

The U.S. join the race

Nearly two years after Europeans, the U.S. have joined the race to stop their ballooning twin deficits. Europeans should logically be ahead of the game. But are they really? So far no real mutualisation of the peripheral debt has been accomplished. In this context, are emerging markets the only winners as they set themselves apart from the rest of the world's economic woes?

The U.S. have finally made the agenda! But it is not the bankruptcy threatening the U.S. government as it nears the crucial 2 August debt-ceiling payment deadline that pushed the public debt -equaling 98 percent of GDP- into the spotlight. At his inaugural press conference last April, the Chairman of the Federal Reserve Ben Bernanke stated point blank that the American deficit was 'not sustainable'. Since then, the deficit has been rivaling in news popularity the headlines of even the most reeling restructuring stories of the European peripheral debt.

Of course, the financial press was not alone at the time to notice the sudden 'urgency'. This also jogged the credit rating agencies' memories that things were not getting better, and that the QE2 (Quantitative Easing 2) and the latest fiscal handouts were indeed delaying any immediate remedy. In fact, shortly thereafter, the credit rating agency Standard & Poor's lowered the U.S. AAA credit score from stable to negative. On 2 June, Moody's launched an ultimatum that if the American Congress and

the Obama administration did not make any progress on raising the USD 14.3 billion borrowing limit, it would review its U.S. rating. Serious consequences would clearly ensue from a negative review. And what appetite would emerging market countries have for a U.S. debt which is no longer AAA, as currency of choice to diversify their reserves?

The impact on markets has been astonishingly muted. The U.S. bond market has been rather complacent with regards to the outstanding national debt problem, being more concerned about slower growth. The 10-year Treasury bond has rallied to dip under 3 percent yield. We anticipate that the main influence on the bond market will remain for some time the general state of the U.S. economy, which should continue to be favourable to bonds, and at least sentiment-wise initially, favourable to the American dollar when the debt-ceiling issue is resolved.

While low interest rates should be positive for stock markets, earnings growth

has been exceptional. U.S. companies have benefited over the last two years from the recovery with low debt and default rates. Going ahead, we feel that there will be little chance for another earnings surprise on the upside. Current P/E estimates for 2011 are 13.21 and 11.66 for 2012. Historically these levels are still moderate, down from the heady levels nearing 18 at the end of 2009, after a strong U.S. recovery, and up from around 10.1 in August 2008 at the height of the financial crisis and ensuing recession.

No need for excessive optimism

However, this does not reflect the whole story. On average, a 13 percent profit growth is forecast for this year and next year. The historical average is between 6 percent and 7 percent. The market is expecting double the historical average for two years running, which seems excessive to us. In this context, we anticipate -and have done so for a few months- a correction in the U.S. stock market, along with some disappointment

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with regards to the U.S. economy recovery.

We have already identified that some important leading indicators are pointing towards a slowdown in the U.S. economy (consumer confidence, manufacturing activity, and business confidence) in the second half of 2011 and in 2012. In the face of still poor unemployment figures and a morose building and real estate sector, a zero interest rate policy will certainly be maintained for some time. This is particularly true as the end of the QE2 will have some negative impact on liquidity. Who will be the buyers of the 80 billion debt issuances if the Fed is no longer there to repurchase? How will the economy be sustained when the government budget is just about to have a razor cut? Any reduction to government net spending, which currently makes up 24 percent of the U.S. GDP, would have a negative impact on growth. This would lead to the proverbial 'double whammy': both the government and the private sector stymied.

In Europe, back to two speeds

Where to head from here? Europeans have actually been trying to solve their respective debt problems for some time. From severe austerity plans in each country, to high-level European caucuses, Europe has succeeded in reintroducing its very distinct two-speed economy. Greece's austerity plan will plunge its inhabitants into yet another minus 3 percent negative growth while Germany is experiencing almost full employment. Greece has little capacity to pay down its debt at financing rates close to 20 percent and is indeed insolvent. The problem needs to be mutualised with the other European countries and especially with Germany, whose 40 percent of exports are destined for other European countries. They have every interest in participating to keep the European activity and the financial system afloat.

When European finance ministers met on June 24 in Luxembourg, a decision needed to be made within the ESM (European Stability

Mechanism) on how to support the bailout fund after 2013. Within the ESFS (European Stability Facility), a decision had to be made on how to boost the current bailout fund. The burden-sharing between core AAA-rated Europe and lower-rated peripheral Europe is unclear, as is the financial weight the private sector creditors will have to share in any event of debt restructure.

Fortunately, some European companies have been able to climb out of the Old Continent's quagmire of ills by developing new brand images and showing a great level of innovation. Others have franchised their revenues to the emerging markets instead of their most immediate trading partners. We continue to view with trepidation European investments and the European Union's general health. Restructuring is a 'time bomb' - an inevitable event that only awaits the clarification of the core European governments' roles, and the implications of their banking systems in future write-downs or prolongations of debt

maturities. It seems like the only safe place is where we can identify positive fundamentals reflected in the solid balance sheets of public accounts such as in the emerging market economies. They actually have been suffering the consequences of their own success - a touch of overheating.

By Didier Saint-Georges