

Enjoy the rally while it lasts - but expect to take a sucker punch

Our delicious spring rally is nearing the limits. The 40pc rise on global bourses since March assumes that central banks have conjured away the debt overhang by slashing rates to zero and printing money. Nothing of the sort has occurred. Two thirds of the world economy will be in deflation by July.

By Ambrose Evans-Pritchard

Last Updated: 6:43AM BST 11 May 2009

Bear market rallies can be explosive. Japan had four violent spikes during its Lost Decade (33pc, 55pc, 44pc, and 79pc). Wall Street had seven during the Great Depression, lasting 40 days on average. The spring of 1931 was a corker.

James Montier at Société Générale said that even hard-bitten bears are starting to throw in the towel, suspecting that we really are on the cusp of new boom. That is a tell-tale sign.

"Prolonged suckers' rallies tend to be especially vicious as they force everyone back into the market before cruelly dashing them on the rocks of despair yet again," he said. Genuine bottoms tend to be "quiet affairs", carved slowly in a fog of investor gloom.

Another sign of fakery – apart from the implausible 'V' shape – is the "dash for trash" in this rally. The mostly heavily shorted stocks are up 70pc: the least shorted are up 21pc. Stocks with bad fundamentals in SocGen's model (Anheuser-Busch, Cairn Energy, Ericsson) are up 60pc: the best are up 30pc.

Teun Draaisma, Morgan Stanley's stock guru, expects another shake-out. "We think the bear market rally will end sooner rather than later. None of our signposts of the next bull market has flashed green yet. We're not convinced the banking system has been fully fixed," he said

Mr Draaisma said US housing busts typically last nearly about 42 months. We are just 26 months into this one. The overhang of unsold properties on the US market is still near a record 11 months. He expects the new bull market to kick off later this year – perhaps in October – anticipating real recovery in 2010.

Keep an eye on the upward creep in yields on the 10-year US Treasury, the benchmark price of world credit. This alone threatens to short-circuit the rally. The yield reached 3.3pc last week, up over 1pc since January and above the level in March when the US Federal Reserve first launched its buying blitz to pull rates down. Bond vigilantes are taunting the Bank of England in much the same way, driving the 10-year gilt yield to 3.73pc.

The happy view is that this tightening of the bond markets is proof of recovery fever, but there is a dark side.

Governments need to raise \$6 trillion (£4 trillion) this year to fund bail-outs and deficits, led by this abject isle with needs of 13.8pc of GDP (EU figures). China fired a warning shot last week, saying the West risks setting off "inflation for the whole world" by printing money. It hinted at a bond crisis.

Yes, the glass is half full. China's PMI optimism gauge has jumped back above the recession line. The global PMI has been rising for seven months. But this usually happens after a crash as companies rebuild battered inventories for a quarter or two.

Note that container volumes in Shanghai fell 17pc in January, 22pc in February, and 9pc in March. Rail freight volumes in the US were down 32pc in April on a year earlier.

The Economic Cycle Research Institute (ECRI) says the US recession will be over by summer, insisting that its leading indicators have never been wrong – except once, in the Great Depression. Quite.

SocGen's other bear, Albert Edwards, says the new element in this slump is that GDP is contracting in "nominal" terms, not just real terms. Money incomes are flat. It is a crucial difference.

"This is like drinking hemlock. The US is gradually slipping further towards outright deflation, just as Japan did," he said. As companies retrench *en masse* they risk tipping the whole economy into Irving Fisher's "debt deflation trap".

If we are spared – still a big if – we can thank a handful of central bank governors and policy-makers who tore up the rule book, defied tabloid opinion, and took revolutionary action in the nick of time. We owe much to the Fed's Ben Bernanke (leaving aside past sins as Greenspan's cheerleader), to Britain's Mervyn King, and the Canadian, Japanese and Swiss governors. Hats off, too, to the Greek speakers at the European Central Bank who have just carried out a monetary *putsch*, outflanking German tank-traps on the Rhine. The hero is Athanasios Orphanides, the Cypriot governor who drafted the Fed's anti-deflation strategy during his 17-year stint in Washington.

The ECB's belated embrace of QE is a watershed moment, even if only a token purchase of €60bn of covered bonds. What poisoned the early 1930s was beggar-thy-neighbour monetary policies. Any country that tried to reflate alone was punished by currency flight (gold loss), yet the mediocrities in charge lacked the imagination to reflate together.

We can now test the Friedman-Bernanke hypothesis that the Fed could have halted the Depression by letting rip with bond purchases. Japan was not a proper test. It eked out a recovery of sorts earlier this decade by embracing QE, but only in the context of a global boom and a yen crash. There is at least one more boil to lance before we put this debt debacle behind us. The IMF says eurozone banks have so far written down a fifth of likely losses (\$750bn) compared to half for US banks. They must raise \$375bn in fresh capital. Good luck.

Germany's BaFin regulator goes further, warning of \$1.1 trillion of toxic assets on German bank books. Landesbanken are a calamity. If the IMF and BaFin are right, Europe has not yet had its crisis. When it does, we will see a second stress pulse through Eastern Europe and Club Med.

The echoes of 1931 are ominous. That year began with green shoots, until Austria's Credit-Anstalt buckled in the summer and took Central Europe with it. Continentals who still thought it was an American crisis learned otherwise. *Plus ça change*.

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