February 2012

Asset Management DEXIA

Market Outlook
Bear Market fatigue

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Market outlook: Bear Market fatigue

The equity markets are off to a good start and people are even becoming cautiously optimistic. By removing the prospect of a systemic bank crisis, the ECB has bought some time for the survival of the euro zone.
It remains to be seen whether the euro-zone governments will make good use of this time. We are always surprised by governments' ability to postpone issues. The piecemeal approach having failed, the decision-makers have turned to the "muddle-through" strategy. Pending challenges are well known and understood but we have seen, over the last 16 months, that implementation was running short of expectations or to at least to what was needed. The current row over a possible loss of Greek economic sovereignty is a pertinent reminder that the risk of a political accident remains high.

Although the ECB's offer of unlimited three-year loans to banks is maybe a game-changer, it also paves the way for a fragmentation of the banking market and, although many banks will use cheap ECB loans to buy domestic bonds, most will continue to cut exposure to other governments. Similarly, they will continue to prioritize domestic lending as they deleverage and try to match cross-border assets and liabilities. Regulators are also likely to encourage this process as they seek to ring-fence their domestic financial systems.

For the first time in a long time, the latest EU summit (January 30) was not surrounded by Great Expectations. A very important question is still unanswered: how can Europe reboot itself to find a new pro-growth model that can compete with State capitalism and the rampant competitiveness of the emerging markets?
Fiscal austerity and bank deleveraging will continue to take their toll on growth. The euro zone needs fiscal transfers to survive as it is not an optimal currency area. Further below, we show how cross-border flows are drying up in the euro zone and how that is a real source of worry. As the euro zone remains a dysfunctional body, a new crisis could erupt at any time. Austerity is still the only cure, as Mrs. Merkel keeps saying. Unfortunately, there are no historical examples demonstrating the success of such as approach.

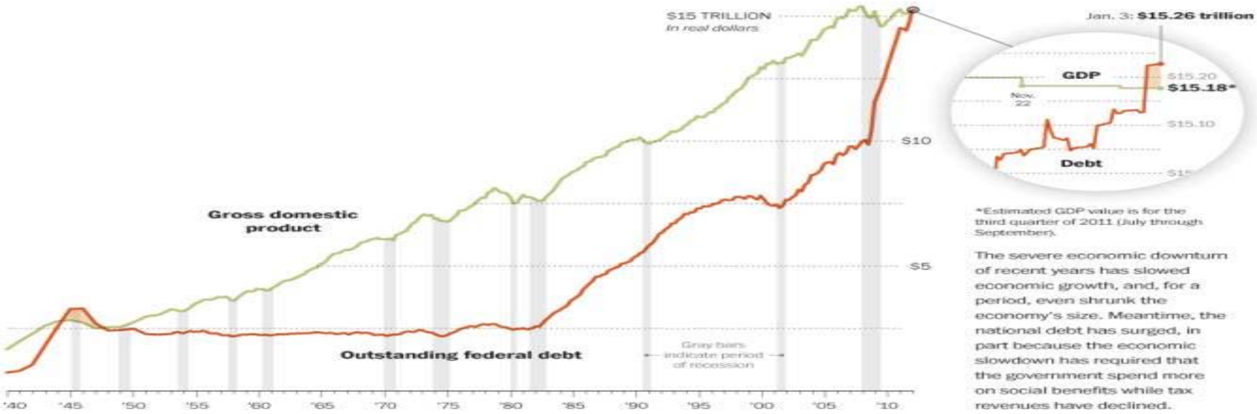
In the meantime, investors are hopeful about a new kind of Goldilocks regime: a sea of liquidity combined with reasonable economic growth. Investors are hopeful that we are transitioning from an acute phase of a crisis to a chronic phase. While existential crises are driven by liquidity and the funding needs of sovereigns and banks, chronic phases are driven by real economic adjustment.
The FED may hold rates close to zero until late 2014 while central banks from key emerging markets are now also cutting their interest rates. In the short term, liquidity is trumping everything else. Although flooding the market with a sea of liquidity is sharply reducing tail risk, it is not solving the roots of the solvency crisis. It could be even counterproductive by postponing the necessary reforms.
People are now speculating on a stunning second LTRO in late February, some articles even reporting a range running from €100 billion to 2 trillion. We are puzzled to see the excitement surrounding the game-changing nature of this deal. Granted, carry trades have, historically, been used to shore up the profitability of the banking system, in particular that of the US in the early 90s, but this time is different. Euro sovereign debt is no longer risk-free, as testified by the japanification of the European banking sector.

Liquidity-driven rallies are vicious as they push stock prices beyond levels justified by fundamentals and blind investors to the key issues.

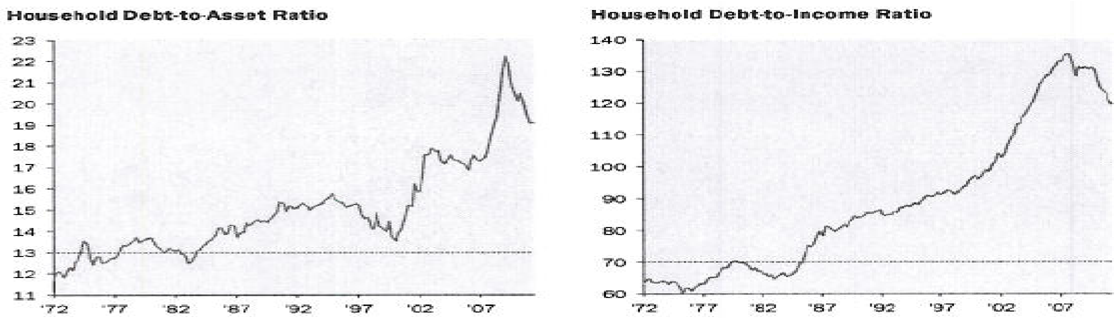
Last month, we said that everything was possible for 2012 … *QED*. Indeed, the equity markets started the year on a strong footing against a backdrop of gloomy expectations. We are entering the fourth year of the financial crisis and, at some point, the sense of bearishness will exhaust itself. European indexes are approaching their early-August, pre-collapse levels. In the meantime, a recession – albeit mild – is under way. The leading question is: what is the fair market value if this is not the end of the recession but one that will worsen down the road?

Too much debt

The world has still to cope with a mountain of debt and the situation is far from improving. The federal debt of the US has climbed to a record high – the first time since the 1940s that the national debt has been larger than US GDP.

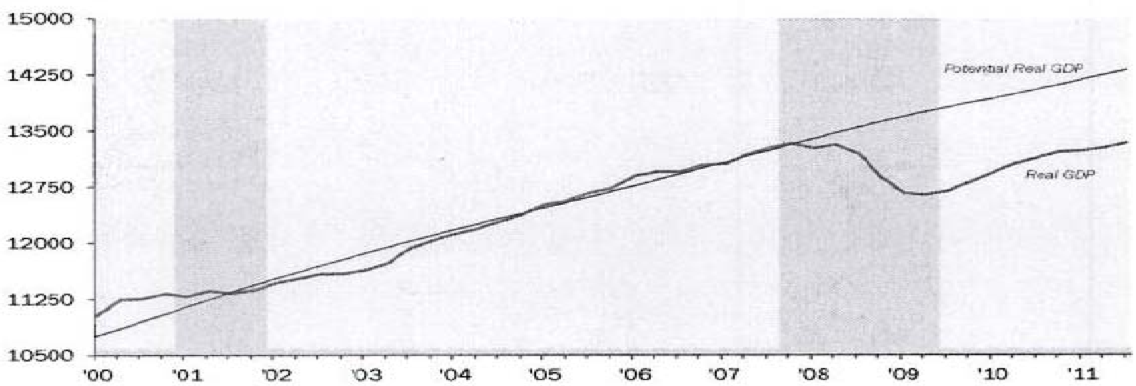


The deleveraging process has a long way to go, especially in the US. McKinsey said recently that the deleveraging cycle might only be one-third to one-half completed.



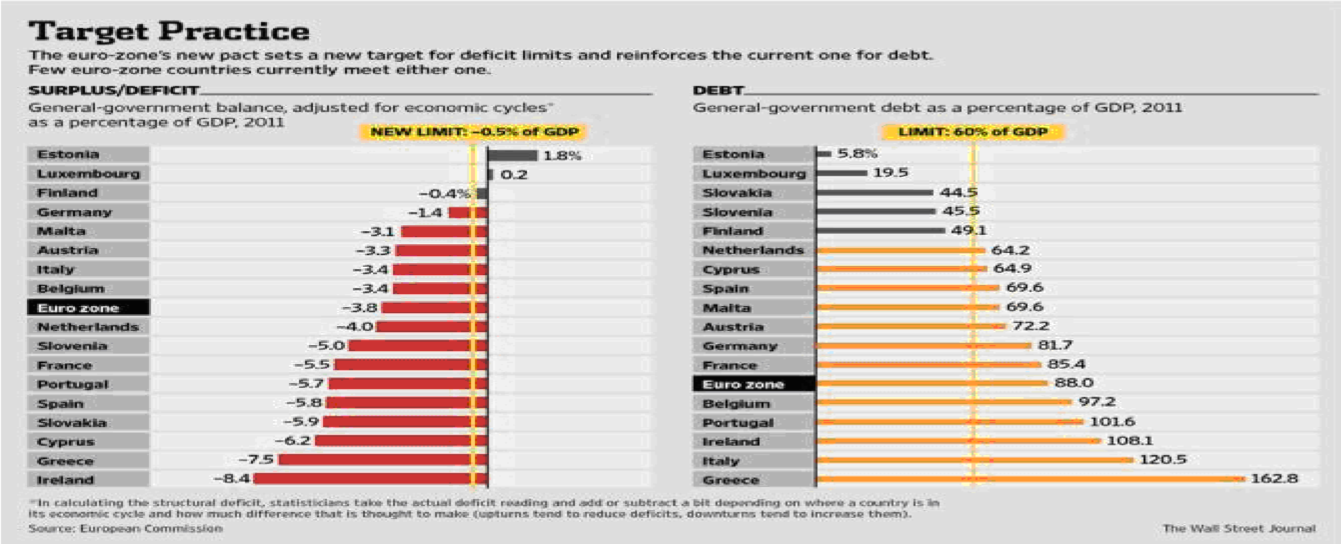
Source: Haver Analytics, Gluskin Sheff

Deflation, rather than inflation, is still the key risk hanging over our heads. The output gap in the US, i.e., the gap between today's real GDP level and the level the economy could achieve by running at flat capacity, is still close to record highs. Under normal circumstances, the output gap – at this stage of the cycle – should be close to closed.



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

The picture is roughly the same for the euro zone, whose leaders have agreed on the details of the new fiscal compact that attempts to bring the region to a low-debt equilibrium. The balanced budget rules embedded in the primary legislation are intended to keep sovereign debt low once the new equilibrium has been reached. In order to reach 60% of GDP, sovereign debt in the euro area needs to decline by around € 3 trillion (i.e., 30% of GDP). Although this degree of deleveraging looks huge, it is achievable for the region provided it is spread over a long period of time. The issue is not the average adjustment but rather its distribution across the region. Germany already has a fiscal position that would meet the new debt rule. For France and the periphery, the required fiscal adjustments to meet the debt rule are very large, as shown below.



A new divergence

As ECB lending to the banks is actually carried out by the national central banks, it is important to look at the balance sheets of the latter to see how lending is distributed across the region. Bank of Italy loans to Italian banks were €57 billion higher at the end of December than a month earlier.

Commentators continue to debate what banks are doing with the three-year funds they borrowed from the ECB in late December. A recent article in the Financial Times reported that Italian and Spanish banks had borrowed over €50 billion and €25 billion respectively, and that this covered 90% and 33% respectively of their 2012 funding needs.

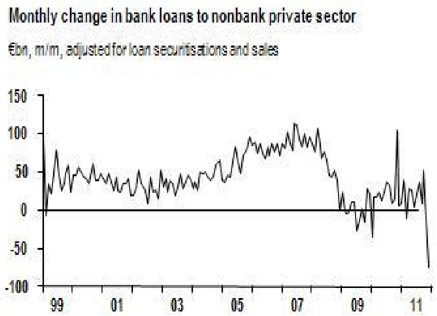
But, does this mean that Italian and Spanish banks have pre-funded themselves? This is less obvious. On the asset side, the Bank of Italy's balance sheet increased because of the extra lending to Italian banks (see first table). However, on the liability side, the total reserves of the Italian banks rose by just €2 billion during December. Presumably, if Italian banks wanted to hold a liquidity buffer ahead of the upcoming bond redemptions, they would (temporarily) be holding more reserves at the Bank of Italy.

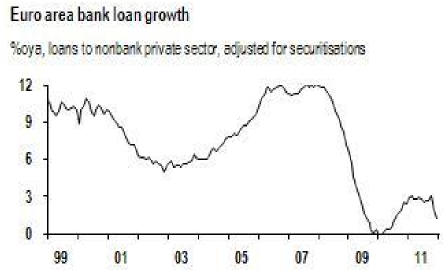
Instead, the Bank of Italy's liability to the rest of the Eurosystem rose by €44 billion in December through the Target2 payment system. Hence most of the additional €57 billion that Italian banks borrowed has already leaked from their balance sheets. Perhaps they bought Italian government bonds from German, Dutch, etc. investors, or lent it to them temporarily. But, more likely, they suffered a further withdrawal of funding, as non-Italian investors and Italian depositors moved money to 'safer' banks elsewhere in the Euro area. When this happens, the Italian banks have to settle those transactions by running down their reserves at the Bank of Italy, which then ends up with a Target2 liability to, e.g., the Bundesbank. In its latest Monthly Bulletin, the Bank of Italy pointed to this reason. €190 billion has actually been withdrawn from the Italian banking system since June.

The balkanization of the financial system has started and is most marked in the euro zone. Cross-border demand for southern European government bonds has virtually evaporated; cross-border lending is also drying up. Many banks (e.g., the French) are prioritizing domestic markets and shrinking international activities. For countries (in, for example, Central and Eastern Europe) whose domestic financial systems are dominated by foreign-owned banks, this home bias represents a potentially serious challenge.

Credit crunch

The latest M3 report showed the balance sheet position of the Euro-area banking system as at end-December – a few working days after the ECB's 3-year refinancing operation. Overall, the report is weak. We are witnessing a record plunge in bank lending.
Bank loans to the non-bank private sector plummeted €74 billion in December – the largest monthly fall on record. Loans to households fell by 8 billion and those to non-financial corporates by €37 billion in December. These are larger declines than during the 2008/2009 recession.

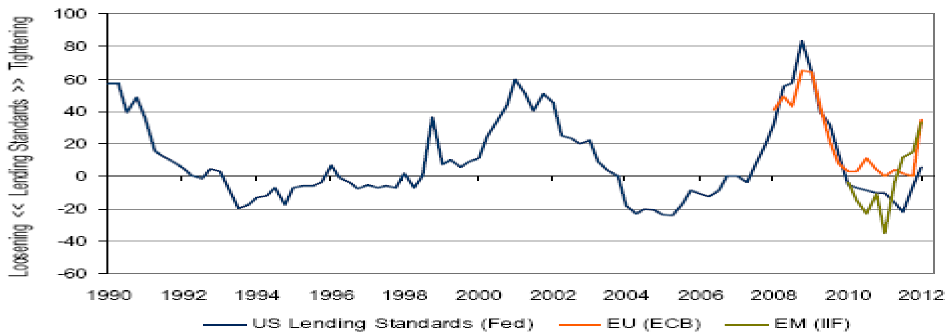




Interpreting these data is not straightforward. The weak economy in Q4 has impacted the demand for loans. Alternatively, it is also possible that the recent stresses in bank funding markets has prompted banks to cut back on their lending to the real economy, which is what the ECB is trying to prevent through its 3-year LTRO. Although the ECB bank-lending survey confirms the tightening of the credit standards, it is not as bad as the picture painted by the M3 report.

Bank-lending standards to corporates tightened globally in Q4. Credit availability is becoming more constrained – a development not just limited to certain regions.

Bank lending standards to corporates

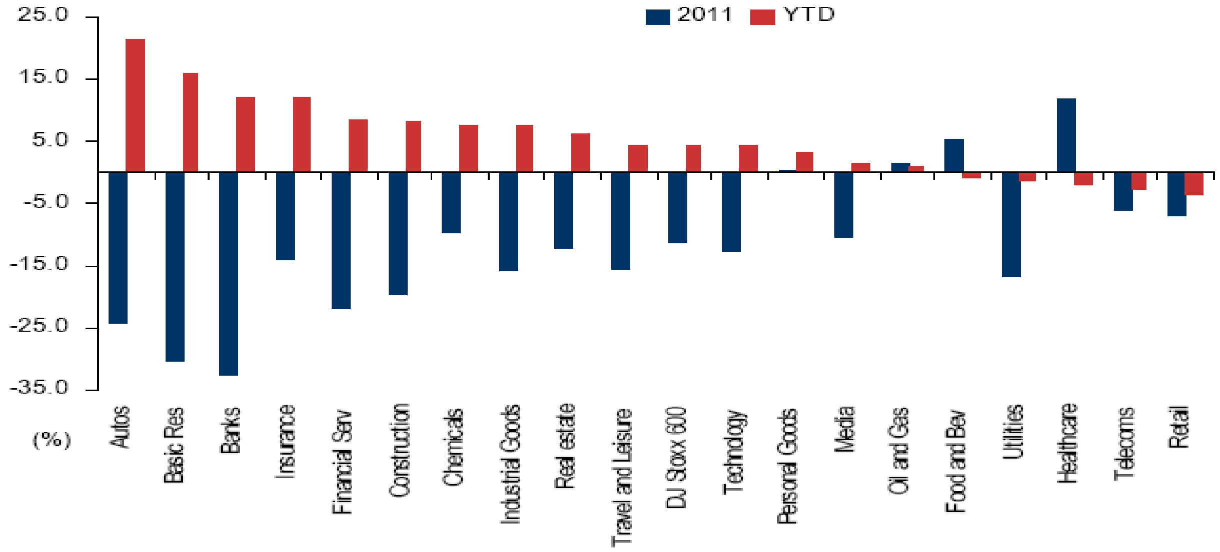


Source: BofA Merrill Lynch Global Research, Federal Reserve, ECB, IIF

Strategy: don't get caught off guard

Last month, we highlighted the risk of a value rally unfolding in January. Our instinct proved to be right. With the exception of Utilities, the strong outperformers of 2012 YTD have been the underperformers of 2011.

2011 vs 2012 YTD performance of European sectors



Source: Datastream, BofA Merrill Lynch European Equity Strategy

In late 2011, the gap between growth and value or between domestic and international stocks, which was simply too high, paved the way for a form of reverse to the mean, which we are therefore not that surprised to have witnessed over a couple of weeks. 2011 had also started in similar fashion. What is maybe different this time is that forecasts are much more realistic than at the start of 2011, when the consensus was predicting that the economic recovery was self-sustained in the US and that there would be 2% growth in the euro zone. This time, a recession in the euro zone is mainstream thinking. The threshold is significantly lower.

We doubt that this reversal will continue throughout the year. A meaningful improvement in the macro would be necessary to fuel this on a sustained basis. We have always said that the potential for the equity market in 2012 was all about the risk premium. So far, earnings releases have proved disappointing and the market has gone up simply because of the risk-premium contraction.

We raised our beta during the course of November in order to be more constructive and more balanced between growth and value. In January, we used this wave of optimism to book some profits and sell our positions in Arkema and Siemens. We also raised our exposure to German utilities, namely EON and RWE, which are deep value and still overlooked by investors.

So far, investors have been taken by surprise. But the world hasn't changed. The outlook for 2012 is highly conditional. If euro-zone members act together, demonstrate a shared vision and are specific in details, we may put a floor underneath the sovereign crisis. Although it is now likely that 2012 will be lost in terms of growth, at least the financial stability can be safeguarded and that, at the end of the day, is what matters. As we never tire of saying, the equity market potential for 2012 is predicated upon a reduction of the risk premium.