

Flash Comment

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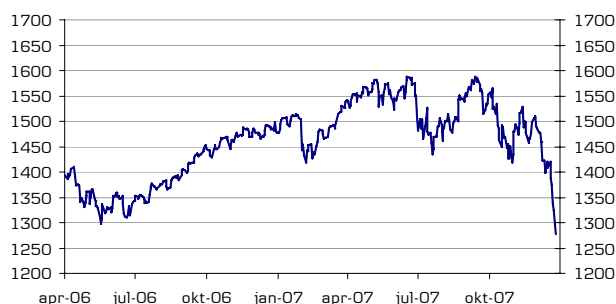
Global – More uncertainty in financial markets

After significant negative newsflow over the last week, the financial markets have again been caught by fears of a US recession and a worsening of the problems in the financial sector (see overview at the bottom of this note). This has led to significant declines in equity markets around the world today. The pace of the decline has been very strong and indicates that investors that have been long equities are now taking their losses.

The rising risk aversion is also visible in credit markets where credit spreads are widening further. Government bond yields are falling rapidly as the rise in risk aversion is fuelling flight-to-safety assets and expectations of more easing from central banks is factored in. JPY and CHF are gaining as you would expect when risk aversion rises. With economic concerns becoming more global, USD has been strengthening – regaining some of its safe haven status on the account of a weaker EUR.

With the rapid decline in asset prices, the risk of further negative impact on the global economy is rising. The magnitude of the negative shock is hard to quantify but the risk of a negative spiral in the global economy is rising at the moment. This also increases the probability of more and potentially sooner rate cuts from the central banks if financial markets do not stabilise soon. Our baseline scenario is still that the Fed will cut by 50bp on 30 January, but if the financial crisis continues to worsen over the coming days, a 75bp cut cannot be ruled out. Further, the risk is that the ECB could be cutting rates sooner (possibly in June) than our current baseline of a rate cut in September and December.

Equities taking big hit (S&P500 index future)



Credit spread widening again (Itraxx cross-over)



Where to go from here?

At the present time, it is very difficult to call a bottom in the **equity market**, but if the incoming data over the coming weeks confirm that the US has sunk into a recession, then equities may still have some way to fall. We are, however, still not certain that a recession is a given, and in the light of this we believe that the latest market correction provides some scope for a calmer market in the next few weeks. Panic selling is rarely a good idea and we are not of the opinion that investors should dispose of additional exposure in the short term. In our view the market needs time – and the data for February and March – before possibly dropping further.

In conclusion, it is, in our view, too early to increase long-term equity exposure. We would use a temporary market upturn in the coming month to reduce equity exposure as 1) The psychology prevailing in the market is too negative, and 2) The expected volatility is currently too high to make long-term investment decisions. We will focus on especially job market data, consumption data and industry data in February for the US economy to confirm or dismiss a recession.

In the short term, **bond markets** are likely to trade on the back of the general risk appetite and hence be very highly correlated with equity markets. If we see more capitulation in equity markets, bond yields might be able to fall a bit further. As equity markets find a bottom, though, we would expect bond yields to take some of the recent declines back. Overall, we would recommend playing the bond market from the “long side” and not try and catch a falling knife. That is; should we see a correction higher in yields this should be used to position for another decline.

The **Emerging Markets** until now have been surprisingly resilient to the general worsening of the global financial environment. However, there are now clear signs that the Emerging Markets are “caving in” under the pressure from the global credit markets. Hence, most Emerging Markets – equity, fixed income and FX markets – have been under serious selling pressure today.

In our view, there is a risk that the global investors are giving up on the idea that Emerging Markets can decouple from the global markets. Hence, Emerging Markets have to a large extent been the “last man standing” in recent months. Therefore, if the global market sentiment continues to worsen the drop in Emerging Markets could potentially be large. We are especially concerned that countries with large funding needs could take another beating. Here the EMEA markets look especially fragile – so currencies like the Turkish lira and South Africa rand (and for that matter the Icelandic kronur) could weaken more than they already have done. The “safe haven” in the present environment among the Emerging Markets would clearly be the Asian currencies. The Russian rouble should also to some extent be seen as a safe haven in the Emerging Markets universe due to Russia’s strong external balances.

The performance of the LATAM markets will to a large extent depend on to what extent the commodity markets react to the rising recession fears. If we see a sell-off in the global commodity markets then the LATAM markets seem destined for a strong sell-off.

Overview of the past week’s negative events

Below is a list of the negative events over the past week that have contributed to fears in the market:

1. The Q4 earnings releases from Merrill Lynch and Citigroup last week, with a total write-down from sub-prime assets of almost USD 30bn, were a reminder that further write-downs from major investment banks may be in the pipeline. Total write-downs currently stand at around USD 110bn,

but estimates of total losses range between USD 150bn and USD 400bn. Market rumours of further write-downs are frequent.

2. The monoliner industry, insuring around USD 2,400bn in transactions, has come under further pressure. One of the large players in this market, Ambac, was downgraded to 'AA' (from 'AAA'). Ambac and the largest monoliner, MBIA, were put on credit watch with negative implications. In conjunction with serious troubles at ACA, a small monoliner, these events illustrate the serious troubles facing the monoliner industry, which guarantees around USD 2,400bn of debt. The downgrades from 'AAA' of all monoliners could cause total losses of about USD 200bn across the bond market, according to Bloomberg data.

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