

The global economy: bad now but some positive signs?



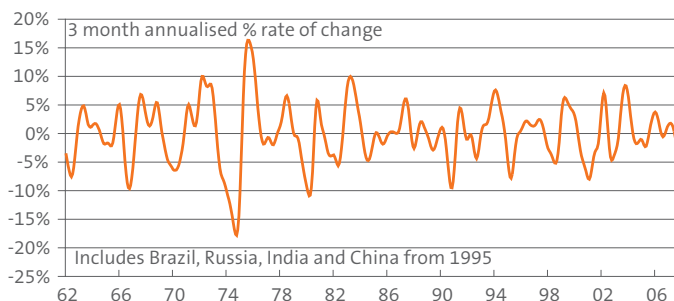
Key points

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

First, the bad news

The global economic situation is obviously bleak. The key problem last year was the financial crisis which, given ongoing bank problems, clearly remains. However this year, the key issue will be the economic fallout. The US, Europe and Japan are now contracting in a synchronised fashion which, 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 appears destined for recession. The OECD's leading indicator is plunging at its fastest ever rate.

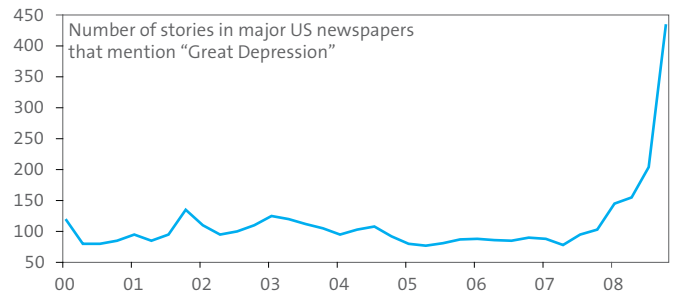
OECD leading indicator for global growth



Source: Bloomberg, AMP Capital Investors

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

Talk of a 'depression' is common



Source: Bank Credit Analyst Research

The keys to when shares and other growth-oriented financial assets resume a sustainable rising trend will be the depth and duration of the global recession. 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 are unprecedented. But so too is the policy response from governments globally. So far, this has focused on:

- **A rapid reduction in interest rates** with rates falling to near zero in the US and Japan and record lows in the UK. Rates have also fallen sharply in other countries including Australia.
- **Fiscal stimulus including spending increases and tax cuts.** A massive mix of tax cuts and extra spending is 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, buying private sector securities, injecting capital into banks, insuring banks against additional losses on their bad debts and providing guarantees over bank borrowing. More measures are on the way with the US seeking 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 is that it has been too slow and inconsistent. Interest rates were not cut quickly enough and the US response has appeared haphazard. These problems reflected uncertainty about the size of the problem, as well as the Bush Administration's ideological bias against intervening in free markets (which is likely to be removed by the more pragmatic Obama Government). But **the policy response in the last year has been far more positive than that during the 1930s** when:

- US interest rates were in fact raised initially and only started to fall aggressively in 1933. Despite consumer price deflation, rates never reached zero. This time around, US interest rates reached zero just over 12 months after the share market peak.

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- US fiscal policy was initially tightened in the early 1930s reflecting an obsession with balancing the budget. Also, there were no 'automatic stabilisers' such as unemployment insurance. Even when the New Deal arrived in 1933 under Franklin D. Roosevelt, fiscal stimulus was modest, amounting to just 1% of annual GDP. This contrasts to what is now being proposed by President Obama - over US\$800 billion 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 of bank borrowing. This led to a massive collapse in the US money supply and was a major contributor to the severity of the depression. Learning from this experience, governments have been bending over backwards to prevent losses to depositors and an implosion in the financial system.

Won't monetary expansion create inflation?

Some fear that pumping cash into the financial system will simply create inflation. This is unlikely. Narrow money supply measures have increased, reflecting increased bank reserves. But to create inflation, banks would have to lend more so that broader credit measures increase. People would also need to start spending more than the economy's capacity to produce. So far, while increased reserves have boosted narrow money measures, banks are leaving them on deposit at the US Federal Reserve (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, the Fed and other central banks will need to reverse their policy stimulus.

Will the deficit financing push up bond yields?

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

Why not let market forces just run their course?

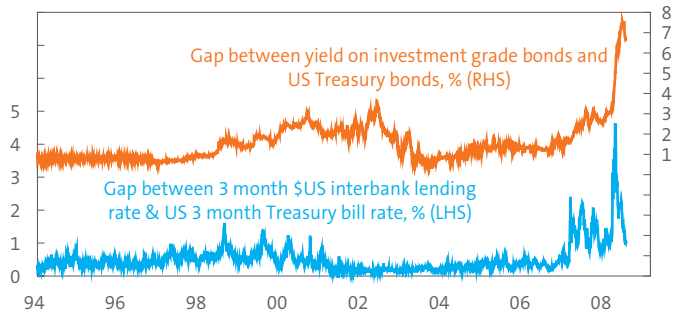
A more fundamental criticism from free market ideologues is that market forces should be left to run their course so as to cleanse the system of past excesses. In other words, after the good times of the boom, we all need to suffer! This was the approach to economic management prior to World War II and resulted in regular wild swings in economic activity and unemployment. The problem with this approach is that it can cause massive economic pain. While the 1930s depression unwound the excesses of the 1920s, this came at a massive cost to society. 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.

Are there any signs it is working?

Given the ongoing losses in global banks and the latest slide in bank shares, the financial crisis is clearly 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, there have been some signs of improvement. Focusing mainly on the key US situation:

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

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



- 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 the number of 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 Australia.
- Chinese money and credit growth have 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 needs to become positive. This includes 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 slightly 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 as a counterweight to the global financial crisis. More action is needed via fiscal stimulus and measures to get banks lending again, which look to be on the way. Economic news will likely get worse before it improves, which will ensure a volatile ride for investors in the short term. But there are signs that the policy response is helping. This provides some confidence that growth will start to stabilise later this year and through 2010, which would be consistent with shares resuming a sustainable recovery path.

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