

# Economics Report

1 July 2009

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## Caton's Corner- July 2009

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### Happy New Financial Year!

It will almost certainly be better than last year! Despite the fact that the ASX200 index rose in each of the last four months of the year, it still finished down by 24% for the year as a whole. This was its second successive down year, with the index having fallen by 17% in 2007/08. This is the biggest one-year loss since 1982, and the worst two-year performance for more than 70 years. As a result, most superannuation (and other) investors have lost a good deal of money for two years in a row. Faith in the process of wealth accumulation has been severely tested.

I have to say that the past financial year was a lot worse than I expected it to be. A year ago, when I looked at the forces that might affect financial markets, I got three important things right, and one *very* important thing wrong. I did say that the US recession had some way to run (it hadn't even been officially admitted at the time that the US was in recession), and that the price of oil would come down. I did also suggest that the second half of the financial year would be better than the first half. What I missed (spectacularly) was that the problems with the US financial sector would get *much* worse. Indeed, the world banking system came close to total collapse in September, following the bankruptcy of Lehman Brothers. This led to a jamming up of credit markets (again), a massive loss of confidence, huge falls in share markets (with the US market down by 18% in a single week at one stage) and a virtual freefall in world economic output. It was not uncommon to hear the view that the world would be in recession (or worse) for a few years.

That is now very unlikely to be the case. At the very least, the global economy is no longer falling as rapidly as it was, and there are more signs of eventual improvement (the so-called "green shoots") almost every day. Indeed, the process of economic healing may already be further along than popularly thought. Going into recessions, there is always a "recognition lag" (it took until December 2008 before the scorekeepers in the United States acknowledged that the US had been in recession for a year already), and there will be a similar lag on the way out. My expectation is that **some time early next year it will be announced that the United States economy began to recover right about now**. If that defies belief, remember that recoveries are about growth and not about level. They begin when economic growth resumes, so the economy remains weak (and unemployment usually keeps rising), possibly for more than a year into the recovery.

I have made the point before that **forward-looking share markets turn before economies turn**. In the United States, the "lead" has generally been remarkably close to four months in recent decades, which makes it very likely that the turning-point was in early March (the Australian market has risen by more than 25% already).

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Indeed, I cannot conceive of anything that would take markets back below that point, short of another event of the magnitude of the Lehman Brothers collapse. And if that were going to occur, wouldn't it have happened already?

Figuring out the size and shape of the Australian recession continues to be challenging. I suggested last month that the Government's budget-time forecast may have been too pessimistic, and the release of the March quarter 2008 national accounts supported this view. That said, Australia grew in the March quarter because **it was the only important country in the world that didn't take a huge hit to the volume of its exports**. But there were some special factors here (we sold a lot of coal to China and a lot of gold to Europe) that are unlikely to be repeated. So we are likely to limp along at close to zero (or mildly negative) growth for the June and September quarters, before the stabilisation of the world economy and the loosening of both fiscal and monetary policy lead to a better outcome.

Our share market therefore has more weak news to contend with, and it has the upcoming reporting season to negotiate. But it is still trading on the cheap side of history (though it's no longer the bargain basement that it was in early March), so it should make forward progress. For what it is worth, I have a target of 4500 for the ASX200 index (currently at 3956) twelve months from now. This would be a gain of 13.8% if realised.

The interest rate outlook is also quite perplexing. Financial markets are toying with the view that rates will begin to rise early in 2010. Given that it would be very unusual for rates to rise before unemployment has clearly stopped rising, it wouldn't surprise me if rates don't rise for twelve months. Indeed, the monthly drumbeat of news that unemployment is rising may well force the RBA's hand, and lead to lower rates. The Reserve Bank is probably reluctant to cut further, given how low rates already are, but it may not be able to withstand the public pressure.

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**The views expressed herein are those of the author and should not be otherwise attributed.**

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