

GYC Macro Strategy Update

From the GYC Investment Desk

The recent action in stock markets may seem to suggest the start of a bear market. The S&P500 lost 7% since its peak in end April. Although the losses are not as bad compared to the period of May - June 2010, the fact that US equities suffered seven consecutive weekly losses was enough to unnerve even the steadiest investor. Hence it is natural for the consensus to lean towards the idea that we are heading into a bear market. Nonetheless, we are seeing signs that raise the odds of a recovery in the second half of 2011.



Recovery to occur in second half of 2011?

Shock No. 1: Trouble in the Middle East

A little perspective helps in envisioning how things could pan out in the next six months. 2011 started with political upheavals in North Africa, triggering fears of trade route disruptions in Egypt's Suez Canal. This was followed by spiking oil prices as a result of Libya's civil war and worries continued to mount that even Saudi Arabia was in danger of being affected by the tide of the spreading civil unrest.



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Shock No. 2: Earthquake in Japan

Next, a powerful earthquake struck Japan, triggering a tsunami and brought the world's third largest economy to the brink of a nuclear disaster. Power supply disruptions and radiation dangers triggered a contraction in Japan's economy in the first quarter, declining 1% on quarter or 3.7% on an annualized basis. Home to high tech and auto parts makers, the disruption to Japanese operations was almost immediately felt in international markets. This was also confirmed by the recent Federal Reserve's Beige Book survey where respondents highlighted the shortages of parts and components arising from Japan's disaster.



Figure 3: Nikkei, Automobiles and Semiconductor Indices

Shock No. 3: Greek Debt Crisis ver 2.0

After a bailout was arranged for Portugal, what followed next was the threat of Europe imploding as rating agencies started to downgrade the credit worthiness of Italy and Spain. The fear that Greece would default on her debt obligations increased several-fold as the possibility of another Lehman-like crisis was voiced by global leaders. The Euro lost further ground against safe haven currencies like the Swiss Franc.



Figure 4: Euro-Swiss Franc Index

In the midst of such consecutive macro shocks to the global economy, a slowdown was already beginning. Having reached very high levels back in March, the manufacturing PMI in the US declined sharply in the subsequent months. The same picture was echoed around the world and raised the spectrum of a global economic slowdown.

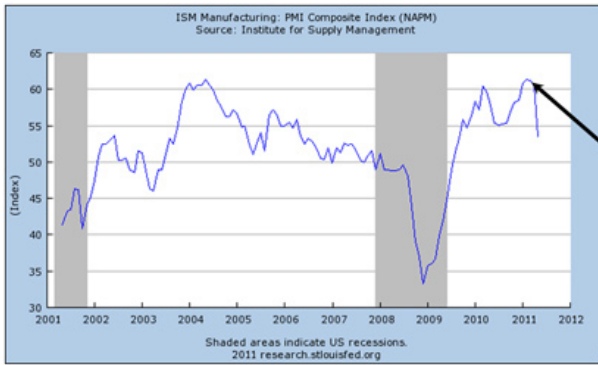


Figure 5: PMI Composite Index

Recession?

Thus, the question on everyone's mind - Would the recent shocks to the market result in a recession or would the markets be able to absorb the shocks and continue to grow? To answer this question, we first need to understand the differences between an economic slowdown and a recession. We see a recession as a downturn in business activity due to expansion in previous months reaching an unsustainable level, e.g. input cost becomes too high or final demand contracts. The keyword here is "unsustainable". If the growth we see today is unsustainable, then it would imply that a slowdown has a high chance of turning into a recession. However what we see today is final demand coming largely back on track as consumer spending and business investment rises. Although housing continues to be a drag, it only limits how high growth can get. Thus on this front, we see demand as actually being sustainable.

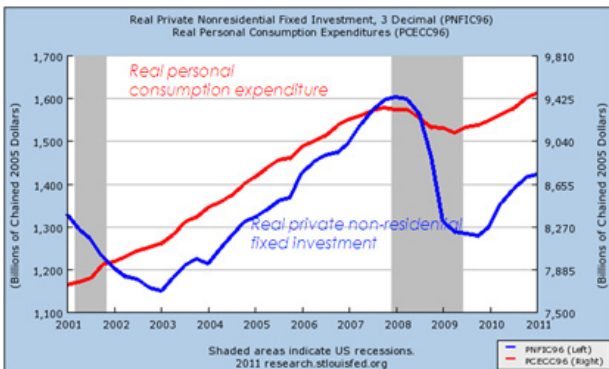


Figure 6: Personal Consumption vs Non-residential fixed investment

Investors are worried by high input prices. Based on PMI surveys, high commodity prices have been cited as a major challenge for businesses. As a result of higher material costs, production is negatively affected due to lower profitability. Higher energy cost is also eating into margins as transportation cost rises. Growth would thus be unsustainable if commodity costs continues to remain high for a period of time.

The lack of components, as a result of Japan's disaster, was another reason cited by businesses. Shutdowns in auto plants in the US were widely reported as shipments of components were disrupted. Electronics manufacturers were also affected by the dislocation in the high tech supply chain. Without parts, the manufacturing process breaks down and market supply is affected. Hence, looking at economic growth from this angle, should commodity prices continue to stay higher for longer, or should Japan take too long a time to get back on track, it would be difficult to sustain economic activity and hence the odds of a slowdown turning into a recession rises sharply.

This is where there have been positive developments in recent weeks. Despite OPEC not agreeing to increase their output, Saudi Arabia (world's 2nd largest oil producer), the UAE (8th) and Kuwait (10th) have agreed to increase oil production to stabilise crude prices. The International Energy Agency (IEA) also decided to release 60 million barrels of oil from strategic reserves, to counter the loss of production from Libya. As a result, crude oil prices have fallen 19% from its May 2 peak and are now back to levels prior to the Libyan crisis. Gasoline prices have also declined in tandem, giving businesses and consumers some breathing space as costs of transportation eases.



Figure 7: Index of Gasoline Prices

As for Japanese manufacturers, the resumption of production activity looks positive. Toyota expects to restore production capacity by September while Nissan is targeting the same in October this year. Renesas Electronics, the world's largest supplier of microcontrollers, has recently restarted production at its Naka factory since the March 11 earthquake⁴. So long as we get positive news that factories in Japan are resuming operations, the risk of a recession reduces.

US companies continue to show profits and their balance sheets are strong. Yet they are still cautious and remain cashed-up, resisting aggressive re-hiring of jobs shed during the last financial crisis and prefer to remain lean in case of an economic downturn. US households have also deleveraged (reducing their consumer and mortgage debts) and increased their savings rate.

Conclusion and Impact on Portfolios

We believe risk assets are likely to rebound from current levels as the recent spate of negative news subsides. Resumption of operations from Japan Inc. combined with lower commodity prices can help sustain the economic growth which began in 2009. A second half rebound in economic activity should support risk assets and arrest the current decline in stock prices. This would be a good opportunity to rebalance our gManaged portfolios (ref our last communication on 22 Jun where we stated the reasons for delaying the rebalancing).

To find out how you can get started on your own investment portfolio, call or email us at:

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