

Title: The Certainty of Uncertainty

Region: GLOBAL

Date: 25th June 2010

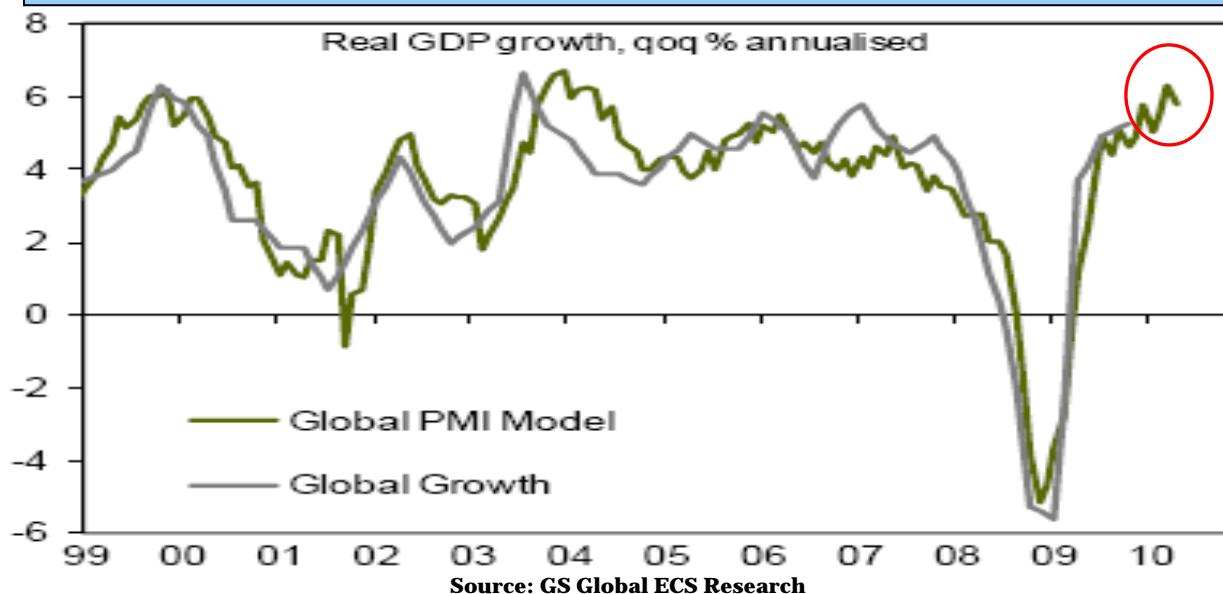
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Since its peak in mid April 2010, the global stock markets have corrected by almost 11.5%, a market capitalization loss of close to USD 6 trn. That's more than 4 times India's GDP. Indian stock markets from its peak till date have barely lost fewer than 3%, once again proving the resiliency of its growth in an uncertain world. The Indian markets have held on well due to its stronger domestic growth outlook and some of the policy actions. Indian markets had given up around 11% from its peak, but has recovered most (81%) of the losses since then. As FIIs returned with almost USD 1 bn net inflows till June 18th, vis a vis net outflow of around USD 1.6 bn in May.

What are the fears (uncertainty) for the bulls or boon's for the bears in global markets?

- The fear of a widespread contagion of the European sovereign crisis has resurfaced again with widening of Greece CDS (Credit Default Swap) Spreads. The Spain banking stress results are likely to be out soon adding to its woes. Will banks in Europe need more capital?
- The fear of the austerity measures and fiscal tightening in Europe would hamper economic growth world over resulting in renewed fears of a double dip. The "W".
- The slowdown in the growth rates of some of the global lead economic indicators putting the cyclical recovery at risk and the tepid revival in housing and employment. The dovish tone of US Federal Reserve in its recent statement has also vouched for a slower recovery.

Chart I : The Global PMI and Growth : Topping out ?



- The fear of overregulation in banking sector in US and banking stress elsewhere in the world.
- The fear of Chinese economy overheating (bank loans and house prices) and the central banks raising interest rates to preempt a boom bust cycle. And the

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subsequent impact on global markets including the commodities ones. Though the recent Yuan Revaluation has mitigated this risk for the time being at least.

- The earnings season being round the corner and the fear of the higher earnings growth implied in markets now, not being met.

The Gold (higher), commodities (lower), USD Dollar (higher and lower) and US treasuries (higher) continue to dance to the tune of the “ **Certainty-Uncertainty Swings**”. And the outcome of upcoming G20 summit is adding to the uncertainty.

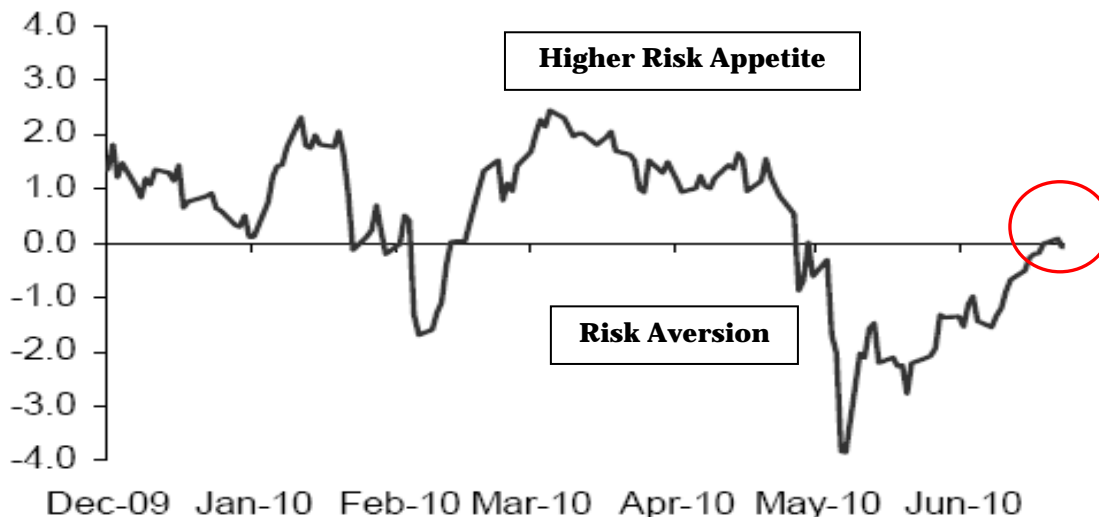
So the world is now being confronted with two opposite forces working: Cyclical Strengths v/s Structural Headwinds. Who will win in the long run?

The Cyclical Strengths: The global economy was slowly finding its momentum after the strong monetary and fiscal stimulus’s by the central banks world over. Various lead indicators such as composite PMIs, Business and Consumer Confidence etc were showing strength. Stock markets had rallied as risk appetite was back. Financing conditions had relatively eased. Developing and Emerging countries, especially Asia witnessed robust growth, lead by China and India accompanied by rising inflation and capacity utilization. Global Trade and Capital flows had recovered from its 2008 lows too. Some indicators were close to pre crisis levels. Inflation levels in developed markets were contained and many of the developed central banks were in no hurry to raise rates till the recovery becomes broad based and well entrenched. Most of the multilateral institutions had raised their global growth estimates. Though jobs and bank lending remained sluggish in US.

And the Structural Headwinds: But there is no free lunch. As the private sector delevered its balance sheet in developed markets, the public sector took all of the debt on its own books, leading to unsustainable budget deficits and public debt especially in Europe, UK, US and Japan. Will the baton now be passed back to private demand? The fear of a contagion of sovereign defaults in Europe though the financial channel and cross holding of banks sent shivers down the global markets, threatening the cyclical recovery (industrial and services) in the world economy. The Europe package has solved the near term liquidity issue but not the long term solvency issue. Unless Europe gets it act through on fiscal policy coordination and bringing down the structural deficits, the overhang of crisis will continue to haunt the global markets. Some of the Asian economies had their own set of problems like Inflation (India) and Overheating (China). And crude oil flare up remains a wild card for the whole world. Political pressures world over pushed the policy makers towards tighter regulations.

What typically happens in a scenario where the hangover of so many of the recent “**Uncertain Outcomes**” (the fears on page 1) exists is that, the Global Risk appetite in the markets wanes, further leading to lack of business and consumer confidence in spending or investing/hiring. This also affects the global liquidity flows and the valuations of risky assets worldwide.

Chart II : GRDI Index :Global Risk Appetite had recovered but is rolling over now



Source: GRDI Index, Morgan Stanley Research

Many of these uncertainties will be impediments to the markets and the growth in the global economy. The earlier such uncertainties get of the way, earlier the world will come back on its normal path. Since on a foggy day, any rational car driver would pull over and not take the risk of driving ahead and taking the risk of a fatal accident.

Policy makers and Central Bankers all over the world especially in Europe now have to be more transparent to communicate in certain terms the path to resolve the problems faced by the world, whether it's the sovereign credit issues or reversal of fiscal expansion or the banking stress issues. The hallmark of good policy making is precise communication and predictability.

If the fog of “Certainty of Uncertainty “persists, the car of global economy will continue to be stationery and never move on unless the fog is cleared and the path ahead is clearly visible. And the policymakers are risking credibility if the fog is not cleared soon.

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