

Press release



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KBC Asset Management's view of the financial markets and investment strategy

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US - more bad economic news on the way...

The housing market, the labour market and the consumer sector in the US are under considerable pressure and are showing no sign of improvement. Moreover, the credit market problems of recent months are becoming more and more noticeable in the real economy. Credit terms were tightened even further in the second quarter. Together with mounting petrol prices, this does not augur well for the economic outlook in the short term. Leading indicators confirm that there will be more bad news in the months ahead. A 'normal' recession lasts between eight and ten months. So, if the recession started in January, there will be roughly another five months of worsening macroeconomic data. This should relate primarily to the housing market (given the large stock of unsold homes, house prices could fall by 12% below their current level) and the labour market (roughly a net 800 000 jobs will be lost in the months ahead).

...but US recession likely to be relatively short-lived and fairly mild

In the meantime, tax rebates totalling 1% of GDP are gradually being received by households. "This should stimulate household spending in the coming months, but will probably not be enough to turn the tide completely. For this to happen, it will be a question of waiting until the slump in the real estate market bottoms out and, more importantly, the effect of the Fed's aggressive rate cuts kicks in. Meanwhile, the robust level of exports is providing the support essential for US economic growth. Ultimately, we expect the recession to be relatively short-lived and fairly mild", says Edwin De Boeck of KBC Asset Management. Although the 2009 outlook has improved, a spectacular recovery is not on the cards, as it could take years to eliminate the excesses on the credit and real estate markets. However, cannot be ruled out entirely that the recovery will be stronger than is generally expected, since a marked fall in the oil price would be a tremendous boost for consumption.

Cracks appearing in the European economy, too

The euro area has held up reasonably well in the past few months and even defied the odds to record robust growth in the first quarter. This was due primarily to the German economy, which posted its strongest growth in 12 years. That was probably a temporary upsurge, because cracks are slowly starting to appear in the European economy. High inflation is exerting pressure on household spending, the strong euro is threatening exports, the screws are being turned on credit terms, and the labour market is gradually starting to wobble. This combination of negative factors is clearly beginning to weigh on the economy. Leading indicators suggest that the economy will have to slow down sharply in the months ahead.

Emerging economies holding up their own

Unlike previous recessions in the US, the emerging markets are holding up remarkably well for the time being. Although exports are slowing down slightly (mainly to the US, of course), domestic demand is strengthening and is generally being fuelled by income from commodities.

Concern about inflation in traditional industrialised countries unfounded

Rising energy and food prices have been pushing up inflation around the globe in recent months. Divergent growth prospects in the emerging markets and the traditional industrialised countries, however, are reflected in other inflation risks. In the traditional economies, the price of oil and food is increasing against the backdrop of clearly slowing economic activity. Consequently, the danger of second-round effects from wages is quite limited. In that respect, more expensive energy and food are mainly eroding purchasing power and leading to a slowdown of the economy, a development that will wipe out the inflation risks in the longer term. It will probably be a case of waiting for the oil market to cool considerably before there are clear signs of inflation cooling too. The inflation scenario is totally different for the emerging markets. In these countries, costs are rising in combination with a robust economy, which is generating significant inflation risks. Although central banks have already reacted to this, they need to continue tightening their monetary policies.

Bond yields are factoring in an overly aggressive monetary policy

Even though the structural inflation risks in the traditional economies are limited in the mid-term, the markets and central banks have not been immune to inflation in recent weeks. Given the weak growth, the Fed is likely to continue with its policy and cut its key rate to 1.50% later in the year. The ECB's tone has tightened significantly of late, and a rate hike can no longer be ruled out in the short term. However, bond yields are already factoring in an overly aggressive monetary policy. In the short term, we believe they could therefore continue to fall somewhat, but certainly not by much given that they are already relatively low. Long rates will probably bottom out later in the year.

Shares dirt cheap for years, government bonds very expensive

While the stock markets may still have a few difficult weeks ahead of them (that is part of normal price fluctuations), they seem to have bottomed out. Stock markets generally anticipate a new phase in the cycle around six months before the end of a recession. We have now reached this point. "The conditions for a new rally are in place - interest rates are low, earnings growth is reasonable and valuations are attractive. Since equities are well placed to significantly outperform the other asset categories in terms of return, we are overweighting them to their upper limit", concludes Edwin De Boeck. In this regard, we are taking a significant position in Southeast Asia. The region is still the growth area, with sound fundamentals and attractive valuations. The main position for sector allocation purposes is the pronounced overweighting of the (European) financial sectors, which have been hit (too) hard in the past year and whose shares are now exceptionally cheap. In the bond portfolio, we are capitalising on the now more attractive yield spreads between corporate and government bonds (again focusing primarily on financial institutions). We are also seeking out additional returns by picking up emerging-market bonds.

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