Global Investment Outlook

By: Steven Bell, Global Chief Economist for Deutsche Asset Management, 01 May 2001

Steven Bell is the Global Chief Economist for Deutsche Asset Management (DeAM), part of the Deutsche Bank Group. Based in London, he is a member of the Investment Policy Committee and is responsible for formulating the economic strategy which underpins the investment process of DeAM. Steven Bell was in the Channel Islands recently to address financial intermediaries and guests of Deutsche Bank Offshore on the global economy as he sees it developing:

Economic forecasters are worried. The US economy is close to recession and clear signs of economic slowdown are evident in almost every country. Hopes that the slow recovery in Japan, the world's second largest economy, would continue unabated have been dashed by recent data that has shown a sharp deterioration, notably in the industrial sector. Euroland should be in much better shape: it faces neither the structural problems of Japan nor the collapse in the technology boom and over-stretched balance sheets of US consumers and businesses. Yet even here, growth has been disappointing. Some slowdown in the traded goods sector was to be expected given the dramatic decline in domestic demand in the United States but consumer spending growth has also slowed in Euroland, disappointing those who had expected it to accelerate in response to tax cuts and rising employment.

We believe however, that we are at or close to the turn. Although global GDP growth is likely to remain sluggish through much of this year, we expect leading indicators to turn up over the next few months and signal a recovery in 2002. This judgement is based partly on the dynamics of the leading indicators themselves but also reflects the fact that the forces that led to the downturn in the first place have gone into reverse.

The Federal Reserve has responded to the economic downturn in the US with an aggressive easing of monetary policy. They have cut the Federal funds rate by 200 basis points so far this year and stand ready to act again. In previous steep downturns the authorities pushed the Federal funds rate down to zero in real terms. With inflation so low, this would imply US short-term interest rates of only 2%. We do not expect that the economy will need this degree of monetary stimulus but it does serve to illustrate that the Federal Reserve has enormous firepower to meet the economic downtown. Some economists have argued that monetary stimulus is impotent in current circumstances, citing the fact that Fed easing has failed to weaken the dollar. We admit to being puzzled by the dollar's strength, however the latest half point cut in rates on the 18th April appears to have been more positively received by the stock market.

This is not a classic bear market, as defined by a sustained, broad-based downturn in stocks. Rather, what we have experienced is a set of rolling sector corrections and rallies. The formation and then bursting of the technology and telecommunications bubble has been extreme enough to drive the market averages dramatically up and then down, and the manufacturing cycle has slowed US economic growth from 6-8% to near zero.

Given the dramatic falls we have experienced in equities, much bad news is priced into markets. To be bearish now suggests that the world is heading for a sustained business slump, driven by US imbalances in technology spending and consumer debt. While we believe there is some risk of this, a much more likely scenario is reflation of the world economy via tax cuts, monetary easing and stabilising energy prices. Equity and bond

valuations now reflect a significant slowdown in growth and profitability. Overall, we are closer to the end of the stock market pain than the beginning.

On a tactical basis, stocks are as cheap now as they were expensive a year ago. Even on lower earnings growth expectations, short-term interest rates and long-term bond yields have fallen enough to create a strong contrarian buy signal for equities. While bonds have rallied everywhere during this slowdown, the largest change has been in the United States, where yields are between 4-5% and two year rates have fallen over 2% in the last 12 months. US yields have now essentially converged with those in Europe. Government yields have the potential to fall further on continued negative news flow, but the rally is stalling as markets have already priced in further global interest rate cuts.

Recent weakness has left equities looking cheap relative to bonds and cash. As a result we remain modestly overweight equities, as valuations have reached extreme levels following six months of weak markets. From a medium-term perspective this will be seen as a significant buying opportunity. But timing the short-term bounce is difficult, as we cannot yet confirm a bottoming in earnings revisions or economic leading indicators. We would like to add to equity positions once a turn in the cycle is more apparent.