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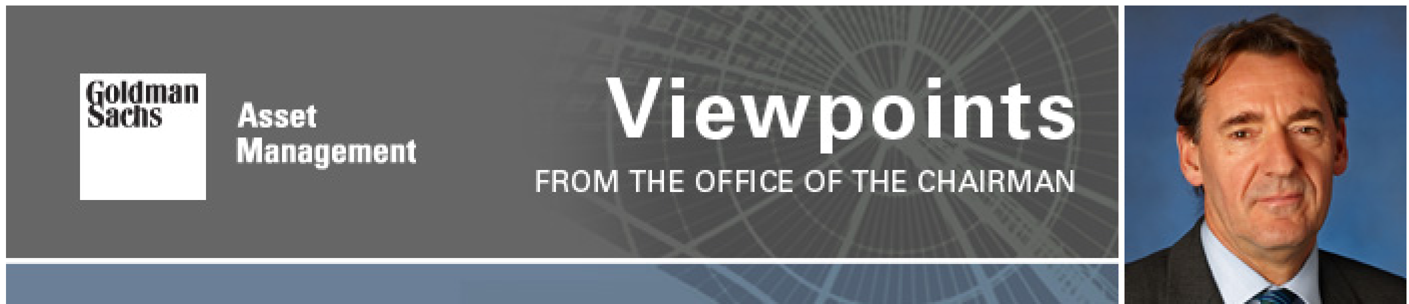

2008 ALL OVER AGAIN?

Another ugly week passes, and it is still only August 20th. What a particularly brutal August this is turning out to be so far, even when compared to many challenging ones in recent and distant years. Although there are many substantive reasons why things are very different, many cannot resist the temptation to make comparisons with 2008. So, I thought I would discuss the comparison this weekend.

MARKET DEVELOPMENTS.

After nearly recovering all of their previous week's losses early this week, world equity markets crumbled from Wednesday onwards, with few signs of discrimination between countries. If anything, those markets with the greatest "global exposure" – such as Germany and Korea – saw the greatest weakness, which suggests concerns are now very much about a fresh major global slowdown and contagion from the weak economies to the stronger ones. The DAX has lost more than 20pct this month, turning an outperformer into an underperformer. It is also hard to decipher movements between so-called developed and emerging economies, with relative weakness spread across many. China has held up better than most, but given its earlier weakness, this could be argued is a bit clutching for straws.

The inability of equity markets to sustain their early attempts at recovering their steep losses since late July has many technicians suggesting that, not only is any bull market over, but this is the beginning of a fresh prolonged bear market. The move of the S&P below its 200-day moving average as well as the 50-day moving average now being below the 200-day moving average mark are cited by some as evidence of a major trend change.

On the bond markets, not withstanding the continued irony that one of the supposed causes of current economic angst is the sustainability of government finances, many markets reached levels not seen for decades in the earlier part of the week, with the UK, US and Germany sharing the continued role of safe havens. Interestingly, in the last two days, despite the renewed onset of equity weakness, these markets no longer rallied. Whether this is because the whole frenzied bond rally of the month to date was essentially short covering, or whether investors are starting to worry more seriously about the true credit worthiness of these governments is impossible to know. It might be neither. It could be that bond investors want to take a breather ahead of important possible policy initiatives, such as the Jackson Hole speech of Ben Bernanke this week. Or, it could simply be just a pause for some other reason.

On the foreign exchanges, the Yen continued to make new highs performing its rather odd role as a safe haven. It's odd because Japanese government debt is more than double the Euro Area average and more than double the US, which in my view, makes it highly likely that there will be fresh FX intervention in Tokyo in coming days. Interestingly, despite the "risk off" mentality, the Swiss Franc struggled to make renewed gains following efforts by the Swiss authorities to reverse at least some of its huge overvaluation. The Chinese Yuan reversed some of its previous strength, questioning many views that the authorities have recently deliberately adopted a stronger FX policy.

On commodity markets, not surprisingly, many experienced considerable weakness.

One clear continued winner from all the unfolding mess continues to be Gold. It almost seems in the minds of some that Gold is a winner either way, from the fears of a fresh 2008-like global recession or stronger monetary (and fiscal?) measures to avoid it.

ECONOMIC AND POLICY DEVELOPMENTS LAST WEEK.

Last weekend, I highlighted three important events coming up this past week. It was indeed those events that

dominated the week.

The much anticipated Sarkozy-Merkel meeting came and went late Tuesday, with the apparent reality that they don't want to offer any new quick fix to the immense challenges around European Monetary Union (EMU). I shall return to this below, but this was a major factor in renewed market weakness.

The meeting of the Swiss authorities Wednesday resulted in further aggressive actions by the SNB and kept open the notion that fresh dramatic policy measures might be used to weaken the Franc further, hence the inability of the Franc to play its usual "risk off" strengthening.

Thirdly, the much anticipated Philly Fed survey Thursday was beyond even the most depressed end of expectations, and its drop to -30.7 is consistent with an economy already in, or about to enter, recession. While the Philly Fed survey can be extremely volatile, it has also proven statistical qualities as a lead indicator. Many, probably including most at the Federal Reserve, had maintained a degree of belief that a modest 2 pct plus real GDP performance was likely in Q3 and Q4. And, until the Philly Fed release, the ongoing evidence was supportive of such views. Adding to these hopes were the release of better-than-expected Industrial Production and the continued gentle trending down in weekly job claims. But, the Philly Fed weakness raises the possibility of a darker path ahead. It is entirely possible that the weakness of the survey has been exaggerated by both the equity market weakness since late July, and also by the highly public and disappointing squabbling over the debt ceiling. But whether this is the case or not, it is also true that they survey might be accurate. As a result, it was no surprise to see the latest bout of US equity market weakness take hold after this release, as market participants priced in the risk of a further related sharp drop in the August manufacturing ISM survey to be released in early September. This now becomes a huge data release in the US.

THINKING BACK TO 2008 AND EARLY 2009.

As I said, it is difficult for us all to avoid 2008-2009 comparisons. So against the background of what happened last week, here are some of my reflections:

1. At the time, as Chief Economist and Head of the Economics Department, we tried to focus even more closely on all the proprietary leading and coincident indicators we had developed over the years, as well as focusing on the policy options that were available. It would seem as though the same is pertinent now.
2. In my view, the build up to the crisis of 2008-09 was different because, even though the apparent bursting of the credit bubble had already started in 2007 and gained momentum in 2008, none of us knew the consequences of major financial institutions failing. This included policymakers. In hindsight, we all have that – only too recent – experience to call on now.
3. In the context of both of the above points, watching measures of financial stress as well as other reliable indicators is critical for following what's happening.. These include the GS Financial Stress Index (GSI), the GS Financial Conditions Index (FCI), and the GS Global Lead Indicator (GLI), for example.
4. So far, of the three, the GLI is pointing more darkly than the other two. Following the Philly Fed survey, the Advanced GLI for August shows a negative reading and suggests more global economic weakness ahead. Because of the speediness of the Fed's response, US financial conditions have only tightened modestly this month, and as a result, OECD financial conditions have not tightened much at all. This suggests that, unless the power of an FCI has been completely broken, any economic weakness, including the degree warned by the GLI, will be temporary. The FSI has tightened notably in the past fortnight, but is nowhere close to what we witnessed in 2008.
5. Many bears now say that the reason we managed to recover in 2009 is because there were many conventional monetary and fiscal options open to US, European and G20 policymakers. Now, they claim these are all exhausted.
6. This is valid, but I am not in agreement. Many conventional monetary and fiscal tools were exhausted by 2008, but not all, and there are many policy initiatives still available. The Fed has already highlighted that they will do "more" and we will no doubt get a flavor of that from Ben Bernanke next week. The Swiss National Bank has demonstrated that it had further policy options this past week. The ECB has plenty of conventional policies it can offer, including reversing the two – arguably mistaken – interest rate hikes it undertook earlier this year.
7. On the fiscal policy front, while the bond market vigilantes are demonstrating their power, the performance of non Euro Area troubled bond markets suggests that specific targeted fiscal initiatives may be supportable. In this regard, more targeted tax measures in some countries seem likely. In the US, steps to help hiring through payroll taxes seem possible. In the UK, a reversal of the top rate of income tax might be offered.
8. The position of the so-called BRIC economies and markets. In 2008, the valuation of many equity markets, especially China and India, were much higher as we went into the market meltdown. This is not the case today, especially after the past fortnight, and especially for China. All markets are trading at quite modest undemanding multiples. As far as their economies are concerned, the biggest cyclical challenge facing most of the BRIC and other Growth Markets has been food- and energy-induced inflation. One of the few good aspects of the recent behavior of financial markets is that it virtually ensures that inflation is going to ease in many of these economies, and local policymakers will no longer have to tighten monetary policy. As I have written on many occasions, this decade, the combined additional GDP created by the eight Growth Market economies will be around $16 trillion, more than double that of the US and Europe put together. In this regard, I find myself thinking that the relative strength of the Growth Markets will be solidified even more because of recent events. This is a great opportunity for all those investors that have claimed they want to invest in them to do so.

WE NEED POLICY LEADERSHIP.

Away from the specific policy measures adopted in 2008, we also saw some evidence of determined leadership, which was perhaps best represented by the emergence of the G20 in November 2008 and then its re-appearance in the Spring of 2009 and the collective determination to stand against recessionary forces.

Similar leadership is again necessary now. I would argue that this is especially true with respect to Europe. While I have misread the US cyclical developments since the Spring, I remain unruffled about the strength of China and the BRICs. I have been concerned about the forces surrounding EMU throughout the past 15 months. It has been clear for months that markets no longer have confidence in its stability, and the vicious circle between sovereign debt and the European financial system has gotten much worse.

At the core of the European problem – which may be the only true global economic dilemma currently – is that the EMU as constructed doesn't work. As I have written on endless occasions now this year, in hindsight, too many countries were allowed to join. There has been no mechanism for ensuring fiscal discipline; there has been no mechanism for encouraging productivity and competitiveness. The markets now realize this and are clearly scared about it. Many European policymakers appear to be in denial, although this doesn't stop many from making lots of statements which isn't helping.

Until a week ago, it was vaguely possible for German policymakers (as Germany was seen as the anchor for the region) to offer some kind of self righteous stance that all EMU member countries had to undertake policies to behave like Germany, and then the system would work just fine. Surely this past week must have laid this mistaken belief to rest? Two things happened of great importance. First, Q2 German GDP rose by just 0.1 pct, actually below the Euro Area average. Second, since August began, the German stock market has continued to fall by more than most. The DAX has gone from being an outperformer – a sort of developed market BRIC index if you will – to being a notable underperformer.

It is questionable whether or not the German economy is as weak as Q2 suggests, but the markets don't think so. Moreover, not for the first time, the GDP breakdown suggests that there has not been any domestic consumption again. There cannot be a sustainable EMU if the biggest member never consumes, especially at a time when those that have consumed too much have to undertake significant corrective policies. This is now happening in Greece, Portugal, Spain and Italy. All countries in the world cannot export at the same time.

Despite their considerable complex internal political issues, German policymakers can't afford to simply hope that the EMU problem will go away. It is going to require some stronger leadership, and something that Germany will support. It seems as though German (and at least in public, French) leadership is hoping for a fresh EU proposal for a new tougher fiscal mechanism to be announced in September, which then can be adopted by all member countries. This may be the foundation for a true common Euro-denominated bond, but without the tougher fiscal discipline, the Euro bond won't happen, at least in the minds of many German leaders. Germany needs to start opining quickly as to what kind of EMU it wants and will support, rather than simply opining on the EMU that it won't support.

Throughout my career, I have learnt that out of every crisis comes an opportunity. The same is true again now, but it requires leadership to bring the opportunity about. Worried by the lack of economic policy leadership, many market dislocations have occurred. If the leadership comes, the opportunities created by this crisis will be snapped up by investors.

In the meantime, luckily, we have plenty of football to watch this weekend.

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