

Market Insight

Contract together, rise alone

Financial markets continue to remain in a state of uncertain flux as conflicting indicators and persistently unpredictable macro events sway sentiment. The frothy risk-rally in equities, commodities and risk FX from March has hit a wall of doubt in mid-May leading to a sense of overextension amongst investors as well as speculators. The sudden boost in confidence was born in the financial sector on the back of returning profitability amongst financials, helped primarily by record levels of stimulus worldwide.

Since May however, range-bound consolidation has occurred in conjunction with increasing variance in macro data flow - several monthly economic indicators have fluctuated spectacularly; suggesting a burgeoning recovery one month, only to shock market participants with a reversal the next. The exact reasons behind this variance are arguable, although it is highly likely that the widespread uncertainty prevalent amongst governments, businesses and individuals has led to a failure in attaining a broad 'consensus of confidence' - whether it be spending decisions on an individual level, investment preferences within businesses or policy frameworks amongst policymakers.

It is also likely that the shock value of the financial crisis created a sense of disbelief that a strong recovery could take place. The psychological effect resulting from the crisis is likely to be as important as the financial because although the tangible impact has been that of falling asset prices and higher unemployment, the psychological impact is only now coming into effect. As if the global economy had suffered a concussion, market participants are struggling for clarity and reluctant to take risks while waiting for a recovery. The risk-rally from March lows was unable to be sustained in part because of the fear that economic conditions cannot recover *that* quickly.

All sections of G20 economies have felt the effect of this dragging effect. Consumers who continue to have stable incomes are choosing to cut spending and/or borrowing; house prices remain under pressure as both buyers and sellers refrain from entering the market, waiting for prices to stabilise. Businesses are doing the same - cutting investment, inventories and staff as a way to survive until economic conditions improve. Paradoxically, a collective biding for better conditions is preventing those conditions from occurring - this is due to the psychological effect of unprecedented asset price falls as well as incessant media coverage that focused on worst case scenarios. The priority is clearly to save for the benefit of yourself rather than spend for the benefit of aggregate demand which although understandable is also worrying for quick recovery theorists. The same scenario occurred in Japan in the 1990's where saving rates rose so high that deflationary effects persisted for a decade.



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Asset prices have reflected macro uncertainty via range bound trade since May; equities, commodities and FX have all been unable to break higher because of ongoing insecurity about how valid the recovery is. The ongoing Q2 earnings season in the US has threatened to change this because where Q1 performance was primarily about financials, investors are hoping for a broad improvement in performance across all sectors in Q2 as confirmation that a return to normality could occur in the near future. Since firms have started to report in early July, US, UK and European equities have rallied close to 10%. Investors and consumers alike are probably going to continue questioning any rapid recovery story, the only difference now is that indications of expansion rather than slowing contraction stand to drive confidence higher.

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