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What follows stimulus?

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August was a month of contrasting views as opinions remain bifurcated regarding the near-term fate of markets. On the heels of July's positive economic data – e.g. stronger than expected PMIs led globally by manufacturing – and news of earnings improvement (the latter albeit from cost cutting rather than revenue growth), developed markets continued moving higher. The MSCI World PL finished the month up +3.51%, with the MSCI US up +3.24% and MSCI Europe PL up +5.60%. Emerging Markets, conversely, finished the month down: the MSCI China PL dropped -7.04% and MSCI EM PL closed the month down -0.14%.

In Developed Markets, stimulus and inventory restocking continued to provide one-off boosts to growth with, in particular, the US 'cash for clunkers' and its German analogue helping to drive up respective car sales and production numbers. Global vehicle sales increased at a 50% annualized rate, while vehicle production in Q3 2009 is expected to increase at a 380% annualized rate. While some economic indicators still remain well below their 2008 levels – particularly those related to consumption and private spending – most manufacturing indices are showing enormous improvement on earlier 2009 figures. The manufacturing ISM has crossed the expansion level of 50 (a level that signals economic growth), up from 30 at its 2008 nadir. A turn in this indicator has predicted the end of every major recession since the 1960s and, at face value, the index level of 53 is now consistent with annual GDP growth of around 3% in the coming quarters.

In the Emerging World (and this author wonders whether we may need to rethink such nomenclature), China, as it has done for the better part of the year, dominated investor focus. Chinese policymakers have opted for quantity over quality in setting macro-strategy, the centrepiece of which has been an enormous surge in infrastructure spending funded by a burst in bank lending. As many remark, China is conducting a perhaps

"audacious experiment" with the sheer size of its stimulus. Based on new loan data, China's banks are on track to extend circa \$2tn (just over 40% of GDP) in credit during 2009 if current trends continue. If the loans which are directed towards infrastructure have the added benefit of sparking a decisive pick up in consumption, the stimulus could positively contribute to rebalancing China's economy (and that of the world). If, on the other hand, this flood of liquidity ends up in stocks, real estate speculation, and excess export capacity, then the stimulus may well 'end in tears' – and not just for China. Indeed the market corrected over the month on concerns that signs of an increase in inflation (not to mention soaring asset prices) might lead Chinese policy makers to rein in credit and monetary expansion. Concerns about tightening, however, proved to be short lived; as we write in September, Premier Wen Jiabao has vowed to "unswervingly" maintain China's aggressive fiscal and monetary policies "until the recovery is more deeply entrenched." Of course with a low debt-to-GDP ratio (18% centrally, 42% including regional governments) and deep FX reserves (\$2.4tn, or 50% of GDP), the Chinese government has ample firepower to maintain this aggressive stimulus policy.

August was also marked by a renewed commitment from Western Central Banks to keep the taps flowing. US Fed Chairman Ben Bernanke made clear his ongoing commitment to easy money on August 21st, stating that "the world has been through the most severe financial crisis since the Great Depression. The crisis in turn sparked a deep global recession, from which we are only now beginning to emerge. There will be no change in policy until banks start to lend again and credit growth picks up." These remarks were reaffirmed by the G20 on August 24th "The continuation of policy stimulus is therefore best seen as an attempt to offset downside risks rather than a guarantee of the strong recovery that is being priced into equity and commodity markets." As we write in September, UK Prime Minister

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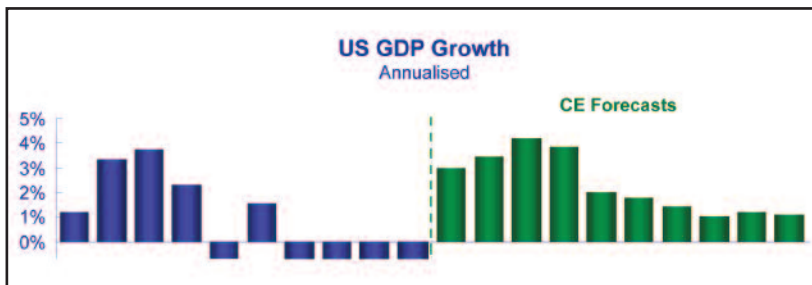
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Gordon Brown has announced that “the stimulus we have still got to give the world economy is greater than the stimulus we have already had” in order to “safeguard the recovery.” The message from policy makers has been crystal clear: there is no question of tightening monetary or fiscal policy until the central banks and regulators believe that a global economic recovery is absolutely secure. With declining bond yields remaining supportive of these easy money policies, it is no wonder talks of ongoing stimulus set the stage for renewed investor enthusiasm in September. Easy money, ample liquidity, low inflation and clear signs of economic recovery together provide a powerful elixir for equity markets. Sentiment was further buoyed by the IMF who revised up its 2010 world GDP growth estimate to just under 3% - half a percent higher than its July estimate for the same time frame.

But it is the fragility and government-led nature of the rebound that has resulted in an increasing bifurcation of investor sentiment. Bulls argue that the stimulus provides sufficient ‘oxygen’ to help the cinders of economic recov-

ery catch, and that the lessons of the Great Depression and Japan’s Lost Decade render both Central Banks and policy makers loath to prematurely tighten. So long as there is no challenge from the bond markets, they see stimulus likely to continue and inflation to remain low (at least in the near term). Furthermore, the bulls argue, markets will remain supported as investors who have missed the rally may be lured by strong gains to reposition portfolios so as not to miss all the action into the end of the year. Money market assets have just returned to their Lehman levels, circa \$3.9tn, which provides plenty of cash fodder to drive prices higher. Already momentum players believe that the break of July’s ‘head and shoulders’ technical pattern sets up a new price target of 1200 on the S&P 500.

By contrast, while bears admit that the world is no longer on the brink of Armageddon, they question the sustainability of a recovery absent significant improvement in private sector demand and with unemployment at record highs for this decade. Even if moderate growth manifests in the latter half of 2009, bears point



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to the mountain of debt – corporate, government, and household – which will remain a drag on economic growth for years to come. They also note that the slowing trend of US benefits (pension and healthcare) is likely to put further pressure on household budgets, in part by shifting costs onto employees in the form of higher co-pays – as will the inevitable increases in taxation. From a technical perspective, the bears warn that current price levels on the index are pricing in not only recovery but two years of growth to follow – a level which looks ambitious even for the most optimistic of forecasters.

It may be that both the bulls and bears will be proved

correct to some degree, as posited by Capital Economics in the quote and chart below:

“The recent improvements in the incoming data suggest that over the coming quarters the US economy will enjoy a burst in growth driven by the fiscal stimulus, a rebound in business investment and an easing in the inventory rundown. We are therefore revising our 2009 and 2010 GDP forecasts higher. But this spurt will be short-lived. Growth is likely to fall back in the second half of next year as the initial stimulus thrust fades and consumption remains weak.”

If the chart above proves correct in its outlook, animal spirits could well continue unabatedly pushing markets higher until year end. 2010 comparisons however could well prove more difficult, however, as stimulus spending begins to fade (or at least become more lagged in its effects) and quarter on quarter comparisons turn lower. Broader market volatility will no doubt remain significant as the underlying debate over whether the world had conquered deflation or circumvented inflation continues to dominate investor thinking.

Investment Opportunities

Given the uncertainty of the sustainability of the rally as well as the unknown shape of the recovery, Fortune continues to seek to position our clients’ portfolios to perform well irrespective of market directionality by combining the following types of hedge fund managers:

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DISTRESSED :
Fundamental credit managers with deep expertise of the previous credit cycles who can

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