

From Despair to Hope

By [Peter Oppenheimer](#)

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To many investors, 2011 has been a "year of fear" with markets being hit by a series of shocks ranging from the Japanese tsunami, concerns over the U.S. debt ceiling and sovereign downgrade and mounting fears over a double-dip recession, to name just a few. But above all, it has been a year of fear over Europe. Its many twists and turns and high political drama has raised uncertainty substantially. Concerns about the possibility of some kind of disorderly collapse of the euro have sapped confidence and pushed up the premium investors demand for taking risk.

From an equity market perspective, there have been bursts of optimism as occasional hopes of a breakthrough on a political agreement have surfaced. The rally in October, for example, was one of the strongest for many years as the European Central Bank started to buy bonds of countries like Italy. But like so many others, it didn't last long and the trend in equity markets has been lower, particularly in Europe. Many emerging markets have also weakened as investors have questioned those countries' ability to sustain high-growth rates and cope with the impact of tighter credit conditions. As a result, the valuation of many equity markets has fallen. The dividend yield, or income, that is being offered on shares, has continued to rise

sharply, just as the yield available on cash deposits and government bonds has fallen.

But in many ways, this rising gap between the income paid on government bonds and company shares is counterintuitive. After all, many investors cite high levels of government debt as one of their greatest concerns while, at the same time, the balance sheets in the corporate sector, in aggregate, are as strong as they have been for decades. The credit crunch has encouraged companies to hoard cash and delay investments. Despite these differences, investors seem prepared to lend money to many governments — by buying government bonds — at falling levels of interest, while shunning the much more attractive yields available on shares.

There are two reasons for this. First, investors perceive equity as increasingly risky, given the prospect of a renewed recession. Second, investors are facing a shrinking choice of assets that are considered to be risk-free. Countries that are no longer thought to be inherently safe have seen their yields rise dramatically, just like shares. The few that are meet the enthusiastic demands of investors starved of available "safe" returns in a hostile investment world.

Is there any room for hope? For the euro zone — and to a large extent Britain — the answer lies in two important, related issues. First, the economy. How deep and prolonged will the economic downturn be and how will it impact corporate profits? Second, politics and policy. Will the euro-zone governments finally agree a way forward that protects the euro and reduces the risks of a disorderly collapse, thereby rejuvenating the much-needed confidence that will drive investment and growth?

The economic outlook over the near term is not promising. The euro-zone economy looks like it is already in recession, and it is expected to contract next year by 0.8 percent, with only a moderate recovery of 0.7 percent in 2013, leaving it below the levels of output achieved in 2008. The combination of fiscal austerity and significant deleveraging of banks' balance sheets is likely to depress economic activity, particularly for the so-called periphery countries, for some time to come, and these forecasts are based on the assumption that the euro survives and that conditions stabilize. Britain will not be immune from this, and it is expected to slip back into a mild recession this quarter. Some offset is likely as a result of continued, albeit weaker, growth in the United States and in the growth markets of the BRICs. But even with this global support, corporate profits across Europe are expected to contract by about 10 percent in 2012, before recovering in 2013.

On the political and policy front, euro-zone governments have yet to reach an overarching solution to the debt problems. The treaty changes that may be required to reshape the euro-zone economy and place it on a secure footing are likely to take a long time. Nevertheless, clear progress is being made and the cost of the euro breaking up remains higher, both politically and economically, than the costs of holding it together. Slowly, more backstops are being put in place to stabilize markets and provide the breathing space for the more substantial reforms and framework-building that is required. ☒

Meanwhile, the European Central Bank's available tools to maintain the system are substantial. Despite a reluctance to be more assertive, for fear of distorting the incentives for politicians to forge credible agreements, the bank's willingness to deploy these resources

is gradually increasing as more political progress is made. While closure on the European sovereign debt problem is not imminent, the "tail risks" of a euro breakup are likely to fade over time, as investors become more convinced that there is sufficient commitment and firepower to hold it together. Given how much risk is priced into markets, this would likely prompt a sharp rebound in share prices. But when?

The bad news is that such a market recovery is likely to start from a lower level than today, since the prospect of recession and contracting profitability may drag prices down further in the near term as investor uncertainty continues. The good news is that equity markets typically start to recover while corporate profits are falling and when the economy is still in recession. If this happens late in the first half of next year, which is possible, and it coincides with convincing progress on fiscal union in the euro zone, it is likely that there will be a powerful rebound in share prices. In addition, for those who can take a medium-term view, the reward being offered to take risk is probably the highest it has been since the early 1980s, just before the start of a strong bull market in share prices. From this increasing despair, therefore, there is likely to emerge hope after all. ☒

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