (Whether it is desirable to prevent the adjustment process by encouraging greater indebtedness is a separate issue.)

Recent months have also encouraged the belief that the emerging world will be relatively less impacted by the legacy of this credit crunch. Perhaps much in the way that the Anglo-Saxon consumer experienced little disruption from the currency crises of the late 90's and instead benefited from the fall in global price levels and interest rates that followed, it is probable that the economies that were forced to make difficult adjustments at the turn of the Millennium will gain most from the efforts to prevent a deflationary collapse of the Western economies.

Not only should the developing world benefit from what in many cases are the lowest interest rates in a generation. As the credit crunch eases, these economies should also be boosted by the return of the supportive currency trends witnessed for much of the 2002-2007 period. During this time improving economic fundamentals attracted capital inflows that contributed to currency appreciation.

The stronger currency reduced the upward pressure on domestic interest rates and helped underpin economic trends, thus creating a positive feedback loop of better economic and current trends. What the strong decoupling argument underemphasised was the importance of the continuation of these capital inflows and the importance of the weakening US dollar to the virtuous cycle underpinning the expansion in the developing world.

As the global financial system undergoes the current healing process, the constraints on the availability of US dollars should ease. Indeed, the dollar trade weighted index (DXY) appears to have peaked in February.

Continuation of the weakening dollar trend should help the positive feedback effects re-establish, further underpinning the growth of domestic demand in emerging economies. Although some of the stronger held views on the ability of the developing economies to decouple from the developed world cycle clearly didn't stand up to the extreme events of 2008; and so, it is not unreasonable to believe that it will be a more domestic focused emerging market to lead to global growth that will become apparent.

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