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Sarasin's Strategy Outlook: Global economic recovery underpinned by Emerging Markets – Central bankers likely to maintain accommodative stance

Emerging Markets' growth, particularly in China and India, will be critical to the recovery of the developed world's balance sheets, according to Sarasin Group's latest Strategy Outlook. With some positive economic data emerging, investors are now concerned by the hangover created by unprecedented economic stimulus, note authors Burkhard Varnholt, Chief Investment Officer, and Guy Monson, Chairman of the Investment Policy Committee, at Sarasin. Given slower global economic growth and heavy reliance on domestic demand in the Emerging World, Sarasin believes central banks will be extremely cautious with regard to withdrawing today's super-accommodative stance, known as Quantitative Easing.

In mid-June, bulls found some data to cheer about. While the World Bank predicted that China's economy will grow by 7.2% this year, in June Germany's ZEW economic expectation index jumped to its highest level since mid-2006, and, in the same month, the much-watched Philadelphia business index rose to its highest level since September 2008. This suggests a summer rebound in the US and UK economies, and an inventory-led rise in industrial production across the G7.

Guy Monson, Chairman of the Investment Policy Committee

"Investors are nervous about the fragility of the economic recovery. They are suffering vertigo from the recent surge in stock market valuations and are rightly concerned about the cost of the cure for the global financial crisis. But there is positive news, with recoveries in the US and the UK in sight."

Burkhard Varnholt, Chief Investment Officer

"We used to say that a good central banker would remove the punch bowl just as the party was getting going. But now we believe the central bankers need to keep the punch bowl full to make sure the party doesn't stop. An increase in money supply to offset falling industrial production will drive an increase in some assets and markets."

China's domestic demand contributes to growth

While the World Bank has argued that China's growth is being driven by massive fiscal stimulus and monetary expansion (6% of the 7.2% GDP growth forecast), domestic demand is contributing more robustly. While Chinese exports have dropped 26.4% in the year to May, retail sales are up 15.2%, housing sales up 26.7% and investment up 32.9% over the same period. Brazil and Russia have benefited as aggressive growth policies in China have driven commodity prices and sales. India has also been resilient, with private consumption up by 2.3% year-on-year Q1 2009. But while these economies show some increase in domestic activity, Sarasin forecasts that the Emerging Markets will not resume their exceptional pre-crisis growth dynamics, especially given that stimulus packages will be smaller next year. Global activity will suffer, suggesting the rally in weaker cyclical companies and oil prices may be overly optimistic.

The hangover needs a cure

The hangover from the global financial crisis may yet be painful, with the IMF estimating terrifying levels of budget surpluses that must be run by Western economies just to stabilize their debt-to-GDP ratios. Rumblings about the US

Dollar continue as yields on US 10-year Treasuries head toward 4%. Pressure on European banks, which may face additional losses of EUR 283 billion by end-2009, saw record demand at the 24 June European Central Bank's one-year fund auction. Meanwhile, Standard and Poor's reported that the value of defaults in May was the largest in 2009 and close to the September 2008 total, when Lehman and its affiliates became insolvent, suggesting weak private-sector balance sheets. The commercial property markets across major economies are feeling similar stresses, with credit still severely rationed.

Central banks will support liquidity

With slower global growth and heavy reliance on Emerging Markets' domestic demand, Sarasin believes that central bankers will be extremely cautious with regard to tightening monetary policy. Christina Romer, Chair of Obama's Council of Economic Advisers, the Bank of England and the Swiss National Bank have each noted the risk of too little stimulus. This creates the possibility that investors may enjoy a "Goldilocks" scenario, in which either global growth recovers or central banks maintain greater liquidity.

Global Investment Strategy Implications

Sarasin continues to recommend that investors should hold quality stocks. The Group continues to increase our Emerging Markets exposure, with a focus on China, India and the Gulf States, although with short-term caution given the recent market rebounds. Sarasin believes that the Swiss National Bank's aggressive exchange-rate policy represents a good buying opportunity for CHF-based investors. Sarasin is somewhat suspicious of the extraordinary rise in oil prices, and recommends a cautious approach. The Group remains enthusiastic over the long-term with regard to selected commodities, including agricultural "softs" and selected gold and platinum holdings.

The quarterly Strategy Outlook is available from media@sarasin.ch or visit www.sarasin.com.

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