

Outlook 2010-2011: A Slow Motion Double Dip

Executive Summary

- While we believe the global recession has ended, we expect that the return to growth will be short-lived – by mid-2011, the global economy could dip into a slowdown (and possibly a recession) again. This is because we appear to be in a period of higher economic volatility – the winter of a Kondratieff cycle – and governments and central banks have more or less denuded their armories.
- A special characteristic of the current return to growth is the speed with which the BRIC countries have started to impact the global economy. ChIndia will contribute more to incremental world growth this year than all the advanced economies put together. This suggests that monetary policy in these economies could have a ripple effect across the globe, and with both China and India in a tightening mode the current equity rally could topple from its wobbly legs.
- The dollar will benefit from this, as risk aversion will come back into fashion, if modestly. The DXY should continue its rally, although this limb would be louder against non-EUR currencies.
- While there is currently a lot of talk about exiting from quantitative easing, we believe this is largely noise. The ECB is likely to lead the Fed in exiting the easy money policy prevailing, probably towards the end of 2010, which could be the factor that cuts the DXY rally short.
- US bond yields may dip from current yields before returning to an upward trajectory; any such opportunity to hedge interest rate risk should be grabbed with both hands. Interest rate caps will probably provide greater value than swaps given the likelihood of modest recoveries and renewed economic slowdowns.
- Commodity prices look stretched and we could see them correct sharply when the DXY starts up again. Gold, however, will remain an exception to this – it will doubtless correct to some extent, but its recovery will be the strongest.

The End of the Recession

The US recession ended in July and the rest of the developed world also grew in Q3, in line with consensus expectations. The monetary and fiscal stimulus measures taken by governments worked - volatility fell, asset and commodity prices recovered substantially, credit spreads narrowed considerably and another depression was avoided. The table below summarizes the fiscal stimulus measures enacted by the G-20.

In addition, central banks of the US, UK, and Japan bought \$2 trillion worth of securities under their quantitative easing (QE) program, amounting to more than 15% and 20% of US and UK GDPs respectively. Finally, Chinese state-owned banks went into an unprecedented lending overdrive, with money supply growth accelerating to 30%+, a level last seen just before the 1997 Asian crisis.

G-20 Stimulus Measures (% of GDP)		
Fiscal Stimulus	2009	2010
G-20 \$ amount	\$ 820 b	\$ 660 b
G-20	2.0	1.5
US	1.9	2.9
China	2.1	2.3
Japan	1.4	-
Germany	-	2.0
Rise in fiscal deficit (wrt.'07)	5.5	5.4
GDP growth forecast	4.7	5.1
<i>*US, China, Germany to spend more in '10 than '09</i>		
Financial Sector support	Dev. Mkt.	Em.Mkt.
Headline support	49.75	2.50
Upfront financing	5.25	0.10

Source: IMF

G7 public debt has gone up by 20% of GDP in the past two years as a result of these measures, with further deterioration in sight. This has pushed the concept of sovereign default risk to the forefront (Central and Eastern Europe appear to be next in line after Dubai and Greece) and forced governments to commit to remedial measures starting in 2011 to bring public debt and deficit in control by 2020. Germany, which was least affected by the crisis and has forever been a proponent of financial rectitude, has just passed a constitutional amendment mandating budget balance by 2016.

As a result of these measures, and on present reading, government balance sheets won't be available to support growth from 2011 and the global economy will have to return to running on its own from the end of this year. The prospects for a sustainable recovery are reasonable, as the 3 largest economies on each continent – the US, China, and Germany – have more stimulus spending lined up for 2010 than for 2009, with the US keeping its cheque book open for even more stimulus than budgeted.

Economic Prospects

Macro Forecasts									
ASIA	GDP			CPI			Current Account		
	2009	2010	2011	2009	2010	2011	2009	2010	2011
Asia	3.2	6.8	6.7	2	2.5	2.5	2.9	3	3.3
Japan	-5.1	2.9	2.3	-1.3	-0.7	0.3	1.9	2	2.5
China	8.5	9.6	9.2	-0.1	0.6	1.5	4.8	5.5	6
Asia ex.JP, CH	2.3	5.8	6.2	5.4	5.7	4.5	1.6	0.9	0.9
India	6	7.2	8.2	8.7	8.4	5.7	-2.2	-2.5	-2.4
NIC	-1.7	4.6	4.6	1	2.2	2.5	6.4	5.9	5.9
ASEAN	1.5	5.40	5.30	2.70	4.70	4.20	3.10	1.80	1.60

Macro Forecasts						
	US			Eurozone		
	2009	2010	2011	2009	2010	2011
GDP	-2.5	3.2	3	-3.9	2.2	2.1
CPI	-0.3	2.4	2.7	0.3	1.2	1.9
Unemployment	9.3	9.7	9	9.4	9.9	9.6
Budget Deficit	-14	-9	-6	-6.1	-6.5	-5.9
Public Debt	82.8	88.4	90.5	78	83.5	87.3
Current Account	-4.9	-2.7	-2.9	-0.8	-0.4	-0.6
Refi Rate	0.00-0.25	1.00	2.00	1.00	1.75	2.50

Source: IMF with our own adjustments

As the tables show, the old order has changed much sooner than expected! As recently as last year, it was broadly expected that it would take nearly a decade for the BRIC countries to collectively match the economic might of the US and EU. While that would still hold, the tables have already turned in terms of a very important metric – incremental growth. *ChIndia will contribute more to global growth this year than all the advanced economies put together, which is why we believe policy actions here will have a much greater impact on financial markets.*

Growth in emerging markets as a whole is expected to be 5-6%, three times that of developed markets. Further, with emerging economies' share of world imports having risen from 24% in 02-03 to 36% today, this higher growth will play a stronger role (than it would have) in helping global recovery and rebalancing.

Growth Drivers

The recovery across the globe has been driven by the manufacturing sector, with industrial output up 25% from the lows in Asia ex-Japan (AXJ) and running at a 10% annualized rate in the US. Businesses slashed inventories as demand fell in 2008-09 and they have just begun to recover as production has caught up with demand. The inventory cycle is still in the early stages and will continue to boost growth at least through the first half of 2010. The fiscal impact of this year's stimulus spending will continue to be felt into early 2011, as infrastructure projects started during 2010 would run into 2011.

However, growth momentum is usually highest in the early stages of a recovery and thus could peak in Q1 2010 followed by stabilization at slightly lower levels through the rest of the year. To make the recovery self-sustaining, the virtuous cycle of job growth and consumption spending needs to kick in.

Asia

AXJ revival has been driven by loose fiscal and monetary policy, as short term rates were slashed from 5.5% in July 2008 to 2.5% and fiscal deficit rose from 0.1% in 2007 to 4% in 2008 and 3.5% in 2009. With activity back at pre-crisis levels for AXJ and 20% higher for China, the output gap has closed faster than expected and momentum appears to have peaked in Q4 2009. Healthier balance sheets across sectors, and a bigger share of public investment in

stimulus packages contributed to this V-shaped recovery – a performance that stands in stark contrast to the developed economies. Private investment in machinery and equipment – a key dynamic of sustainability – revived quickly as businesses expanded to meet demand. Even Japan showed a strong improvement in private fixed investment, despite very low capacity utilization.

While runaway credit growth made China the main growth driver in Q2 2009, Q3 2009 growth was strongest (in AXJ) outside China, as labor, property markets and private investment demand improved across Asia. The impact of supply chain linkages with, and hence dependence on, China is clearly visible in this sequencing. This virtuous dynamic of improving labor and property markets should continue to support private consumption, making the recovery self-sustaining despite the expiry in March 2010 of subsidies for car and durables purchases in both China and Japan.

United States

While the manufacturing and inventory cycle drive US GDP growth, fiscal stimulus will provide a 1-1.5% boost in H1 2010, although its impact will fade by H2 and turn negative in 2011.

With housing inventory below its long term average, and affordability at a record high, residential construction has the potential to revive and contribute to growth. However, we need to watch the data flow as building permits and housing starts continue to scrape the bottom despite a 30% yoy rise in existing home sales to above 6 m. Apparently, homebuilders are concerned that the spurt may not outlast the tax credit, which has been extended to April 2010, or remain worried about the shadow inventory of yet to be foreclosed homes, which is estimated at 5-7 million.

We also have concerns about the job market, although the terrible payrolls number in December 2009 was likely an outlier. The alternate household survey has already shown that unemployment is falling and payrolls, and we would expect the non-farm payrolls to return to positive territory by Q1 2010. However, job growth is likely to be hurt by low level of working hours, record levels of part-time employment and the huge number of people who are no longer looking for work. This could hurt confidence and consumption, and hence require further stimulus. The US Senate is already in the process of approving another \$154 b spending bill, with half of it going towards unemployment insurance, and the Fed also discussed further quantitative easing at its December FOMC meeting. On the other hand, if things do turn out well, unemployment could drop below 9% in 2011.

Europe

Asian growth has come as a boon to Europe, especially Germany, with a spurt in exports to Asia compensating for declines in the US and CEE (central and eastern Europe). While low interest rates and tax cuts are helping support private consumption, job growth must pick up soon for a sustainable recovery. Historical analysis and current data point to a turn in Q1 2010, in time for private consumption to take over from exports and the inventory cycle. Job losses have been much lower than in the last recession despite a much sharper

drop in output, perhaps due to job hoarding under political pressure. This would constrain job growth, if true.

There are also headwinds from the entire periphery of EU – excessive budget deficits in Portugal, Ireland, Greece, and Spain; and huge current account deficits and bad loan problems arising from CEE. These are balanced by a robust heartland, comprising of Germany, France, Netherlands, and even Italy.

Monetary Policy

While headline inflation dances to the tune of commodity prices, core inflation is expected to fall early in the year and bottom out in Q2 2010 at around 1% in both the US and EU. Inflation, expectations, measured by the difference between the 10-year nominal yield and 10-year TIPS (treasury inflation protected securities) yield, rose from 0.2% to the pre-crisis level of 2.2% during 2009. Money and capital markets have become normal, mortgage rates are at record lows, and credit spreads are back to pre-Lehman levels (Baa halved from over 600 bps, and junk fell from over 2000 to 700). Both central banks are moving to withdraw excess liquidity during the year, perhaps as early as March. The Fed has armed itself with an additional tool of offering interest rates on excess reserves; while the ECB's last long-term refi auction was at floating rates.

However, commercial, industrial and consumer loans are still contracting at 6% yoy in the US, even though mortgage demand has turned positive. In the EU, loans are contracting at 0.7%. This makes us suspect that all the noise about exit and rate hikes is just that – noise!

You don't hike prices on your merchandise if it isn't moving! In which case, market expectations of a 1% Fed rate by year-end may need to be corrected. The latest FOMC minutes might be of some help – "...special liquidity facilities will expire on Feb 1, 2010...the anticipated expiration dates for the Term Asset-Backed Securities Loan Facility remain set at June 30, 2010...*The Federal Reserve is prepared to modify these plans if necessary* to support financial stability and economic growth."

We suspect that, unsurprisingly, it will be the ECB that is first off the block in terms of rate rises, some time in H2 2010.

In Asia, China has already set the ball rolling with a surprise 50 bps CRR hike following 2 consecutive moves on T-bill rates, all in the first fortnight of January. A rate hike should happen in Q1 2010.

Given the pressures it is facing from the government and business, the Reserve Bank of India is likely to follow the Chinese example – CRR hike in January followed by rate hike in April. While the business cycle sequencing would dictate this path, inflation (CPI 12%, WPI 7.31%) suggests an immediate 50 bps move on both fronts. We think the RBI will take the slow and steady approach, given the supply side nature of inflation.

Financial Markets

Equities

The current equity rally has run two months longer than the one which kick-started the previous bull market in 2003-04. It is very long in the tooth and has been losing momentum for months. With monetary tightening having arrived in China and India, a correction should be just around the corner.

How deep will it be? Using Fibonacci ratios of 0.50% to 0.62% correction of the previous move gives us targets of 910 and 850 on the S&P500 and 3910 and 3600 on the Nifty. Barring 'black swan' events, the lower of the two levels will not be violated in practical terms. At the moment, despite pattern similarity with 1930, we are not inclined to favor some technicians' views that equities will go straight down, break last year's lows, and be in a multi-year bear market.

Rather, we believe that the global economy is now in an environment of high *economic* volatility – the Kondratieff cycle's winter. Kondratieff cycles are very long tenor (around 75 years) cycles observed in natural processes, including financial markets. The last leg of these cycles always have high frequency changes in direction, which may not be of very large amplitude. This suggests that we will face more frequent and prolonged recessions with intervening growth spurts over the next 4 to 8 years. Given that governments and central banks are left with precious little ammunition to protect against the next dip, this prognosis does seem to match the physical reality.

Thus, we look for the equity correction to end in Q2 2010, and be followed by another strong equity rally, which would peak in Q1 2011.

Currencies

The DXY (dollar index) has already turned around in early December and we expect the rally to continue for many months. However, we don't see the dollar rallying above its March 2009 high of 89.62, and consider 86-87 to be the most likely target.

While the first leg of the DXY rally was euro-centric due to sovereign downgrades, the next leg, which could start as early as the end of January or mid-February at the latest, would be broader and pull down every currency against the dollar. While this might seem counter-intuitive given the expected monetary tightening in Asia, Australia's experience would be instructive - the AUD 's performance was no different from NZD and CAD despite three consecutive rate hikes in Q4 2009.

Applying the Fibonacci ratios gives us targets near 82 and 84 for the DXY, which implies 10-14% declines for all currencies depending on their beta. This correction should also end in Q2 and be followed by another decline in the DXY to test – and, probably, break – the 2008 low of 70.70 by the middle of 2011.

The strong correlation between USD/INR and DXY suggests that, despite the obvious case for rupee appreciation, we will likely see considerable volatility over the next few years. Given our dependence on external capital because of our negative current account, it would seem that the rupee will be hit more by dollar

strength than be able to capitalize on dollar weakness (that we expect later in 2010 and into 2011). Again, with all and sundry calling for the rupee to hit and probably break 45 in short order, the larger risk is of a near-term decline in the rupee if, as we expect, DXY continues to pick up strength.

Commodities

Industrial metals are a mini-bubble as most of the buying was done for stockpiling and not to meet underlying demand. LME inventories are at or near 5-year highs for all metals, and there have been stories of Chinese farmers speculating in copper. Current prices are unsustainable, especially in view of the imminent tightening in Asia and withdrawal of surplus liquidity in the west. Given the gains of the past year, 30% price declines should be viewed as a normal correction.

Crude oil could correct more - \$85 a barrel is a major resistance and key supports are 70, 60, and 50. While the IEA is forecasting demand returning to the 2008 peaks this year, it took 14 years after the last oil shock in 1979-80 for oil prices to regain their peak levels.

Gold

Investment demand for gold has been rising steadily – from 19% of total demand in 2007 to nearly 42% in the first nine months of 2009. It peaked at nearly \$ 18 bn, or 59% of total demand, during Q1 2009, with reports that there were a couple of hedge fund houses sitting on positions worth \$3-4 bn each.

While gold will likely dip when the DXY rallies – gold has the highest negative correlation (-75%) with DXY – we expect that the strong resistance in the 800-1000 range will hold. As for the upside, the gold bug community is talking of 2000-3500 an ounce; while this sounds crazy, it is worth noting that 2000 dollars today is merely equal to the 1980 high of \$854 in inflation adjusted terms, and, given the unprecedented global macro crisis, and the fact that we may be in the final phase of the bull market in precious metals, anything can happen.

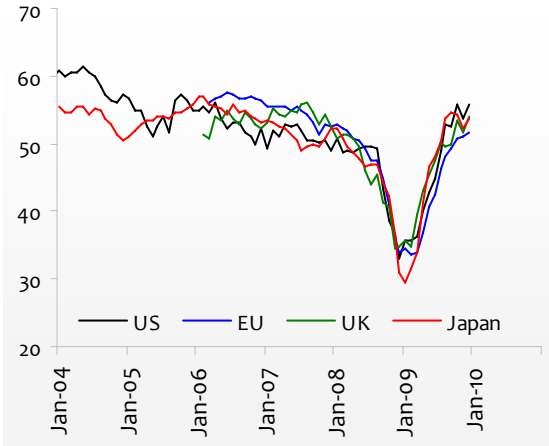
Bonds

While there are widespread fears of a sharp rise in global bond yields on rising inflationary expectations, we believe the initiation of the tightening process worldwide and the resulting risk aversion will keep a lid on yields in H1. While you can't really hide from the huge monetary impact of the oceans of liquidity released over the past 18 months, we believe that the continuing uncertainty – disbelief that the growth we see is sustainable, and just when we begin to buy in, another slowdown – suggests that yields will not rise as much as they could/should. Indeed, bond price volatility will increase.

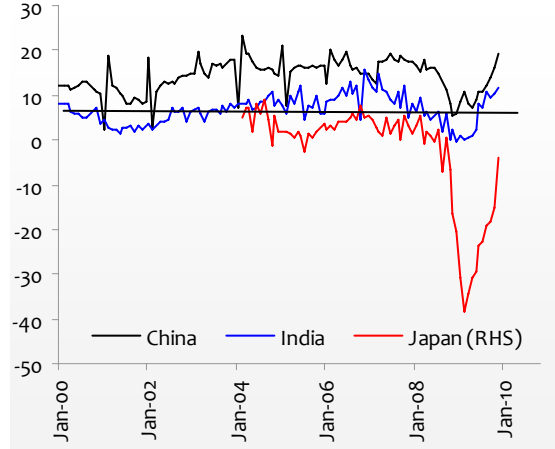
In India, the 10-year yield has gone up from 4.75% to 7.75% in a year and would continue to nudge up if the RBI doesn't act at the January meeting. The recent issue of floating rate bonds has enabled the yields to ease a bit, but market simply appears to be consolidating. Yields could threaten – and possibly breach – 8% by the end of 2010.

Global Economics

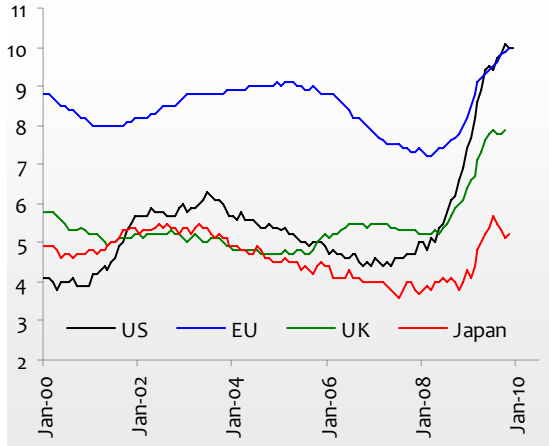
PMI Manufacturing



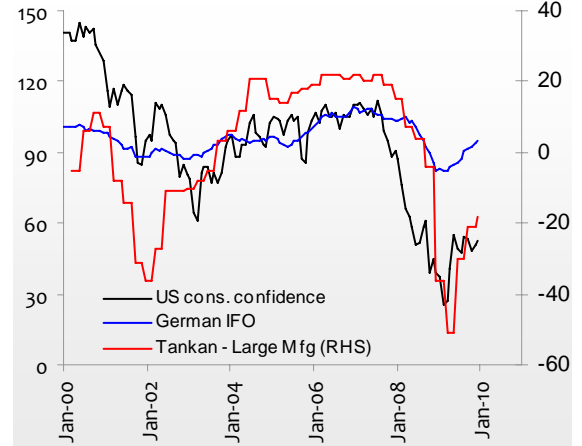
Industrial Production



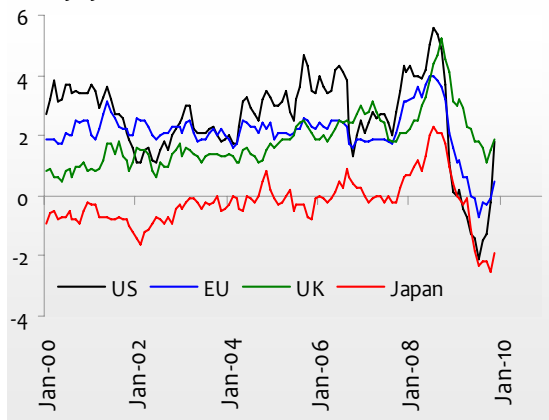
Unemployment Rate



Confidence Indicators



CPI - yoy%



Reserve Bank of India

