The market and the economy in 2009

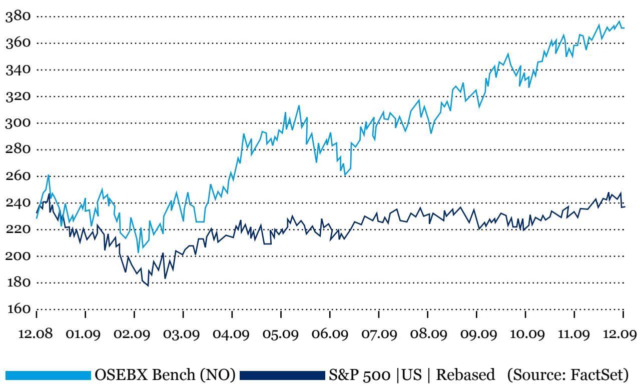
Pareto has always sought to understand companies, industries and long-term development trends rather than timing peaks and troughs in the market. The reason is simple: short-term prediction of the market is notoriously difficult. Developments in 2009 provided a striking example of this.

Not since the 1930s had pessimism been so deeply rooted as it was at the outset of 2009. Over the course of little more than seven months, US stocks (S&P 500) had dropped by almost 37 per cent and bond buyers were demanding sky-high risk premiums: globally, high yield bonds recorded spreads of up to 2,000 basis points.

In Norway, the stock market response was even more profound: the Oslo Børs Benchmark Index fell by more than half and the pessimism continued into the new year. By 3 March, the Benchmark Index had fallen by a further 12 per cent.

But then the situation reversed. And when the upturn finally arrived, it came in spades – not least in Norway. Having bottomed out, the Benchmark Index soared by over 88 per cent by the end of the year. We would be hard put to find a better illustration of the importance of patience and a long-term stance in the equities market.

Sea change on Oslo Børs

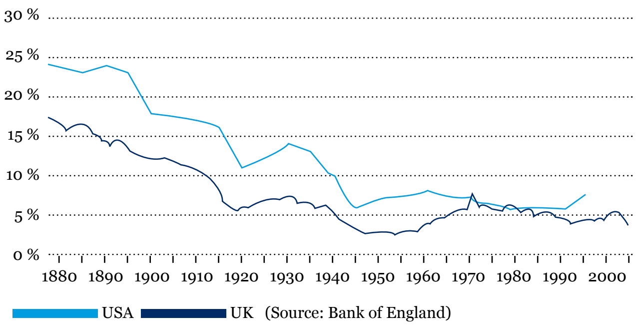


The Norwegian stock market bottomed out at about the same time last year as the US market, but went on to perform significantly better.

But why were the reactions so dramatic?

At this point it might be useful to recount the financial crisis, starting with the fundamentals: within a very short space of time the realisation emerged that financial institutions worldwide were risking major losses on lending and other investments. At the heart of the financial crisis lay the danger of major financial losses.

Steadily falling capital adequacy



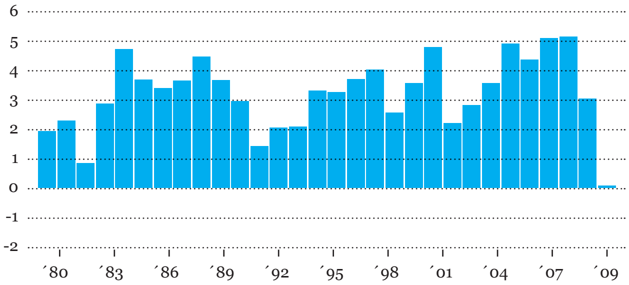
The capitalisation of banks in several countries had been falling for years. This made them more vulnerable when the crisis came.

And big the losses would be. In October of 2009 the IMF put expected losses at 3,400 billion dollars, of which 2,800 billion would be sustained by banks and the rest would be distributed between insurance companies, pension funds and other financial institutions.

Simplifying somewhat, we can say that the extensive losses can be attributed to a combination of two factors: firstly, the market was overstretched. Low interest rates and the widespread availability of credit had pushed up credit volumes and asset prices in a number of countries, not least the United States. This drove both housing prices and share prices upwards. In a parallel development, the gearing ratio of many home owners and financial investors was increasing. Similarly, financial institutions in many countries were over-extending themselves through steadily decreasing capital adequacy and the creative evasion of capital requirements. All this meant that there was a long way to fall and that the potential for losses was considerable.

Secondly, the risk of triggering such losses was even greater than had been initially realised by the market. The securitisation of top risk mortgages in the US (subprime loans), the lack of understanding of financial innovations and the emergence of poorly regulated banking operations alongside the ordinary banking system – known as the shadow banking system – had both concealed the risk of losses and increased the actual level of risk.

Dramatic falloff in growth



Per cent global GDP growth, historical and estimated (Source: IMF)

During the period from 1980 to 2008, the world economy grew by an average of 3–4 per cent a year. In 2009 the growth disappeared.

On both points – the size of potential losses and the probability of losses – the situation had reached historical levels. When the market discovered this combination and realised how dire the situation actually was – when it became clear to all that potential losses could become actual losses – the downturn was amplified by good old-fashioned fear.

After this we saw an unusually exciting tug-of-war between negative effects and counter-measures. In the first round it was apparent that the knock-on effects would in any event be enormous. Estimates by the IMF show that global growth shrank from a solid 5.2 per cent in 2007 to -0.8 per cent in 2009 – significantly worse than all other years in the IMF database. Later this was revised upwards to zero growth.
However, the counter-measures too were of historic dimensions. Last year the IMF estimated that the support measures announced by the advanced G20 countries amounted to some 5.7 per cent of GDP. Never before has a stronger dose been administered. And it would take time before the full effect was felt. By the autumn of 2009, the advanced G20 countries had used up half of the capital injections that had been adopted.

In retrospect it seems clear that support measures of this order would have to work and that their effects would be powerful. Even so, it was not until the spring of 2009 that this realisation sank in sufficiently for financial markets worldwide to shake off the fear of an even worse downturn.

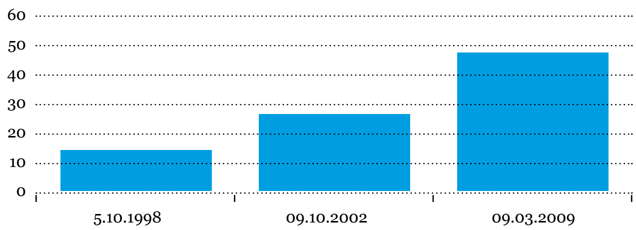
At the same time, there was a dawning awareness that demand in the emerging economies, not least China, was far more robust than had been widely feared. In part, this was because these countries had reached a level of development at which they were no longer so dependent on the West, in part because they had higher levels of savings and lower debt entering the crisis. Moreover, they had now reached a sufficient size in economic terms to make their presence felt in the world economy. This became steadily more apparent as 2009 unfolded.

Accordingly, the rational foundations for renewed growth were in place. The effect on markets that shortly before had swung from naïve over-optimism to exaggerated pessimism was dramatic. And once again the effects were enhanced by a large-scale synchronisation of the world's securities markets. First they had dived in concert, now they were rising in concert.

This has clearly served to undermine the argument that the globalisation of securities markets would reduce their volatility. It has also undermined the idea that risk can be easily controlled by diversification and hedging. One obvious conclusion to be drawn from this is that healthy equity levels and common sense can, when it comes down to it, not be replaced by models.

In 2009, however, few complaints against this synchronisation could be heard. By the end of the year, the S&P 500 had reached a level that was 26.5 per cent higher than at the previous yearend, while the Morgan Stanley Capital International World Index had risen by 30 per cent. Moreover, bond spreads were down by up to 70 per cent from their peak levels.

Deepest crisis, highest oil price



Average oil price (Brent Blend) 25 trading days before and after trough levels for the Morgan Stanley Capital International World Index. (Source: FactSet/Pareto)

Although the stock market downturn was far deeper this time around, the oil price fall was halted at a much higher price floor.

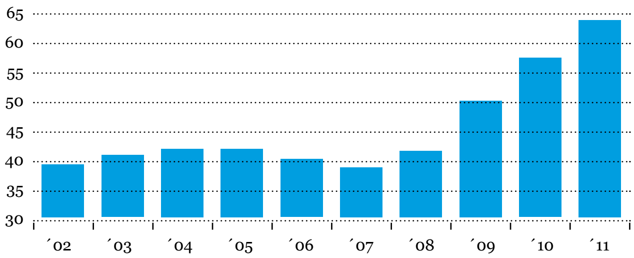
By comparison, Oslo Børs rose by no less than 64.8 per cent during the course of the year. Was this simply a classic bounce by a particularly volatile stock exchange?

Not at all. Because on one point this financial crisis differs markedly from earlier crises and stock market slumps: the oil price remained far higher. Whereas, for example, the Asia crisis sent Brent Blend down to approximately 12.50 dollars, the financial crisis – which was a far more serious crisis for the world economy – merely lowered the oil price to somewhere around 48 dollars. This is calculated as an average of price quotes during 25 trading days before and after the stock market bottomed out. It is true that the oil price had risen far higher before things went awry this time, but we don't need to look that far backwards in time before 48 dollars would be perceived as a remarkably high price.

Accordingly, it is not difficult to understand that Oslo Børs, with its high proportion of oil and energy related stocks, performed far better than other exchanges. This came as something of a relief to Pareto, which focuses on industries in Norway that enjoy particular advantages – not least oil and energy related shares.

At the start of 2010, the support measures have become the greatest cause of concern for the markets. Worries now centre around public sector debt problems and the danger of higher inflation further down the line and, not least, future belt-tightening measures in order to rein in these debt problems. Major price fluctuations thus far into 2010 indicate that the market is bewildered as to future developments.

Significant debt growth



Net public debt as a percentage of GDP, OECD total. (Source: OECD December 2009)

This is what investors are concerned about at the outset of 2010: The abundant stimulus measures within the OECD are contributing to a sharp increase in debt. Will this result in corresponding austerity measures further down the line? Or will we see a rise in inflation?

Pareto's basic outlook on both the Norwegian economy and the international economy is optimistic and we are convinced that well-run companies will pull through this period of turbulence, as they have pulled through earlier crises. Some will even emerge strengthened. The important thing is to make the right choices, weather downturns and take a sufficiently long-term view.

2009 in a nutshell

OSEBX	+64,8%
S&P 500 return	+ 26,46 %
MSCI World net	+30,0%
3-months NIBOR	from 3,97% to 2,19%
10 year Norwegian Treasury	from 3,81% to 4,15%
Share turnover Oslo Børs (value)	-38,6%
Brent Blend	from USD 48,80 to USD 78,70
GDP growth global	0,0%
GDP growth Norway	-1,6%
GDP growth Mainland Norway	-1,6%

Sources: *Oslo Børs, Standard & Poor's, MSCI Barra, Norges Bank, FactSet, IMF, SSB, Pareto. GDP growth is updated with revised estimates after the respective Pareto annual reports were published.*