

Is the economic recovery finally on?

Has the US turned? Are the numbers coming out of the US the first signs of a sustainable global recovery? **Ritwika Chaudhuri** seeks answers from experts, while analysing some of the fundamentals.



There are definitive signs of economic recovery in the US, the epicentre of the great recession of this decade. Even if it was symbolic, the Federal Reserve's raising of the discount rate by 25 basis points last month was an indication of the first move towards withdrawing critical support measures.

Bloomberg reports also show positive indications based on government data and a median estimate of 48 economists surveyed by the National Association of Business Economies.

The US economy expanded 5.7 per cent in the last three months of 2009, the most in six years, according to data from the Commerce Department. Business investment increased at 13 per cent, the most since 2006.

Manufacturing, which accounts for 12 per cent of the US economy, expanded in January at the fastest pace since August 2004, according to the Institute for Supply Management's factory index released last month.

Spending on equipment and software by companies is expected to increase 7.2 per cent this year. And predictions are that corporate spending is likely to drive economic growth of 3.1 per cent this year and 3.2 per cent next year.

Additionally, the sales of existing homes rose 0.9 per cent in January to a 5.5 million annual rate, according to the median estimate of economists. Another report from the Commerce Department showed that sales for new homes rose 3.8 per cent to 355,000 last month, while the unemployment rate fell to 9.7 per cent in January from 10 per cent the previous month, according to Labour Department figures.

Purchases are forecast to increase 2.2 per cent this year before gaining 2.8 per cent in 2011. Personal spending grew at an annual pace of two per cent from October through December of last year.

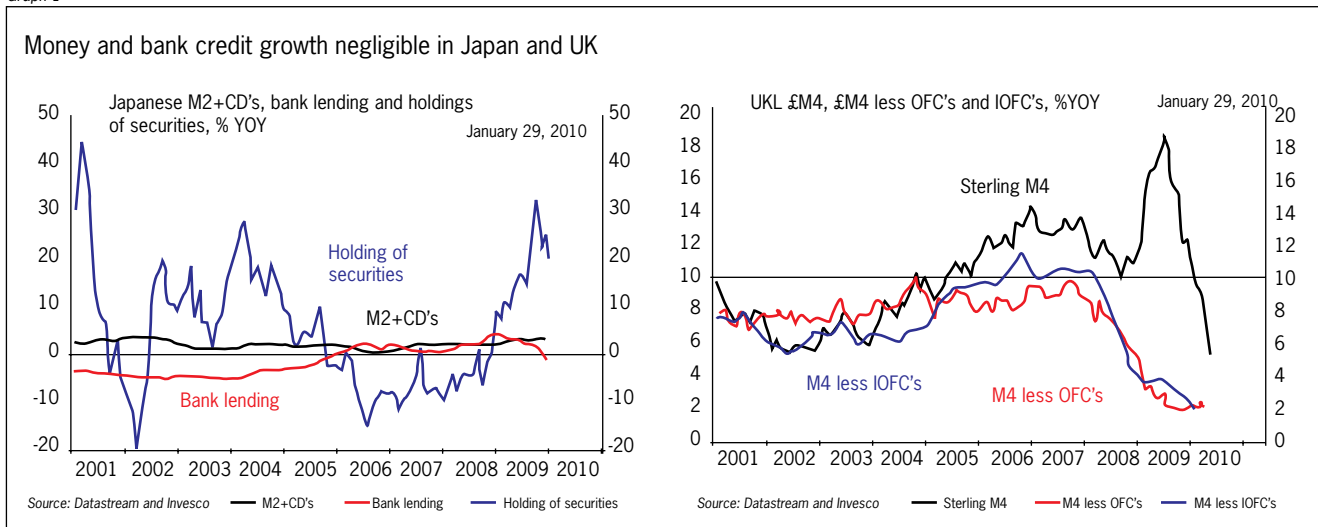
While the above (see graph 3) establishes that the US economy is on the right trajectory, it also brings hope

to the rest of the world. However, while it is true that signs of some stimulus-led growth are evident selectively, apprehension lies more in the rate of growth for the world, as most fear that it will be subpar and long drawn. Although the US has started recovering, the same is not true for the UK, some of the Eurozone countries and Japan, where crisis-led damages are deep and healing is likely to be slow.

The stories of the emerging markets and the Gulf are slightly different. While emerging markets – especially India, China and Brazil – are already on a sound recovery path, the Gulf countries are likely to benefit from higher energy demand and steady energy prices.

Tim Fox, chief economist at Emirates NBD, is optimistic and is bullish about the positive emerging trends, including the recovery of global trade, the upward trend in US consumer spending and a visible improvement in overall financial conditions. However, weaker-than-

Graph 1



Key themes for 2010:

- Global recovery well under way, albeit at a sluggish pace
- Momentum of economic growth at risk due to structural headwinds, hence structural change to become more evident
- Withdrawal of stimulus measures is a possibility more likely in the second half of this year, as it might be too early during the first half
- Interest rates to stay low
- Abundant liquidity to remain due to accommodative policies
- Credit supply to remain impaired as financial sector balance sheets are trimmed in advanced economies
- Differentiation based on fundamentals to return; risk climate is changing
- A temporary disconnect between emerging markets and mature economies
- Emergence of two-speed world: companies in emerging markets to accelerate more quickly than their western rivals
- Emerging economies to grow at a slower pace than normal due to low export demand from west
- Commodity prices to be supported by demand in emerging markets
- Heading towards less disinflationary environment; inflation to remain muted in 2010 but seeds of future inflation have been planted

Compiled by MONEYworks and based on presentations from Societe Generale Private Banking, Emirates NBD, Saxo Bank and Bank Sarasin.



expected unemployment figures in December and lagging recovery in the UK and the Eurozone bothers him.

“Although the global recovery is well underway, it is unlikely that global economies will return to their trend growth rates before 2011. I also feel that the withdrawal of stimulus measures and central bank policy measures will likely to be a key theme over the next 12 months,” he adds.

Jan Amrit Poser, head of research and chief economist at Bank Sarasin, feels 2010 will determine whether or not the recovery is sustainable.

“We are still a long way from seeing a positive economic trend with the power to sustain itself without external assistance. The economy still needs support in the form of monetary and fiscal policy measures. With capacity utilisation so low, deflationary risk will prevail over the next two years,” he argues.

There are also various structural hurdles that could hinder a sustainable growth

cycle. The process of deleveraging will rein in lending volumes. In fact, the mid-term economic outlook is overshadowed by the need to manage public deficits and restore the trade balances, according to Poser.

David Karsbøl, chief economist at Saxo Bank, backs Poser’s view that structural hurdles will temper the growth process in 2010. He says that notwithstanding the positive trends, the structural headwinds that lie ahead could turn 2010 into a rollercoaster ride.

Karsbøl further adds that one of the most influential potential triggers for global market turmoil in 2010 could be a sharp decline in economic activity in China, when the so-called investment-driven export model runs into a brick wall of fading western demand.

Chinese exports are down almost 20 per cent over the past year, and the eyes of the world are looking at China in the same way as they did at Japan in 1988, he points out.

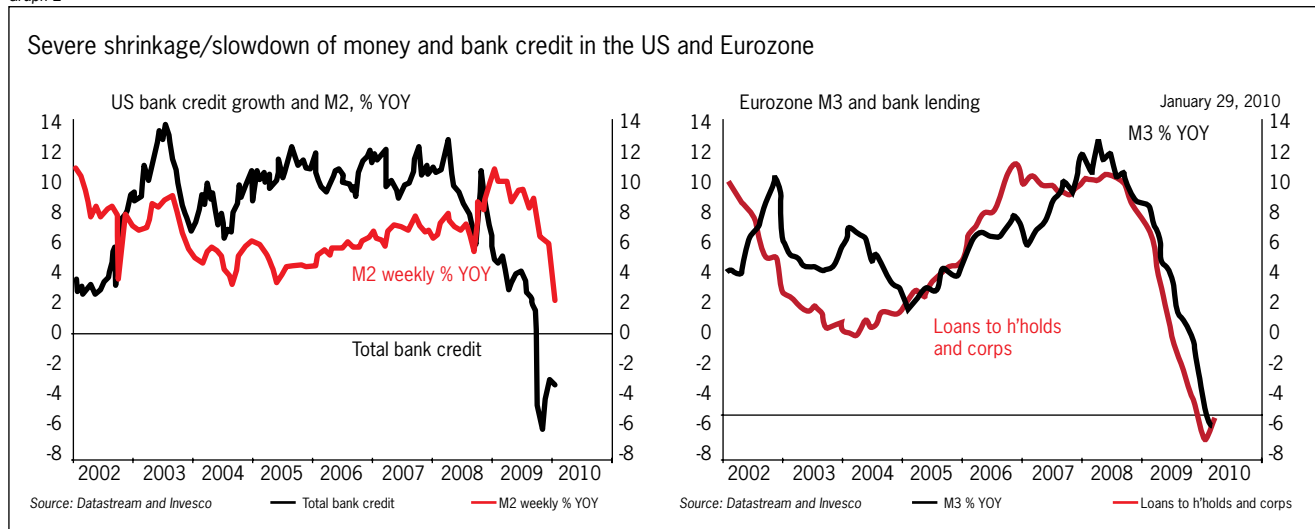
“The current improvement in financial

markets, GDP figures and consumer sentiment is no more real than the speculative boom fostered by easy money during 2003-2006. The developed world has been dominated by credit-induced bubbles since the mid-1990s and each problem has been met with lower rates and more debt,” says Karsbøl.

The problem is that it takes an

Continues on page 28

Graph 2



Subpar recovery predicted for 2010

John Greenwood, chief group economist at Invesco Asset Management, is of the view that one of the biggest challenges post economic downturn is repairing balance sheets – not only of corporates and banks, but also of households. Since this takes time, global recovery will be subpar this year, he says.

What do you think is the path of recovery this year and beyond?

I would like to focus first on the major developed economies and differentiate among those that have the least downturn and will recover quickly and those that are in deep levels of debt.

The countries that will take the longest time to recover are the UK and Spain. Both of these countries are heavily indebted economies in Europe. The UK just had the positive quota of GDP growth and the number is 0.1 per cent quarter on quarter, signalling very weak recovery. The fourth quarter GDP growth in Spain is negative, so still no signs of recovery.

When a recession is not caused by a central bank increasing interest rates in response to inflationary pressure, but is caused by a larger hang of debt and the collapse of a credit bubble, it usually leaves people with a lot of debt (especially mortgage borrowing) and negative equity. In this situation, the priority for most people across countries is first repairing the damages in their household balance sheets. That takes time, as unlike banks and companies, households cannot raise money from capital markets.

However, raising capital is one way of repairing a balance sheet. There are two other methods of repairing a balance sheet. For households, it can be done through selling assets and repaying debts with the proceeds, although, in a weak market, nobody wants to sell assets; they wait until banks tell them to pay up.

The other way to repair balance sheets is to cut consumption, increase savings and pay down the debt through one's saving. And that again takes time. As far as major developed economies are concerned, like the UK, Ireland, Spain, Greece and the US, the balance sheet repairing process is going on, but it is a slow process and historical

evidence shows that it can take six to seven years.

It might not take that long now, as the quick response of the central banks to lower interest rates has enabled mortgage rates to come down, which is helping the balance sheet repairing process. But still, people are not spending aggressively and are only resorting to discretionary savings. This, in turn, might help in improving the savings rate, but that includes debt repayment as well.

I think we are at an early stage of subpar recovery. It is not going to be a steep rise unless and until the balance sheet repairing process reaches a substantial level. Until then, I do not see any hope for the economy to grow normally or naturally.

In the case of the US, 65 per cent of the fourth quarter GDP growth of 5.7 per cent quarter on quarter is due to reduced inventory reduction. For the same quarter, domestic consumption is up by only 1.7 per cent, less than the growth in the third quarter. And if demand does not increase substantially, then there will be the problem of building fresh inventories.

The picture is very different in the emerging world, though, and especially in emerging Asia. Asia had its balance sheet crisis at the time of the Asian crisis in 1997-1998, and there was a prolonged period of balance sheet repairing during 1997-2004. Those economies did not participate in the latest housing and credit bubble like the west. So, by and large, balance sheets in those Asian countries are in good shape and they can expand monetary and fiscal policies.

In the Chinese case, for example, the government simply can issue the order that credit should be expanded and the banks are willing to lend. This is working well, as there is also capacity to borrow and at the same time willingness to lend. In the west, in developed countries, there is no appetite to borrow.



John Greenwood

Similarly, situations vary from emerging Asia to Latin America and from Eastern Europe to Gulf areas.

What is the best way to repay debt?

You have to think about what debt repayment means. When you write a cheque, it is drawn on a particular bank's deposit and is payable to the bank the money is borrowed from. In the process, the deposits of the bank from which the cheque is issued go down and the drawer bank cancels all or part of the debt and both sides of the bank balance sheet contracts. Deposits go down, loans go down and the overall balance sheet of the bank remains static if it does not start lending.

That is what we are seeing right across major economies in the US, the Eurozone and Japan. The rates of money growth and credit growth are at an unprecedented low.

The money growth rate in the UK (graph 1) is two per cent, and this is money held by household and non-financial corporations. Even broader money held with the financial institutions is rapidly decelerating and will soon converge with the domestic end. In the US (graph 2), bank credit (loans and investment held by banks) is down considerably, while money growth has slowed about 10 per cent. The current money growth recorded is only about three per cent.

In the Eurozone (graph 2), we have negative money growth for the first time ever and also negative loan growth. Furthermore, non-bank sources of credit like commercial papers, repos and assets and bank securities have declined as well. Hence, all the sources of financing for the credit

and house bubble are evaporating quickly. As such, it is inconceivable for me that we will have a stronger recovery against this background of a tight credit scenario.

In the US, the Eurozone and Japan (graph 1 and 2), growth of money supply is coming down. Along with it, the supply from the non-bank financial sources is coming down too, registering a negative rate of growth. Take, for example, commercial papers. What was earlier a major method of financing has become almost half in the US currently at US\$1 trillion from US\$2.2 trillion issued earlier. This is not a sign of upturn.

How do you explain the situation in the Gulf where the oil price has remained strong and yet governments are spending less?

I cannot comment on individual cases, but the oil price is still half of what it used to be. Surely an increase in the oil price should help. But domestic consumption is much higher now compared to five to 10 years ago, so there is a requirement for a higher cash flow just to maintain the existing level of domestic consumption and growth. It is not that a sudden deteriorating dollar or an increase in the oil price will precipitate a boom here. Also, because of the like in other areas, some regions have considerable debt burdens too. So the focus will be on debt repayment and balance sheet repairing first, and then there can be expansion.

In the US, during the third quarter of 2009, 23 per cent of all mortgage holders had negative equity. That is terrific and implies a prolonged period of recovery: first repayment of debt and getting the household finances in shape and then borrowing again or spending.

A bubble bursting is also a psychological event, following which people undergo considerable trauma, as in the case of negative equity when banks chase them and their incomes decline as well as their wealth. The dramatic change in personal behaviour as a result of these changes lasts for a long time. For instance, people who went through this pain in the 1930s refused to borrow again.

People lived through similar situations in Japan or Thailand, and this can be explained through bond yield and inflation rates in these countries. Due to the pegged currency, if

you look at 10 years before the crisis and 10 years after and then look at the inflation and bond yield, inflation is much lower after the crisis. And the reason for that is the dramatic change of behaviour of people, as they were more interested in repaying debt than borrowing. The result was lower money growth and lower inflation. The other reason for this sort of phenomenon is the existence of pegged currency.

There is a strong debate about the decoupling of the eastern economy from the western economy. What is your view regarding that?

The issue of decoupling has become important in today's perspective. The debate has gone through two or maybe three phases, as initially people thought Asia would decouple. Then the downturn happened and the Asian economy was hit badly due to falling exports. But their domestic spending was not badly affected and that is why balance sheets remained in better shape. Now the domestic demand has bounced back there.

However, the external side has not recovered properly. Chinese and Indian exports have just turned positive on a year-on-year basis, but in many countries, the level of export is below where it was in 2006-2007. So, what we see now is the newest version of decoupling. Decoupling is happening in the domestic demand, but on the external side, it is still dependent on the west.

The fact that exports to the west are not growing is affecting the domestic GDP growth rate in these countries too and they are growing two per cent less than what would have been their actual growth had their exports kept growing at the earlier rate. The figures clearly show that growth in Asia Pacific (see table) was affected during 2008 and 2009 vis-à-vis 2007 due to the global crisis. And the consensus forecast for 2010 shows that expected growth is considerably less than 2007 and that the difference is mainly due to the lack of net export boom.

Financial experts are talking about a synchronised regulatory mechanism in the financial field. Do you think that's possible?

It is clearly desirable to have consistent regulation because otherwise we have

regulatory arbitrage and that will undermine the usefulness of regulation. It is possible at the basic level to do that, but it is unlikely to be possible at a wider level in greater details.

I feel enforcement has to be on a national basis, as I do not find international or cross-border enforcement conceivable. There are different sets of regulation in different places. However, I feel there is lot to be done in this field.

Do you think withdrawal of stimulus is the right thing to do or that now is the right time to do it?

Most of the recovery in the US, the UK and to a lesser extent Europe is stimulus based. And that means if you remove them, the economy will go back to recession. The idea is to withdraw the stimulus 'pari passu', and that is in an equal step paving the recovery for the private sector. But the private sector recovery is in its infancy and it will be too soon to withdraw the fiscal stimulus.

On the other hand, the underlying cause of the problem is balance sheet distress, which needs repairing urgently. Policy should help in restoring balance sheets. Unfortunately, in a number of countries, we see governments spending money to address symptoms of a problem, like the lack of spending while the real problem is the balance sheet damage. Like a doctor, along with symptoms, these governments need to look at the cause of symptoms.

Government should repair household and financial institutions and not just inject money and expect people to do their necessary adjustments. If you simply replace private sector debt with public sector or government debt, then you are simply transferring the deleveraging problem from the private to the public and that will mean long period of higher taxes and higher government levies and charges.

In my own views on the monetary front, interest rates in both the UK and the US will stay very low throughout the entire 2010 and we will probably see rates hiked only in 2011, which will primarily be due to the incredibly low rate of economic growth. Though people are talking about a liquidity-led recovery, in reality, there is no liquidity. Also, interest rates are low not because new liquidity is provided, but because the demand for borrowing has evaporated.

Continued from page 25

exponentially growing amount of stimulus to keep the party going. Low interest rates have fostered wild speculation, moral hazards, over-investments and mal-investments, creating an unserviceable debt burden, Karsbøl notes.

“What we need now is deleveraging and defaults in order to reduce the debt burden and make it serviceable again. Unfortunately, every government effort to stimulate the economy stands in the way of change towards long-term sustainability and will only prolong the crisis into 2010,” he adds.

Asset allocation

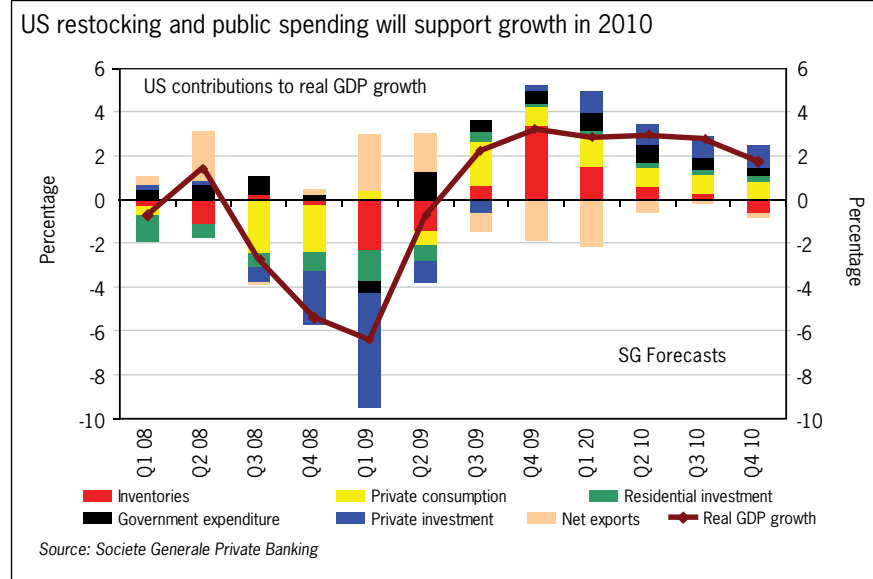
All roads seem to head towards emerging markets both for equities and bonds. There is also a lot of interest in commodities, which have returned on an upward trend. Despite volatility in the foreign currency market, people like Xavier Denis, economist and strategist at Societe Generale Private Banking, are upbeat about continued recovery of the US dollar.

Gary Dugan, chief investment officer of private banking at Emirates NBD, says that asset allocation among investors is likely to be driven by monetary policy measures of regional central banks vis-à-vis the US and the strengthening of the US dollar.

According to both Dugan and Fox, equities in the emerging markets are great picks in 2010, as this asset class is likely to be supported by positive surprises from corporate profits.

“Energy, technology and green

Graph 3



sectors are likely to see the most interest over the next 12 months, with an increased appetite for mergers and acquisitions,” says Dugan. “As far as bonds are concerned, developed market government bonds are unlikely to offer much value in 2010. However, emerging market bonds continue to be well supported.”

Dugan adds that the Middle East and North Africa region especially offers good risk-adjusted returns with increasing international interest.

In its global sector allocation, Bank Sarasin’s favourites include the consumer staple sector, industrials, energy and technology. The bank has a neutral weighting on healthcare, commodities, basic materials, telecom and utilities. The losers in 2010 are consumer discretionary

and the financial industry; however, the climate for insurance companies looks positive, says the bank.

Gulf economies in 2010

Economists are positive with their predictions for the Gulf economies. The key driver of growth for these economies will continue to be the evolution of the oil price, they say.

Bank Sarasin is slightly cautious about the outlook for Dubai (which contributes only 10 per cent to the GCC’s GDP while Saudi Arabia contributes 45 per cent), but it is more optimistic about the region as a whole.

Emirates NBD too has a similar view that GCC economies are poised for gradual economic growth led by growth in the hydrocarbon sector and higher energy prices. However, the bank also believes that over the same period, the region’s non-energy sector is likely to be boosted by strengthening external demand and higher energy prices.

“Increasing oil prices will continue to be fundamental to regional recovery in the short term, with non-energy sectors drawing on demand from outside the region and continuing strong energy prices,” says Dugan. “We anticipate corporate results for 2009 in the region to be stronger than expected, with gradual growth in GDP output across the region.”

Can Asia decouple? Two-tier growth pattern in Asia					
	Actual		Forecast		Growth slowdown 2007-2010
	2007	2008	2009F	2010F	
Asia-Pacific*	9.1	6.5	4.8	7.4	-1.7
NIEs*	6.2	1.5	-2.6	4.3	-1.9
SE Asia-4*	6.1	4.3	-0.1	4.3	-1.8
China	11.9	9	8.4	9.5	-2.4
India	9	6.7	6.1	7.5	-1.5

*NIEs are Korea, Taiwan, Hong Kong and Singapore. SE Asia-4 includes Indonesia, Malaysia the Philippines and Thailand. Asia Pacific is NIEs+SE Asia-4+China+ India-weighted. Table shows real GDP annual growth rates.
Source: Consensus Economics and Invesco calculations. Data to and forecasts as at Oct 12, 2009