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Global Equity Markets Vulnerable to a Pull Back

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Global equity markets are vulnerable to a pull back after the recent recovery with returns expected to go through a long period of consolidation in the next year, says investment management company NZ Funds.

Michael Lang, Chief Investment Officer of NZ Funds says last night the US Federal Open Market Committee stated that economic activity is leveling out, but he warns that may not translate into higher equity market prices. "

One of the reasons for being more cautious on global equities is that the Baltic Dry index has started to trend down. Michael Lang, Chief Investment Officer of NZ Funds says, "The Baltic Dry index is a good indicator of global economic trade and since 2002 it has been well correlated with global equity markets.

"Recently however, there has been divergence between the Baltic Dry index and the equity markets. Global equity markets are reaching new highs, but the Baltic Dry index has dropped and therefore the equity market could follow."

Lang says global equities are currently pricing in a normal recovery which is why we have seen a bounce in equity markets. "Although we believe we have probably seen the end of the financial crisis and what is probably the beginning of an economic recovery, we expect the recovery to be more muted than normal and we are likely to see a long period of consolidation with low nominal GDP growth."

The Baltic Dry Index (BDI) is one of the purest indicators of economic activity. The Index measures the demand to move raw materials to production and the supply of ships available to move this cargo. The BDI offers a real time glimpse at global raw material and infrastructure demand by providing an assessment of the price of moving the major raw materials by sea. Taking in 26 shipping routes measured on a timecharter and voyage basis, the index covers Handymax, Panamax, and Capesize dry bulk carriers carrying a range of commodities including coal, iron ore and grain.

Unlike stock and commodities markets, the Baltic Dry Index is totally devoid of speculative players. The trading is limited only to the member companies, and the only relevant parties securing contracts are those who have actual cargo to move and those who have the ships to move it.

The Baltic Dry index fell sharply from about October to December 2008. Lang says shipping costs declined while companies used existing stock and ran inventories down to extremely low levels. He says, "In early January this year, there was some restocking and that was associated with a bounce in the Baltic Dry index and a recovery in global equity markets."

The fact that the Baltic Dry index has started to fall again indicates that the bounce we have seen may be coming to an end explains Lang. "The bounce was caused by firms restocking their inventory from zero back up to a modest level of stock. Restocking can make it look like the world is recovering, when in fact all that is happening is that things are bouncing back to a new, but much lower base."

Lang says it is important to remember that despite the Fed’s confirmation that economic activity is leveling out, this has not been a normal economic cycle as the global recession was the result of an unprecedented financial crisis. He says, “As a result we expect the recovery to be slower with economic activity likely to be lower for a long of time. The level of indebtedness in the US is still extremely high and it will take some time for consumers to reduce that debt to a sustainable level before they can start spending again and fuel a strong recovery.”

Lang says US savings data indicates that consumers are resuming a lower level of consumption in order to pay down their debt.

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Background Information:

New Zealand Funds Management Limited (NZ Funds) is the largest wholly New Zealand owned investment management group. NZ Funds manages in excess of NZ $1 billion on behalf of a group of professional financial advisers and for over 14,200 investors.

NZ Funds successfully hedged clients’ global share exposure in late 2007, saving clients from an estimated $150 million loss over the next 18 months during the financial crisis.