

Market Focus

Global Strategy

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Ten Tweets For 2010

Brevity used to be the soul of wit; now it's the badge of banality. But twitter is the word of the year, and we like a challenge....

So no 2010 tome from us; we'll post ten short pieces on our blog over the holidays, and send them all out on January 5.

Here's the summary, Part 1 and a favourite reading list.

The Great Divide: correlations cluster near one in crises; now it's not so macro. Re-focus on alpha and country specific trades.

Think 1890s: a deflationary recovery that may feel like a depression. Plus Robots and Virtual Worlds and How To Live Forever.

Out of the Valley of Debt: for US consumers, it's all about income, not debt. Plus "rational re-balancing" and "discounted decadence."

Oil as a Policy Tool: why the Saudis set oil prices for now. And how they could be the key to recovery.

Sovereign Debt Sustainability: why growth, not inflation, is the solution. Plus "the entitlement endgame."

Exits and Entrances: time for the BoJ to get serious, timing the exit elsewhere.

Decoupling: was one of the 2008 buzz words. But not 2009! What about 2010?

Bubbles Here, Bubbles There, Bubbles Everywhere: except that we can't find them anywhere. Look east, young man....

Brunnermeier on Bubbles: why rational arbitrageurs ride bubbles and how trivial news can trigger crashes (by synchronising selling).

In Gold We Trust: a momentum trader's dream. Oh, oh, we just found one (a proto-bubble that is).

We wish all our readers peaceful holidays and a less dramatic New Year.

The Great Divide:

The outlook... is uncertain in a very specific sense: two very different "equilibrium" outcomes are possible for the world economy and markets, that are poles apart. A simple way to capture this is to say that the S&P 500 could end the year around 1200 to 1300 in the "healing" equilibrium, but nearer 650 - and falling - in the "bad" equilibrium. Market Focus: Overwhelming Force

We wrote that in December 2008, and argued that "healing" was ultimately more likely than deflationary breakdown. We went to the brink, but global production and risk assets bottomed out in March and have recovered powerfully since.

As we write, global industrial production, our world wealth index, funding liquidity in the financial system, credit spreads, emerging equities and the leading "digital lifestyle" stocks are back at their pre-Lehman levels or slightly better. Not surprisingly, the recovery has been much less complete in most developed equity markets, financial stocks and commodities, but the systemic part of the crisis seems to be over.

If that is right, then country, sector and stock specific news will drive markets and investment returns as much or more than global macro trends. Stock picking and idiosyncratic risk should be far more rewarding in equities and credit; while spreads, relative value and range trading dominate the interest rate world. And different commodities dance to their own tune.

Ironically, however, we could *almost* apply our opening paragraph from last year to 2010: we expect the healing process and recovery to consolidate as income growth, collateral values and credit availability improve, but it can't be totally excluded that we will restart the vicious debt deflation spiral.

The most obvious risk is a rolling sovereign debt crisis that undermines investor confidence, not only in the long-term creditworthiness of governments, but by extension in the banks and financial institutions that they have guaranteed or underwritten. Here we expect the BoJ and the ECB to play pivotal roles in staving off any systemic impact within Europe and Japan, while the UK will experience all the volatility you might expect in an election year.

Otherwise, our key macro themes can be summed up very succinctly. We think this will be (once again) a disinflationary recovery: 10-year G3+ real yields will end the year higher, breakevens lower and nominal yields little changed. We think the three stages of the "exit strategy" (winding down QE, raising interest rates and fiscal consolidation) will help cap the upside for equities, though 1250-1300 for the S&P 500 will be achievable at some point. And the key for us to the fate of financials will ultimately be US house prices - the most important collateral within the (global) financial system - and in our view, extremely cheap.

It will be a slow and granular grind to find more rational workouts than foreclosure, however, and establish a proper base for more sensible pricing. In that context, the profile for global IP growth - where momentum should slow quite sharply in the February to May period - and the gradual winding down of QE suggest the potential for a risk asset correction in the first half rather than the second. That also happens to fit the history of post-crash rebounds, as shown in Exhibit 1 below.

Pessimism about the medium-term outlook still rules, in our view, but investor sentiment for the shorter term may just be a little too happy. This is a time to keep "hope on a short leash" and be ready to fade extreme fears as and when they arise.

In sum, though we expect the healing process to progress in 2010, the stakes remain extremely high and the potential for policy error or sheer bad luck non-trivial. Even if it proves to be a much less dramatic year for markets, it is unlikely to be straightforward or any less intellectually challenging. Happy Holidays!

Some Favourite Reading

When Washington Shut Down Wall Street: The Great Financial Crisis of 1914 and the Origins of America's Monetary Supremacy by William L. Silver

Only Yesterday: An Informal History of the 1920s by Frederick L. Allen

Everything and More: A Compact History of Infinity by David Foster Wallace

A Short History of Financial Euphoria by John Kenneth Galbraith

Propaganda by Edward Bernays

Origin of Wealth: Evolution, Complexity, and the Radical Remaking of Economics by Eric D. Beinhocker

Oil Politics: A Modern History of Petroleum by Francisco Parra

Natural Gas and Geopolitics: From 1970 to 2040 by David G. Victor

The Persian Puzzle: The Conflict Between America and Iran by Kenneth Pollack

Conspicuous Consumption by Thorsten Veblen

Knowledge and the Wealth of Nations: A Story of Economic Discovery by David Warsh

Joseph Schumpeter Depressions: Can we learn from past experience? 1934, Economics of the Recovery Program, reprinted in *Essays on Entrepreneurs, Innovations, Business Cycles and the Evolution of Capitalism*, Transactions Publishers, 1990

Exhibit 1: US Equity Performance, Selected Post-Recession Recoveries

Troughs	Crash (relative to 12m before trough)	9m after trough	3m since first 9m	6m since first 9m	1Y since first 9m	2Y since first 9m
Feb 2003	-25%	27%	8%	4%	9%	14%
Jul 1920	-27%	13%	-1%	4%	36%	47%
Oct 1907	-36%	37%	3%	9%	23%	2%
Oct 1857	-41%	42%	3%	10%	-1%	43%
Feb 2009	-43%	49%				
Sep 1974	-48%	49%	-13%	-8%	7%	5%
Mar 1938	-48%	58%	-14%	-12%	2%	-6%
Mean(excl.09)	-38%	38%	-2%	1%	13%	18%
St. dev	10%	16%	9%	9%	14%	22%
Incomplete Recoveries						
Oct 2002	-17%	12%	6%	14%	10%	21%
Jan 1855	-25%	12%	-9%	-1%	-6%	-45%
Nov 1917	-36%	6%	-5%	-2%	2%	-17%
Outlier						
Jun 1932	-62%	45%	88%	64%	86%	56%

Source: Credit Suisse, IDC

Exhibit 2: Global IP with forecast

Log scale

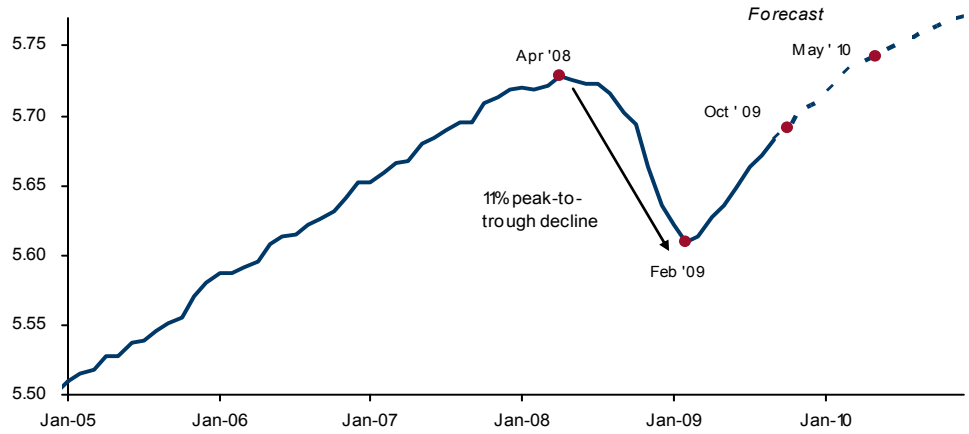


Exhibit 3: World Wealth with 63-week moving average

Since trough in 2002, log scale



Exhibit 4: Hot: China and Digital Lifestyle

* Market Cap weighted Google, Apple and RIMM



Source: Credit Suisse

Exhibit 5: G3+ 10 yr real yields with kernel

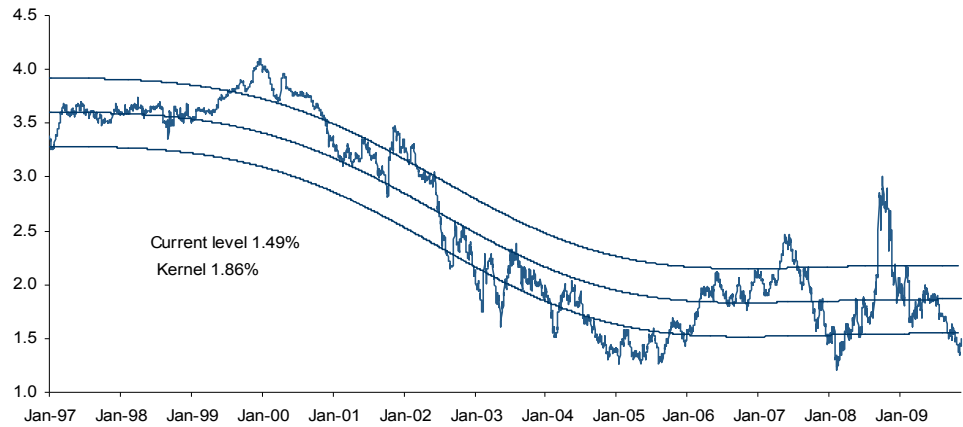


Exhibit 6: G3+ Core Inflation

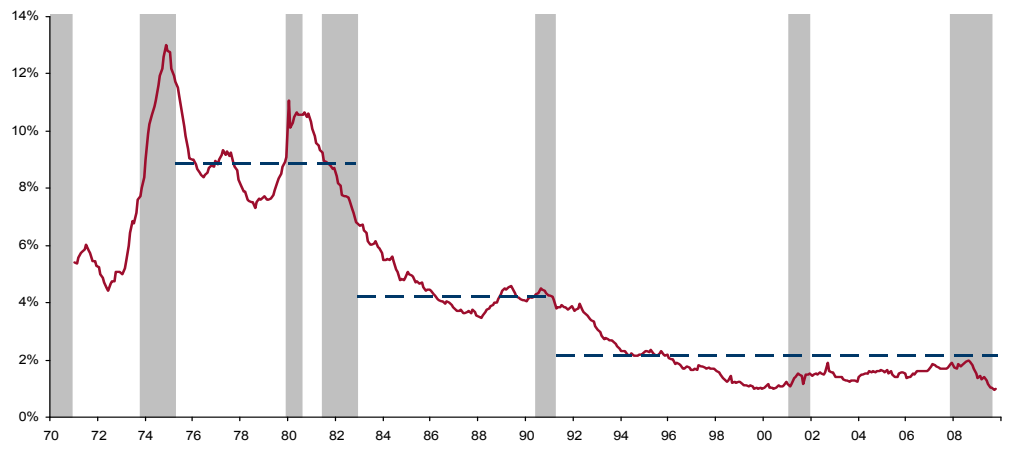
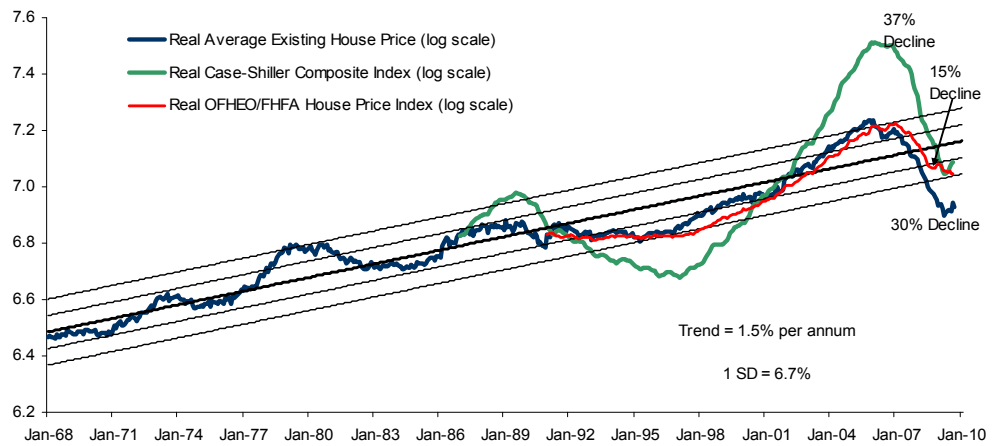


Exhibit 7: US house prices



Source: Credit Suisse

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