

How deep the recession?



Oliver's insights

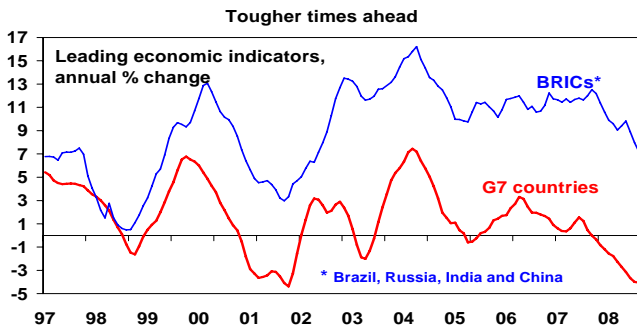
Key points

- Global recession is now a given. Australia is also headed for at least a mild recession.
- The key issue is the depth and duration of the slump. At the moment, leading indicators for global and Australian growth are still in free fall.
- Rapid policy action should help drive a recovery from the second half of 2009, but given the de-leveraging now underway the risk of a longer recession is high.

The coming recession

Lehman Brothers' collapse in September and the resulting panic it set off in global money markets, and more broadly in confidence, has caused immense damage to the global economic outlook. In particular, it would seem that the efforts by the US Government to convince Congress to pass the bank rescue program last month by arguing it is a Main Street problem as well as a Wall Street problem has convinced investors and the wider global population of the seriousness of the situation. This has led to a sharp deterioration in economic data recently.

Recession is now a given in key advanced economies – Japan and Europe have already had two consecutive negative quarters and it is only a matter of time before it is “officially” declared in the US as well. Recession is also probable in Australia. And the emerging world will be running far enough below potential to qualify as a recession as well (even though growth will still be positive). Right now, leading indicators of economic growth are still pointing down and provide no indication of when the slump will end and of how deep it will be. See the next chart.



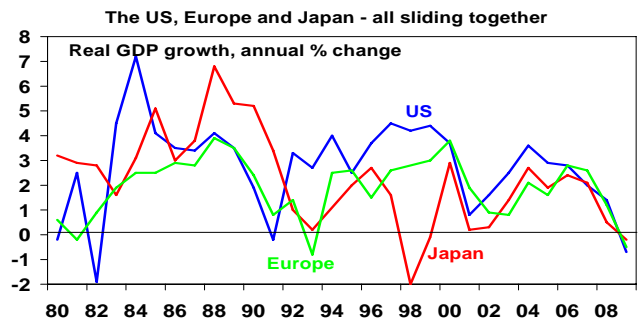
Source: Thomson Financial. AMP Capital Investors

Not a normal post war slump

The current situation is very different to that going into past post war recessions for several reasons. Normal post war recessions were part of a cycle which saw inflationary pressures build during an economic upturn, interest rates

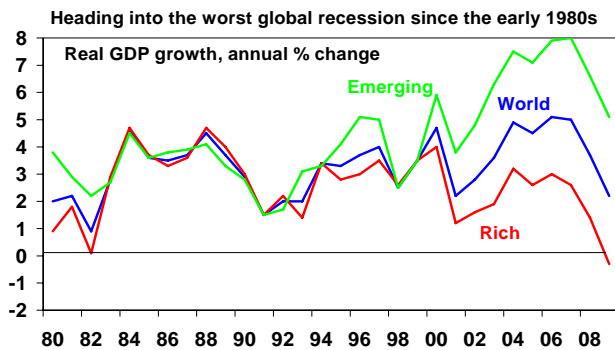
rise, demand slow and inventories rise resulting in a downturn which is ultimately turned around via lower interest rates and after de-stocking has run its course. The current cycle has some elements of this and it was made worse by the huge surge in oil and commodity prices into mid year which saw interest rates increased or maintained at higher levels than should have been the case. But two considerations make this global slump potentially more serious and hence add to the level of uncertainty.

- Firstly, **we are faced with significant systemic risk as the flow of credit has been radically impaired** by a severe loss of confidence on the back of the sub-prime mortgage crisis and subsequent banking problems. The resultant pressure to reduce gearing (whether in hedge funds, real estate investment trusts or indebted households) has meant that the current slump has many of the signs of a debt-deflation cycle described by economist Irving Fisher in relation to the Great Depression. In a debt deflation spiral: distressed selling of assets leads to wealth destruction, which leads to falling spending which leads to rising unemployment and then more distressed selling of assets (including houses) and more falls in asset prices, etc. The UK & US are already in a form of this.
- On top of this **most countries are weakening at the same time**. For example, back in the early 1990s, the US had a recession in 1990 and then recovered but Japan and Europe did not really succumb till 1992.



Source: IMF, AMP Capital Investors

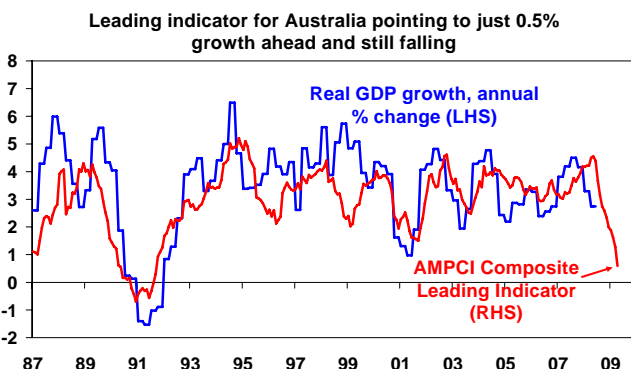
So the synchronisation in the economic downturns in the US, Japan and Europe is now making the global downturn a lot worse. As a result, weighted average growth in the world's advanced countries is now expected to contract for the first time in the post war period. See the next chart. While the emerging world is coming from a higher growth base than was the case going into the early 1980s and early 1990s downturns, momentum here is also fading rapidly.



Source: IMF, AMP Capital Investors

As a result, there is greater than normal uncertainty regarding the economic outlook. Our base case would see the global recession last to around mid 2009. But given de-leveraging and the uncertainties it sets off, a longer and deeper recession stretching into 2010 is possible. Rapid government policy - to stabilise money markets along with fiscal stimulus and lower interest rates - should head off the deep recession scenario (or a 1930s depression).

Australia is currently better placed than many countries. Our financial system is less impaired, it has more scope for policy easing, growth in its trading partners will likely remain above that in the advanced world and the fall in the \$A will provide a boost to domestic production. But even in Australia the risks are high given our high levels of household debt and house prices relative to income and Australia's high reliance on foreign capital. Our leading indicator for Australia now points to growth slowing to 0.5% over the next six months and it's rapidly falling to the levels associated with the early 1990s recession. This along with the still deteriorating global outlook, plunging confidence and negative wealth effects indicates Australia will at least have a mild recession at some point in the next year.



Source: Thomson Financial, AMP Capital Investor

During the last two recessions in Australia, unemployment rose by 5 percentage points and inflation fell by an average 5 percentage points. **Inflation will fall sharply** as lower commodity prices and the slump in the economy feed through. Unemployment is likely to rise to between 7 to 9%.

What to watch

Given the uncertainty regarding the outlook, and specifically the lack of certainty between whether the world is facing a mild or deep recession, we are monitoring a range of signposts. To gain confidence in our base case view that global growth will start to stabilise around the middle of next year and improve thereafter we are looking for:

- A rapid further decline in short term interest rates relative to long term rates.
- More global rate cuts and more fiscal stimulus quickly.
- A slowing rate of decline in US house prices.
- US consumer spending to slow but not collapse.
- A stabilisation in consumer confidence in key countries.
- A modest pick-up in corporate defaults.
- An easing in bank lending standards.
- A further improvement in money markets.
- A fall in private sector borrowing rates.
- An improvement in broad money supply measures relative to the monetary base, indicating monetary easing is getting traction.
- A stabilisation in global trade indicators.
- A stabilisation/improvement in China's growth.
- Weekly auction clearance rates are also worth watching in Australia.

While there has been some improvement in some of these signposts it is not enough to provide confidence yet.

Implications

The bleak and uncertain economic outlook has several implications for investors:

- Firstly short term cash rates are likely to fall a lot further. Japan and the US are in a race to zero. In Australia, the Reserve Bank is likely to cut by another 0.75% to 1% next month and **the cash rate will probably ultimately bottom out below 3% next year.**
- Just as shares led on the way down they will lead on the way up. Having now had 50% plus falls shares are already factoring in a recession. But while they are great value from a long term perspective the uncertainty about the outlook and the continuing flow of bleak news means it's too early to say the bear market is over.
- Commodity prices and currencies like the \$A lag the economic cycle and so it's hard to see them moving higher until there is more confidence that global growth is back on track. In the meantime, more weakness in commodity prices and resource stocks is likely.
- Unlisted assets – including housing and commercial property – are now more vulnerable than financial assets which have already been hit hard.

Concluding comments

While the next year is likely to be pretty tough, all is not lost. Australia's long term growth prospects remain bright given our exposure to China which will resume its rapid industrialisation process after the current pause and our financial system is in far better shape than in many other countries. **And in the short term it should be borne in mind that a lot of stimulus is being pumped into the household sector, with lots more to come.** A middle income Australian family with a \$250,000 mortgage, two kids and two cars will be seeing their finances bolstered considerably. Their mortgage interest bill will have fallen by about \$375 a month (and will fall a lot further) since August, their monthly petrol bill will have fallen by about \$95 since July and, if they qualify, they will get a one off \$1000 per child payment next month. Of course, the uncertainty caused by rising unemployment will mean a big chunk of this will be saved, but it will certainly help avoid a big collapse in spending and more importantly at some point later next year will help drive a recovery.

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