Market Focus

Global Strategy

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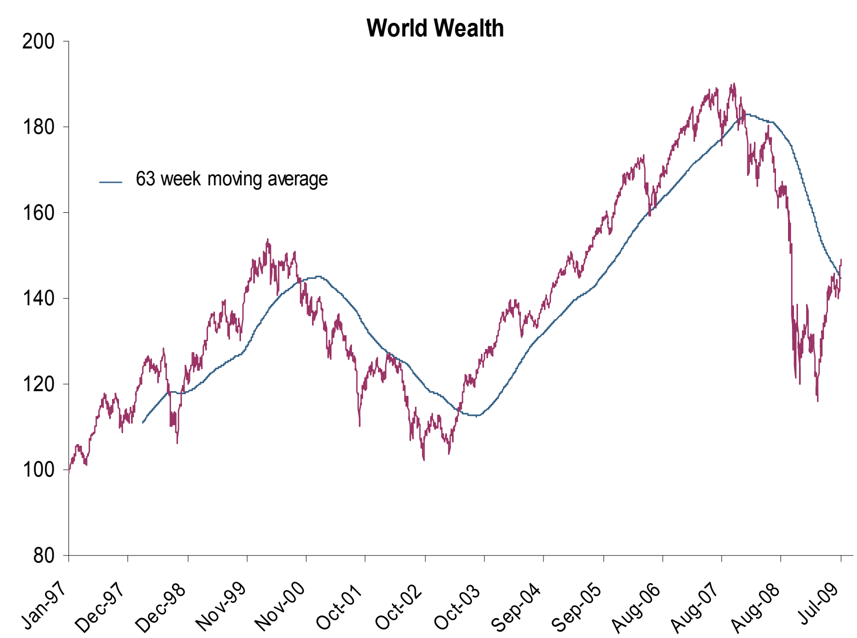
Shaping Up

Exhibit 1: World Wealth with 63-week Moving Average



Source: Credit Suisse

This is supposed to be one of those defining moments. For many in the "bear market rally" camp the latest push higher in equity markets should fail around 1000 on the S&P 500 (which means where we are now just about qualifies) before most likely plunging to new lows.

Technically speaking that is still possible but one thing the markets seem to be trying to tell us is that the US equity market is no longer shorthand for global equities and for risk assets in general.

A simple way to picture this is to look at Exhibit 1 above, which shows our world wealth measure shaping up in a fashion that suggests two things: first, that a return to the pre-Lehman level looks highly plausible, and second, that it's no longer clear that the primary downtrend is still intact.

In other words, the shorter-term outlook looks more like the beginning of another upleg than the end of a bear-market rally, and over the longer term we may be in a bull market rather than a bear market for risk assets.

Many people find this notion hard to credit. Haven't we noticed that the US consumer has hardly begun the process of painful de-leveraging, that unemployment is not only racing towards 10% but has no prospect of getting back to recent lows for several years, that the "new normal" will be insecurity, thrift, higher taxes and more productivity sapping government interfering in the economy?

Or to put it in the more measured language used by Fed Chairman Bernanke last week:

"Job insecurity, together with declines in home values and tight credit, is likely to limit gains in consumer spending … The possibility that the recent stabilization in household spending will prove transient is an important downside risk to the outlook."

Well yes, we have noticed these things too. And indeed all the other vast array of really dreadful things that might go globally wrong in the future, ranging from corrosive deflation to (hyper) inflation, and from pandemics to protectionism.

But to drag out the old cliché, bull markets are supposed to "climb a wall of worry".

And where, we wonder, was that wall of worry in 2006 and 2007? Compared to the current Matterhorn of angst, it was a little white picket fence.

Even so, and contrary to the notion that the consensus is always wrong, there can be wisdom in crowds. So we try to think seriously all the time about the serious issues that pre-occupy today's thundering herd of pessimists.

But also to spare some time for what just possibly might go right: opportunity and risk are usually different sides of the same coin.

In that spirit we offer ten very short-hand observations:

1) It is precisely when so many of the most experienced and serious people are most deeply troubled that risk assets are most likely to be seriously cheap.

2) Confirmation comes from the bulk of the high level valuation indicators we track, which indicate that risky assets are still cheap – or very cheap – even after their recent V-shaped rebound. A couple of examples are illustrated below (Exhibits 4 to 8). That US housing also looks extremely cheap (Exhibit 13) is also highly relevant.

3) For the much shorter run, the bulk of the cyclical data we follow confirms our thesis that global industrial production is shaping up very strongly, and that momentum will likely surge to a record peak of around 20% p.a. by September/October, before slowing again.

4) Rebounding auto, steel and non-energy materials production in the G3 should lead the next phase of recovery, but there is also evidence of stronger consumer buying intentions, and tentative but spreading signs that capital goods orders are bottoming out. (The auto production story is illustrated in Exhibits 9 to 11.)

5) We also think that final demand has overshot on the downside, just like production, and that at least some recovery is more likely over the next several months than a sharp secondary downturn. This assumes that the savings rate of middle-class and wealthy consumers will actually fall back a bit, as the banking panic fades and equities rebound.

6) An essential part of the healing mechanism for the financial system and the economy must be a stabilization and partial recovery of housing activity and prices. Especially in the most troubled markets. Here too the hard data is starting to look more constructive. See Exhibits 12-15.

7) One big difference between the US and the UK is that real house prices look (very) cheap in the former, but not in the latter (though mortgage servicing costs are at a record low proportion of income). In the UK, therefore, it looks as though housing might be much more vulnerable to any future normalisation of interest rates. See Exhibits 16 and 17 from our European Economics team.

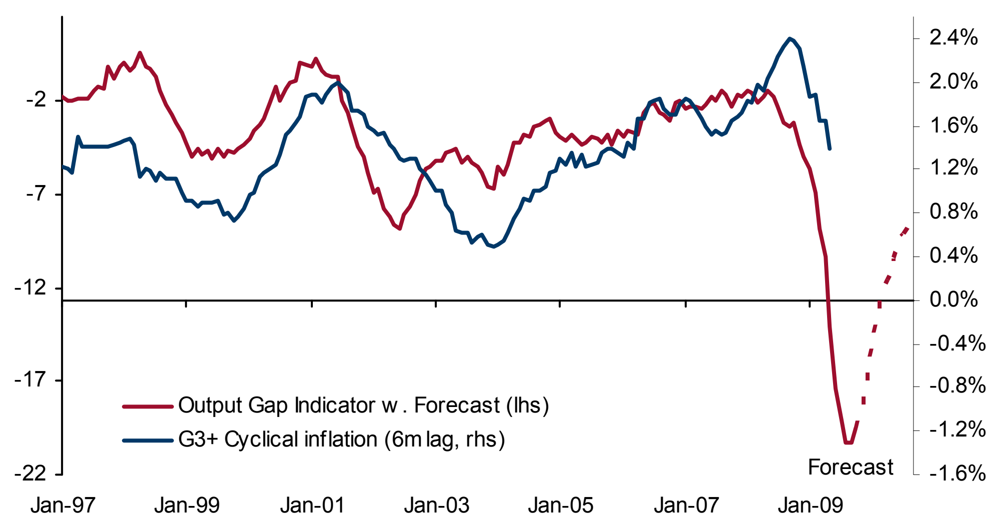
8) Much of the discussion of the future of global demand is arguably much too US centric: slower structural growth in US consumer spending does not necessarily mean slower growth in global consumer spending. For now, perhaps the most relevant challenge for US consumption is the very sharp slowdown in nominal income growth. We think this will be softened by a decisive move down in cyclically sensitive prices (Exhibit 2), and by softer oil prices. The future of US and global consumption is a central issue to which we will revert.

9) Despite what we would describe as the secular undertow of pessimism, our measures of global and equity risk appetite are elevated and apparently set to head (back) into the euphoria zone (Exhibit 3). We suspect we may see a proper cyclical "euphoria" phase (with both measures above 5) if world wealth does indeed head back to its Lehman's break down point. That will be the time to think more seriously about a tactical reduction in risk.

10) There is one immediate caveat. Were confidence in the medium-term "solvency" of the world's largest governments to collapse, the consequences for the financial system, growth and risky assets would indeed be dire. (Imagine a world in which the US and several other G-20 governments were prematurely downgraded by the rating agencies and one in which the world's biggest reserve holders went on a buyers strike for longer-dated bonds). The upcoming US refunding will provide a crucial near-term test. It is implicit in our constructive near-term view for risk assets that the auction will not be a disaster, and may even go surprisingly well after the usual price concessions. Indeed, with global IP momentum set to peak soon, this may be the time to extend duration.

N.B. Our world wealth index measures the excess return over G5 cash of a global portfolio of stocks and bonds (65% equities, 35% bonds).

Exhibit 2: Global Output Gap and G3+ Cyclical Inflation



Source: Credit Suisse

Exhibit 3: Global Risk Appetite and Equity-only Risk Appetite

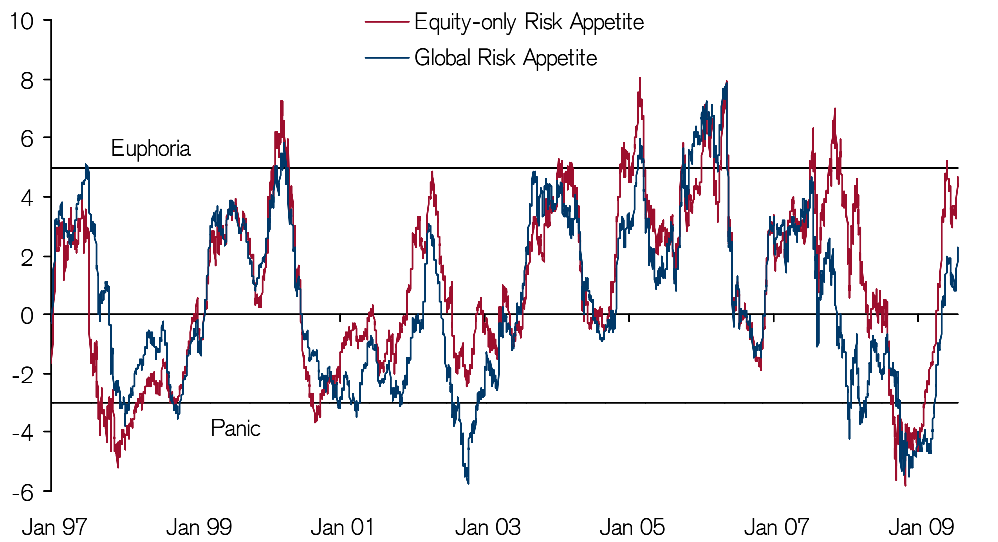


Exhibit 4: World Wealth with Kernel Trend

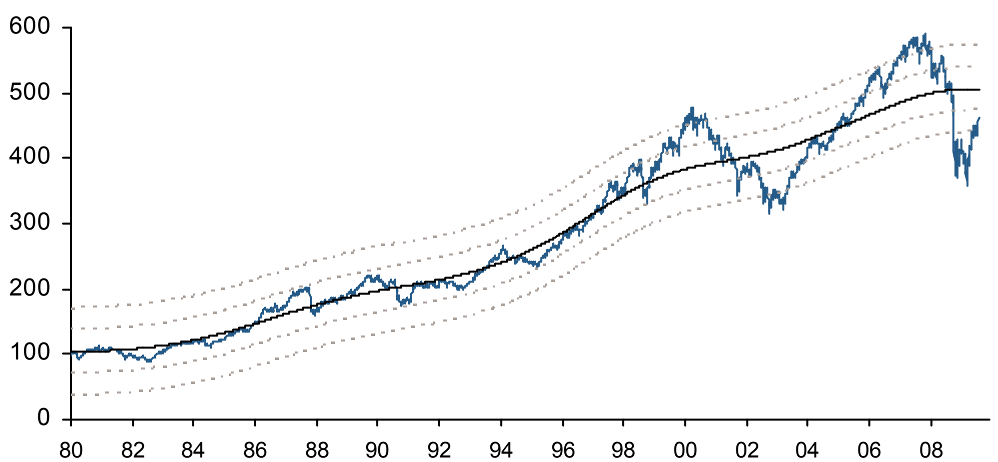
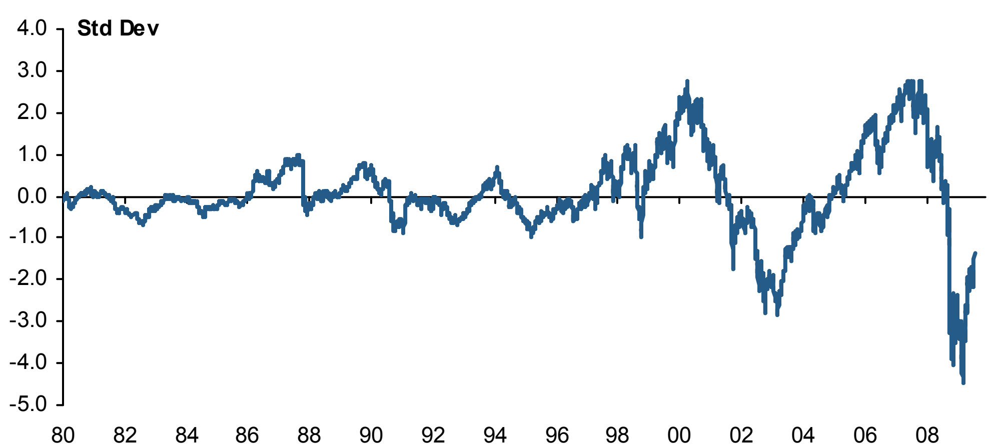


Exhibit 5: World Wealth – Deviation from Kernel



Source: Credit Suisse

Exhibit 6: Fixed Income Basket Portfolio (log scale)

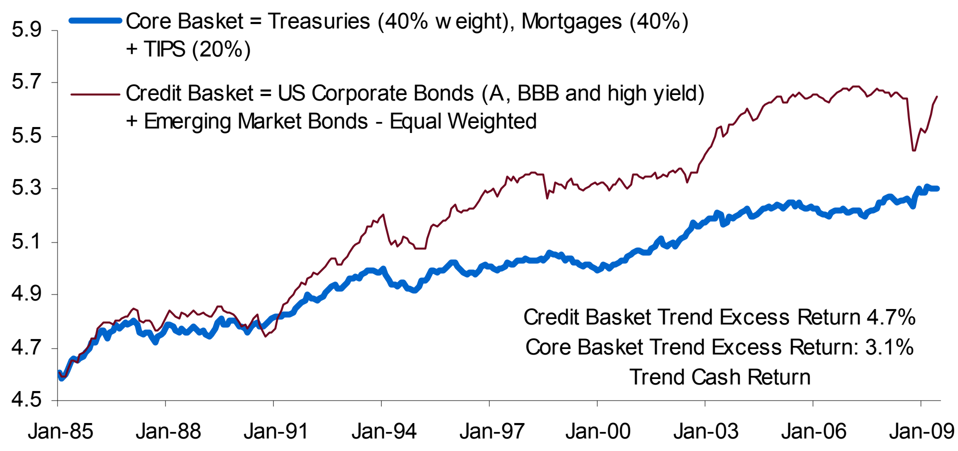


Exhibit 7: Credit Returns: Risky basket versus Safe basket (log scale)

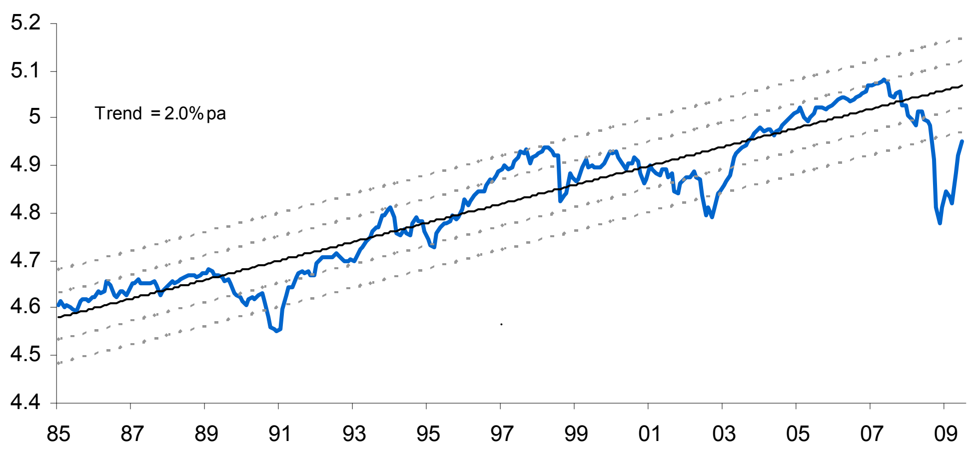
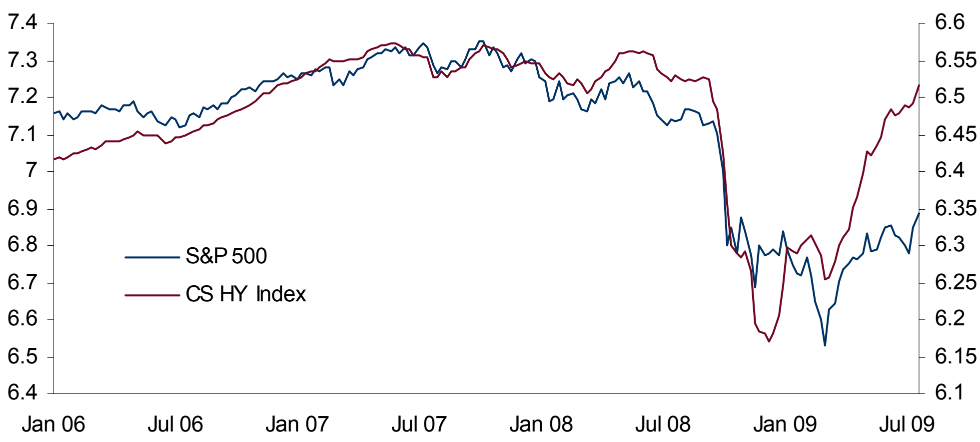


Exhibit 8: Total Returns: SPX (RHS) vs. High Yield (LHS) (log scale)



Source: Credit Suisse

Exhibit 9: G3 Car Production

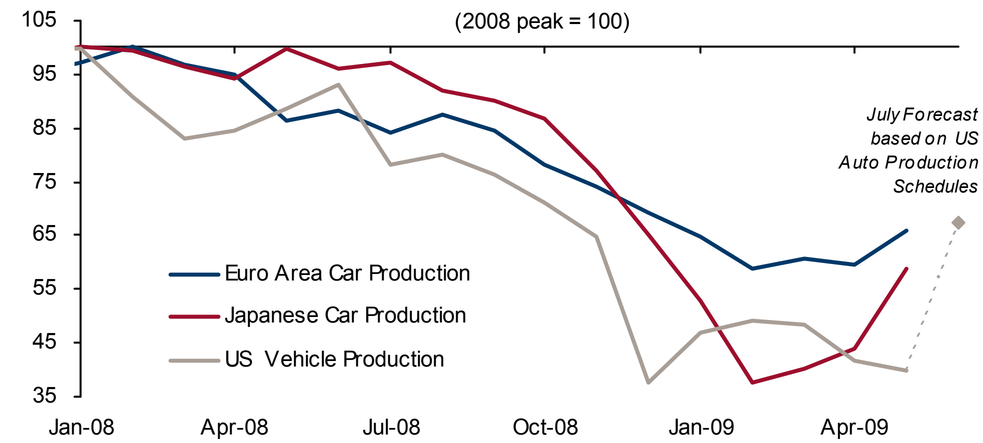


Exhibit 10: G3 Car Production and Sales

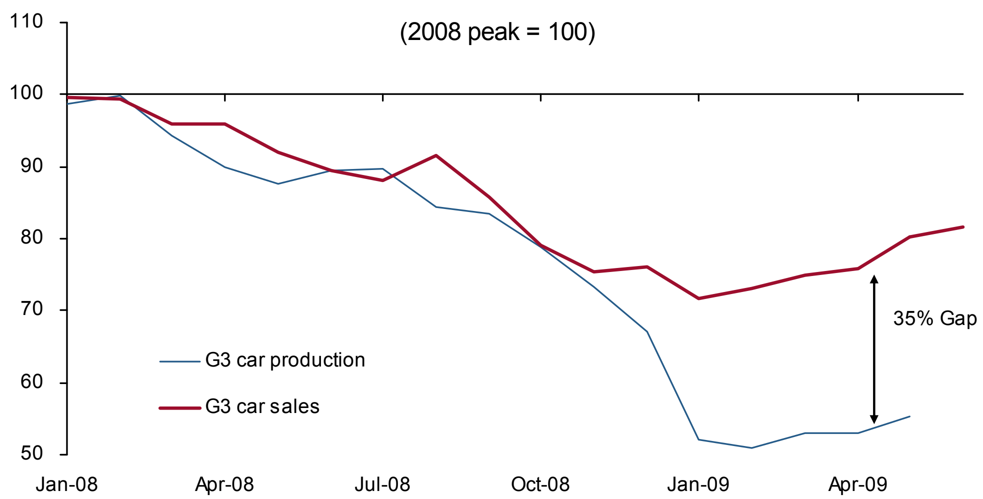
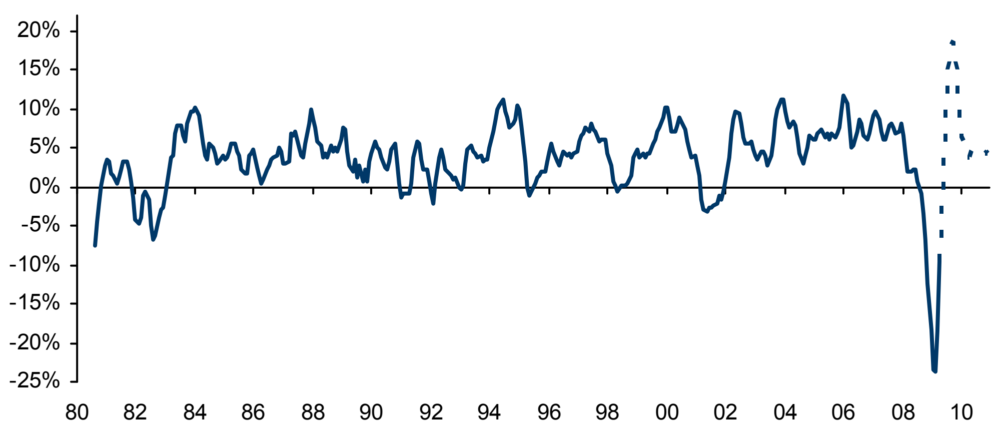


Exhibit 11: Global IP Momentum with Forecast



Source: Credit Suisse

Exhibit 12: NAHB Survey and US Housing Starts

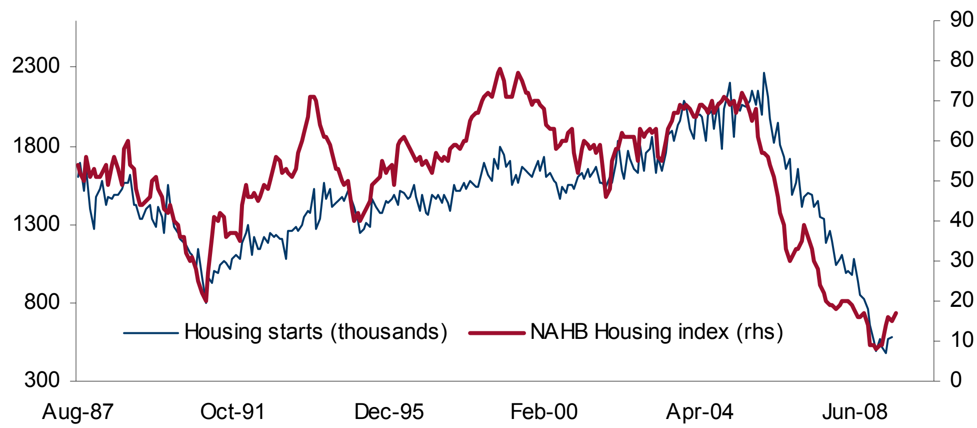


Exhibit 13: US House Price Indicators

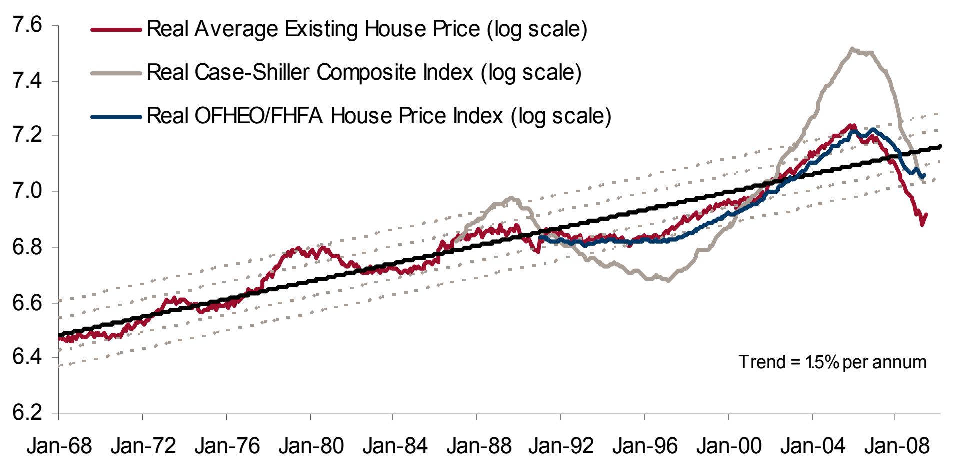
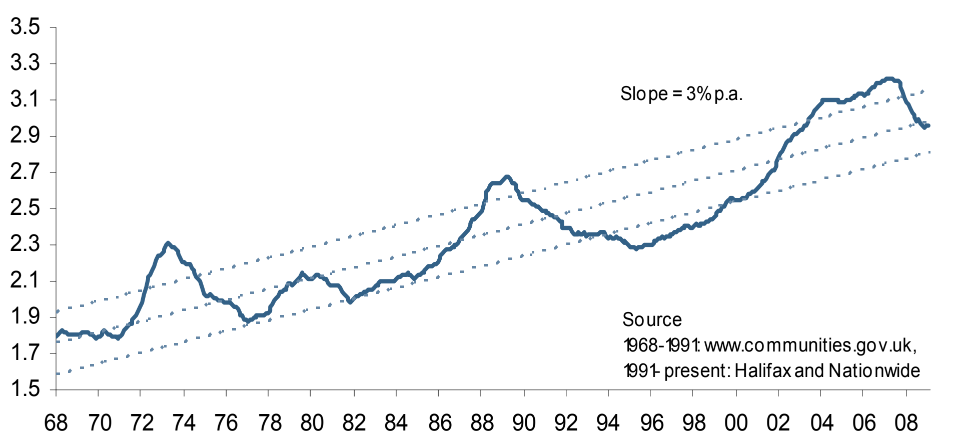


Exhibit 14: UK Long Run Real House Prices (log scale)



Source: Credit Suisse

Exhibit 15: UK Mortgage Approvals

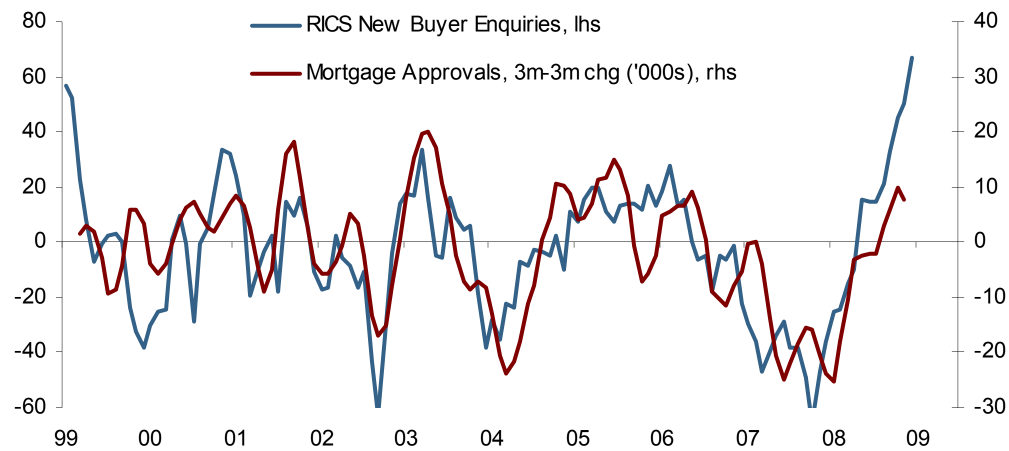


Exhibit 16: UK House Price Affordability (Ratio of Prices to Average Earnings)

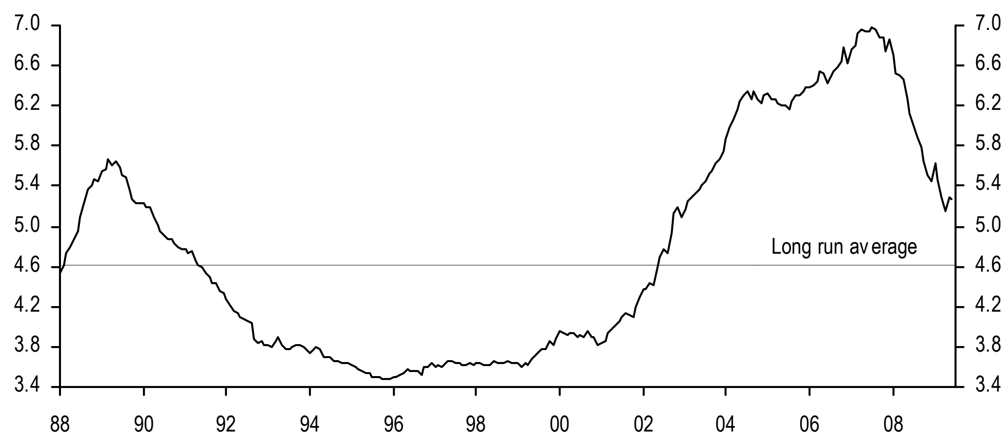
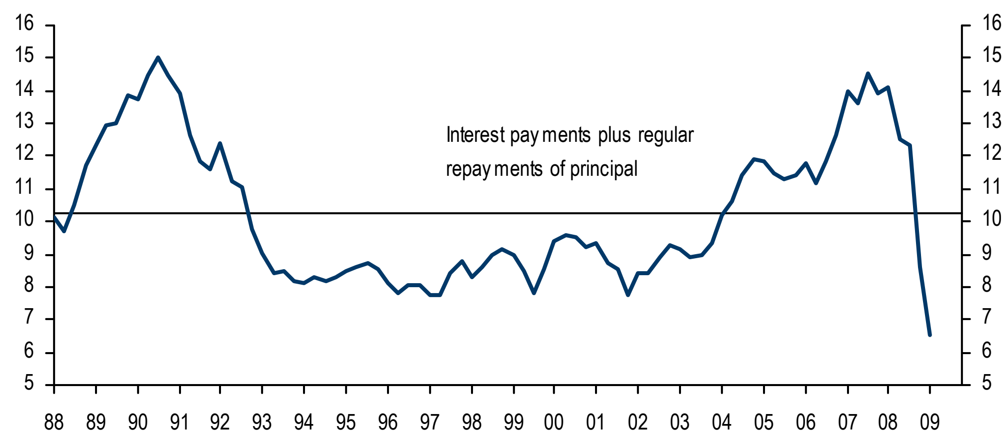


Exhibit 17: UK Mortgage Debt Service as% of Disposable Income



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