Weekly Market Analysis 1 June 2009

Market Overview

The last two weeks saw European equity markets build on gains posted since early March, with risk appetite remaining firm and investors seemingly desensitised to negative news-flow. While economic data remained mixed, gains in the EU sentiment survey and German business sentiment index helped markets higher, while in the UK, a rise in May house prices combined with falling inflation contributed to improved sentiment. In equity markets, continued appetite for capital raising initiatives pointed to repaired confidence, while a generally supportive first quarter results reporting season came to an end. A more positive global economic outlook contributed to further gains in commodities, with oil, gold and base metal prices all rising strongly. This fuelled further upside in the basic resources sector which, with a 12.4% rise over the fortnight, was the market's strongest performer. The bank sector was also strong, gaining another 7.1%, as progress in the US and UK banking sectors reassured the markets. On the downside, the traditionally defensive sectors continued to suffer from the ongoing beta rally, with the food and beverage sector losing 2.2%, while both the media and healthcare sectors also posted negative returns. By the close on Friday, the DJ STOXX 600 had gained a further 3%, extending its rally since early march to 32%. In terms of country performances, the Spanish IBEX and the German DAX posted rises of 5% and 4.3% respectively, while the poorest performers were the Swiss and UK markets, which ended the fortnight 0.2% lower and 1.6% higher, respectively.

Standard & Poors UK's sovereign debt on negative outlook

Standard & Poors (S&P), the rating agency, put the UK's sovereign debt on negative outlook, citing the worsening fiscal position. "We have revised the outlook on the UK to negative due to our view that, even assuming additional fiscal tightening, the net general government debt burden could approach 100 percent of gross domestic product and remain near that level in the medium term," a level that they deem "incompatible with a AAA rating." We would note that this is a 'negative outlook,' which signals the potential direction of a rating, typically over a period of a year or two, rather than 'negative watch' which usually is a precursor to a ratings downgrade in a few weeks or months. Latest data show that the fiscal deficit continues to soar as revenues sag and public spending continues to rise rapidly.

Our economists believe that fiscal trends are likely to remain poor in coming months and years, forecasting a public debt to GDP ratio of near 100% out to 2014e. They highlight that in the last three months, central government revenues fell by 10.2% year over year, while the Chancellor's budget forecast an 8-10% rise in public spending in 2009-10. Our economists caution that for the UK to be in this position should ring alarm bells, especially given the high internal debt levels and the UK's heavy reliance on gilt (government bonds) purchases by overseas investors.

IMF report on UK bank sector:

The International Monetary Fund (IMF) has warned that the UK government may have to pump more capital into the banking system, in order to more swiftly aid economic recovery. The IMF said that "It remains to be seen whether the recent efforts to recapitalize banks will be sufficient to sustain credit provision at levels required for a robust economic recovery. Although banks are expected to continue to remain above minimum regulatory capital requirements, further shocks will lead to an erosion of capital buffers." To mitigate this the IMF suggested that the government should be ready to offer further support, that capital structures would need to see further improvements and that contingency plans would need to be put in place to counter further financial shocks. Interestingly, the government has refused to reveal the results of the stress tests that were carried out on the UK banking sector, with the Treasury justifying the decision by saying that the release of this information may increase instability. The Financial Services Authority has revealed that the tests included what would happen to banks' assets if unemployment rose over 12%, and house prices recorded a 50% peak-to-trough fall, alongside a 60% drop in commercial property prices.

Our economists comment that even once the recession ends, the UK's financial system is likely to remain impaired and credit availability will stay poor for an extended period. While government efforts have ensured survival for the bank, it has not been enough for them to return to normal lending levels. In turn, this is expected to lead to an extended period of further asset shrinkage, poor credit availability and wide lending spreads, all of which suggest an on-going drag on private spending.

Currencies

UK pound rallied versus dollar, surpassing the $1.60 level for the first time in almost seven months, as optimism that the worst of the financial crisis is past (which weighs disproportionately on the UK) stoked demand for higher risk assets denominated in sterling. Rating agency Standard & Poors (S&P) lowered their outlook for the UK to 'negative' (down from 'stable') and commented that the debt burden was incompatible with its AAA rating, which initially hit the pound. However, this quickly reversed as investors speculated on whether the same principle could actually be applied to the US, a view that was fanned by market commentators. The pound also received a further late boost after the UK mortgage lender, Nationwide, stated that house prices in the UK unexpectedly rose by 1.2% in May, and after UK consumer confidence remained at its highest level in almost a year. Having started the two-weeks at $1.518, the pound was worth as much as $1.62 in trading on Friday (5/29).

The euro rose to a four month high against the US dollar as investors went in search of assets with higher returns, as evidence mounted that credit markets continued to thaw and that the global recession is easing. Investors have continued to grasp at the green shoots of recovery and this has eroded the need for the safe-haven status that the greenback has offered over the past few months. As was the case with the UK pound, the fall was further exaggerated by the concerns over a potential reduction in the US credit rating and as investors sold dollar-denominated assets such as US Treasuries as the US government's budget shortfall widens. The euro moved from $1.3495, at the beginning of the two-week period, to trade as high as $1.417 during trading on Friday (5/29).

Commodities

Crude oil saw a steady rise over the two-week trading period, reaching a new six-month high on Friday (5/29), despite OPEC deciding to leave production quotas unchanged based on the view that a recovery in the global economy will increase demand. Following the decision by OPEC, the Saudi Arabian oil minister was explicit about a price objective, saying that oil should remain in the $60-$70 barrel range for the rest of the year. Prices had been buoyed in the run up to the OPEC meeting following further newsflow that suggested the worst for the economy is past. This included better than expected consumer confidence data and a larger than expected gain in US durable goods orders, both of which added to the belief that demand will naturally return in the coming quarters. Weakness in the US dollar versus other major currencies was another of the main drivers for the price of crude, as the trend makes dollar priced commodities cheaper for non-US based consumers. Some analysts on the Street also commented that recent demand may have been driven by China topping up its strategic petroleum reserves. In the US, oil inventories declined by their largest amount since September (dropping 5.41 million barrels in the week 18-24 May to 363.1 million) according to the Energy Department, suggesting an up-tick in US demand. Having started the two-week period at $56.34/barrel, oil reached an intra-day high of $66.46 during trading on Friday (5/29), to complete its largest monthly gain for more than 10 years.

The price of gold continued to rise during the two-week period, as investors increased their demand for the metal as a store of value as the dollar weakened. The metal is often seen as a hedge against the US currency, as well as inflation, and a larger than expected gain in durable goods orders (the largest since December 2007) brought the prospect of accelerating inflation back into the headline. Having started the two-week period at $931.80/oz, the precious metal moved as high as $973/oz during trading on Friday (5/29). The price of silver followed suit and also rallied, up 10.9% over the two weeks, completing its largest monthly gain for 22 years (of 25%).

Copper also moved higher, driven by the falling dollar and market sentiment that the worst of the economic slowdown is past, reaching a new three-week high on Friday (5/29). The metal especially benefited from the news that Japanese industrial output surged at the fastest pace in 56 years and on evidence of a strong performance from the Indian economy in the first quarter. The metal was also boosted by a 16 day consecutive reduction in inventories, as monitored by the LME (London Metal Exchange). On Friday, copper for 3-month delivery was trading at $4800/metric ton, having started the two week period at $4450/mt.

Economics

The EU Commission confidence indicator increased from 67.2 in April to 69.3 in May. This second consecutive increase was larger than expected, but the May level remains well below the long term average of 100. As a result, our economists expect the contraction in economic activity to continue, but at a slower pace. According to the details, the increase in sentiment was broad based among businesses, including a 5 point increase the retail confidence (to -15). Consumer confidence disappointed in May, remaining unchanged at -31. Our economists highlight that the recession is not over yet and that further declines in inflation expectations contribute to non-negligible risks of deflation in the euro area.

In the UK, the Consumer Price Index (CPI) for inflation declined to 2.3% year over year (YoY) in April 2009 from 2.9% YoY in March, only 0.3% above the Bank of England’s target rate. This is the slowest pace of inflation since January 2008. The retail price index dropped to -1.2% YoY, largely due to fall in mortgage interest repayments following March's half point decrease in the Bank rate to 0.5%. This is the second consecutive negative print in annual inflation. Data showed that food price increases moderated in April, as did services inflation. Looking ahead, our economists believe that consensus inflation expectations remain too low, especially for 2010, where they believe inflation will be 3% for the year.

In the Confederation of British Industry (CBI) retail survey, the net balance of retailers reporting sales up YoY is minus 17% for May, down from plus 3% in April. However, while the May reading is weaker than April's, it must be noted that the April figure was meaningfully inflated by the relatively late timing of Easter this year. The May figure is still well below average, but is better (i.e. less weak) than any other month since June last year, at the onset of the recession. The same (weaker than April, above prior months) applies to the readings for retailers' orders and "sales for the time of year.” As a result, our economists think that the message from the CBI retail survey is that the trend in retail sales is becoming less weak than a few months ago. While it may be too early to talk of recovery, it does appear that the worst in terms of YoY sales growth is probably past (and the worst months were very poor). The survey also gives signs that the drag on the economy from destocking is now easing. The net balance of retailers with excess inventories fell in May to the lowest since June 2007 and is well below average.

Evidence of the widespread weakness being experienced by the German economy was presented in data released on Tuesday 26 May, which showed that German GDP declined by 3.8% in the first quarter, following a 3.8% drop in the last quarter of 2008. In addition, data showed that exports fell by 9.7% in the first quarter (having posted declines of 7.3% in the last quarter of 2008) and that falls in capital investment accelerated from 2.7% to 2.9%. Our economists believe that while the pace of GDP contraction may moderate in the second half of the year, the overall picture remains tough. They currently forecast a GDP decline of 5.8% this year, followed by anaemic growth in 2010.

The German ZEW business sentiment index rose to a 36-month high of 31.1 in May, reporting one of the largest month over month gains in its history. This reading was well above consensus expectations of 20, but slightly weaker than our economists forecast of 39 and represents the seventh consecutive rise since the trough reached in October 2008. Our economists comment that the recent increases were probably underpinned by general improvements in financial markets which should have made survey participants (i.e., financial experts) more optimistic about the outlook. However, the current conditions index continued to weaken, from -91.6 to -92.8, suggesting that economic activity probably remains in contraction territory.

German unemployment claims increased by just 1,000 in May, following a slightly downwardly revised increase of 57,000 in April. This seventh consecutive increase is much smaller than expected by both our economists (65,000) and consensus (63,500). The seasonally adjusted unemployment ratio unexpectedly declined from 8.3% in April to 8.2% in May. Our economists would note that the further expansion of subsidised short-shift work (by around 280,000) in May substantially capped the increase in unemployment. As a result, and given the record large contraction in economic activity and the ongoing substantial deterioration in employment plans, our economists expect a further increase in unemployment in coming months.

Data releases in Spain pointed to the recession spreading from construction to the rest of the economy. Business investment fell by -9.3% quarter over quarter (QoQ) in the first quarter, as firms faced liquidity constraints and falling profits both on domestic and foreign markets. Private consumption was even weaker than in the fourth quarter of 2008, declining by 1.7% in the first quarter. Our economists note that although monthly indicators have been signalling some stabilisation in the pace of contraction in private spending, the sharp deterioration in the labour market is likely to weigh on households' spending ability. Overall, our economists believe that construction sector malaise, combined with high unemployment will likely remain key drags on Spanish growth for number of years. They currently expect GDP to decline by 3.6% in 2009, followed by a further 0.6% fall in 2010e.

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