

Europe's Growth Surprise

August 2009

It appears that the worst is over

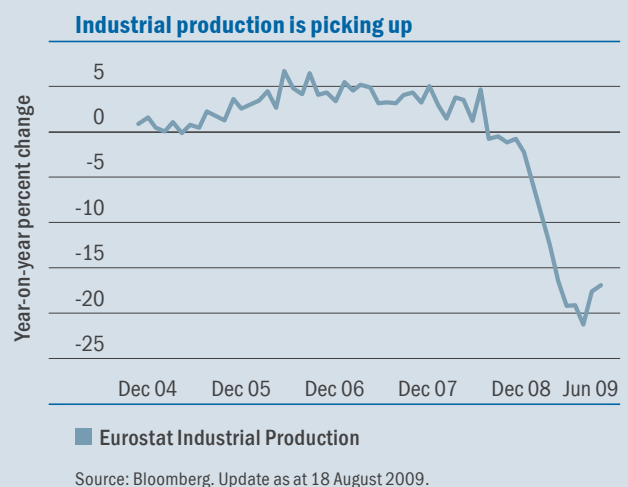
For almost six months now, financial markets have embraced the idea that the worst is over for the global economy. As a matter of fact, the Morgan Stanley World Index is up more than 50% since March lows and impressive gains have been made by corporate bond markets (which had been another casualty of the recession). Investors have pinned their hopes on a few "green shoots" of recovery, such as renewed demand for resources from developing countries helping to overcome the global slump in manufacturing.

Companies aggressively cut their inventories late last year when the financial crisis turned into outright global recession and dragged down GDP figures in the process. As warehouses were emptied and demand is now recovering, companies are ready to start production again, which is the main reason for second-quarter growth surprises.

The European economy is benefiting from that. After collapsing in Q4 2008 and Q1 2009 by 1.8% and 2.5% respectively, the Gross Domestic Product fell only 0.1% in the second quarter, but with the two biggest countries (Germany and France) posting an increase.

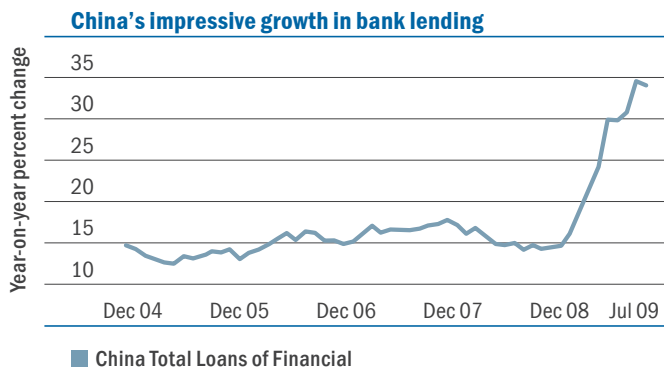
The year-on-year GDP comparison still lies deep in negative territory but it is improving nonetheless. If this is the most accurate reading of economic data, then quarter-on-quarter changes are the ones to watch as evidence of a supposed turnaround. In this respect last week's GDP data can be counted as a growth surprise. In fact forward-looking indicators such as business surveys have pointed to a slow recovery since bottoming out early this year. The return to growth in a single quarter was deemed near-impossible before next year for the European Union, while other economies outside Europe were given better prospects. These signs provide a lot of relief in Germany, whose dependence on exports meant it was particularly hard-hit by the global recession. Even after the second-quarter growth surprise, the German economy is likely to see its GDP down 6% in 2009.

To put this surprise in perspective, we should keep in mind that export-driven economies other than Germany have also experienced an impressive turnaround in the second quarter. Among developed countries, Japan is the best example, with a quarterly small gain in GDP of 0.9% following a year-long slump. Even more significant is the change seen in countries closely intertwined with the global economy: Singapore's GDP rose by 5% in the second quarter.



Government support likely to stay for a while longer

Consumer spending also picked up in the second quarter, suggesting that exports were not the only contributor to the improved data. However, government subsidies for car sales, which cannot continue indefinitely, also proved supportive. Looking in more detail at exports, orders for German manufacturers were revived in part by China's investment surge. This has been mostly state-sponsored, along with the impressive growth in bank lending.



Source: Bloomberg. Update as at 18 August 2009.

Government help has played a pivotal role in overcoming the recession or, in China's case, in stimulating the economy. However, it is unclear how the economy will perform once this support is removed. In China the recent boom in bank lending and investments, mainly at big enterprises, may be unsustainable and even prompt a sharp rise in nonperforming loans. For all the caveats the latest positive developments make it less likely that central banks will resort to further stimulative measures in order to boost the economy. The European Central Bank (ECB), however, has just confirmed its commitment to growth and looks more concerned about higher unemployment than inflation. In other words, emergency

policies are unlikely to be wound down in the eurozone, or indeed in other continents.

We maintain that Europe is highly dependent on a buoyant global economy and therefore on renewed strength in demand from abroad. The breakdown is set to change. Exports to developing countries, mostly of industrial goods, will play an increasing role, while consumer goods may account for less than in past recoveries as American households save more and refrain from going back to boomtime shopping lifestyles.



Source: Bloomberg. Update as at 18 August 2009.

In our asset allocation strategy, we have consistently favoured countries or areas where the policy response to the crisis has been more forceful. In Europe, the ECB has definitely been more proactive of late, but there are uncertainties about the effectiveness of fiscal policies (not surprisingly, since no fiscal union is in place).

That is why for the time being we confirm our position, notably with an underweight in European equities and a longer duration for euro-area government bonds compared to US Treasuries. Moreover, with valuations made much less compelling by the rally, our overall equity exposure can stay neutral.

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