

The global economy looking a little less scary

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Oliver's Insights



Key points

- > The last month or so has actually seen better news regarding the global economy – European Central Bank (ECB) action appears to have reduced the risk of a banking crisis in Europe, US economic data has continued to surprise on the upside and Chinese economic data remains consistent with a soft landing.
- > While shares are at risk of a short-term correction and Europe remains a source of volatility, the improved global economic backdrop is a positive sign for shares and related growth trades going forward.

Introduction

The past few weeks have been interesting. Sovereign rating downgrades in Europe have intensified. The World Bank and now the International Monetary Fund (IMF) have slashed their growth forecasts for this year and warned of the risk of a global downturn worse than that associated with the global financial crisis. Yet share markets and other risk trades have almost said “ho-hum”. So what’s going on? Our take is the markets are telling us that a lot of the bad news has already been factored in. The ratings downgrades were flagged back in early December and the World Bank/IMF growth forecasts downgrades have only just caught up to private sector economists.¹

This is not to say we are out of the woods, or that volatility will disappear. But it does seem the risk of a global financial meltdown has receded somewhat and that the global economic recovery appears to be continuing.

Europe – reduced risk of a financial blow-up

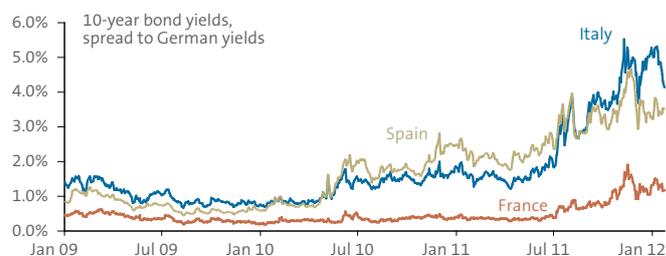
Europe is on track for a mild recession but the risk of a financial blow-up resulting in a deep recession seems to have receded a bit. The provision of cheap US dollar funding by the US Federal Reserve and very cheap euro funding for three years by the ECB under its long-term refinancing operations appears to have substantially reduced the risk of a liquidity crisis causing banking collapses. It has also reduced pressure on European banks to sell bonds in troubled countries.

We would have preferred the ECB to have directly stepped up its buying of bonds in troubled countries, but its back door approach has nevertheless seen a sharp expansion in the ECB’s balance sheet. In other words, it appears to have embarked on quantitative easing, albeit it wouldn’t admit it.

Reflecting this, bond yields in Spain, Italy and France and spreads to Germany – which were surging towards the end last year – have settled down. Similarly, European bank stock prices appear to have stabilised.

¹ Our global growth forecast for 2012 is 3%, which compares to the IMF’s new forecast of 3.25% and the World Bank’s new forecast of 3.4% (if purchasing power parity weights are used to combine countries).

Italian, Spanish and French bond yields have been stabilising relative to German bond yields



Source: Bloomberg, AMP Capital Investors

This is not to say Europe is no longer a source of risk. It still is – it’s doubtful that even with the proposed debt restructuring Greece’s public debt is on a sustainable path, fiscal austerity is still bearing down on growth across Europe, more ratings downgrades are likely and monetary conditions are still too tight. But the risk of a meltdown appears to have receded. What’s more European business conditions indicators have picked up in the last two months.

In November, we referred to three scenarios for Europe:

1. Muddle through – i.e. a continuation of the last few years of occasional crises temporarily settled by last minute bare minimum policy responses.
2. Blow up – in which a financial crisis and deep recession see a break-up of the euro.
3. Aggressive ECB monetisation – with quantitative easing heading off economic calamity, albeit not quickly enough to prevent a mild recession.

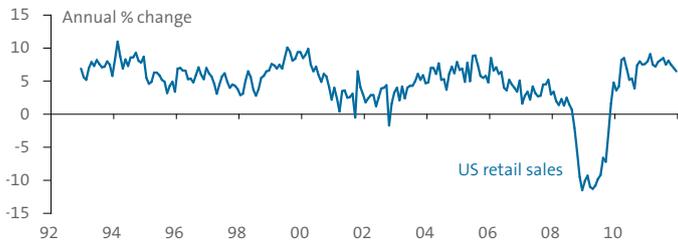
Recent action by the ECB appears to have reduced the chance of the ‘Blow up’ scenario (probably to around 25%). The costs of leaving the euro for countries like Greece (which would include a likely banking crisis as Greek citizens rushed to secure their current bank deposits, which are all in euros, and default on its public debt anyway) still exceed the likely benefits, so it still looks like the euro will hang together. Overall, the most likely scenario appears to be some combination of ‘Muddle through’ but with more aggressive ECB action preventing it from spiralling into a ‘Blow up’.

The US – no double dip (again)

During the September quarter a big concern was that the US economy would ‘double dip’ back into recession. This, along with escalating worries about Europe and the loss of America’s AAA sovereign rating, combined to produce sharp falls in share markets. Since then, US economic data has turned around and surprised on the upside:

- > Retail sales growth has hung in around 7% year-on-year despite a sharp fall in consumer confidence
- > Jobs growth has picked up
- > Housing-related indicators have stabilised and in some cases started to improve, and
- > Gross domestic product (GDP) growth has picked up pace again after a mid-year softening.

US retail sales growth has held up reasonably well



Source: Bloomberg, AMP Capital Investors

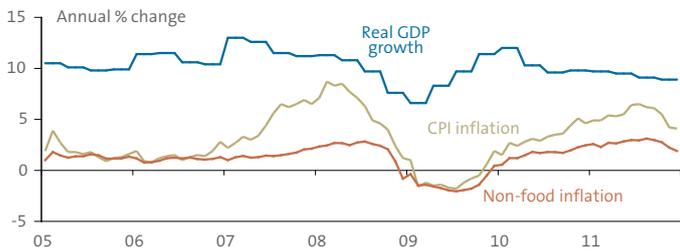
Earlier concerns about a 1.5% to 2% of GDP fiscal contraction in 2012 dragging growth down have faded as Congress has agreed to extend payroll tax cuts and expanded unemployment benefits for another two months, with a good chance they will be extended for the full year.

More fundamentally, the US appears to be starting to enjoy somewhat of a manufacturing renaissance (in stark contrast to Australia!). There are numerous anecdotes of global companies moving manufacturing to the US including Electrolux, Siemens, Maserati and Honda (which chose to build a new 'super car' in Ohio rather than in Japan). Furthermore, General Motors is now the world's top selling car maker again. Could a decade-long fall in the US dollar and very strong productivity growth be sowing the seeds of a long-term turnaround in America's fortunes?

China – so far so good

Chinese economic growth has slowed to 8.9%, but there is no sign of a hard landing. Export growth has slowed sharply but so too has import growth and in any case net exports have not been a contributor to growth in recent years. Moreover, retail sales growth has held up well and fixed asset investment has slowed only slightly.

China's growth is cooling, not collapsing, and falling inflation will allow policy easing



Source: Bloomberg, AMP Capital Investors

Furthermore, falling inflation (from 6.5% in July to 4.1% in December) and a cooling property market, evident by falling prices in 52 of 70 major cities in December, and falls in sales and dwelling starts provide authorities with the ability to ease the economic policy brakes. And there is plenty of scope to ease. Large banks are currently required to keep a record high 21% of their assets in reserve, the key one-year lending rate is at 6.6%, the budget deficit was just 1.1% of GDP last year and net public debt is around zero once foreign exchange reserves of US\$3 trillion and other assets are allowed for.

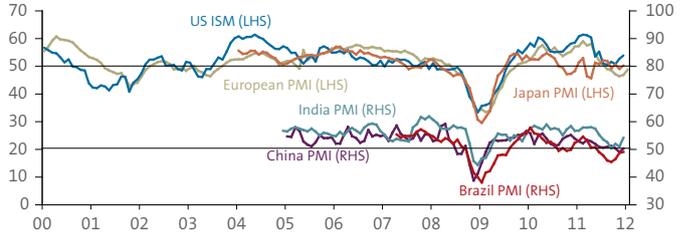
After doubling between October 2008 and August 2009 on global financial crisis related stimulus and a growth recovery, Chinese shares fell 38% to the low early this month as investors feared

tightening policy would result in a hard landing. With Chinese price to earnings (PE) multiples having fallen back to bear market lows and policy starting to ease again, decent gains are in prospect over the next few years.

Global growth

The next chart highlights the improvement recently in global economic indicators. Manufacturing conditions in most major countries were in decline into the September quarter, but in recent months have either stabilised or started to improve.

Global business conditions indicators have recently stabilised or improved virtually everywhere



Source: Bloomberg, AMP Capital Investors

What does this mean for investors?

None of this is to say it will be smooth sailing going forward. Europe's problems are a long way from being solved, uncertainty remains regarding fiscal policy in the US, Chinese authorities will need to ease soon to ensure a soft landing and the Reserve Bank in Australia also needs to cut more. On top of this, after a solid start to the year shares are getting a bit short-term overbought, some short-term sentiment measures are a bit elevated and the hot and cold pattern of US data releases warns we may soon see a cold patch. So shares are vulnerable to a short-term setback (with February often a soft month in contrast to the seasonal strength seen in January).

However, the improved global economic outlook and reduced tail risks regarding Europe suggests 2012 should be a better year for shares and other risk assets. This is also supported by the fact that shares are starting the year on share market valuations well below year-ago levels.

Share market price to earnings multiples remain low



Source: Thomson Reuters, AMP Capital Investors

Signposts investors should watch include: the size of any share market setback in the seasonally weak month of February; bond yields in Italy, Spain and France; the US ISM manufacturing conditions index; and Chinese money supply growth.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital Investors

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