

The risk of a double dip has risen, but is still not probable



Key points

- While the risk of a double dip for the global economy has increased, we remain of the view it will be avoided.
- Shares may still see further weakness into September/October but are likely to experience strong returns on a six to 12 month horizon as it becomes clear the global recovery is continuing.

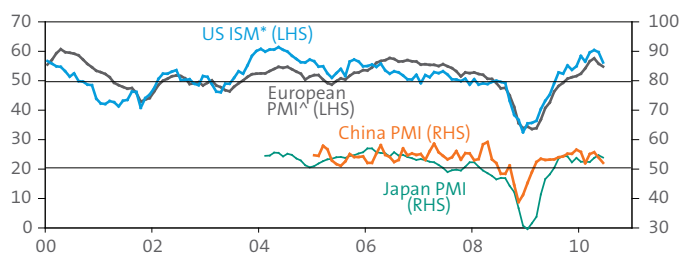
Introduction

It seems every time I go on holiday share markets go on a roller coaster. The last three weeks have been no exception, with shares plunging in the first two weeks that I was away, only to then recover a portion of their losses. The main driver of the latest turbulence is concern the global economy will double dip back into recession. So the key remains whether the world double dips or just sees a growth slowdown after the surge of the last year.

Double dip unlikely

The European sovereign debt crisis, a premature shift toward fiscal tightening in countries like Germany, the UK and maybe Japan, renewed weakness in the US housing sector, and China's aggressive measures to stop property speculation have all boosted the risk of a dip back into global recession. However, while the risk of a double dip has risen, our view remains it will be avoided. Firstly, business conditions indicators in the US, Europe, Japan and China appear to have peaked but so far their fall is consistent with a moderation in growth, not a collapse back into recession. After a strong bounce in the second half of last year to near cycle highs, some loss of momentum was inevitable. This is entirely consistent with past experience, e.g. the moderation in 2004 after the recovery from the tech wreck recession.

Global business conditions appear to have peaked



Source: Bloomberg, AMP Capital Investors

* Institute for Supply Management, ^ Purchasing Manager's Index

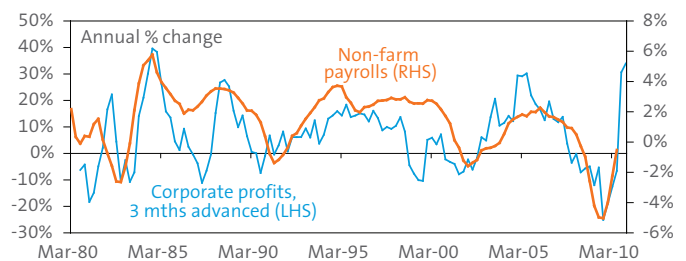
In fact a moderation in growth in some regions is desirable, otherwise we would have seen a return to a boom/bust cycle. This is notably the case in China.

Secondly, double dips are unusual. Since 1925, the only double dip in the US economy occurred in the early 1980s when recession was followed by a recovery in 1981, only to see a return to recession in 1982 due to the US Federal Reserve's move to squeeze out inflation.

Thirdly, while fiscal policy is being prematurely tightened in Europe, this is not the case in the US. Also, global monetary policy remains very easy with near-zero interest rates in major developed countries.

In addition, the corporate sector in the US is in good shape. A surge in profits, which seems to have continued in the June quarter if recent earnings results are anything to go by, is likely to underpin stronger employment and business investment going forward.

Rising US profits point to more employment gains ahead



Source: Bloomberg, AMP Capital Investors

Finally, it should be recognised the emerging world is in a very different situation to the major developed countries. Emerging countries have experienced a typical cyclical recovery without the structural problems evident in the US, Japan and Europe. But with growth back up again – and becoming too strong in some countries – it was appropriate to reign it in. Hence we have seen the adoption of tightening measures in various countries including Taiwan, Malaysia, South Korea and Peru in the last few weeks, and this has contributed to market jitters. However, this tapping of the brakes is perfectly normal and is unlikely to lead to another recession. In fact China, which led this process, has now seen economic growth slow to a more sustainable pace, i.e. 10.3% growth for the year to 30 June 2010 compared to 11.9% growth for the year to 31 March 2010, and inflation showing signs of topping out. As a result, it's likely to start easing up again in the next few months. The bottom line is that the emerging world will be a major contributor to global growth over the next few years, offsetting the softness in developed countries.

Chinese growth has cooled down and inflation may be peaking



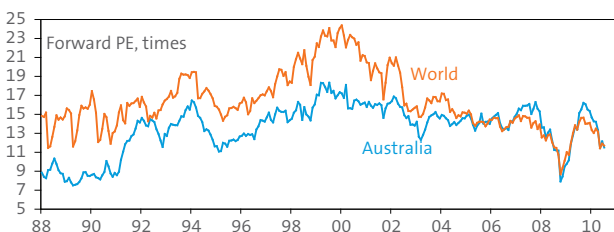
Source: Bloomberg, AMP Capital Investors

Although the risk of a double dip back into global recession has increased and cannot be ignored (and a double dip is a high risk in Europe), the most likely outcome for the global economy is continued recovery, albeit at a more modest rate than seen over the last year.

What does this mean for shares and other growth assets?

The second 12 months in share markets after a bear market ends is usually more rough and constrained than the first 12 months of recovery, which is certainly proving to be the case this year. This often reflects worries about a double dip back into recession. On top of this, the September quarter is traditionally the worst quarter of the year for shares. So with double dip fears likely to persist for a while yet, further weakness and volatility in share markets and other growth assets like commodities and the Australian dollar into September/October is a high risk. Against this, we remain of the view that reasonable gains are likely in share markets on a six to 12 month horizon. Firstly, shares are cheap, with global and Australian shares trading on price to earnings (PE) ratios well below their longer-term averages. Australian shares are trading on a forward PE ratio of 11.5 times, which is well below their long term average of 14.5 times and below the 13 times level that might prevail in the more volatile environment we have now entered into.

Shares are cheap



Source: Bloomberg, AMP Capital Investors

Secondly, profit growth is likely to be strong at around 15-20% over the next year as still rising sales on reduced cost bases boost earnings. Obviously it may be a bit less than this in some developed countries and slightly more in emerging markets.

Thirdly, continuing near-zero interest rates in major developed countries provide strong support for shares.

Finally, investor sentiment toward shares has fallen back to levels normally associated with market bottoms. In other words, it's so negative that it is positive from a contrarian perspective.

Overall, our view is that even though volatility will likely remain high and because it's premature to say that shares have seen their lows for this year, the broad trend in shares is likely to remain up. Gains in share markets over the next year may well be led

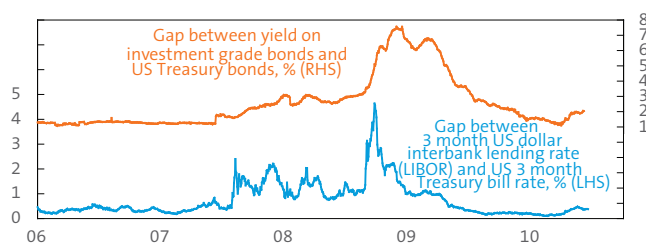
by the emerging world, particularly China if it starts relaxing its tightening measures in the coming months.

What to watch?

Admittedly the risks remain high, so several things are worth keeping an eye on, including:

- Credit and money market spreads for signs of a renewed global credit crunch following the problems in Europe. So far the impact remains minor and the release of stress tests of European banks next week may help relax market concerns on this front to the extent that transparency around bank exposure to Greek and Spanish public debt will be improved.

Money and credit market spreads are up, but are still low



Source: Bloomberg, AMP Capital Investors

- Signs that global business conditions indicators (as shown in the first chart) are starting to turn down significantly. So far it just looks like a moderation in growth and not a collapse.
- A more aggressive move toward fiscal tightening in the US and Japan.
- The continuation of tightening measures in China, even though growth is slowing.

Conclusion

After last year's strong gains, this year is certainly proving to be a lot tougher. Such a pattern though is not unusual in a historical context, with both 1992 and 2004 seeing a tougher patch in markets after initial recoveries from bear market lows in 1991 and 2003 respectively, only to see the recovery continue again in 1993 and 2005. In the very short term, further weakness in share markets cannot be ruled out, particularly into the normally weak September/October period. However, if we are right and global economic growth doesn't lurch back into recession, then the rising trend in shares will resume, supported by solid earnings growth, attractive share market valuations and low global interest rates.

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