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AMP capital INVESTORS

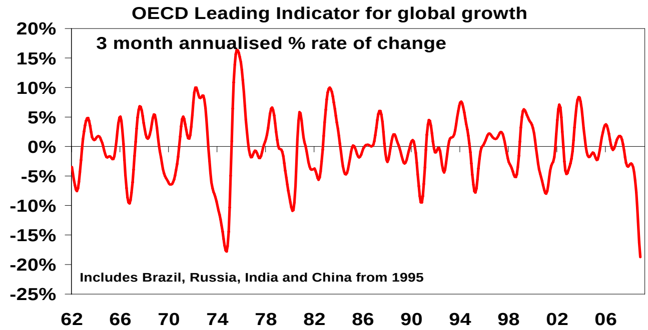
The global economy – bad now, but some positive signs?

Key points

- The depth and length of the global recession now underway will be the key determinant of how shares and other financial assets perform this year.
- Compared to the 1930s, the global policy response this time around has been far more positive and far quicker, so a re-run of the Great Depression is very unlikely.
- It is early days and the financial crisis is continuing but some key signposts to global economic recovery are showing tentative signs of improvement.

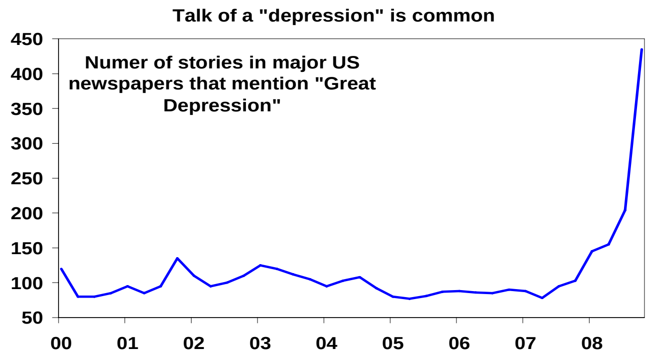
First the bad news

It is obvious the global economic situation is bleak. The key problem last year was the financial crisis. Given ongoing bank problems this is clearly still with us, but this year the key problem will be the economic fall out. The US, Europe and Japan are now contracting in a synchronised fashion and this, along with a gathering slump in the emerging world, is likely to make it the worst global recession in the post war period. The Australian economy is also being hard hit and looks destined for recession. The OECD's leading indicator is plunging at its fastest rate ever.



Source: Bloomberg, AMP Capital Investors

Talk of not just recession but depression has become common place as evident in the next chart.



Source: Bank Credit Analyst Research

The key to when shares and other growth oriented financial assets get back on to a sustainable rising trend will be the depth and duration of the global recession and a big driver of this will be the global policy response.

The policy response

The financial crisis and the synchronised global economic slump that is still unfolding is unprecedented. But so too has been the policy response by governments all around the world. This has focussed on:

- **A rapid reduction in interest rates** with rates falling to near zero in the US and Japan, to record lows in the UK and falling sharply in other countries including Australia.
- **Fiscal stimulus including spending increases and tax cuts** with a massive mix of tax cuts and extra spending soon to be announced in the US.
- **Unprecedented measures to stabilise the financial system**. These vary by country but include providing loans to financial institutions, providing funds for credit markets and buying private sector securities such as mortgage backed securities, injecting capital into banks, insuring some banks against additional losses on their bad debts, the provision of guarantees over bank borrowing and, in some countries, bank lending. More measures are on the way with the US now looking into a comprehensive way to remove toxic debt from banks' balance sheets.

The question is will it work? This raises several issues.

Very different to the 1930s

One criticism of the policy response to date has been that it has been too slow and inconsistent. Interest rates weren't cut quickly enough and the US response has seemed haphazard at times. However, these problems partly reflected a combination of uncertainty about the size of the problem and the Bush Administration's ideological bias against intervening in free markets. The latter problem is likely to be removed by the more pragmatic Obama Administration. But **the policy response in the last year has been far more positive than was the case in the early 1930s as the Great Depression unfolded** when:

- US interest rates were in fact initially raised and only started to fall aggressively in 1933 and never reached zero despite consumer price deflation. This time around US interest rates have reached zero in just over 12 months after the share market peak.
- Fiscal policy was initially tightened in the early 1930s in the US reflecting an obsession with balancing the budget and there were no "automatic stabilisers" such as unemployment insurance. Even when the New Deal

arrived after Franklin D. Roosevelt became president in 1933 fiscal stimulus was modest amounting to just 1% of annual GDP compared to what is now being proposed by President Obama with over $US800bn spread over two years equating to 2.7% of annual GDP.

- In the 1930s over 5000 US banks went bust taking their depositors' savings with them as there was no deposit insurance or government guarantees over bank borrowing. This led to a massive collapse in the US money supply and was a major contributor to the severity of the Depression. Now having learned the lessons of the Depression governments have been bending over backwards to prevent losses to depositors and to prevent an implosion in the financial system.

Won't the monetary expansion just create inflation?

Some fear that by pumping cash into the financial system central banks will simply create inflation. This is unlikely. Narrow money supply measures have increased largely reflecting increased bank reserves. But to get inflation we need the banks to lend more, so that broader credit measures increase and we need people to start spending in excess of the economies' capacity to produce. So far, while the increase in reserves has boosted narrow money measures, banks are leaving them on deposit at the Fed, broader money supply measures have picked up but not by much, credit growth is still negative, and spending in the economy is contracting such that excess capacity is rising. **Until demand picks up there is no reason to worry about inflation. In fact the big concern is more likely to be deflation**. When demand does pick up then the Fed and other central banks will need to reverse their policy stimulus, but they seem well aware of this.

Will the deficit financing just push up bond yields?

Every time there is a recession and public sector budgets shift into large deficits as is occurring now there is concern that it will boost inflation and that the increased supply of bonds will boost bond yields. Both fears are misplaced. **Expanding budget deficits don't cause inflation or higher bond yields in economic downturns because they are offsetting an increase in private savings** as private consumption and investment are slashed. The Japanese experience in the 1990s was a classic example of this – the budget deficit and public debt blew out but inflation turned into deflation and bond yields fell below 2%.

Why not let market forces just run their course?

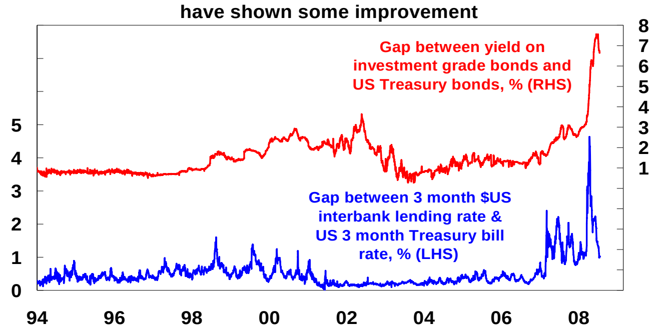
A more fundamental criticism from free market ideologues is that market forces should be left to run their course so as to cleanse the system of past excesses. In other words, after the good times of the boom we now all need to suffer! This was the approach to economic management prior to World War Two and it resulted in regular wild swings in economic activity and unemployment. The trouble with this approach is that it can cause massive economic pain. Sure, the 1930s depression unwound the excesses of the 1920s but this came at a big cost to society and much of the pain was borne by innocent people – ordinary workers who lost their livelihoods as unemployment rose above 20% and ordinary people who lost all their savings in bank failures. It also runs the risk that the people on the receiving end of the pain will decide that capitalism is not for them possibly leading to more extremist fascist or socialist governments. As such a "do nothing" approach is not politically acceptable to most governments.

Are there any signs it is working?

Given the ongoing losses in global banks and the latest slide in bank shares it is clear that the financial crisis is still with us. However, **were it not for the capital injections into banks and guarantees over bank borrowing, the situation today would likely be far worse**. More fundamentally though there have been some signs of improvement. Focussing mainly on the US situation, which is the key in all this:

- The gap between interbank lending rates and government short term borrowing rates has fallen sharply from levels in October. The gap between corporate borrowing rates and long term bond yields has also fallen, albeit only tentatively. See chart below.

Money market spreads have narrowed and credit spreads have shown some improvement



Source: Bloomberg, AMP Capital Investors

- Mortgage rates in the US have fallen over the last two months from around 6.5% to around 5%. This in turn has seen a huge increase in US homeowners refinancing their mortgages to lower fixed rates, which is normally a precursor to stronger consumer spending.
- Consumer confidence measures are showing tentative signs of stabilising in the US and in Australia.
- Chinese money and credit growth have recently started to pick up again.
- There are some signs of stabilisation in global trade, as indicated by the Baltic Dry Freight index (a measure of shipping costs) which has stabilised after a 90% fall.

To be confident that economic recovery is definitely on the way a range of other signposts need to turn positive including: a slowing in the pace of US house price declines, an easing in bank lending standards and an improvement in credit growth. However, **the fact that some indicators have turned a bit more positive is a good sign and consistent with our expectations for a global economic recovery from later this year and/or through 2010**.

Concluding comments

The global policy response is absolutely necessary in providing a counterweight to the global financial crisis. More action is needed in the way of fiscal stimulus and measures to get banks lending again and this looks to be on the way. The economic news will likely get worse before it gets better and this will ensure a volatile ride for investors in the short term. But there are signs that the policy response is helping. And this provides some confidence that growth will start to stabilise/improve later this year and through 2010, which would be consistent with shares getting back onto a sustainable recovery path this year.

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