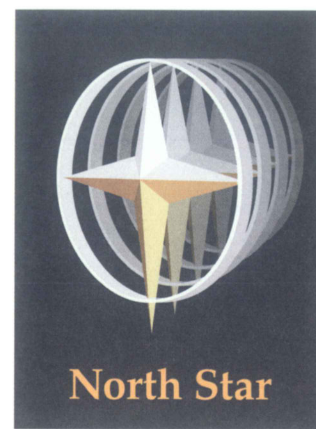
North Star News



August 2010

Dear Investor / Intermediary,

The world seems to move from crisis to crisis. Just as the repercussions of the subprime crisis emanating from the US seemed to be subsiding, Europe took over the baton with a sovereign debt crisis. While not registering the same strength on the financial Richter- scale as the subprime crisis, the European successor has sent shock waves through the markets and highlighted, once again, the hazards of indebtedness, this time in the public sphere. So where do we go from here? In addressing this question we begin, as usual, with a look at the US, move on to Europe, and finalise with a view of the international financial markets.

The US: A Serial Dipper?

One phrase which has re-entered the vocabulary of market commentators is that of a "double-dip", the notion that the US economy could fall back into a recession after having exited from the previous one only about a year ago. Most economists dismiss the idea and we would concur. Double-dips are rare indeed not least because recessions, especially when they are as deep as the most recent one, leave few excesses untouched, such as the prices of financial assets and houses. Put differently, after a recession there are typically few bubbles left to burst, and a double-dip would therefore require some other shock to the economy, such as an extreme increase in interest rates, which it is difficult to envisage in the current scenario.

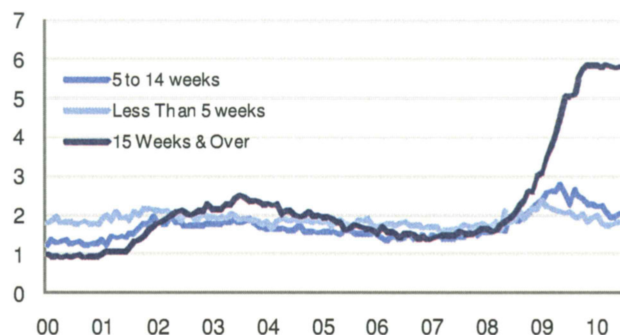
But a double-dip is not the only adverse scenario imaginable. Hard data, forward-looking indicators, and underlying fundamentals all suggest that a slowdown to a growth level well below that registered in the first half of 2010 is in the offing for the second half of the year.

To start with the hard data, GDP growth slowed from an annualized rate of 3.7% in the first quarter to one of only 2.4% in the second quarter and importantly household consumption, constituting nearly 70% of GDP, grew only 1.6%. While hardly the stuff of a recession, it appears that the positive effect of inventory growth is petering out and that housing demand, and with it demand for household appliances, saw a sharp setback as soon as the tax credit for new home purchases expired mid-year.

Forward looking indicators, such as the ISM Manufacturing index have rolled over and while the level of the indicator is still consistent with a relatively high growth rate its trend appears to be clearly downward. As important as this are the underlying factors. Apart from the inherent weakness in housing demand and the persistent signs of an excess supply of homes, the job market remains exceptionally weak with a much higher than usual number of long-term unemployed (see chart). The growth in household incomes provides no background for acceleration in spending, and consumer sentiment remains stuck at a level consistent with low growth in consumption. All in all, the data, indicators, and underlying factors suggest

a growth rate in the region of 1.5% in the second half of the year against approximately 3% in the first. The outlook for 2011 hinges critically on any new growth initiatives and on whether the tax cuts implementing under the Bush administration are finally allowed to expire or will be renewed. The political process will thus play a critical role from now on.

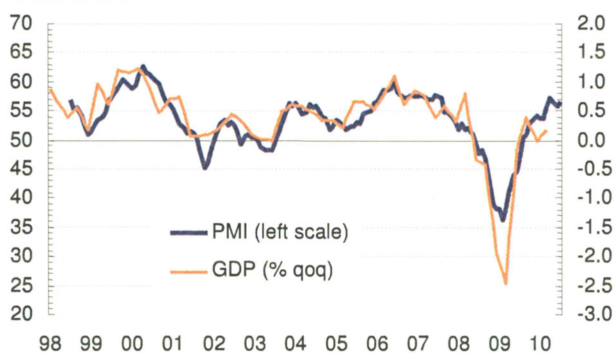
US Unemployment Rate (Duration), %



The Eurozone: growing divergences

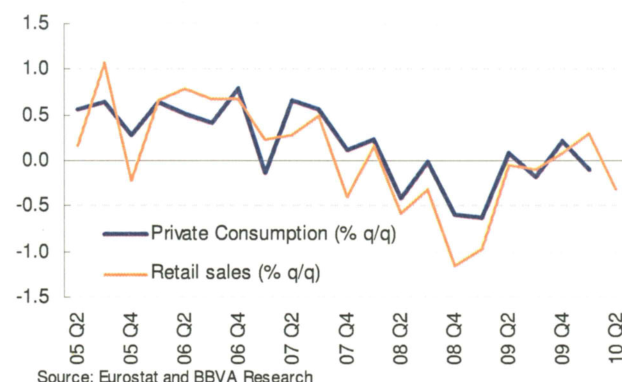
The characteristic that stands out most clearly in the current scenario is the difference in economic performance between Germany and the rest of the major Eurozone economies. Germany's competitiveness has improved over the past several years compliment of previous years' labour market reforms, wage moderation, and improvements in productivity, and German companies have been particularly well positioned to benefit from demand for capital goods from Asia. At the other end of the scale are the peripheral economies like Italy, Spain, Portugal and Greece, suffering the combined effect of a weaker housing market, structural problems in the labour market and, most recently, the financial effects of the sovereign debt crisis (see below).

Eurozone Composite Purchasing Managers Index and GDP



The sovereign debt crisis prompted plans for fiscal consolidation of varying degrees across the board of the Eurozone countries, a fact which spurred pronounced pessimism in the markets with respect to growth. But both hard data and forward looking indicators like the PMI index have subsequently surprised positively, leaving markets perplexed and ultimately reversing the relative underperformance of the Eurozone markets vs. those of the US (see further below). Still, the overall scenario does share the feature of sluggish consumption demand with the US and some loss of growth momentum for the second half of 2010 does look likely, dragging GDP back below 2%.

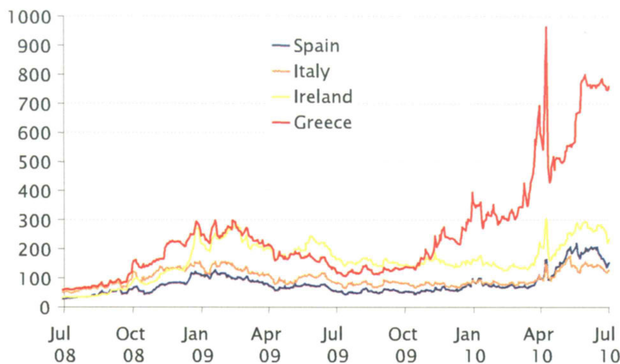
Eurozone: Households' Consumption



Source: Eurostat and BBVA Research

The Sovereign Debt Crisis: A Greek Tragedy

As is well known, Europe's sovereign debt crisis emanated from Greece, dating back to late 2009 when the country's newly elected government announced that its public deficit would be considerably higher than previously estimated, and hinted at prior accounting irregularities. Market concerns peaked around April of this year at which point the general feeling was that a Greek default was now overwhelmingly likely. Given the modest size of the Greek economy, a default might not have created more than a temporary stir under different circumstance. But the markets soon zoomed in on other countries whose fiscal situation might place them next in line. Starting with Ireland and Portugal focus was finally squarely on Spain, a much bigger economy with much greater potential ramifications for the rest of the currency bloc. Even with a high deficit level, given Spain's relatively modest level of public debt, it is debatable whether a Spanish default was ever very likely. But markets began to focus increasingly on the level of *total* debt, i.e. including that of the private sector which in Spain's case is among the highest in the Eurozone. Even more seriously, accounting data showed that European banks, especially in Germany and France, were heavily exposed to the debt of the peripheral markets in general, implying that default on a larger scale could prompt similar defaults in the banking sector.



This suggested the need for a joint intervention from Eurozone governments which finally arrived, after considerable political tension, in the form of a European Stabilisation Fund designed to provide available funding for any country having difficulties accessing the markets. A series of relatively successful bond auctions on the part of Spain and the subsequent publication of better than expected results of a Stress Test for the European banking system finally managed to calm markets. The above chart shows 10-year spreads over Germany. As can be seen, most spreads have narrowed significantly from their peak even if they remain high. Importantly, the Greek spread has remained at unsustainable levels, signalling that even if the country can now use the Stabilisation Fund to avoid accessing the bond market for a couple of years a default is clearly seen as the end-game and is now almost fully priced in.

Equities: Shifting Focus

The stocks market has seen significant changes in sentiment over the year. The very beginning of 2010 saw a continuation of the bullish trend that commenced in March of 2009, spurred in great part by the signs that both the US and Europe were in recovery mode. The sovereign debt crisis interrupted this violently and prompted a significant underperformance of the Eurostoxx index vs. the S&P. Equities began to rally again when the sovereign debt crisis appeared to abate with the European markets closing part of performance gap to the US. Corporate results out of the US have generally surprised positively. This reflects in part the advantages of international diversification available to major companies and therefore seems to contradict the relative weakness seen in the macro figures. Earnings estimates for 2010 look likely to be met and might even be surpassed. Estimates for 2011, however, seem to err on the side of optimism, suggesting that the macro concerns could soon enter the equation again. Market movements continue to be range-bound, albeit with a higher level of volatility than last year. We expect this to continue throughout the remainder of the year, with a year-end stock market level not far from the current both in Europe and the US.

Bond Markets: Gloomier than Stocks

For economic optimists one of the most disconcerting facts this year has been the unremitting trend towards lower long term government bond yields in the core markets (US & Germany). To be sure, these markets have benefited from a flight-to-quality from the European peripherals and have generally seen an inverse correlation with credit markets and stocks. But this hardly explains everything. A market prediction of a recession or a sharp economic downturn would normally appear in the form of an inverse yield curve, with long-bond yields below those of short-dated bonds. Given the extreme laxity of monetary policy generally such a scenario is ruled out beforehand. But the near 100bp drop in US 10-year government bond yields this year must be attributable to an implicit prediction that economic growth will falter later this year and next. While the curve looks unlikely to invert, the market has indeed been moving it in that direction recently with a flattening between the 10 and 2 year sectors of around 40bp (see below chart).

In the short run, we would expect a backup to somewhat higher 10-year bond yields in the US and Germany and an improved performance of credit in general and mortgage instruments in particular. Looking towards year-end and into 2010 we would expect the core markets to be well-bid once more as it becomes even clearer that central banks will remain on hold for as far as the eye can see.

FX: The Clash of Two Wounded Titans

At the height of the European sovereign debt crisis in April, US economic figures still looked significantly more buoyant the European ones, and the US dollar rallied with a vengeance against the euro, briefly touching a level below 1.20. Now markets are no longer so sure. Firstly, the sovereign debt crisis seems, at least for the time being, to have been put under control. Secondly, as discussed above, the Eurozone has turned in surprisingly solid figures since then, while the US has disappointed. The manifestation of this in the money market is shown in the chart below which plots the 3 months rate differential between the US and the Eurozone 6 months into the future against the performance of USD/EUR.

This spread is effectively the markets' bet about relative monetary policy into the future and the prediction is now that the policy of the US Federal Reserve will remain lax for longer than that of the ECB.

3m/6m forward rate spread & USD/EUR

While this is the current market sentiment, we believe things could well change again later this year and in early 2011.

Firstly, Eurozone growth looks likely to eventually track that of the US lower, and the effect of positive data surprises will be reversed. Secondly, while a return to the sovereign debt crisis in full blast now looks unlikely, the fiscal problems facing Europe's peripheral market look likely to prompt renewed concerns at a later stage. In summary, we believe the euro is close to its peak for this year and looks more likely to have reached a lower level against the dollar by year-end.

Yours sincerely,

North Star Fund Managers (Cayman) Limited

Mogens Kjøller-Petersen
Chairman

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