

## Economic Review By Andrew Hunt January 2009

### About Andrew Hunt

Sparinvest works with independent economist, Andrew Hunt, of Hunt Economics. In his Economic Review, he gives a precise and unreserved analysis of world economic developments. As we at Sparinvest do not claim to be able to predict economic trends, we pass on Andrew's Economic Review to illustrate the degree of uncertainty about the economic future, which also serves to emphasise the importance of maintaining thoroughly diversified portfolios. ■

### December 2008 – Outlook for 2009

#### Widespread weakness in world economy

Clearly, the world economy is in a poor state at present and - despite our reputation for being less than cheery - even we have been surprised by the extent of its weakness. At the centre of this co-ordinated collapse in global activity lies the slump in international capital flows which occurred in the middle part of 2008. During the boom years of the mid 2000's, surging international capital flows had allowed many countries - and certainly the vast majority of the OECD - to grow rapidly on the back of easy credit conditions, falling savings rates and rising asset prices. Countries as diverse as Denmark, Spain, New Zealand, the UK and of course the US each borrowed heavily from abroad. This enabled them to augment their low savings rates and so finance huge increases in consumption, property investment and (in some cases) even productive investment. Unfortunately, now that these capital flows have abated or even reversed, this spendthrift behaviour has had to end. This is most notably the case in those countries which possess significant current account deficits in their trade accounts (and this covers three-quarters of the OECD), since without an easy supply of international capital, it is no longer possible to fund these deficits. ■

#### Cutting imports and production

Unfortunately, with so many large rich countries trying to save more, spend less and close their trade gaps, global trade activity has naturally been weak and export growth has been hard to come by, whatever the level of one's currency. Consequently, trade adjustments have been necessary and the onus has increasingly been on the need to cut imports. This, of course, has been hugely detrimental to world trade trends. Thus, with global import growth now collapsing, even the surplus countries are finding downward pressure on their exports revenues. This imposes an income loss on them - as the recent collapse in Japanese and Chinese economic growth rates has revealed.

Indeed, global demand is now so weak that, despite the savage production cuts already seen in many countries, inventories of unsold goods are continuing to rise around the world, most notably in the US, Japan and China. This in turn suggests that we can expect further sharp production cuts in the early part of 2009, and hence employment can be expected to decline sharply. Consequently, although weak demand may have produced remarkably negative GDP figures in Q4 2008, production weakness will likely cause continued severe economic weakness in Q1 2009. Clearly, the next six months are going to be a very unhappy time for many of the participants in the global economic system - but perhaps profitable ones for government bond holders over the medium term, although bouts of profit taking are likely even in these markets. For the currency markets, we expect these difficult times to produce considerable volatility, with countries effectively taking it in turn to depreciate their currencies. It will be difficult to pick a likely winner in these depreciation cycles but we suspect that Sterling and the Asian currencies may tend to be weak. We find little to choose between the Yen, Euro and Dollar at this time. ■

**Greater stability in H2?**

Fortunately, we suspect that the economic situation may improve a little, at least temporarily, in H2, 2009. We expect that the ongoing easing of monetary policy in the major economies will begin to restore some semblance of stability to the global credit system early next year, although any growth will remain anaemic at best. At the same time, the size of the fiscal responses now being 'leaked' in the US and mooted in Europe should be sufficient to provide the world's highly indebted consumers with sufficient new cash flow to enable them to pay off at least some of their debts without the need for further dramatic cutbacks in their own expenditure. For the corporate sector, such an end to the nominal income deflation would clearly go a long way to easing the financial strains in that sector.

Therefore, although we do not believe that the fiscal policies will be enough to rekindle global growth, we do nevertheless believe that by mid 2009 the size of the public cash injections could be sufficient to stop the negative cycle and produce a degree of stability in the real economy. It is therefore our view that the massive monetary response of recent weeks, combined with the proposed fiscal response expected in early 2009, will be enough to bring stability back to the global economy in mid-late 2009. Presumably, equity markets have begun to sense this and they have naturally rallied, since even a degree of economic stability will mark a dramatic improvement on where we are today. However, we do wonder whether 'travelling will be better than arriving' for the markets. ■

**Echoes of Japan?**

During the 1990's and early 2000's, Japan's authorities introduced a number of ambitious economic packages designed to prevent Japan's economy from entering the type of depression seen in 1930's America or in Asia in the late 1990's. In response to the introduction of each new recovery package or rate cut, Japan's equity market enjoyed frequent and often quite long bull-market phases, as belief spread that the latest intervention would deliver growth to the economy. Although depression was avoided in Japan, the ultimate effect of a hugely expensive (15-16% of GDP) budget deficit or zero interest rates was merely economic stagnation and a 'disaster avoided outcome'. As the equity markets came to realise this, they usually sank back to new lows fearing (correctly) that the authorities would not be able to remain expansionary *ad infinitum*.

Consequently, we do wonder whether at some point in 2009 or even early 2010, financial markets may look at the results of Obama's \$3 trillion spending splurge, the effects of the Fed's monetary policy actions, the similar events in Europe and conclude that, despite the effort and the long-term costs to the public purse, the results were unimpressive and probably not sustainable. We suspect that it could well be that at this point the ultimate lows for the equity markets are reached, as they were in Japan.

As for timing such a potential reversal in equity markets, we would suggest that it is unlikely to be before March 2009 (barring unforeseen circumstances) and probably not until the second half of the year, although we shall simply have to watch the speed of the fiscal expansion and monitor its effects as time unfolds. But, until then, it is possible that the recent rally may continue a while longer, although clearly markets have already come a long way and, as Japan's experience has revealed, the period of 'maximum positive gains' within the rallies were usually heavily front loaded in the bull market phases. ■

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