

Strategy Research

Global Strategy Weekly

What next?

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Global asset allocation

%	Index	Index neutral	SG Weight
Equities	30-80	60	30
Bonds	20-50	35	50
Cash	0-30	5	20

Source: SG Equity Research

Equity allocation

Very Overweight	
Overweight	US UK
Neutral	Cont Europe
Underweight	Japan Emerging mkts
Very Underweight	

Source: SG Equity Research

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BEGINNING ON PAGE 4**

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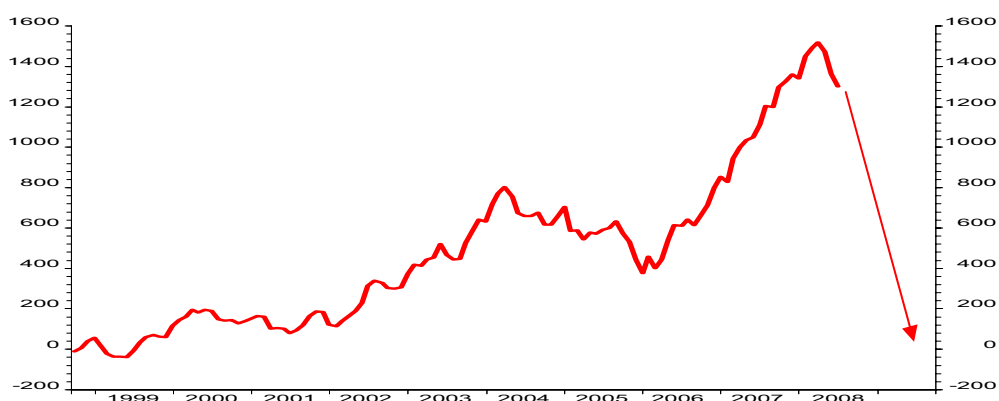
Recent events should not come as a surprise to those who, like us, see the US economy sliding into deep recession as a result of long years of grotesque debt excess. Amid recent chaos, few realise that the next phase of de-leveraging has only just started. A key pump for global markets and EM economies - global FX reserve growth - is only *now* beginning to reverse. All things EM related will crumble as *The Great Unwind* moves into a new phase.

■ I was recharging my batteries last Wednesday down in my apartment near Perpignan. Sitting on my balcony at midnight sipping some local Rosé with my good friend Dr Bob, we were discussing recent market developments and generally putting the world to rights. To our amazement the most stunning shooting star raced across the night sky and exploded spectacularly out to sea. Now on my return I did a little research. Amid this week's turmoil was it pure coincidence that a [Shooting Star](#) is a well known bearish signal for markets?

■ I had a similar oblique signal some six months ago on commodities. My fiancée, a press officer at a large Swiss investment bank, had been involved that day with the launch of some commodity related product. That evening I was regaled with the investment virtues of commodities backed up with arguments on the secular nature of emerging market economic growth. That's all fine and dandy, but this conversation was taking place at 11pm whilst I was in bed trying to get to sleep. I knew then that this was surely a signal that the end of the commodity bull market was close.

■ While most focus on the rapid deleveraging currently being forced on financial institutions, it is important not to miss that a rapid correction in the US trade deficit will now bring about a second round of financial de-leveraging. As the growth in global FX reserves begins to slump expect the credit crunch to intensify as EM economies slide into recession. Hence, as James Montier pointed out recently (see [Mind Matters: Financials - Opportunity or value trap?](#) 13 Aug) we would be shorting EM exposed banks such as HSBC, Standard Chartered and Banco Santander. Amid the chaos, *The Great Unwind II* has only just begun.

One key measure of global liquidity only beginning to decline – yoy chg in global reserves (\$bn)

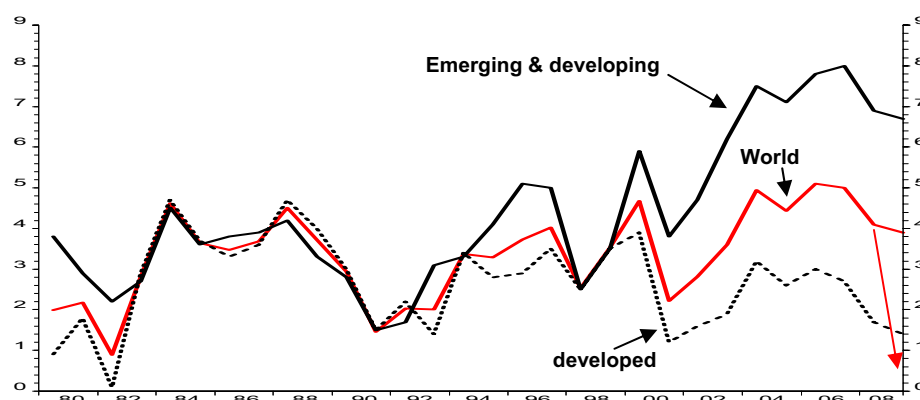


Source: SG Global Strategy, Datastream

A year ago our views were so far off the mainstream, we were treated by some clients as if we needed locking up under the mental health act. Yet now even some of our most dire forecasts are being accepted by market participants as mainstream. For example, the rapidity in the turn in sentiment against commodities has been stunning and as more accept that deep recession looms, deflation is even being talked about as a serious risk. Yet despite even some of the more extreme parts of our economic and market vision becoming mainstream, **there are still two key areas where we would continue to highlight that investors could be massively caught out.** First is the depth of the equity bear market that is likely to unfold. Our central case is that Ice Age multiple contraction will send the S&P down some 70% from the peak to 500 (we will re-visit our arguments for this outcome next week).

The second event that will shake investors to their core over the next year is a collapse in emerging market (EM) economic growth (and all that brings). The consensus still touchingly believes that despite a deep economic downturn in developed economies, continued rapid EM GDP growth will keep overall world growth resilient in the 3-4% range next year (see chart below for a consensus (IMF) view for 2009, but my red arrow added). My own view is that outright contraction of global GDP is entirely possible next year.

Sources of world GDP growth (IMF definition, PPP-weighted)

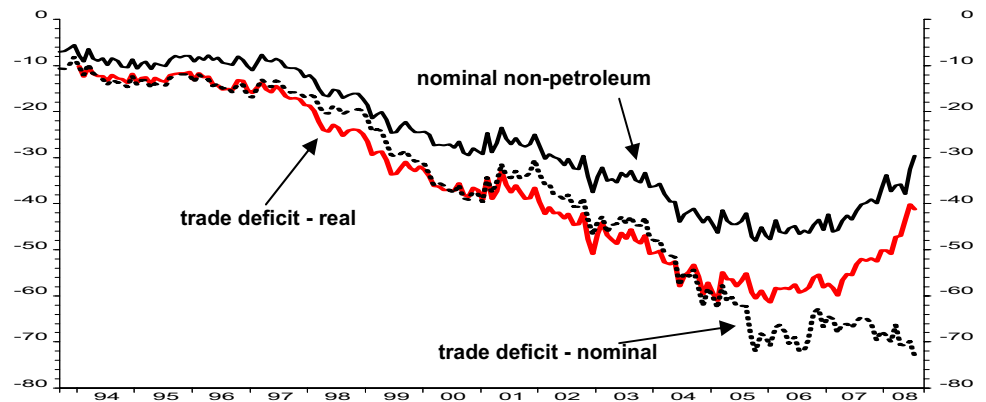


Source: SG Global Strategy, Datastream

Our argument for EM recession hinges on the improving US trade deficit. We articulated the argument in detail back in April when we explained why commodity prices would collapse (see [GSW 18 April](#)). The causality is simple. Surplus savings in Asia and elsewhere in the EM world *are the result* of the US consumer and housing boom (the argument from Greenspan and Bernanke that causality is the other way round is self-serving rubbish). High current account surpluses in EM economies are the mirror image of the US's huge current account deficit, which peaked out at 7% of GDP. To prevent EM currencies from rising against the dollar, EM central banks have been intervening heavily in the FX markets and as a result, their FX reserves have exploded over the last year (see front page chart).

EM FX intervention is pure monetary creation, which inevitably spills over into rapid EM money supply growth, underpinning EM domestic demand and asset price booms. **Hence the US consumer has not only boosted EM growth directly via exports, but also indirectly via EM central bank liquidity creation.** Buoyant EM economic conditions in turn sucked in bond and equity investors forcing the EM authorities to print money *even more* aggressively to keep their exchange rates pegged. It was a virtuous circle that has gone on virtually unchecked for the last decade as the US trade deficit continued to increase (see chart below).

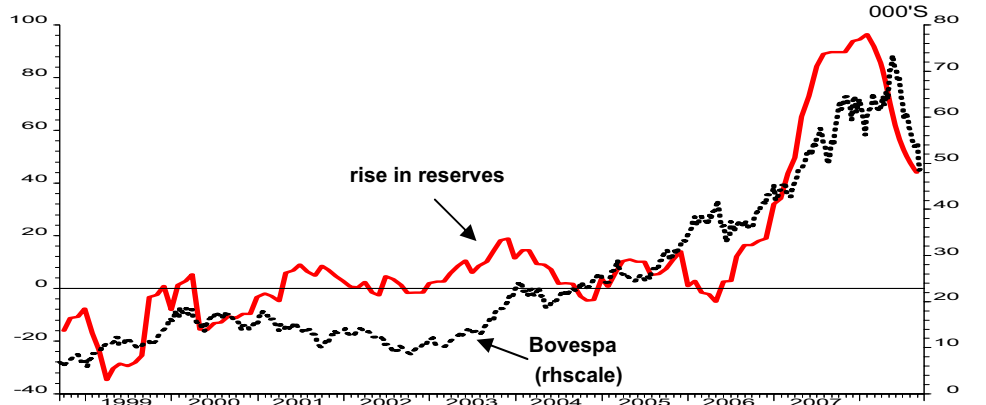
US trade deficit (\$bn, monthly)



Source: Datastream

This rapid growth in global liquidity (as measured by global FX reserves) has been providing rocket fuel for the rapid EM growth that we now all take for granted is structural. But this virtuous cycle has now turned vicious as the US trade deficit evaporates. Indeed if one excludes petroleum imports it is already clear that the US trade deficit is already falling quickly (see chart above - note also that in constant prices, the *overall* trade deficit is collapsing). Hence a liquidity squeeze has *already* been transmitted to non-oil producing nations as growth in EM FX reserves slows rapidly (see chart below, we chose Brazil because it is one of the most favoured EM markets currently). Indeed in recent weeks we can see investment flows reversing out of many EM markets and hence EM central banks have been intervening to prop up their currencies. Totally separate from the ongoing credit crisis, a new type of liquidity squeeze has just begun. It is *The Great Unwind Part 2*.

Brazil growth in FX reserves (\$bn yoy) and Equity prices (Bovespa)



Source: Datastream

As the baton of domestic US recession moves from the housing sector (which has a very low import propensity) to the consumer (which has a high import propensity), expect the headline US trade deficit to almost totally vanish over the remainder of this year. Hence the EM liquidity squeeze will intensify ferociously and much to the shock of most commentators, recessions will unfold in the EM universe (including China in case there is any doubt). All things connected with EM will become toxic waste. And as we highlighted on the front cover, that includes previously resilient banks such as HSBC, Standard Chartered and Banco Santander.

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