Invesco

Investment Perspective

Invesco Global Asset Allocation

Second Quarter Global Markets Review and Outlook

Muddling Through

No one really expected this to be easy. The Great Recession was a "balance sheet recession" (see box) which makes it different from all other post-World War II recessions in the U.S. Balance sheet recessions are, by nature, more fragile due to the heavy debt loads and the need to de-lever. The particulars of the current situation leave less room to maneuver than usual. Policy rates in most countries are already close to zero while markets, taxpayers and politicians have a limited tolerance for continued fiscal wastefulness.

Invesco's Chief Economist, John Greenwood, makes the useful distinction between ordinary, relatively mild recessions and severe recessions that are both deep and protracted. The key difference between the two types of recessions lies in the role of debt – an idea credited to Irving Fisher in 1933.[1] Severe recessions always begin with a large accumulation of debt that forces households and businesses through a painful de-leveraging process that typically require an extended period to work through due to negative feedback effects. These are considered "balance sheet recessions" due to the cause and required subsequent adjustment.

Several sources have considered the historical precedents of balance sheet recessions. Two that Greenwood cites are Reinhart and Rogoff[2] along with management consultants, McKinsey & Co.[3] A key investment question is how economies work their way through these difficult situations. McKinsey groups them into four categories; Greenwood adds the fifth.

1. **High inflation** erodes the real value of debt while raising nominal cash flows. Although enticing on the surface, the inflation "solution" does have negative effects on the real economy and has been very rare in recent years. In addition, it can be difficult to generate inflation due to low private sector credit demand and inflation-related mandates of (largely) independent central banks.
2. **Government defaults** most frequently occur along with currency and banking crises. Investors respond to such actions by limiting access to capital markets for several years which forces governments into fiscal austerity.
3. **Growing out of debt** is a more pleasant, but rare method. The method most often occurs in conjunction with a shock such as war or commodity-induced boom.
4. **Belt-tightening** is the multi-year process of reducing debt-GDP by growing debt more slowly than nominal GDP. This has been the most commonly used approach in recent decades.
5. **Debt traps** occur when GDP fails to keep pace with debt growth and debt servicing therefore consumes an increasing amount of the nation's budget.

Data as of June 30, 2010, unless otherwise stated.

1 The Debt Deflation Theory of Great Depressions (1933). http://fraser.stlouisfed.org/docs/meltzer/fisdeb33.pdf
2 Reinhart and Rogoff, "This Time is Different: Eight Centuries of Financial Folly" (Princeton University Press, October 2009).
3 McKinsey & Co, "Debt and Deleveraging: The Global Credit Bubble and its Economic Consequences" (McKinsey Global Institute, January 2010).

Although Western governments are generally following the fourth strategy, belt tightening, they are continuing a practice begun in the depth of the crisis: experimenting with a variety of measures to counter the worst effects of the crisis, often with great speed and under market pressure. Such efforts have naturally raised the ire of some commentators who accuse policy makers of simply "kicking the can down the road."

But is delaying the inevitable such a poor strategy? It clearly carries some benefits. Taking the example of Greece, most market participants have little doubt that Greece will ultimately need to restructure its debts leading to large losses for many European banks, if done today. The rescue package will simply delay this by a few years and does not address the solvency problem.

However, delaying the losses until exposed banks have (hopefully) rebuilt their capital cushion may help avoid a further round of retrenchment for a global economy still on tenuous footing. In addition, the delay tactic allows Greece more time to reduce its fiscal deficit than if it were to default immediately, and thus close its deficit entirely due to lost access to external funding.

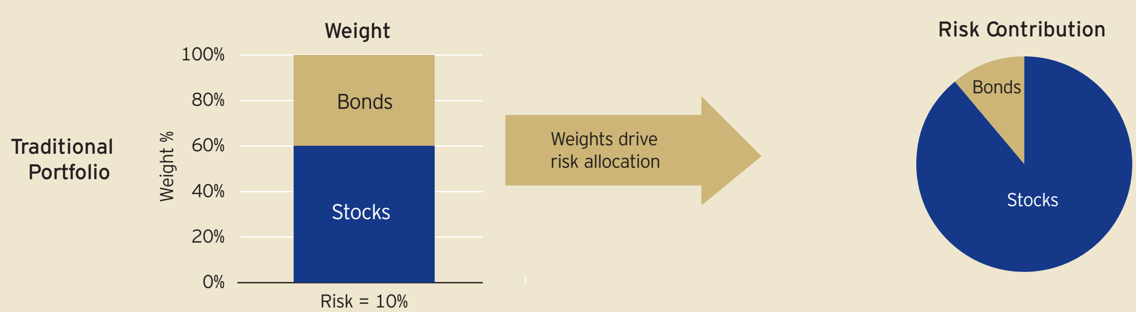
In short, the benefits of successfully muddling through are clear – we extend the period over which we experience the economic pain rather than face it all today when the consequences could be more dire. But the risk is also clear: failing to deal with the problems today can result in their transformation into even larger ones tomorrow. Might current unresolved problems turn the pursuit of belt-tightening into the less pleasant means of working out of balance sheet recessions: high inflation, government default or debt trap?

Historical precedent indicates that they could. Although rare, one can see the unintended results of muddling in Japan's zombie banks in the 1990s and Germany's hyper-inflation in the 1930s. Even outcomes that are far short of these extremes would be unpleasant compared to the last few decades.

From an investment perspective, this must lead investors to consider how their portfolios will perform in some unpleasant but plausible circumstances. For example, what would your portfolio do if we faced a material rise in inflation due to loose monetary policy? What will it do if we face renewed deflationary pressure or a double-dip recession?

For investors who have honored the traditional approach of a roughly equal mix of stocks and bonds, the answer comes down to how equities perform. As shown in the exhibit below, the vast majority of risk in a 60% s tock/40% bond por tfolio comes from stocks. Unfortunately, the performance of stocks in these scenarios would be poor.

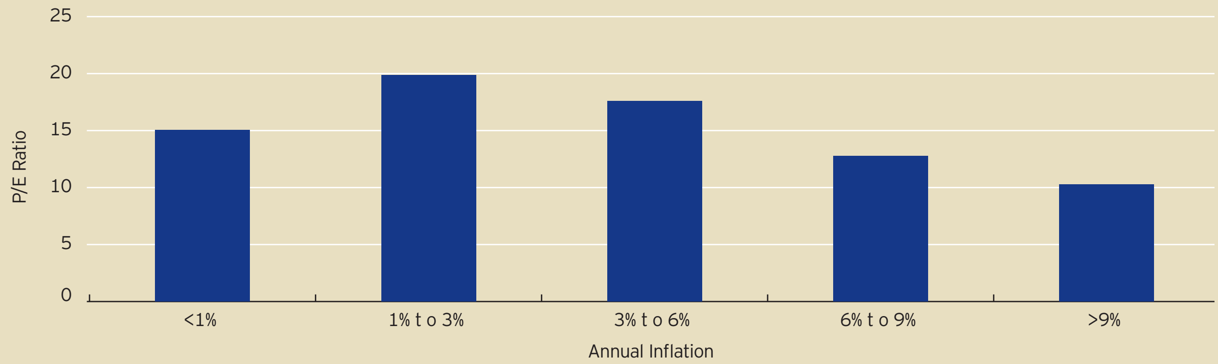
Exhibit 1 - Traditional Risk Contribution



Sources: Invesco analysis and DataStream. Bonds are represented by the Barclays Capital Treasury Index. Stocks are represented by the S&P 500 Index.

Why should equities perform poorly in these situations? In the case of inflation, many have argued that since equities outperform inflation over the long-term, they can act as a hedge against it. As the graph below clearly shows, price-earnings (P/E) ratios are affected by changes in inflation. If inflation were to rise materially from current levels, equities would deserve a lower P/E ratio; prices would therefore fail to keep pace with earnings increases. Additionally, in the last inflationary episode, profit margins fell and earnings growth was only in-line with inflation.

Exhibit 2 – Cyclically-Adjusted P/E Ratio by Inflation Environment

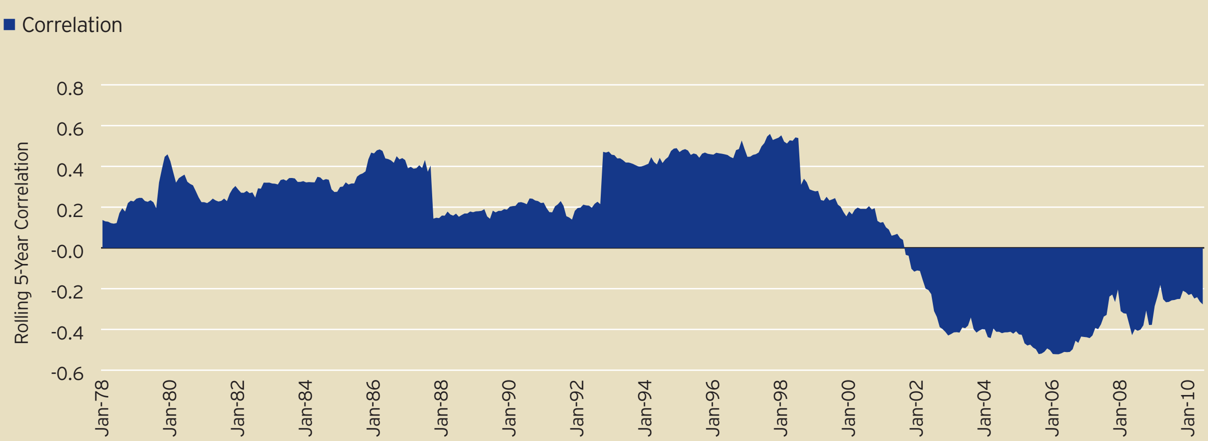


Sources: Robert Schiller, S&P and Invesco.
Data as of December 1881 - June 2010.

If the global economy were to falter again or if we entered a period of deflation stocks would also suffer. Very low or negative inflation and therefore lower bond yields would not benefit equities in the same way they did in the 1980s and 1990s – the period typically used to support the Fed model (earnings yield – bond yield). The reason is simple: bond yields respond to expectations for real growth and inflation. In the 1980s and 1990s declines in the inflation rate led to declines in bond yields and earnings yields (i.e., higher P/Es).

A decline into deflation or another recession would result in expectations for lower real growth – good for bonds, bad for stocks. If this is true, we would expect to see a shift in the correlation between stocks and bonds from the 1980s and 1990s to now. That is precisely what we find (see Exhibit 3 below). The good news is that all correlations have not gone to one – they are very negative for stocks and bonds today, providing an opportunity for diversification.

Exhibit 3 – Rolling 5-Year correlation between Stocks and Bonds

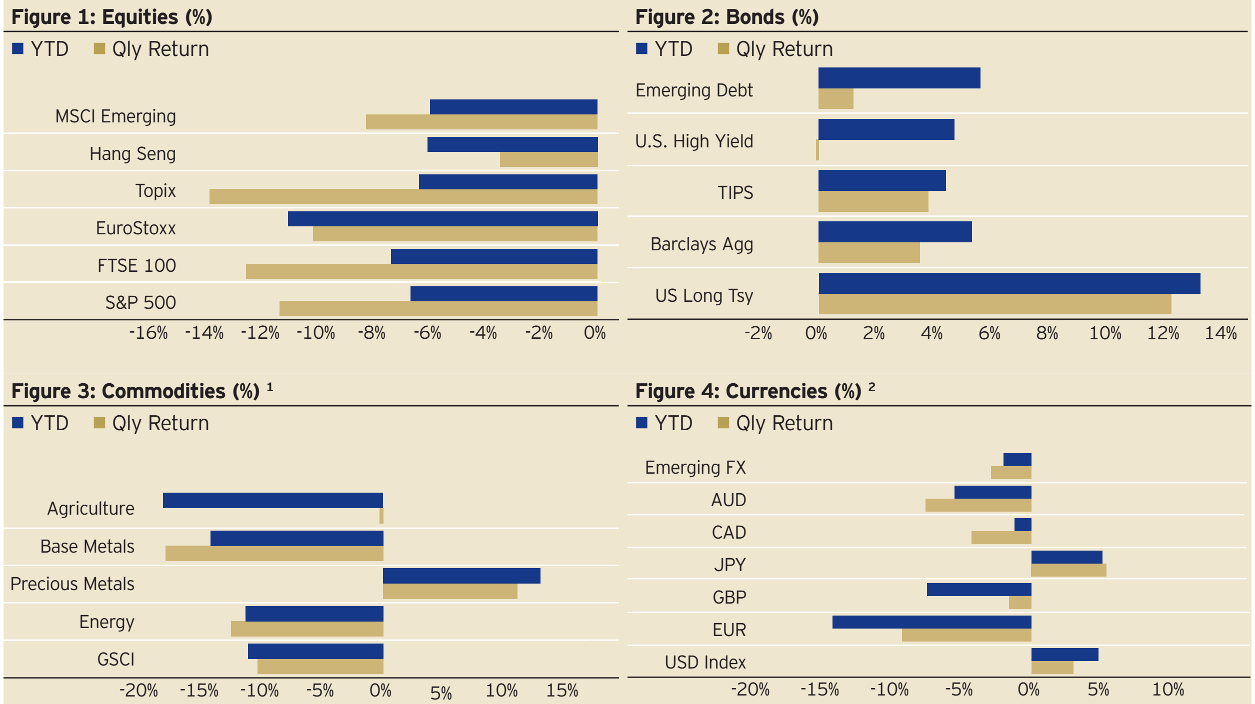


Source: Datastream, Invesco analysis.
Note: Stocks represented by the S&P 500, Bonds represented by the Barclays Treasury Index.

If stocks do poorly in these scenarios, and most portfolios are driven by equity returns, the proper response is to consider what assets can best complement equity holdings to defend against negative outcomes. While we have specific ideas on this which are manifested in a number of strategies, the essence is to extend high quality fixed income duration (e.g., move from the Barclays Aggregate to the Barclays Long Treasury) and replace some equity exposure with real asset exposure, preferably with reasonably high volatility, such as commodities.

The intent of this report is not to argue that the economy is ready to spin out of control. It is to point out vulnerabilities in current portfolio structures and encourage broad, scenario-based thinking about how to defend against negative outcomes while still benefiting from economic growth. The second quarter demonstrates the importance of this idea with equities down approximately -10% and long government bonds rising by a similar amount (see Exhibit 4).

Exhibit 4: Market Performance: 2nd Quarter and Year-to-Date 2010



Sources: Standard & Poor's, FTSE International Limited ("FTSE"). ©FTSE 2010., Dow Jones, Tokyo Stock Exchange, Hang Seng, MSCI, Barclays Capital Inc., Bank of America Merrill Lynch, JP Morgan, S&P/GSCI, BBA Invesco. Performance data as of June 30, 2010. Past performance cannot guarantee comparable future results.

1 Energy, precious metals, base metals and agriculture are all sub-components of the S&P GSCI Index.

2 Quarterly returns versus the U.S. Dollar Index.

Not surprisingly, our portfolio positioning remains largely defensive in the wake of heightened financial market volatility and economic uncertainty (see Exhibit 5). This is reflected in our continued overweight to government bonds and underweight to global equities. We continue to advocate an overweight to precious metals (gold), given the loose monetary conditions. For energy-related commodities (crude oil), we have moved to a more defensive posture in light of prospects for weaker global growth. In some markets, while government bond yields have reached historic lows and equity valuations are more attractive, our defensive posture will likely persist until investors feel more confident about the health of the global economy and risk appetites improve.

Exhibit 5: Representative Positions[1] as of June 30, 2010

Equities

Market	Position
U.S.	▼
U.K.	▼
Europe	▼
Japan	▼
Hong Kong	N
Emerging	▼

Fixed Income

Market	Position
U.S. Treasury	▲
Barclays Aggregate	▼
U.S. high yield	▼
Emerging debt	▲
Treasury bills	▼

Commodities

Complex	Position
Energy	▼
Precious metals	▲
Base metals	N
Agriculture	▲

Currencies

Currency	Position
EUR	▲
GBP	▼
JPY	▲
CAD	▼
AUD	▼
Emerging FX	▼

1 The Global Asset Allocation team has a view on a wider range of assets than shown here but these are the assets most frequently asked about by clients.

Note: ▲ = Overweight, N = Neutral, ▼ = Underweight.