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Investor Info
Investment Commentary

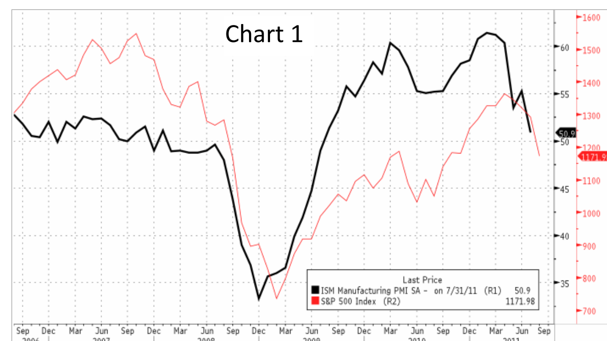
Lehman crisis, part two?

Volatility has greatly increased again in most markets. The current investment commentary examines the probability that the new downturn is signaling another worldwide recession.

Within just a few weeks, market prices worldwide collapsed dramatically. Memories of three years prior – back when the SMI dropped 35% in a single year and many investors suffered major losses – were quickly awakened.

The current turbulence was caused by weak ISM Purchasing Managers Index data in July comparable to that of two years ago. Chart 1 (right) illustrates the significance of this early indicator in terms of the market. The chart clearly shows the correlation over the last several years: a falling index (black line) tends to push market prices, here the S&P 500 (red line), downward as well. Conversely, a rising index signals an increase in economic activity, which is typically observable in market prices within six months. The threshold value of 50 is particularly key. If the indicator falls below this value, there is an increased risk of recession; if it exceeds the threshold, the economy remains on a path of growth. Currently, the Purchasing Managers' index stands at 50.9 and may slip below 50, which led to panic attacks on the market.

However, the forecast of a recession is not that simple – the index could very well fall below 50 without necessarily indicating a recession. For example, in 1998 the index temporarily dropped to 47.3. Those who reacted by turning their backs on the market missed out on the 30% increase in prices over



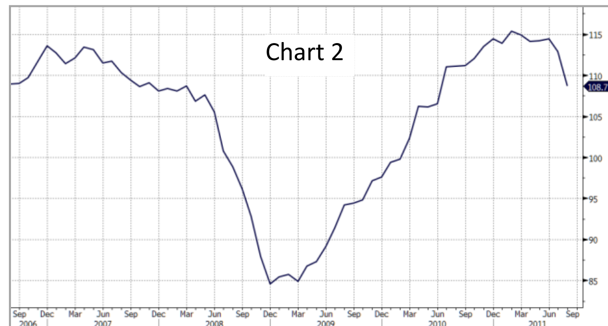
the following two years. The index also fell below 50 in 2002 and 2003. Those who nevertheless bought stocks in 2003 saw profits of up to 70% by 2007. Granted, pinpointing the ideal time for entering and exiting the market is anything but easy and hindsight is, of course, for 20/20. The above examples are merely meant to show that an indicator alone is not enough to predict market behavior.

Nevertheless, investors were already feeling uneasy due to debt problems in the US and Europe even before the Purchasing Managers Index figures were published. So it's no wonder that the above news was just the icing on the cake that allowed fears of a double dip to resurface. These fears triggered a sell-off in the market that gave the impression that the world might be on the brink of a second Lehman-style catastrophe. However, the Deutsche Bundesbank has made it very clear that there are currently no signs whatsoever of the repeat of such a crisis. As Andreas Dombret, member of the Executive Board of the Bundesbank, emphasized: "We are very far away from a situation like the one we experienced in 2008." The ARVEST Investment Committee shares the opinion that the current situation in the banking sector is not comparable to that of 2008.

What can't be denied, however, is the slowdown in growth in both the US and Europe. It's also not unlikely that both regions will once again post negative growth rates for several quarters. The Ifo Index (see Chart 2) paints a similar picture for Europe's growth engine, Germany, as the Purchasing Managers Index does for the US.

This dim economic environment also matches the exact prediction of the ARVEST Investment Committee at the beginning of the year for the current year (see the ARVEST Privatbank Annual Report and the January edition of our Investor Info, issue 70). However, unlike many market participants, based on the current data we do not expect the economic environment to deteriorate as much as during the peak phase of the financial crisis. Nevertheless, stagnant growth, as is gradually being observed, is very likely. An analysis of past recessions shows that economic recovery following a financial crisis is always weaker than after a "conventional recession" at the end of an economic cycle.

At the start of the year, the ARVEST Investment Committee had also predicted that the booming developing countries would continue to grow despite inflationary



problems. The recent news that China has now become the world's largest personal computer market in the world confirms this. With 18.5 million computers sold in the second quarter of 2011 (+14%), the Middle Kingdom has, for the first time, overtaken the US, where sales declined by just under 5% to 17.7 million units.

We expect this kind of disparate economic performance to continue over the next several years as conditions in various Asian economies remain much more favorable thanks to the lack of growth-dampening debt problems and continued pent-up demand. Our ARVEST Global Stars (ISIN CH0011250575) and ARVEST Eurasia Stars (ISIN CH0018972502) equity funds are therefore currently 37% and 47% invested in the Asian region (excluding Japan), respectively. We firmly believe that this strategy will pay off for our clients in the long term.

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