BDO

GLOBAL MARKETS MONTHLY

JANUARY 2010

Equities and commodities managed to eke out further gains as 2009 drew to a close. Developed world equities rose by 3.7%, emerging markets gained 4.0% and commodities returned 2.0%. Japan was one of the strongest equity markets, gaining 8.0% as a result of a new government commitment to boost economic growth.

But it was government bonds which showed the most startling changes in December. The yield on the US-10 year government bond jumped from 3.20% at the end of November to 3.84%, a very large monthly rise. Using the 10-year bond future, December ranks as the sixth worst month for the 10-year bond since 1982. Four of the other five bad months were between 1984-87 when monetary policy was notably more draconian; the other was July 2003. The two-year bond yield also jumped to 1.14%, from 0.67%, although November's levels represented artificially low levels as banks moved into short–term bonds ahead of the year end.

Is this significant? Well, not much happened on the economic front to justify such a large spike - job losses were negligible (but at this stage of the 'recovery' the economy should be creating jobs) and retail spending was somewhat stronger in November - but overall the data has not changed the widespread perception that a 'V-shaped' recovery is unlikely.

Most importantly, the market has started to digest the Federal Reserve's more pronounced musings of an 'exit strategy' from the current policy. While the Fed continues to talk of 'formidable headwinds' to the recovery and the likelihood of 'exceptionally' low interest rates for 'an extended period', the Fed is publicly debating new measures to drain liquidity from the banking system (such as paying interest on bank reserves held at the Fed and so-called 'reverse repo's'). In 'thin' holiday markets large moves should be taken with a pinch of salt, but market prices now incorporate the belief that the Fed is close to raising interest rates, despite its more sanguine public statements.

According to Fed funds futures prices, the market assigns a 62% chance of interest rates being increasing on or before 23rd June (compared to a 32% chance at the end of November) and a 67% chance of rates at 1% or higher by 3rd November. Such an event would dramatically change the landscape across all financial markets.

Similarly, in the UK the 10-year Gilt yield pushed through the 4% level on 29 December to 4.08%, the highest level for the year and up from 3.52% at the end of November. So in effect the spread between US and UK yields declined, indicating a marginally less worrisome outlook for the UK government. This is in contrast to the notable increase in press rhetoric over the course of month on the size of UK government borrowing and the rising concern (for Gilts) of a Lib-Lab coalition after the general election. UK Gilts lost 2.8% last month while corporate bonds lost 1.3%.

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"9.9% OF ALL MORTGAGES WERE 'DELINQUENT' IN THE THIRD QUARTER OF 2009"

BACK TO WHERE THE CREDIT CRISIS BEGAN

Following the dramatic recovery in equity prices in 2009 it is worth looking back to where the financial crisis began – in American housing.

The headline numbers look encouraging. US house prices have now risen for five consecutive months in a row, up 5.3% since May according to the Case-Shiller index, although the rate of increase has cooled somewhat in the past two months, following a 32% decline from the peak in July 2006.

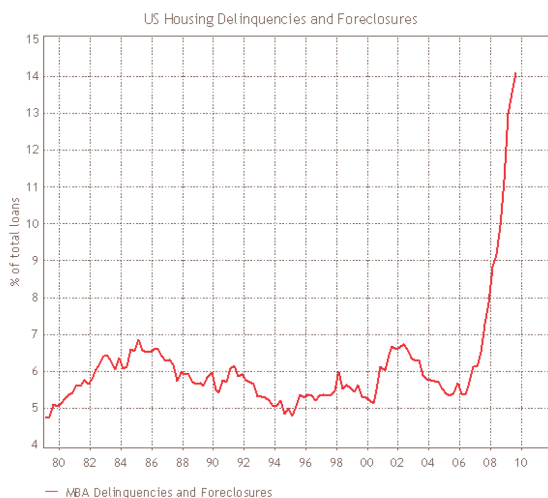
The market for existing homes has staged a dramatic recovery. Single-home sales have jumped by 44% in the past 12 months and are only 9.8% off the peak month for sales in 2007. Moreover, the glut of newly built homes which have not been sold has fallen dramatically in response to significant price cuts and incentives, down from 572,000 to 235,000 units.

Underneath these encouraging signs, the market is perhaps not as buoyant as it looks. Firstly, after a small recovery in the first half of 2009, new home sales have declined every month since July. Home builders are now reporting falling buyer interest. Moreover, the jump in existing home sales appears to be largely the result of the US government's $8,000 tax credit for first time buyers, enabling many to buy a home without any cash required (sound familiar?).

First time buyers accounted for 51% of sales and 71% of homes sold cost below $250,000. The programme was extended by the president on 7 November to run until 30 April 2010.

While the stock of new homes for sale has fallen significantly, a glut of foreclosed (repossessed) homes hangs over the market and as many houses with 'delinquent' (more than 30-days overdue) mortgages have not been repossessed. According to the Mortgage Bankers Association, 9.94% of all mortgages were delinquent in the third quarter of 2009, a new all-time record (since 1972). This trend is not just a 'sub-prime' story – delinquencies in prime mortgages were 6.8% of prime loans in the last survey. Around 23% of borrowers are in negative equity, according to First American CoreLogic.

The American government has made significant attempts to limit foreclosures through loan modifications, but these appear to be having



limited impact. Figures from RealityTrac show that foreclosures were still up 15.2% in the year to December. According to the Wall Street Journal, some 900,000 borrowers have begun trial modifications of their mortgage loans under the President's plan to limit foreclosures, although just 7% have received permanent changes to their terms (borrowers need to make three trial payments under the scheme).

The overall message is that there is still a large amount of housing stock that is seriously delinquent, but has not been foreclosed by the banks and is likely to hit the housing market at some point.

So despite the upturn in new home sales, the market looks fragile. In December 2009 the Conference Board's survey of consumer sentiment showed that the opinion of whether it is a 'good time to buy a house in the next six months' hit a new low for this downturn.

RENTS FALLING FOR FIRST TIME SINCE SINCE 1930'S

Weak housing markets are having a deflationary impact on US inflation. Housing costs account for 43% of the US consumer price index, of which 5% is fuel and utilities costs and 33% 'shelter' costs. This means that 43% of the 'core' rate of US inflation (which excludes food and energy) targeted by the Fed is determined largely by rents, or implicit rents of an owner-occupied property.

Rents have fallen in each of the past six months and are now declining at an annual rate of around 1%. This is highly unusual – we have to look back to the 1930's to find a similar phenomenon. In the third quarter the rental vacancy rate hit a new post-WWII high of 11.1%, up from 10.1% at the end 2008. In other words, one in every nine properties are vacant. With a massive overhang of houses still likely to come on to the rental market in the future, rentswill continue to fall for some while yet.

CONSUMERS STILL IN RECESSION

Consumer sentiment has barely recovered despite what appears to be a reasonable improvement in economic activity. So if the economy has actually come out of recession, US households have not yet noticed. This is due to the extreme weakness of the labour market. The unemployment rate was 10.0% in December, down slightly from November but still close to the highs of the 1980/82 recessions. More importantly, a startling 20% of the workforce are underemployed – 15.27m are officially unemployed, 9.16m are 'working part–time for economic reasons' (ie. they cannot find a full–time post) and another 6.31m have stopped looking for a job (these are not counted as unemployed and so artificially depress the jobless rate).

Moreover, for those in jobs, income is very weak as companies cut working hours and pay rates. Wages and salary income was down by 3.6% in the year to November. Indeed, Colorado will cut the minimum wage in 2010 due to falling consumer prices in the state – the first cut in any state since the minimum wage was first introduced in 1938.

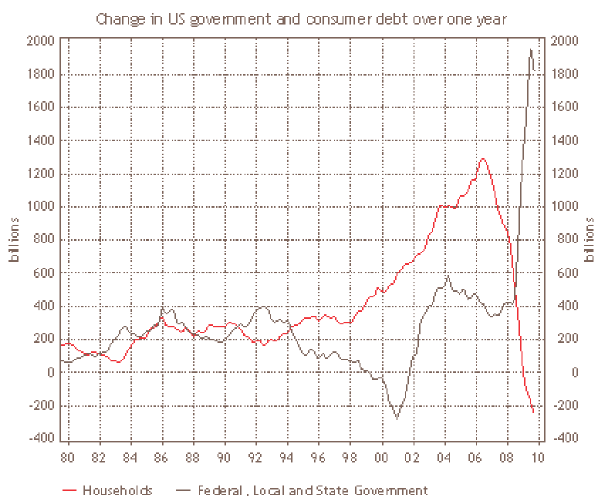
The result is a large increase in social security payments to support the unemployed and the 'working poor'. Transfers from the government now account for around 18% of personal income, a new record. One component is the more widespread take up of food stamps. Food stamps

"ONE IN EVERY EIGHT AMERICANS RECIEVE FOOD STAMPS... IN SOME STATES IT IS ONE IN FIVE"

were initially created in the echo of the 1930's depression but ended once the economy rebounded. A new formal programme was legislated in 1964. The current programme – now called Supplemental Nutrition Assistance Program - ('SNAP') – typically pays out to supplement the income of low–wage households. According to the US Department of Agriculture, 87% of households who receive food stamps are below the poverty line (gross income of $22,000 for a family of four) and the average recipient has a monthly gross income of $701 (including other benefits).

In October, 37.92 m Americans received food stamps, up 22% from a year ago; Texas was the only state not to report an increase (as the October 2008 figure was boosted by Hurricane assistance). For a population of 307.2m October's figure represented 12.2% of the population – so one in every eight Americans collect food stamps. In states like Missouri and Tennessee it is close to one in five and some counties have reported nearly 50% of the population on the programme.

Not surprisingly, retailers are adapting to the change. More companies are changing electronic systems to accept food stamps (or more accurately, electronic benefits transfer cards) and altering stock systems to cope (demand spikes on the first day of the month when electronic benefit cards are re-charged). A recent report showed that 85% of benefits are spent within the first three days of the month, highlighting how important this source of income has become.



With the labour market in a torrid state, households will shift to maintain permanently higher savings and to reduce debt.

DE-LEVERAGING STILL IN THE WINGS

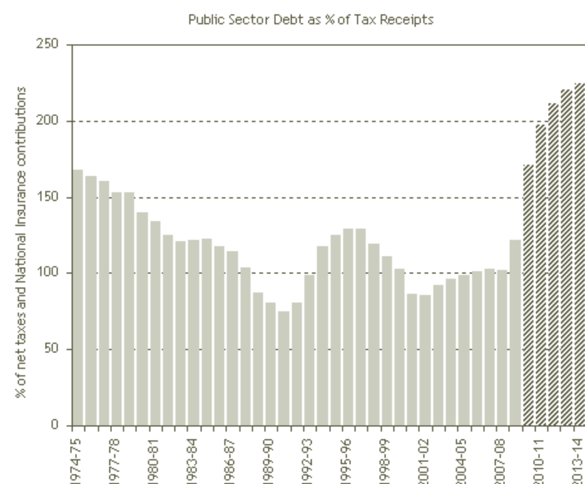
Not surprisingly, consumers are loath to borrow in this environment. Consumer debt is declining at the fastest rate since 1944 but on an aggregate basis such 'de-leveraging' of the US economy has only just begun. Company balance sheets appear to be in relatively good shape (hoarding cash and replacing bank debt with new bond issuance) but lower household debt is being replaced by ever higher government debt.

A recent study by the McKinsey Global Institute examined de-leveraging episodes in 14 major economies since 1930. In the majority of cases (32 out of 45) this was the direct result of a financial crisis. De-leveraging took four forms (a) austerity (b) massive default (c) high inflation (d) growing out of debt (eg. post war). Austerity was the most common path: de-leveraging began only after two years from the crisis and lasted on average for seven years.

On an aggregate basis such de-leveraging looks unlikely in the short term, as private debt is replaced by public debt. In the US, the Fed plans to stop buying mortgage debt issued by the Government Sponsored Enterprises (GSEs), limited at a mere $1.25tr ! In its place, the Treasury recently committed to provide unlimited funding to the GSEs for the next three years with the aim of "preserving the continued strength and stability of the mortgage market". The two largest GSEs, Fannie Mae and Freddie Mac, accounted for 74% of all new mortgages in 2009. So, there are no signs of de-leveraging here - in effect the government has nationalised the US mortgage market.

Looking at the UK, consumer debt has declined by 5.7% in the past 12 months. Meanwhile, public sector debt rose by 19.6% (£138.3bn) in the 12 months to November and the projections in the UK government's last spending review show that debt is expected to rise significantly in the coming years. Measured against the level of projected tax receipts – the country's ability to service this borrowing - the level of debt is forecast to rise from 121% in 2008/09 to 171% in the current fiscal year and 211% in 2011/12. In the 1970's the peak was 168%. Bringing back public finances to some sort of stability will undoubtedly be very painful.

While US fourth quarter growth may be as high as 5–6% (driven by re-stocking) and perhaps a similar a 4–5% rate in the first quarter, the risks of a 'double-dip' recession are non-negligible with de-leveraging only just beginning and government stimulus coming to an end, or worse – being withdrawn. Prominent academics are now expressing this sentiment. Economist Paul Krugman recently stated that the probability of such an event at 30-40%. With policymakers seemingly on a path towards withdrawing exceptional monetary stimulus, and in some countries tightening fiscal policy, such a probability does not seem excessive. 2010 will be a difficult year for policymakers, and by implication a volatile one for financial markets.



THE MONTH IN GRAPHS

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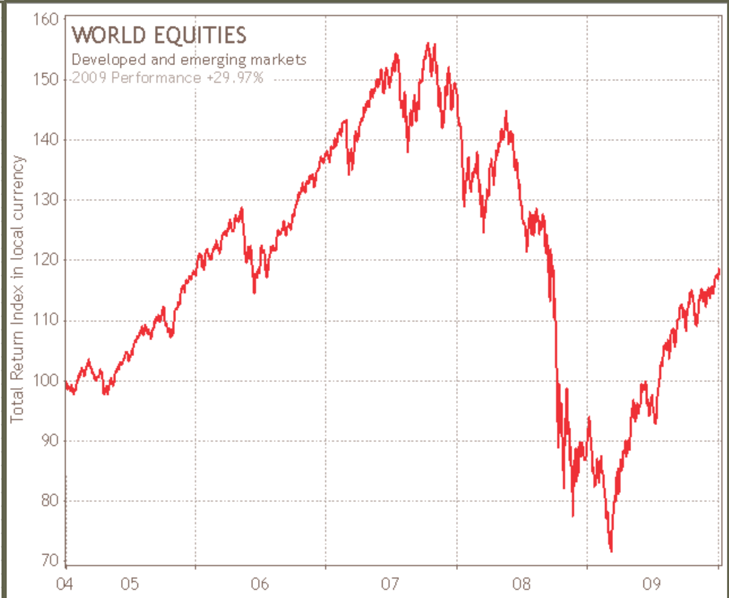

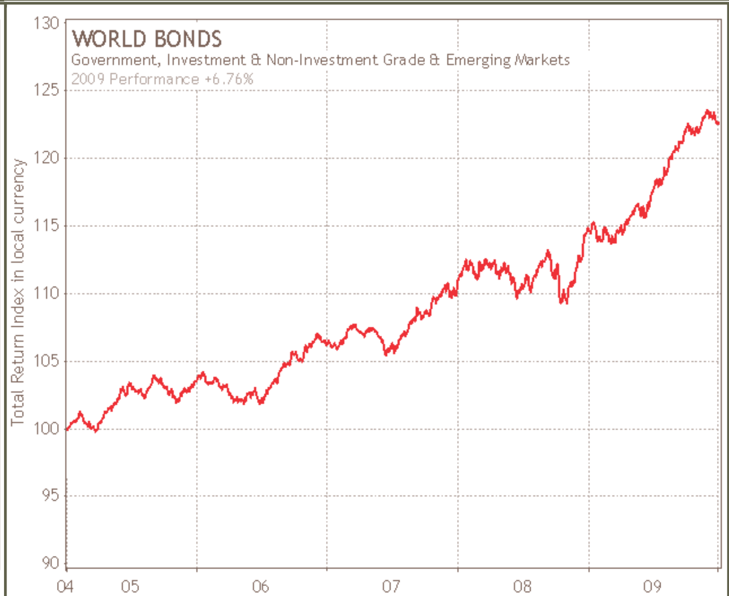

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