

What the world needs now – the world economy back on the brink

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Key points

- > The falls in share markets since April have been due to poor global economic data and political dysfunction in the US and Europe.
- > After falls of 20% or so, shares are good value for long-term investors but it's too early to say they have bottomed.
- > For confidence that shares have bottomed look for Europe to follow through with expanding the firepower of its bailout fund, aggressively buying sovereign bonds and recapitalising its banks along with concerted global monetary easing including in Asia and Australia.

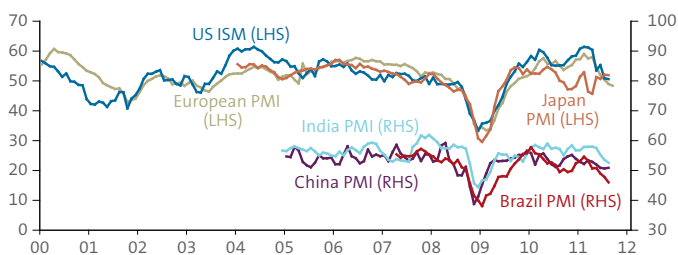
Introduction

The chronic failure of Europe to bring its debt problems under control, an ongoing flow of poor global economic data combined with comments from global officials that there are “significant downside risks”, “the current situation has entered a dangerous phase” and the “world is in a danger zone” has seen global share markets retest or in some cases fall below early-August lows. What's more, sharp falls in commodity prices, Asian currencies and the growth-sensitive Australian dollar in the last few weeks indicate the threat to the emerging world has intensified. There is now a sense of hopelessness that policy makers in the US and Europe have fired all their bullets and there is not much more that can be done. But is it really that hopeless?

The current situation – why are markets down

There are basically two reasons for the deterioration in the global economic outlook and the sharp falls/skittishness in investment markets since April. Firstly, global economic indicators have softened, with Europe looking like it is back in recession, the US close to it and the emerging world also slowing. This is all evident in a slide in business conditions indicators as can be seen in the next chart.

Global business conditions indicators weakening



Source: Bloomberg, AMP Capital Investors

Secondly, official policy makers have either been in denial or political processes have become dysfunctional, all of which is leading to either policy inaction or inappropriate action. By adversely affecting confidence amongst other things, this has

arguably turned a soft patch in global growth into something more serious:

- > Europe has continued to squabble regarding its debt problems. It has yet to approve the expansion in its bailout fund that was announced months ago. It continues to speak with multiple voices which confuse investors. Its medicine of fiscal austerity, i.e. tax hikes and spending cuts, is making things worse. It is not sufficiently protecting otherwise solvent countries such as Spain and Italy from market panic. And monetary policy is too tight following the European Central Bank's (ECB) misplaced rate hikes earlier this year.
- > Political bickering in the US associated with its debt ceiling and culminating in its credit rating downgrade has dealt a huge blow to business and consumer confidence. Unfortunately it's continuing, with President Obama announcing plans for a short-term fiscal stimulus, then announcing that this and long-term deficit cutting plans would be financed in large part by tax hikes, with the knowledge it likely won't be accepted by Republicans. This vociferous political debate is also spilling over to the Federal Reserve (Fed) with top Republicans urging against further quantitative easing, possibly adding to the reluctance of Fed Chairman Bernanke to deploy a third round of quantitative easing, i.e. QE3.
- > Policy makers in emerging countries and Australia remain too focused on keeping a lid on inflation when the real threat is fast becoming the slump in growth and confidence emanating from Europe and the US.

Historically, there are not a lot of examples of double-dip recessions, where growth recovers from recession only to slide back in a short while later. However, those that have occurred have been either by design (e.g. America's slide back into recession in 1981-82 as the Fed tightened to squeeze out inflation) or due to a policy mistake (such as in the US in 1937 or Japan in the 1990s). The danger is that political ineptitude of the sort we have been seeing from the North Atlantic lately will lead to the same thing now.

So what needs to be done?

It's not true that global policy makers have run out of policy bullets. There is still plenty of scope to cut interest rates in Europe (where the short-term rate is 1.5%) and in the emerging world. Central banks in advanced countries that have near-zero interest rates can employ more quantitative easing, i.e. inject cash into their economies. The pace of fiscal austerity in Europe could be slowed and the US could afford another short-term fiscal stimulus in return for more aggressive moves to wind back entitlement spending over the decade ahead. Moreover, Europe needs a bond buyer of last resort to ward off speculators from otherwise solvent countries such as Italy and Spain in order to prevent further contagion and market panic and there is nothing to stop the ECB doing this if it wanted to. So the real issue is not a lack of firepower, but dysfunctional politics.

I would nominate five measures that would help keep the global recovery going and provide confidence to investors:

1. Coordinated global monetary easing involving quantitative easing in the US, UK, Europe and Japan, and interest rate cuts in Europe, Asia and Australia.

2. **An increase in the firepower of the European bailout fund**, i.e. the European Financial Stability Facility (EFSF), possibly using leverage provided by the ECB and/or the private sector. It has generally been estimated that to provide sufficient firepower to put a firewall around Greece it will need to increase to around €2 trillion.

3. **Aggressive and unlimited buying of peripheral country bonds by the ECB / expanded EFSF.** This is necessary to push bond yields in countries like Portugal, Ireland, Spain and Italy back down to more sustainable levels and to keep bond yields down in other potentially vulnerable countries. In other words, send a strong signal to speculators to back off.

4. **A recapitalisation of European banks**, with banks either forced to seek capital from the market or from the EFSF.

5. **The passage of President Obama's stimulus plan** in return for more aggressive moves to wind back increases in spending on entitlements in the decade ahead (e.g. by capping health benefits and increasing retirement ages).

Following the G20 Finance Ministers, International Monetary Fund and World Bank meetings in Washington last weekend, there are strong indications policy makers are starting to get the message.

- > In particular, European officials are reportedly working on plans to recapitalise banks and increase the firepower of the EFSF using leverage possibly involving the setting up a European Investment Bank to borrow and buy European debt. There is also talk Europe is on the brink of recognising that Greece is insolvent, and therefore moving to Plan B. This might involve some sort of 'controlled insolvency' for Greece, whereby say half of its debts are written off and an expanded EFSF or the ECB is used to stop a market panic from threatening banks and other countries. At this stage it seems the German Government is still not behind the idea to expand the EFSF and it's likely that the ECB is also sceptical. However, the key in all of this is for Europe to move fast, rather than go through another long debate and ratification process, requiring more investor panic along the way to force action, as has been the case to date. In the meantime, there are indications the ECB will start cutting interest rates next week along with providing enhanced liquidity-boosting measures to help banks.
- > In the US, QE3 is likely in November and the Bank of England also looks like it is heading towards another round of quantitative easing.
- > With slower growth and a sharp fall in commodity prices taking pressure off inflation, central banks in the emerging world, Asia and Australia will likely be cutting interest rates by year-end. Brazil, Russia and now Israel are already showing the way on this front.

What about just letting Greece leave the euro?

There has been much talk that Greece and the rest of Europe would be better off if Greece just left the euro and went back to using the drachma, which would depreciate allowing it to trade out of its problems. Unfortunately it's not that simple. In getting out of the Euro-zone, Greece would likely see a run on its banks as Greeks seek to withdraw their euro-denominated bank deposits before they are converted into depreciated drachmas,

and the depreciation in the drachma would see Greece's euro-denominated debt burden explode to the point where it would default anyway. It is for this reason that German Chancellor Angela Merkel has insisted that Greece's future remains within the euro. Germany leaving the euro and returning to the deutsche mark would be equally as bad with German exporters suffering from a sharp rise in the new deutsche mark and German banks suffering big currency losses on their euro loans.

Aren't common Eurobonds a solution?

Another idea commonly floated is that European countries simply issue common Eurobonds to replace their public debt up to say 60% of their gross domestic product, and this would lead to much lower interest rates. However, Eurobonds might have worked if there was a central fiscal authority and public debt levels were similar. Fiscal union and common Eurobonds may also be part of a long-term solution to make sure sovereign debt problems don't arise again. But Germany and similar countries won't agree now to borrow in Eurobonds which would carry interest rates well above the levels they can borrow at currently. For this obvious reason, Germany has repeatedly ruled out Eurobonds for now.

So where does all this leave investors?

For the past few months I have felt that shares are cheap but given the issues in Europe and the US they could still get cheaper. **For long-term investors willing to look beyond short-term uncertainties, shares offer great value.** Currently the dividend yield on Australian shares is 5.1%, but grossing up for franking credits means the cash flow being paid from Australian shares is over 7% of their current value. For financials and blue chip stocks, dividend yields are even higher than this. This is well above bank term deposit rates and means that share values only need to rise by 3% per annum or so to provide pretty attractive returns for long-term investors.

For short-term investors, it's still too early to be confident that shares have seen their lows. However, there are some reasons for optimism. After 20% plus falls, and with forward price-to-earnings (PEs) multiples down at around 10 times, share markets have likely already factored in a return to mild recession, particularly in Europe where forward PEs are down around seven or eight times. Investor sentiment is very bearish, which is normally positive from a contrarian perspective. And global policy makers appear to be getting the message that they need to do something. However, in order to gain confidence that shares have bottomed I would look for Europe to follow through with expanding the firepower of its bailout fund (or some variation around that), aggressively buying sovereign bonds and recapitalising the banks, along with concerted global monetary easing. It's also worth noting that after the September quarter, normally being the weakest quarter of the year, October often marks an important turning point ahead of strength into year-end and there is a good chance the same will happen this year if policy makers deliver.

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