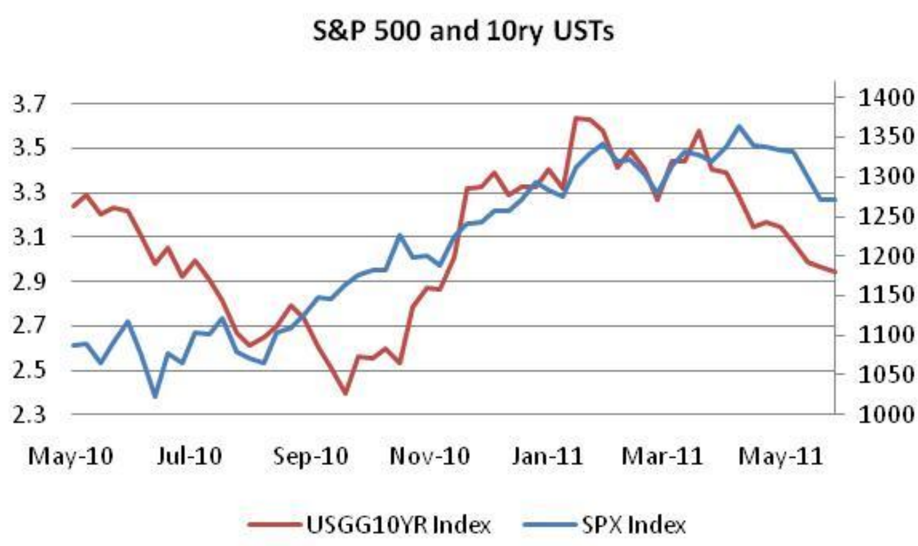
From A Great Overheating to a New Normal OR Where Do We Stand Along the Risk Story

The past couple of months have heralded a sea change in investment attitudes. In a sense the market has unpriced the main assumptions which dominated portfolio positioning at the start of the year. To the extent that the global central bank balance sheet expansion phase is now over, while private sector balance sheets are still contracting, then the sweet spot of the global risk recovery is probably behind us. A renewed focus on expected asset returns and bank capital risks amid slowing global growth and an increasingly destabilizing euro zone crisis prescribe a more selective approach to currencies, even if "fat tail" scenarios (a US double-dip, a disorderly Euro zone sovereign default) are avoided.

The Great Overheating Seems a Long Time Ago

To appreciate the significance of the U-turn in global investment attitudes, one has to begin with the psychology which dominated portfolio positioning at the start of the year. The first quarter brought about the kind of symptoms that one would ordinarily associate with the mature stage of a global recovery. Concerns about stretched emerging market valuations, growing inflation fears, gaping budget deficits in the West as well as weak credit risk-yield rewards in money markets all channeled investor flows into developed market yield and commodities. The maturing financial recovery brought with it widespread expectations of a global monetary normalization cycle, accompanied a decline in global volatilities and a strong rally in growth currencies. The strong performance of high beta majors such as ZAR, NOK, AUD and CAD against USD, CHF and gold was a sign of the clear supremacy of global cyclical yield over structural fears. The VIX index (a proxy for global market fears) troughed below 15%, the lowest since pre-securitization crisis in 2007, in April, with the down-leg delayed but not derailed by the MENA and Japan crises between February and March.



The ingredients of the Q1 Rally: Cyclically-Ultra Easy Monetary Liquidity

To suggest that this was all a function of the Fed's QE "displacement" effects, which channeled private sector savings out of cash (US Treasuries and the US dollar) and into riskier assets, would be an understatement. Arguably, this is likely the key driver behind Risk Rally 2 that lasted from September 2010 until April 2011. At the same time, the implied yield on the

Dec12 eurodollar contract surged by 135bps to 2.25% between November 2010 and February 2011 in a sign that the market anticipated a rapid shrinkage of the Fed's balance sheet and a return to conventional rate targeting in the not too distant future. To be fair, global monetary conditions looked excessively easy against the backdrop of surging commodity prices, upward revisions to global demand expectations and rapidly improving market liquidity conditions, which helped underwrite the risk rally.

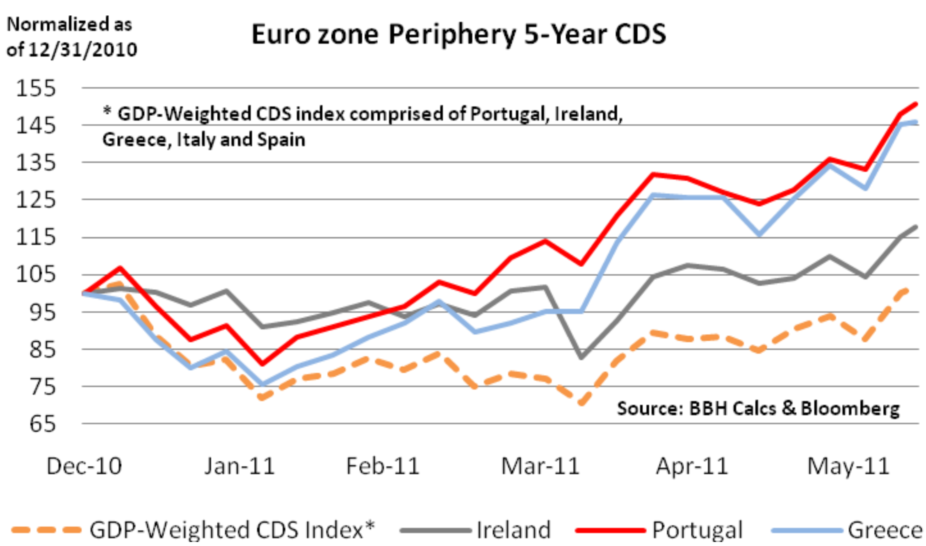
But there were quite a few other more interesting things going on as well:

Stronger than Expected Global Demand

Perhaps most encouragingly the source of liquidity support for investor risk appetite had shifted from the public to the private sector. If 2009 and 2010 were largely about government capital support for the banking system and the Fed's asset purchases that provided a lift for depressed equities, since then it had been a rising share of US corporate profits in national income as well as better than expected global demand growth that supported cyclical investor optimism about valuations. With US policy, both fiscal and monetary, firing on all cylinders to reflate the domestic labor and housing markets, optimism about the US recovery was growing. US growth forecasts at the start of the year were looking for an above-par 3-4% expansion.

A Strong Policy Safety Net

Against the strongly risk-positive global cyclical backdrop, the Euro zone crisis side-show was an important case with convergent results. Although Portugal followed Greece and Ireland to become the third candidate for a bailout this year, Spain was insulated by the EU safety net, with the effect that GDP-weighed CDS spreads actually fell in the first three months of the year. What is the implication for risk markets? The policy safety net against another global systemic crisis remained in place, protecting the global recovery.



As a side note here, the effects of the MENA crisis and the Q1 spike in US Treasury yields to amplify volatility in EMs, if anything contributed to the positive revaluation of global risk assets by channeling flows in favour of developed stocks and credit. The MSCI and US high yield corporate bonds returned 4.3% and 1.9% respectively in Q1, against returns of 1.7% and 1.0% for the MSCI EM and the EMBI each. Against this backdrop, SEK, EUR, NOK, GBP and US cyclical proxies (CAD and

MXN) saw the strongest performance, together with the latecomers to the rally - euro-block to the East (HUF, RON, CZK, RUB and PLN).

In summary, the first quarter of this year now looks to have been the sweet spot of the recovery as global cyclical sentiment, global financial liquidity and the effects of the global policy safety all came to a peak, notwithstanding the disruptions from the MENA and Japan crises. It is the recalibration of this goldilocks situation that ultimately drove the correction across global risk assets since May.

Q2 Has Brought About a Major Rethink of the Assumptions behind the Global Recovery

Since May of this year, global markets have seen a major rethink of the assumptions behind global asset valuations. Suffice to say the market's optimism at the start of the year is a long way away from the reality faced today. Even if the effects of the MENA, Japan and Greek crises prove transitory, as the optimists would argue, the fading effects of the post-Lehman mega global stimulus cycle and an increasingly disruptive Euro zone crisis prescribe increased investor sensitivity to risk for the rest of the year.

- **Global growth is slowing.** Although some of this at least is related to higher oil prices at the start of the year and supply-chain disruptions in the global auto in Japan, the US economy will struggle to manage growth above 3% this year. We are still looking for a continued global expansion and in our view concerns about a double-dip may be overdone in the absence of another cataclysmic natural or financial event. Yet, between the moderation in EM growth and a disappointing expansion in core G10 markets, global rebalancing is not a zero sum game and international growth is set to disappoint. Perhaps more importantly, the shortfall of demand against potential supply is most pronounced among those countries where systemic risks are greatest, including the US, the UK and peripheral Euro zone. Yet at the same time weaker growth increases rather than reduces the pressure on G10 governments to shrink to a sustainable size. That means that fiscal exit strategies are likely to coincide with the waning effects of monetary stimuli into 2012, prompting financial markets to be a great deal more discerning in terms of fundamental risks.
- **The policy safety net is thinning.** The political discourse surrounding the second Greek bailout has confirmed that politicians are still prepared to use public capital to underwrite systemic risks in financial markets. However, policy co-ordination has been ever harder to achieve and the combination of weaker global growth and unsustainable budget deficits across many G10 economies means that the political resolve for further bailouts is only set to diminish further. The rise in political risk and its link with market systemic risk has been as evident in Europe as it has been apparent in the Washington debate surrounding the public debt ceiling. In the US QE3 is unlikely, not because there is no need for further stimulus, but because of the diminishing effectiveness of financial asset purchases during periods of deleveraging in the real economy and their undesirable side effects on inflation expectations and asset bubbles.
- **Global financial conditions are set to tighten, even as G10 monetary exit strategies are set to lag behind market expectations.** Without support from stronger global demand growth and a solid policy safety net, the markets have as we expected started to trade through the global liquidity safety net to become more sensitive to capital and systemic risks. Tighter regulation, especially in the highly leveraged commodity markets, will play further into this trend. In the fx world safe havens CHF and JPY, in particular, have been strong outperformers since the beginning of May. While avoiding a disorderly Greek default may help trigger some negative re-pricing in safe havens short-term, we would see this as a short-term correction, particularly as we are talking about the pricing out of an extreme negative risk, i.e. another global capital markets crisis, rather than the pricing in of a new positive. Looking ahead, it is becoming clear that the 2009-2010 recovery failed to correct global imbalances and de-leveraging across the US, the UK and the Euro zone has much further to run. A Greek Financing Deal 2 will not

bring an end to the euro zone solvency crisis. Hence we see little scope for the market's structural demand for safe havens to diminish.

An environment of tempered global cyclical optimism, depressed government bond yields and increased investor sensitivity to risk is likely to favor demand for strong credit and defensive dividend yield stocks. In the fx world, we like the "AAA credits" that offer the potential for a more attractive carry and/or limited domestic control over currency appreciation with a focus on the Scandies, AUD and CHF. We are also bullish on EUR short-term as a renewed financing firewall around Greece, once approved, will reduce the chances of disorderly developments in Spain and Italy, while leaving the door open to further ECB rate hikes.

Lean Komileva
Global Head of G10 Currency Strategy

For more information, please contact our Currency Strategy Team:
Marc Chandler, Global Head of Currency Strategy, 1.212.723.8800, marc.chandler@bbh.com
Lena Komileva, Global Head of G10 Strategy, +44 20 0761 8763, lena.komileva@bbh.com
Win Thin, Global Head of Emerging Markets Strategy, 1.212.723.8867, win.thin@bbh.com
Mark McCormick, Currency Strategist, 1.212.493.8744, mark.mccormick@bbh.com