

16<sup>th</sup> February 2010

## Market Insight

### The recovery story begins to dwindle

Since the beginning of the financial crisis in mid-to-late 2007, almost every market participant was wondering where exactly prices would stabilise and in turn, how the recovery would shape up. There have been numerous anecdotal predictions, quite often mimicking letters of the alphabet. Optimists were predicting a V-shaped recovery while pessimists were more inclined to favour an L-shape. Of course, such opinions are only indicative of market psychology and sentiment but if we look back at what has happened since asset prices bottomed out and the recovery began in March 2009, it becomes clear that the optimists were closer to the mark.

At the height of the financial crisis in 2008, almost all asset prices were experiencing severe falls. Equities, commodities, cyclical currencies, property and even bond markets found it difficult to find support amidst a period of sharp de-leveraging and risk-aversion. Market participants were wary of a complete breakdown of the financial system but this was averted, largely due to immense government support across the globe. The largest doses of capital injections were done in the US and the UK via unprecedented use of monetary policy – not only in the form of drastic interest rate cuts taking policy rates below 1% but also through Quantitative Easing (QE) whereby new capital was ‘created’ in order to support ailing banks and financial institutions.

So far, QE policies seem to be working judging by steady up trends in all global equity and commodity indices. Property prices around the world have also stabilised. In the G20, companies in almost every sector have reported strong earnings and profit growth suggesting that economic output is on the increase.

Despite all the bright factors indicating recovery, a slow but assured realisation is surfacing. Financial markets have weathered the crisis extremely well when compared with a worst case scenario but inherent demand from the private sector is anaemic and is being primarily supported by public funds. The much touted “green-shoots” of recovery were largely reliant on a communal belief that conditions were beginning to show improvement but few questioned what the causes behind any recovery actually were. Looking back, it is highly probable that without state support, the broad asset price rallies since last March would have been much shallower at best and would have turned into further declines at worst.

Currently, financial markets stand at a crossroads after seeing their largest retracements from December peaks. US indices are 5 – 10 per cent lower and have broken their year long trend lines; similar price moves have occurred in Europe, Asia and the Emerging Markets. In the recent past, relatively small retracements have been seen as an opportunity to join the rally at better levels but with sovereign debt fears driving market sentiment combined with the fact that government debt issues usually taking decades to resolve (rather than months for financial institutions); many market



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participants are becoming sceptical. Essentially, the fear is that the causes & effects of the financial crisis have been nationalised by each respective country implying that the root problems of excessive debt, overleveraging and over complexity of financial instruments has simply been transferred over to the public purse. If this theory is proven correct then we are likely to see asset price declines akin to those of 2008 but instead of banks declaring bankruptcy, we could see whole countries default on their obligations. Going back to the alphabet analogy – this would resemble an ‘h’ shape.

The question of how valid the recovery has been is only now being asked as indicators of private sector demand continue to show weakness – at a time when they are expected to show strength. Employers are reluctant to hire with medium-long term outlooks, preferring to concentrate on short-term solutions such as increasing temporary/contract staff. House prices have stabilised, helped by lower mortgage rates but demand for housing remains low in much of the developed world as consumers continue to retrench via higher saving rates, lower borrowing and lower consumption rates. You could argue that if consumer demand remains flat, future rates of growth will never match those of the past. Ironically, most central banks are assuming strong growth rates despite the lack of strong jobs growth.

Another risk is that the ultra-low rate environment we currently find ourselves in continues with more creative ways of loosening monetary conditions thus prolonging the anaesthesia provided by public money. Policymakers worldwide are hopeful that an initial burst of state support will quickly induce private demand. On the contrary, such support is only having a minimal impact in attracting bruised firms and households. Huge overhands of debt in the developed world are preventing people from making long-term investment decisions given how traumatic the past two years have been. The key question now is can the catalyst provided by governments and central banks remain active until private demand takes over without causing uncontrollable inflation.

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