

Market Focus

Global Strategy

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Angry Bears and Timid Bulls

“All is the for the best in the best of all possible worlds”

Dr Pangloss in Voltaire’s *Candide*

“Everything that can go wrong will go wrong”

Murphy’s Law: attributed to Edward Murphy, aerospace engineer responsible for testing safety systems.

“Murphy was an optimist”

Anonymous

Summer is over, and it is time to take stock. Here’s what we see:

Zeitgeist: funding liquidity has returned and equities are up 50% from the low, but serious opinion and the popular press still see the world darkly. Much more Murphy than Pangloss. Not coincidentally our new long-run valuation indicator suggests March might have been the third best buying opportunity for stocks in 150 years.

Clients: the hard core bears are angry – truly, madly, deeply angry – at trivial, myopic, self-indulgent, bubble-loving “Mr. Market”. And even the bulls appear unusually timid, constantly looking for the next sign of trouble. No one we know is truly, madly, deeply bullish.

Global Industrial Production: the bungee bounce is all but over too. Chinese momentum is peaking, and the world should follow by October. But we don’t see a double dip: just broader slower growth as final demand crawls back from the abyss. Even that will be a surprise to many.

Risk Appetite: is flirting with euphoria, but early cycle euphorias are seldom momentous. More often rotation than (renewed) collapse.

Inflation: even as it resets close to zero, the consensus fears a serious surge after a year or two. For the portfolio the problem is how to “hedge” against deflation and inflation at the same time. Just in case.

No Early Exit: central banks are more concerned about the zero bound. Which means ultra-low rates until further notice (meaningful drop in unemployment). And after Jackson Hole they took care to let the world know where they stand. Even the ECB joined in.

Not By Rates Alone: Jackson Hole also anointed the new orthodoxy in high policy circles. It is now officially better “to lean than clean”. Though not just via interest rates: they all backed (international) macro-prudential measures to head off future bubbles and bank runs. For now, there is a lot of “cleaning” left to do.

Oil: has more than doubled from its low but the new demand outlook does not suggest a quick return to very tight supply conditions. We see spot capped near recent highs but plenty of demand from macro inflation hedgers one to two years forward.

Gold: the rich are running scared (higher taxes, more government regulation, huge fiscal deficits and hostility to private wealth in the wake of the crisis). Gold is now seen as the only real hedge against the (some think inevitable) debasement of all fiat money, and of the dollar in particular. It is an expensive hedge (more than double its long-term average price in real terms) but the rich like expensive things. Shaping for another surge, even as bonds perform well.

Hard to Credit: whatever happens to potential growth in the longer term, even partial recovery will come with surging productivity and low or falling unit labour costs. As our economists point out this is the “sweet spot” of the cycle – that rare point when growth can resume and profits rise even as inflation falls. Absent a major new exogenous shock we think equities and credit will also transition to a slower, broader recovery while longer-term bond yields drift lower (bull flattening). For most people this just seems too good to be true, but we suspect it can last until the exit strategy starts.

Surprisingly Classical: the general assumption is that the current crisis is a secular debt crisis from which there can be no good escape. We see it as a surprisingly classical banking panic of the type that we were supposed to have abolished (after all that’s why we have central banks, deposit insurance and financial regulation). That is deeply shocking, disruptive and painful but makes us wary of the more extreme forms of pessimism. The 19th century was harsh but dynamic, and that’s the kind of world we live in now.

Surprisingly Classical

“While each crisis has its own specificities, the current one has been surprisingly close to a “classical banking crisis”. What is new about this crisis is the extent of securitization, which led to an opaque web of interconnected obligations.” Professor Marcus Brunnermeier – Princeton University¹.

In our view, the current crisis has unfolded much like a typical 19th century banking crisis, after a run on the “the shadow banking system” triggered a truly dangerous systemic failure of funding liquidity (see [Market Focus: Overwhelming Force](#) and [Long Shadows](#)).

This collapse has been truly shocking because of the often brutal human cost, the extreme policy measures needed to address the crisis, and because this kind of thing was just not supposed to be possible any more. Indeed, the main reason we now have central banks, deposit insurance and financial regulation is to try and make sure that bank runs do not lead to this type of systemic breakdown, something which happened quite regularly in the great boom of the late 19th century and led to outright economic disaster in the 1930s.

For us, this perspective had, and still has, five important implications:

- 1) If and when governments were able to fix the funding liquidity failure (observable through indicators such as the TED spread and Libor/OIS) the almost inevitable result would be a very sharp initial rebound in global output as the period of violent destocking came to an end. This is what is happening now.

¹ www.princeton.edu/~markus/research/papers/liquidity_credit_crunch.pdf

- 2) Beyond that the healing process should be positively self-reinforcing in the absence of major policy error or bad luck (e.g., swine flu becoming much more deadly, a political shock to oil supplies, etc). This longer-term healing process should in principle show up as a transition to slower but broader economic recovery.
- 3) There would of course be no rapid return to the *status quo ex-ante* in terms of investor, consumer or business behaviour, or indeed public attitudes to bank regulation, etc. So the nature of the system itself is likely to change in complex ways, although many of those changes might in fact be positive. (Think of someone who has survived a near fatal car crash driving far more carefully than he used to.)
- 4) A very serious relapse, perhaps even a true depression, would also become virtually inevitable if government fiscal credibility collapsed as a result of the perceived long-term cost of underwriting the banking system and of fiscal stimulus. These costs would, however, probably be much lower than feared if the healing process took proper hold. In that sense economic recovery would ultimately be good for bonds as well risk assets.
- 5) We would expect central banks to change their behaviour also. Before the crisis the Fed's philosophy, and on balance the prevailing wisdom, was that it was better to clean up after bubbles than to lean against them when they were forming, since it was never possible to know in advance just how bubbly asset prices had become. Bill White, the former Chief economist of the BIS has been a long time critic of this attitude, very much associated with Alan Greenspan. That debate is now over, and the new orthodoxy is that it is better to lean than to clean, meaning that there is a strong consensus in favour of using other instruments besides interest rates – bank capital requirements, liquidity and funding targets, perhaps regulation of haircuts in the repo market – to try and preempt bubbles before they become truly dangerous. That most central banks now endorse the principle of “macro-prudential” regulation was evident at the recent Jackson Hole conference, but until an internationally coordinated approach can be agreed the practical conclusion is to keep interest rates unusually low for a (very) extended period to ensure that the healing process and economic recovery does take hold. Of course, if concrete forms of macro-prudential regulation are agreed, the implication is that interest rates will need to do less work, and they may be lower on average through the next cycle anyway. See the following link for a short note by Neal Soss on this topic: www.credit-suisse.com/globalstrategyblog.

It is these implications that lie behind our economic and market outlook from here.

First, we think that the most intense rebound phase in global industrial production – associated by the way with the end of destocking more than restocking – will be over by September/October, after which the transition to broader but slower growth in both final demand and output should begin.

Second, China and the emerging markets rebounded earlier and should show the earliest signs of reverting to more normal growth rates. Especially since they would be expected to show greater willingness to rein in the emergency policy stimulus. That's exactly what's happening now in China, provoking the sharp correction in the Chinese equity market.

Third, emergency cost cutting by firms (firing especially) plus the sharp drop in capacity utilisation would put strong downward pressure on unit labour costs and core inflation that will even accelerate as recovery took hold. Since Saudi Arabia has the desire and the means (ample spare capacity) to cap the rebound in oil prices (the high 60s to mid-70s might be their ideal price zone) we expect headline as well as core inflation and wage growth to “reset” to a very low range for some time to come.

Our working hypothesis for markets is that, absent another major shock, global equities have a further 20-30% upside over the next year or so; that credit spreads have now nearly priced in the revival of funding liquidity but not necessarily the lower-than-feared default rates likely to be seen as recovery takes hold; but that the inflation “reset” and extended period of low short rates suggests that longer-term bond yields may have already peaked and in any case remain near the top end of their likely trading range. Longer-term fiscal credibility is by no means assured, but in a low inflation recovery there will be time to reassess what really matters, which for most countries is not so much the fiscal legacy cost of the current crisis as the ability to meet the challenge of entitlement obligations in an ageing society.

If we are right about the transition to broader but slower growth, moreover, stock selection in equities and credit should once again become much more rewarding, and macro asset allocation less overwhelmingly important.

The problem with our “surprisingly classical” story, or perhaps the merit of it, is that it seems a million miles away from the consensus view of what we are going through, which is much more inclined to emphasise the negative implications of excess leverage (for our own reading of the debt data see [Market Focus: False Idols](#)).

The more common view, at least up until now, has been that this is a secular debt crisis brought about by reckless bankers and profligate consumers and that it is short sighted and shallow in the extreme to think we can avoid much more profound and system-changing economic pain.

Which brings us back to the psychology of the moment.

Pangloss and Murphy

Ideas are just as infectious as viruses. Meaning that we are seldom fully conscious of how our own (sincerely held) opinions are influenced by looking or sounding credible within our immediate peer group, and by the impact of relatively recent trends and events – most especially when they are unusually extreme.

It could not be any other way: we are social animals, and being too contrarian risks exclusion from the group or groups we depend on.

The same goes for “animal spirits”. Most of us have some predisposition towards optimism or pessimism, but the balance between optimism and pessimism in the herd is itself prey to the emotional legacy of recent events, and the natural human tendency to extrapolate.

It is almost a law of nature therefore that investors will take too much risk when risk taking has recently been handsomely rewarded, and too little when it has recently been punished.

Which is precisely why we think our small family of risk appetite measures are so popular. They are, after all, specifically designed to track the cyclical oscillation between optimism and pessimism that is, more often than not, associated with unusually high or low rates of global growth.

But there is also what might be called a much larger cycle of psychology, a more secular overshooting process.

Really major bubbles can be thought of as moments when we get collectively infected with the idea that some new era of positive economic performance (productivity, profitability, economic stability, etc.) justifies Panglossian assumptions about asset prices that are already very overvalued by all normal criteria. There is always some grain of truth behind the bubble mentality, and always some heady period of better-than-usual growth or wealth creation to fuel our gullibility. But just as inevitably there is in due course a harsh day of reckoning and painful aftermath.

Psychologically, it seems to be equally inevitable that we overreact to extremely bad events. (Indeed, the evidence is that we are even more inclined to overreact to very negative shocks.) War and inflation, extreme social or political instability, debt deflation and a broken financial system produce what one might call “inverse bubbles”, where we collectively fail to imagine how things could ever improve or even get back to some semblance of normality.

So one of the many skills that professional investors need is a capacity to distance themselves from the Panglossian mood that arises at the end of a long boom and bull market, but to think and act positively when disaster strikes.

We all know this in theory – it is just very hard to put it into practice.

Things get particularly confusing at a time like this, when there has been a very violent recovery from a particularly violent panic.

Psychologically, we have just started to recover from a “black swan” phase: a period in which it suddenly became credible to argue that either extreme deflation or extreme inflation were all but inevitable, and that unprecedented policy stimulus was doomed either to fail altogether, or to succeed so handsomely and quickly as to catapult us from the brink of a devastating deflation spiral to devastating hyperinflation in a flash.

As the economy and financial system continues to heal, however, we think that these extreme scenarios will come to seem less credible – or at least as only the far out tails of a more recognisable distribution. The fact that extreme events and outcomes happen more often than they would in a statistically “normal” world does not mean that they happen all the time, or that it is sensible to forecast or plan for them all the time.

The fact that the “great and the good” – from Nobel Prize winning economists and serious analysts to experienced investors are (still) giving so much weight to bad outcomes is totally understandable after the biggest credit crisis since the Great Depression and the worst decade for equities in 150 years (Exhibit 4).

But it does not make it any more objective or wise.

Just ask yourself how much mental and emotional energy you have invested in thinking about how the healing process might be self-reinforcing, or on how some of the fall out from the crisis might help to lay the foundations for sustainable growth in the future. As opposed to how much time and energy goes in to thinking about bad outcomes and risks. Equally, ask to what extent the opinion formers you respect are – without being fully conscious of it themselves – positively looking for ways in which things can go (very seriously) wrong, and how much emphasis is now being put on a “new era” of negative feedback that children of the bull market can hardly comprehend.

It is impossible to prove that this safety-engineer-like “bias” really exists, let alone to measure it objectively, but in principle we feel that it should show up in valuation measures. To be more precise it should show up as pretty much the opposite extreme of undervaluation in the same indicators that suggested extreme overvaluation in 1999/2000, when the tendency was to find rationalisations for a new era of positive feedback loops, increasing returns to scale and infinite wealth creation.

To test this proposition we decided to aggregate three of our favourite long-term valuation indicators for US equities and credit.

This “composite valuation indicator” looks at (1) the deviation from trend of real equity returns since 1850, (2) the deviation from trend of equity versus bond returns since 1850, and (3) the deviation from their long-term average of long-dated BBB credit spreads since 1920. (Given how extreme the breakdown in funding liquidity has been in the recent crisis, and its impact on credit spreads, we thought it was important to include some measure of credit stress, even if we don’t have adequate data for the pre-WW I period.)

We scale each component by using standard deviations, but given the very abnormal nature of the credit spread distribution, we have used the standard deviation of a log distribution, which leads to less extreme readings on the undervaluation side. The CVI is then computed as the simple average of all available components.

Obviously, this is a bit crude, is not fully consistent across time, and doesn't address the issue of whether one valuation measure should have a higher weight than the others, or to what extent they are simply giving the same information. But as a partial test we did look at how well equities performed after extreme undervaluation readings for the CVI. The results are shown below.

Exhibit 1: US Composite Valuation Indicator

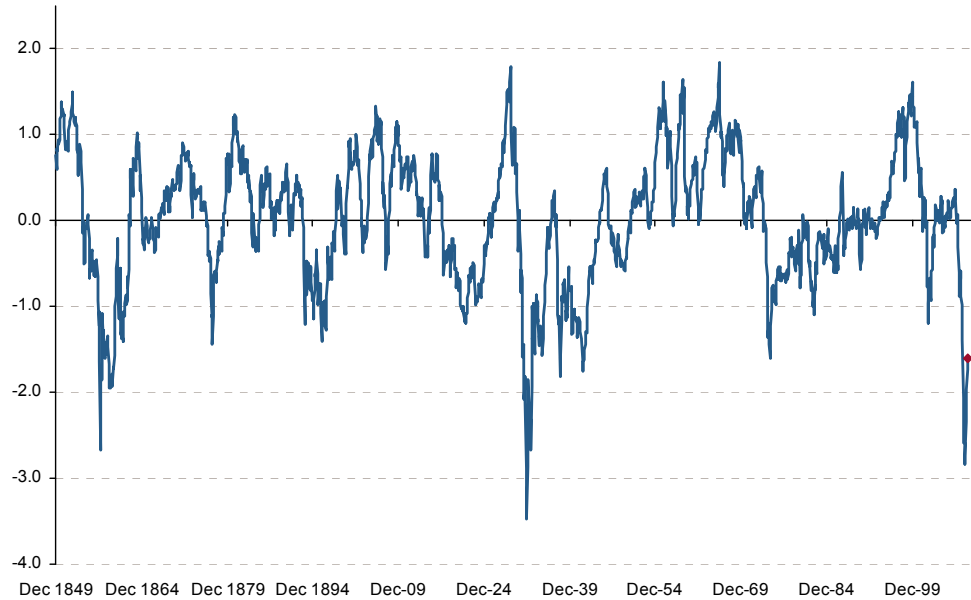
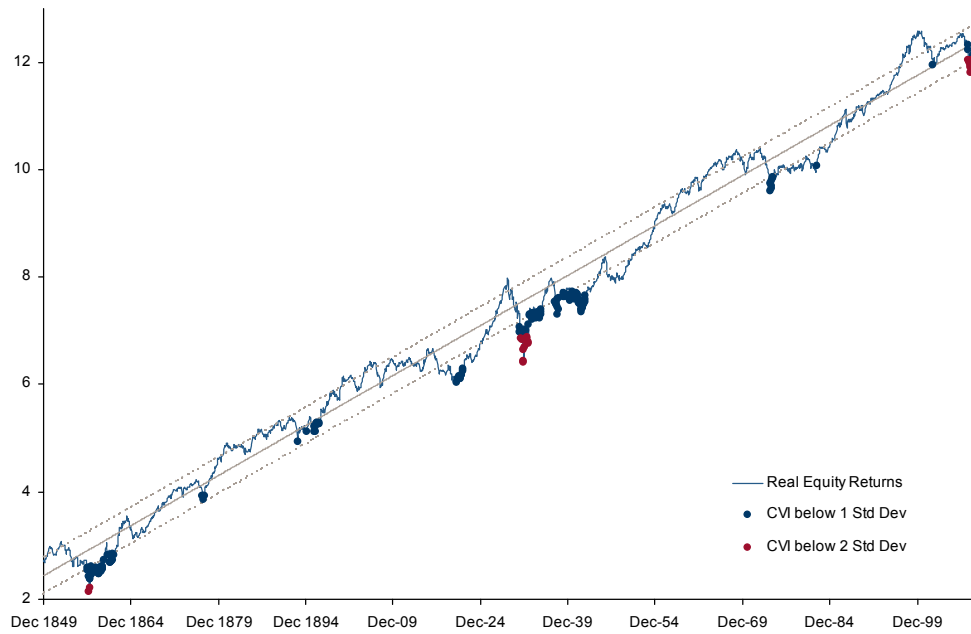


Exhibit 2: US Real Equity Returns (Extreme CVI Reading marked)



Source: Credit Suisse

Three things stand out as far as we are concerned.

First, the recent crisis has been very extreme on the CVI – in February/March we had the third lowest reading ever. This does not completely seem out of line with what one might expect given the “near-death” experience the financial system has been through. Taken literally, it also means that risky assets in March were cheaper than they were at the start of the secular bull market in 1982, after the first oil shock and deep recession of 1974, and during the WW I and II periods (1920, 1942). If we had a consistent credit series going back into the 19th century, the crises of the 1870s and 1890s might have looked more like the current episode, but we can’t really be sure. Even so the current episode still looks like a very rare event.

Second, during each major crisis episode – those occasions when the CVI is more than one standard deviation below trend – the problem is to know whether the crisis will get even worse. Once the equity market had bottomed, however, there was almost always a 5- or 10-year period of strongly above average equity market performance. In no case was either the 5- or 10-year return below the long-run average of 6.4% p.a.; the average 5-year return was 17.3% and the average 10-year return was 11.0%. 1974/5 was the least impressive with 5- and 10-year returns around 8% p.a. (a repeat now would imply barely positive real returns from here). Performance in line with the average 5- and 10-year returns would imply over 10% p.a. real returns from here.

Exhibit 3: Conditional Real Equity Returns with CVI Starting Point Below -1

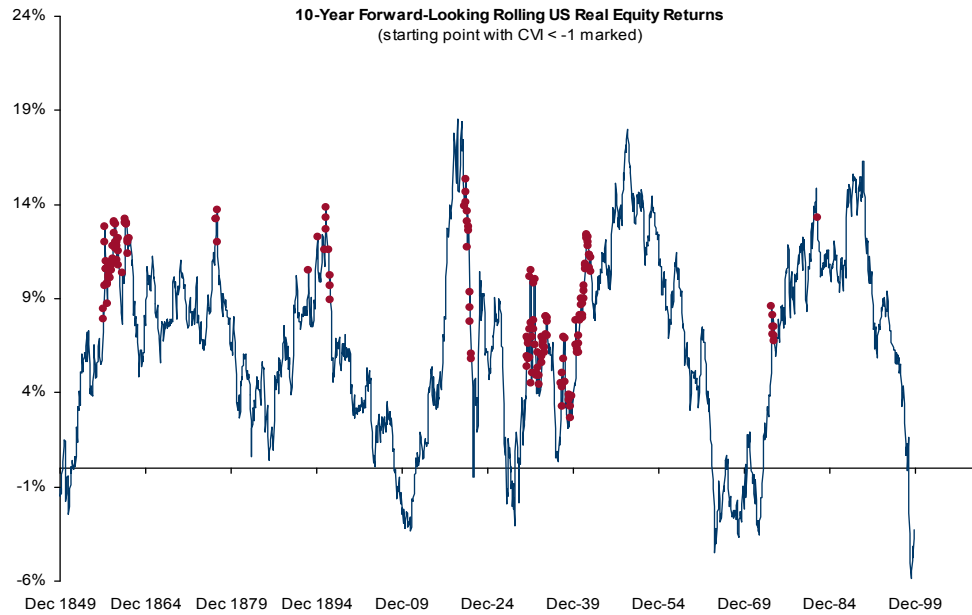
	5-Year Average Annual Return	10-Year Average Annual Return
1857	23.1%	12.8%
1861	12.6%	12.1%
1877	20.1%	13.7%
1896	21.7%	13.8%
1921	19.3%	9.3%
1932	32.7%	10.5%
1935	12.0%	8.0%
1938	9.1%	6.9%
1942	13.0%	12.3%
1974	8.5%	8.1%
1982	22.7%	13.3%
2002	12.2%	n/a
Average	17.3%	11.0%

Source: Credit Suisse

Third, the speed and volatility of the recovery in the CVI itself from the three really extreme episodes was – as one might expect when the elastic had been so stretched – exceptionally high. This is also visible in the chart of 10-year rolling returns (Exhibit 4) and in Exhibit 5, where we show the path of recovery for real equity returns starting in 1857 and 1932.

In effect, there was a tendency for the market to get exceptionally overbought in the first stages of recovery, leading to very big corrections along the way.

Exhibit 4: US Real Equity Returns – Rolling 10-Year Returns

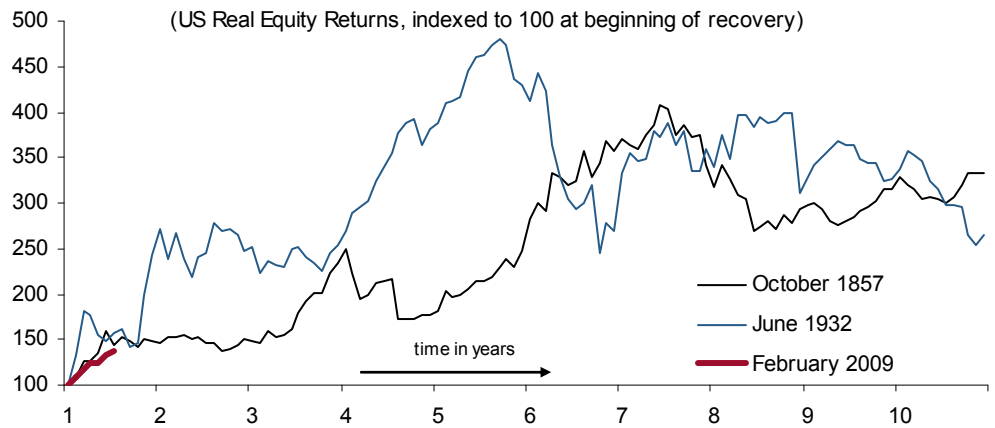


Source: Credit Suisse

Whether we have got to that point yet is obviously a big issue and it is something we will be taking a look at. Suffice it to say for now that of our three main risk appetite measures only equity only risk appetite has hit the euphoria zone so far. That is telling us that emerging equities are overbought relative to developed equities, more than it is signalling a major problem for equities in general. Moreover, if we are right that bonds can rally from here, the equity market will have to absolutely rocket post-Labor Day to push global risk appetite into euphoria.

Finally, we put much less emphasis on growth momentum peaks and risk appetite euphorias in the early stages of an expansion, and when risk assets are cheap, than we do on “expensive” euphorias coming at the end of a long boom.

Exhibit 5: US Equity Recoveries



Source: Credit Suisse

But important as the risk appetite cycle is, it is in the end less significant than the even larger pattern of extreme overvaluation and undervaluation we have tried to capture in our composite valuation indicator.

Obviously, there are numerous question marks about such a simple approach: in particular it relies on the idea of continuing long-term economic growth, and a mean-reverting pattern after extreme overshoots in long-term equity returns.

It is always possible to argue (as many did in 1999/2000) that the world will never be the same again and that history – especially far distant history – tells us nothing about our medium- to long-term future.

But for some 150 years the natural tendency to invent new “eras” in the face of exceptional triumph or disaster has been wrong – very badly wrong. Yes, empires do end, the scale of policy intervention in the current crisis is unprecedented, the population is ageing in a way never experienced before, and it is possible that the effects of climate change will be so overwhelming that whatever puny efforts we make to arrest it they will be doomed to fail.

But what the CVI highlights is that we should not be surprised if the risk premium on equities and credit is exceptionally high after such a profound shock to the assumptions on which modern economic and political life rests.

And in that sense the larger question as markets get back to work is whether this is just the beginning of a gradual recovery from the psychological depths that will see that exceptional risk premium erode, and over time build a new base for a period of more sustainable and – quite possibly – non-inflationary global growth.

We would not rule that out.

And in the meantime, we would concentrate on what seems to be happening on the ground. Our judgement is that the financial system and global economy are embarked on a healing process which is more self-reinforcing than not, that credit and equity markets have built a base for a more extended recovery, and that the sweet spot of the cycle can coexist with the desire to (partially) hedge against the fat tails of extreme deflation and inflation.

This is certainly not – and never was – a “Panglossian” universe, but there is far more truth in the idea that prosperity and comfort are seldom compatible for long, and that long-term bull markets are born from a world of pain.

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