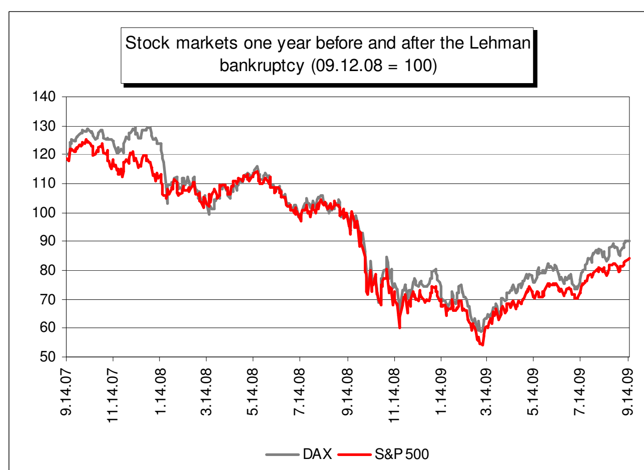
ECONOMIC SITUATION AND STRATEGY

A year after the Lehman Brothers bankruptcy: What lies ahead?

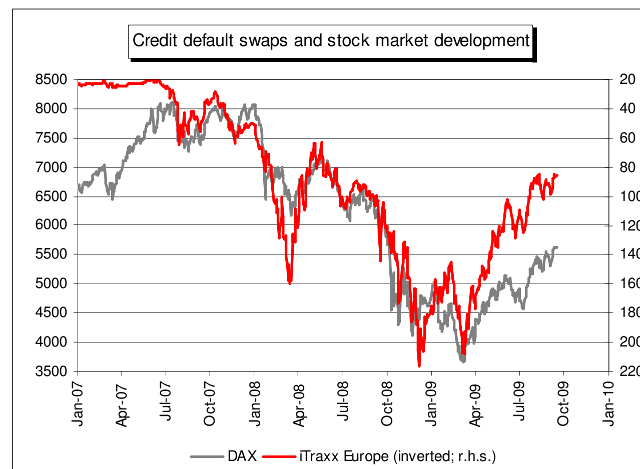
Lehman Brothers was forced to declare bankruptcy on September 15, 2008. The whole weekend before, desperate efforts had been made to keep the tradition-rich investment bank afloat, as previously in the case of Bear Stearns and mortgage finance companies Fannie Mae and Freddie Mac. Most market participants were nevertheless surprised by the bankruptcy, since they had expected the US Treasury and the Federal Reserve to avert the firm's demise as they had for the other troubled institutions. After all, Lehman also appeared to be systemically relevant, i.e., "too big to fail." At first, the Lehman bankruptcy caused comparatively little agitation on the stock exchanges. True, the DAX lost almost 3% on that day, and the S&P 500 almost 5%, but those losses were practically made up by the end of the week, which also saw the rescue of AIG, once the world's largest insurer. The DAX was quoting at almost 6,200 points again, and the S&P 500 at more than 1,250.



The actual slump on the stock exchanges did not begin until October 2008 and took place in several stages as the effects of the Lehman bankruptcy on global financial markets became more and more evident. Risk premiums on the credit and interbank markets increased enormously in the aftermath, and many financial products could not be traded at all or only on a limited basis. The DAX fell below 5,000 points for the first time, and the S&P below 1,000. The DAX then plunged to just over 4,100 points by the end of November 2008, and the S&P to less than 800. Thanks to the measures taken by governments and central banks to support the capital markets with liquidity and the banks with guarantees, the situation calmed by the beginning of January 2009, before the market came under pressure again. By March, the DAX dropped below 3,600 points, and the S&P to less than 700. The main factors contributing to the renewed price slump were bad economic news and fear of an impending 1930s-style depression.

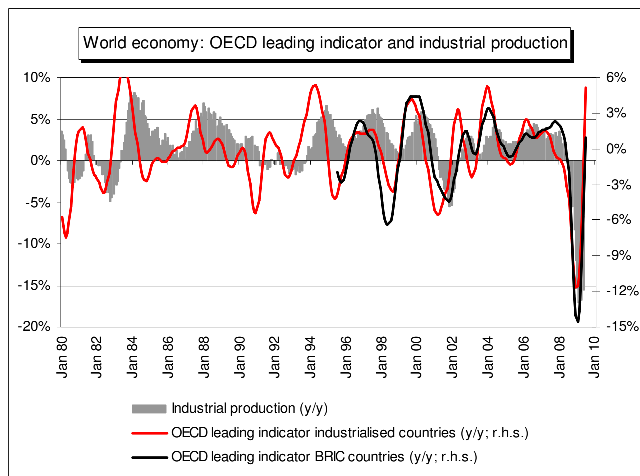
The stock market recovery that began in spring 2009 was critically questioned by many market participants, including us. More than a short bear market rally, as had repeatedly occurred since the beginning of 2009, was hardly considered possible. Our own investment strategy was characterized by great caution at that time, since almost all the indicators that we consider relevant were sending negative signals. Our asset allocation model accordingly recommended maintaining the strong underweighting of the stock ratio that had been in place since October 2008.

In April 2009, however, the sentiment indicators began gradually to improve. One of the decisive factors for that was probably the G20 meeting in London, at which extensive spending and support programs for the world economy were announced. It was also decided to regulate hedge funds more strictly, dry up tax havens, and implement new rules for bonus payments at banks. Although the "new financial architecture" is at best only discernible in outline today and the proposed regulation of financial markets and their participants is already being called into question, the most important goal of the G20 summit, restoring confidence, has been achieved. The return of confidence in the functionality of the financial markets is reflected perhaps most clearly in the risk premiums on the credit markets. For example, the risk premium (vs. triple-A government bonds) for the iTraxx Europe index, which is based on the 125 most liquid European bonds from issuers with investment-grade credit standing, has fallen from more than 200 index points in March 2009 to 86 basis points. That is the lowest spread since June 2008.



The situation is similar with respect to risk premiums on the interbank markets. The TED spread has declined from 458 basis points in autumn 2008 to 16 basis points. Risk premiums have not been that low since 2004. The TED spread is the difference between the interest rate on unsecured 3-month money among commercial banks and the interest rate on secure government paper with a 3-month maturity.

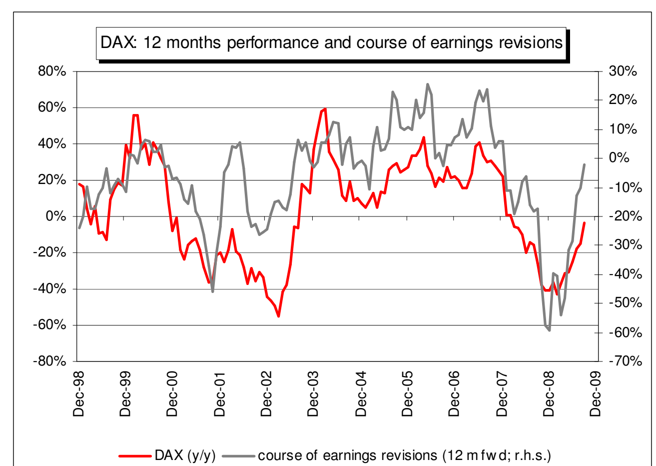
However, a return to normalcy may be observed not only on the financial markets. A remarkable recovery has also been registered in the leading economic indicators since last spring – and around the world. The OECD leading indicator for industrialized countries has risen in the last three months more strongly than at any other time in its almost 50-year history. The indicator's trend momentum is at a level last seen in 2003 and thus points to a strong, i.e., V-shaped, economic recovery to be expected in the next few quarters. It is interesting that among the industrialized countries, the strongest recovery of this indicator may be found in Germany and Italy, but that is probably partly due to the preceding severe slump in those national economies. The OECD leading indicators for the BRIC countries have also recovered significantly in the past few months, with the strongest changes registered in China and Russia, followed by India and Brazil. As in the industrialized countries, it may also be assumed that government stimulus programs are the main reason for the current recovery in the emerging markets.



Given the consistently positive development of most leading indicators, we believe it is reasonable to conclude that the global recession is over. Moreover, this economic downturn would have occurred even without the Lehman bankruptcy, but it would probably have been significantly more moderate if not accompanied by the financial crisis. It is easy to see now that not only the leading indicators are recovering, but also the real economy. We expect that economic momentum will positively surprise most market participants in the coming months, since a strong cyclical catch-up effect is emerging. In Germany, that is discernible in the recovery of new orders and exports. In the United States, the real estate market has stabilized, and consumer spending and industrial production are picking up. Also, inventories are no longer being reduced as fast as they were a few months ago. These data confirm our surmise some time ago that GDP in Germany and the United States might grow in the third quarter at an annualized rate of up to 6%. At least with a view to growth rates, the economy thus appears to be recovering in a V-shaped trend, although we still assume that aggregate economic output will not reach the level of early 2008 for some years to come. The crucial question is: What will happen to the economy after the expansionary effects of monetary and fiscal policies recede next year? Are the market's own recuperative powers strong enough to bring about a sustained economic recovery, or will there be a relapse when government support is removed? From today's perspective, we regard the scenario of a renewed downturn as quite plausible and well-founded, especially since we see considerable risk in the fact that the very dynamic economic recovery now beginning will increase pressure on governments and central banks to quickly end expansionary monetary and fiscal policies. The consequence would be the threat of a "boom-bust" cycle in which recoveries and downturns follow one other in rapid succession.

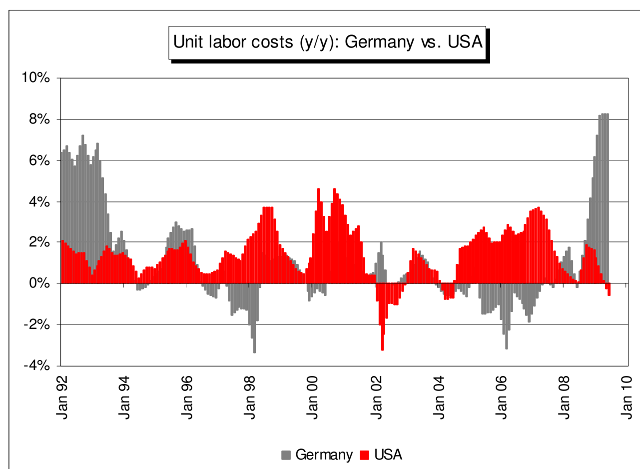
Despite the remaining risks, we consider it too early for investors to orient themselves to another possible economic dip. We expect that the positive economic data, high liquidity, and lack of investment alternatives will allow the stock markets to continue their rally. True, the DAX has almost reached our revised year-end target of 5,750 index points, but our asset allocation model, based on leading economic and financial market indicators, signals that it is not time yet to become more cautious regarding stocks. Thanks to improved conditions, the model has successively increased the recommendation for the stock ratio from "strongly underweight" to "slightly overweight" since May 2009.

The stock market is also receiving support from an improving earnings revision ratio. Thanks to the better economic data and restructuring efforts begun by many companies, corporate analysts have slightly raised their earnings estimates for the DAX for the first time in 12 months. Based on the current estimates for 2009 and 2010, the DAX shows a P/E ratio of 13.3, which is somewhat higher than the valuations of the Stoxx 50 (P/E of 12.2) and the Euro Stoxx 50 (P/E of 12.4), but lower than those of the S&P 500 (P/E of 15.2) and the Nikkei (P/E of 25.3). If one assumes a perfect ability on the part of corporate analysts to forecast earnings and an unchanged P/E ratio, then the DAX might advance to 6,200 points by year's end, and the S&P 500 to just over 1,100 points. The German stock market thus has the potential to reach its "pre-Lehman" level of 6,234 points this year.



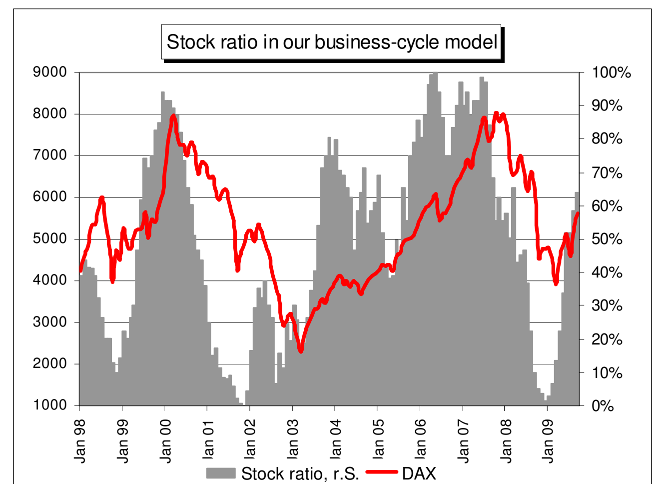
However, this account has a flaw or a large unknown factor. According to data provider Factset, corporate analysts expect that the earnings of DAX companies will increase next year by 35%, and those of S&P companies by 25%. In view of still existing economic uncertainties and historical development, those are extremely optimistic assumptions that certainly have potential for disappointment. However, it will not emerge until sometime next year how reliable the earnings forecasts actually are. The recently observed tendency to revise earnings estimates for the coming year upward is therefore likely to continue for a while.

In contrast to the forecasts of corporate earnings for 2010, analysts' expectations for the current year might actually prove to be too pessimistic. For the first two quarters, it turned out that companies registered a smaller than previously feared earnings decline thanks to good cost management. In the United States, almost 7 million jobs have been cut since January 2008, which is far more than in previous recessions. At least some of the job losses are probably structural, not cyclical, in nature. In the construction industry alone, 1.4 million jobs have been cut, and in the manufacturing sector 2 million. On the other hand, German companies have eliminated far fewer jobs, because they have tried to cushion the crisis-driven production decline by means of short-time work. But that entails cost disadvantages for the companies, as shown by the comparison of unit labor costs in the United States and in Germany. While US unit labor costs were at last count 0.6% below the year-earlier level, an increase of more than 8% was registered in Germany. That threatens to undermine the international competitiveness that German industry has earned in the past years.



Thanks to the huge savings, US companies might surprise on the positive side when the upcoming reporting season for the third quarter begins. For, US corporate analysts have recently further reduced their earnings estimates for the third quarter. As in the first and second quarters, the bar of expectations to be surpassed is not especially high, so the stock market should benefit from a number of positive profit surprises.

The upward trend on the stock market thus appears able to continue, and future price advances seem likely. We do not expect mounting risks until next year when exit strategies for expansionary monetary and fiscal policies are likely to be implemented. It is therefore a good idea to keep an eye on leading economic indicators. For the time being, however, they are likely to continue trending upward, even though their positive momentum may well have peaked. An increase of leading indicators with low momentum is the most likely scenario, in our opinion, but that need not be negative for stock market development. The situation will not become critical until the leading indicators start to fall again. Meanwhile, however, some time is likely to pass, so investors should utilize the opportunities that present themselves on the stock market.

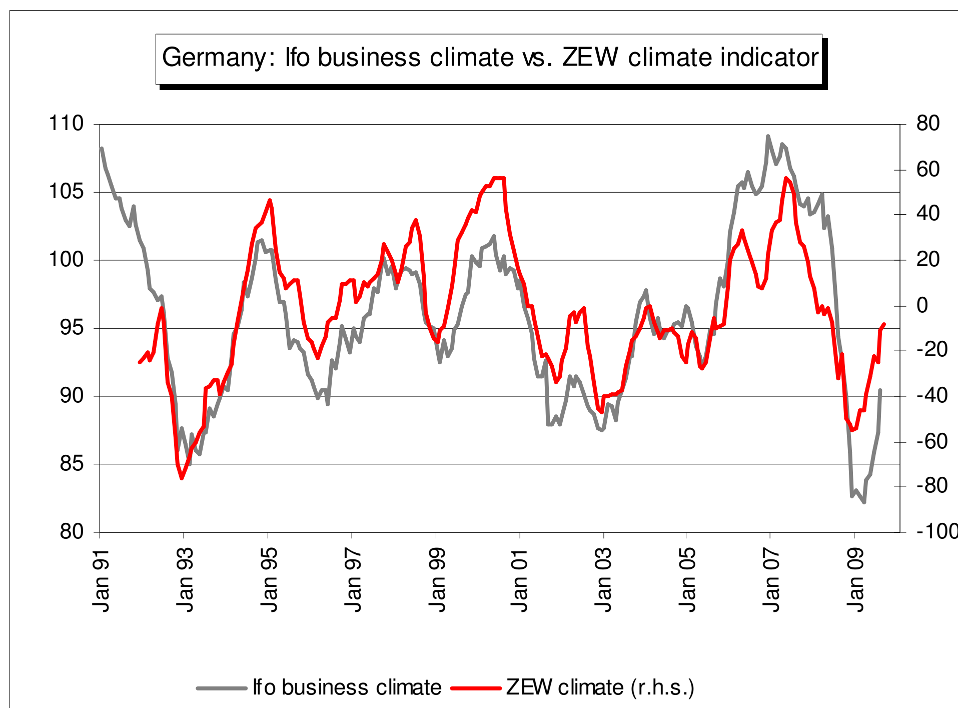


Weekly outlook for the period of September 21-25, 2009

	Apr.	May	June	July	Aug.	Sept.	Release
DE: PMI, manufacturing	35.4	39.6	40.9	45.7	49.2	52.4	Sept. 23
DE: PMI, services	43.8	45.2	45.2	48.1	53.8	56.6	Sept. 23
DE: Ifo business sentiment	83.8	84.3	85.9	87.3	90.5	92.8	Sept. 24
DE: Cost of living, prelim., m/m	0.0%	-0.1%	0.4%	-0.1%	0.2%	-0.1%	from Sept. 23
DE: Cost of living, prelim., y/y	0.7%	0.0%	0.1%	-0.6%	0.0%	-0.1%	from Sept. 23
DE: Import prices, m/m	-0.8%	0.0%	0.4%	-0.9%	1.5%		from Sept. 24
DE: Import prices, y/y	-8.6%	-10.4%	-11.3%	-12.6%	-10.7%		from Sept. 24
EU16: PMI, manufacturing	36.8	40.7	42.6	46.3	48.2	50.7	Sept. 23
EU16: PMI, services	43.8	44.8	44.7	45.7	49.9	51.6	Sept. 23
EU16: New orders, m/m	-0.5%	-0.5%	3.1%	3.5%			Sept. 23
EU16: New orders, y/y	-31.7%	-29.3%	-25.1%	-27.1%			Sept. 23
EU16: M3 money supply, y/y	4.9%	3.7%	3.5%	3.0%	2.7%		Sept. 25

MMWB estimates in red.

Chart of the week: In an updraft – Ifo index likely to rise further



The Center for European Economic Research (ZEW) released the results of its monthly economic survey of about 300 investors and analysts on Wednesday. Analysts' economic expectations and ratings of current conditions both improved in August, even though the increase was smaller than expected. That should not be overestimated, however. In June, the survey was disappointing and caused uncertainty among investors and analysts. At that time, the economic outlook had surprisingly dimmed although ratings of current conditions were again more optimistic than in the preceding month. Moreover, on the plus side there is the fact that the ZEW sentiment index calculated by us has improved significantly in the past few months. That is good news for the Ifo business sentiment index, which is to be published next week. Perhaps the most important German economic indicator, it has been highly correlated with ZEW sentiment, and improvements in ZEW sentiment have consistently been a good indication that Ifo business sentiment might increase further. We expect that the Ifo index will rise in September to 92.9 points. If the economic barometer advances further, the German stock market might also benefit from that – after all, Ifo business expectations show a highly parallel development relative to the stock market.

Financial markets at a glance

Stock markets	As of 17.09.2009	Change versus 11.09.2009 -1 week	17.08.2009 -1 month	17.06.2009 -3 months	31.12.2008 YTD
Dow Jones	9.784	1,9%	7,1%	15,1%	11,5%
S&P 500	1.065	2,2%	8,8%	17,0%	18,0%
Nasdaq	2.127	2,2%	10,1%	17,6%	34,9%
Wilshire 5000	11.008	2,4%	9,3%	18,0%	21,1%
DAX	5.731	1,9%	10,2%	19,4%	19,1%
MDAX	7.434	3,4%	16,6%	32,7%	32,7%
TecDAX	766	2,7%	11,9%	26,9%	50,7%
EuroStoxx 50	2.895	2,3%	11,2%	21,5%	18,3%
Stoxx 50	2.486	1,7%	8,9%	18,5%	19,3%
Nikkei 225	10.444	0,0%	1,7%	6,1%	17,9%
Topix	940	-1,1%	-1,1%	1,8%	9,3%
Bond markets					
3 months Euribor	0,77	-1	-10	-48	-213
3 months Treasury Bill	0,10	-4	-8	-7	-1
10 year US Treasuries	3,39	4	-11	-26	113
10 year Bunds	3,36	11	8	-12	42
10 year JGB	1,34	4	-1	-10	16
US mortgage rate	5,07	0	-22	-52	-7
IBOXX AAA, €	3,74	12	-1	-52	-143
IBOXX BBB, €	5,65	4	-7	-145	-312
ML US High Yield	10,49	-59	-112	-280	-905
JPM EMBI+, Index	485	2,2%	5,9%	11,3%	23,8%
Convertible Bonds, Exane 25	4.673	0,9%	4,6%	10,7%	20,6%
Commodities					
CRB Index	433,36	3,8%	6,5%	6,8%	19,4%
MG Base Metal Index	312,21	2,2%	4,0%	25,9%	82,5%
Crude oil Brent	70,06	0,3%	-3,0%	-1,8%	77,2%
Gold	1017,70	2,1%	7,5%	8,7%	18,0%
Freight rates Baltic Dry Index	2.390	-3,2%	-13,8%	-40,6%	208,8%
Currencies					
EUR/ USD	1,4712	0,8%	4,5%	6,3%	5,7%
EUR/ GBP	0,8916	1,9%	3,3%	4,7%	-7,8%
EUR/ JPY	134,38	1,3%	1,1%	0,8%	6,5%
EUR/ CHF	1,5187	0,3%	-0,2%	0,6%	2,3%
USD/JPY	91,05	0,4%	-3,7%	-4,9%	0,3%

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