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May 2012

Anxiety kicks up

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The chronic instability in Europe continued in April. The focus of investor concerns was Spain – Spanish bond yields rose notably (back toward 6%) while the CDS rose to new record highs and the equity market fell sharply. Spanish financials have traded to new lows as the banks have revealed a further significant rise in non-performing loans in the context of a deepening recession and a deflating housing bubble.

To add to their woes, the banks in Spain (as well as Italy) now have mark to market losses on the sovereign bonds that they bought through the European Central Bank's (ECB) 3 year Long Term Refinancing Operation (LTRO) program. And European bank share prices are testing the lows reached in the second half of last year.

It must be very concerning for the authorities in Europe that the crisis seems to be resuming so quickly. In the latter part of last year and early this year, the crisis finally abated due to the combination of a number of measures by the authorities in Europe. Most important was the success of the LTRO in providing a much needed circuit breaker. It enabled the ECB simultaneously to provide much needed liquidity for the banks as well as support for peripheral sovereign bond markets.

Also important in the turnaround in European assets were the restructuring of Greek debt and the agreement to a new fiscal compact. For a time, the vicious cycle down in European asset prices was halted and became a virtuous circle up.

These measures were, however, never going to be a complete panacea. To be sure, it 'kicked the can down the road' yet again, but it did no more.

The deficiencies included:

- The LTRO provided no incentive for banks to lend to the private sector. This concern has been mitigated to some extent so far by the fact that the widely expected European recession has been mild. More recent data (including a spate of weaker than expected purchasing managers indices), however, have given rise to concerns that the recession may be deepening.
- The issue for European banks is more one of solvency than of liquidity. The LTRO provided liquidity, but only indirectly addressed solvency by increasing demand for peripheral European debt. This worked only as long as the LTRO was maintained. Now that the ECB has announced an end to the LTRO, the solvency issue has become more acute because of increased bank holdings of peripheral debt.
- The restructuring of Greek debt is perceived as only a step along the way to a much more substantial default. Moreover, the damage done to the private demand for sovereign bonds by the treatment of private investors in Greek bonds is likely to be significant (although it is impossible to calibrate how significant).
- The fiscal compact was only a small step towards total fiscal integration. Moreover, the European economy is caught in a mutually reinforcing cycle of fiscal tightening causing economic weakness which requires yet more fiscal tightening to meet deficit targets.
- Finally, the measures do nothing to address the lack of competitiveness of the periphery compared to Germany.

The fiscal slippage in Spain has exposed some of these deficiencies and there are many potential triggers for a resumption of the full-blown crisis. These include elections in France and Greece in early May and the unrelenting schedule of bond auctions in Italy, Spain and France. The background for these events is a general backlash to the austerity programs being implemented in Europe. Fiscal tightening, combined with private sector deleveraging, has driven Europe back into recession and the political challenges this presents have seen governments fall across Europe.

The difficulty of achieving a major fiscal tightening in the midst of private sector deleveraging is highlighted by the UK. Notwithstanding monetary policy settings pushed to the limit to stimulate the economy (with zero rates and successive quantitative easing programs) and a very weak currency, the UK economy was back in recession in the first quarter of this year. The ECB has been much more reluctant to expand its balance sheet and, as a consequence, the exchange rate has been stronger and 'financial conditions' much tighter.

The market reaction has been savage in European equity markets. Sovereign bond markets are also weakening anew in the periphery and sovereign CDS are becoming more expensive as investors look to insure against sovereign defaults. By contrast, the reaction in currency markets has been extremely muted. In addition, the reaction of risk assets outside Europe continues to be quite modest. Volatility in risk assets outside Europe remains notably subdued given the apparent increasing risks in the Euro-zone.

For example, there has only been a minor correction in the US equity market which has been supported by a remarkably good profit reporting season. That said, doubts remain about the outlook for the economy given the looming 'fiscal cliff' in 2013 and the possibility that economic growth has been over-stated by the warm winter and the difficulties of seasonal adjustment caused by the plunge in activity at the end of 2008 and the beginning of 2009.

Our contention would be that it is difficult to envisage the US equity bull market continuing while Europe lurches from one crisis to another. We would expect a period of consolidation at best in US risk assets with a significant risk of a more serious correction in the months ahead.

We continue to view the likelihood of a more broad based correction in risk assets as quite high. As we noted last month, we are past the peak liquidity phase in the market as Operation Twist winds down; the LTRO program is done and the ECB has expressed reluctance to do another program; and the Bank of England has moved to a more neutral policy stance given the 'stickiness' of inflation outcomes in the mid 3s or above (the recent GDP figures may have changed this however). The European situation appears intractable. And the risk of an independent slowdown in US growth is also quite high.

We remain most sanguine on the Chinese economic outlook where growth has slowed from an unsustainable pace but appears to have stabilised, inflation is falling and the authorities have lots of ammunition if the economy slows too quickly.

As was the case a decade ago, when the Chinese banking system suffered a surge in non-performing loans, the government will simply extend more capital to banks with the explicit understanding that they keep lending to support the economy. Bottom line: China's economy is slowing, but a soft landing (rather than a hard landing) still appears to be the most likely outcome. That said buying sovereign risk protection in Australia is attractively priced insurance against a worse outcome.

Notwithstanding the sell-off in some risk markets noted above, it is our sense that financial markets are priced for quite a sanguine outlook which may be presenting an opportunity given the myriad uncertainties affecting the global economic outlook. It is premature to conclude that US growth has moved into high gear or that the euro crisis is behind us.

It may be that we have moved past the peak liquidity phase of the market as the LTRO is done (and the ECB has indicated that the hurdle for another tranche is high) and the Fed's 'operation twist' is due to finish in the middle of this year. Meanwhile, the VIX has dropped to around the 15 level – equal to the lowest level since before the crisis – suggesting investors have become complacent again.

Volatility in currency markets is also at the lowest level since Lehman's bankruptcy. This raises the odds of a set-back in risk assets in coming months. The severity of any pull-back in risk assets will be determined by the extent of any slowdown in US data, whether the risks cited above in Europe materialise and how the China slowdown unfolds. Given reasonable outcomes, risk assets can continue to climb the wall of worry.