

Economic outlook for 2009

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Overview

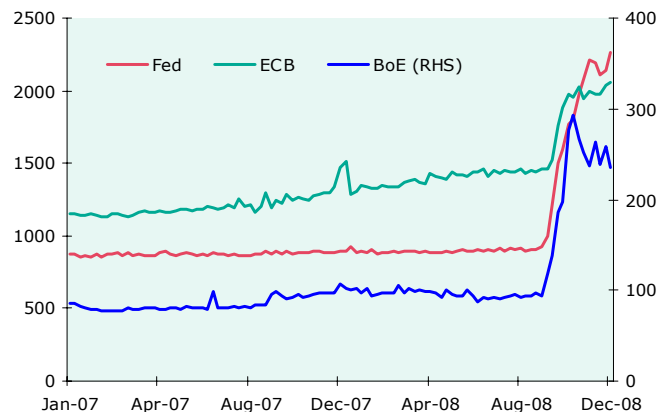
- *The US, the Eurozone, the UK and Japan are all in recession. The recessions in the west are primarily "balance sheet" recessions due to excessive indebtedness in the household and financial sectors, and therefore likely to be prolonged and deep compared with most post-war contractions.*
- *In Japan, non-Japan Asia, and much of the emerging world the recessions are driven by large trade-dependence on the richer OECD economies. None of the EM economies – even China or India – is in a position to be an independent engine of growth sufficient to counterbalance the recession in the developed world.*
- *Most major economies will remain in recession or at least in relative stagnation through most of 2009. I do not envisage a rapid recovery in the second half of 2009. A modest recovery is possible in 2010.*
- *Official, central bank interest rates have declined in all the developed economies (including even Japan). In the US the Federal funds rate has been lowered to virtually zero. The US Fed has embarked on a type of "quantitative easing" strategy to try to prevent further contraction, and intended to kickstart an economic recovery.*
- *In the Eurozone and the UK more rate cuts will be implemented in 2009, but households and businesses will be reluctant to respond with new spending and investment.*
- *Collapsing demand for commodities, falling production and slowing income growth have together caused inflation to fall abruptly in recent months. Headline inflation rates (which include food and energy prices) will fall further, implying a risk of deflation in some economies in 2009. Core inflation (which excludes food and energy) will fall to very low levels.*
- *The Fed, the ECB and the Bank of England have responded to the crisis not only with steep cuts in interest rates but also with unprecedented balance sheet expansion. The Bank of Japan also announced a renewed attempt at quantitative easing from 19 December. Meanwhile, following the announcement of schemes to recapitalise the commercial banks, governments in most economies are embarking on large-scale fiscal spending plans.*
- *However, until balance sheet repair in the household and financial sector is well under way, there is no assurance that these government expansion schemes will do more than moderate the downturn.*
- *Corporate debt spreads are at record levels reflecting the stresses of recent forced sales due to de-leveraging. More controversially, they indicate an unimaginably high risk of substantial corporate defaults in the next few quarters.*
- *With near-zero official interest rates, 2009 and 2010 will see a search for yields by investors.*
- *Stock markets have been immensely volatile, because they are in the middle of a tug-of-war between plunging economic activity, falling sales growth and declining profits on the one side and government and central bank rescue and stimulus plans on the other.*

Introduction

Starting with the US, most leading economies have entered "balance sheet" recessions. The recessions have resulted not so much from steep hikes in interest rates by central banks or from bloated business inventories, but more in reaction to the combined effects of falling asset prices -- especially houses -- interacting with high levels of debt on the balance sheets of households and financial firms. Irving Fisher, the great American economist of the 1920s and 1930s explained in 1933 that economic downturns resulting from a build-up of debt were likely to be more severe than others, and were more likely to cause deflation¹. The reason was that the sale of assets to repay debt would cause debt liquidation (or a credit contraction), reduced spending on goods and services, and hence deflation. From a current perspective there are two key questions. First, when will the de-leveraging that is behind all the current turmoil come to an end? Second, when will the monetary and fiscal expansion plans by the various central banks and governments start to tilt the playing field from recession and deflation towards recovery and perhaps inflation?

A key point to understand is that although de-leveraging in the financial sector is being counteracted by central bank and government expansion, overall credit is almost certainly still contracting. More precisely this means that while commercial banks, investment banks, private equity pools and hedge funds are all **reducing** the size of their balance sheets by paying back debt, the central banks and governments are doing exactly the reverse, **expanding** their balance sheets. However, private sector balance sheets are vast compared with the balance sheets of the central banks and governments, and it will therefore take some time before the overall amount of credit stabilises. In other words, private sector credit contraction is exceeding public sector credit expansion. Until the public sector expansion can counterbalance the private sector contraction, asset prices in financial markets will continue to be under pressure and deflationary forces will tend to dominate.

Central banks expand their balance sheets
(billions of local currency units)



Source: Datastream, Jan 07 to Dec 08

There can be no doubt that monetary and fiscal expansion together will eventually succeed in turning the current economic downturn into an economic upturn. (In the Japanese case in the 1990s the authorities only used fiscal

¹ <http://fraser.stlouisfed.org/docs/meltzer/fisdeb33.pdf>



expansion, and hence they failed to generate a sustained recovery.) However, as long as households and financial institutions do not want to borrow, banks will be unable to increase their lending. The need for balance sheet repair in the private sector will therefore slow down the transmission of stimulatory government spending programmes, and this will translate into extended economic weakness in 2009-2010.

However, when the public sector expansion strategy eventually succeeds (i.e. once the balance sheets of households and financial institutions are repaired and bank lending has begun to recover), then at that point there could be a risk of a significant rise in inflation. However, that is a problem for 2011 and beyond, not for 2009.

	2008 estimate		2009 Consensus Forecast	
	Real GDP	CPI Inflation	Real GDP	CPI Inflation
US	1.2%	4.0%	-1.3%	0.3%
EU-12	1.0%	3.3%	-0.9%	1.4%
UK	0.8%	3.6%	-1.5%	1.2%
Japan	0.4%	1.6%	-0.9%	0.1%
Australia	2.3%	4.5%	1.1%	2.8%
Canada	0.7%	2.4%	-0.1%	1.2%
China	9.3%	6.1%	7.8%	1.7%
India	6.9%	8.1%	6.3%	6.2%

Source: Consensus Economics, Dec 08

United States

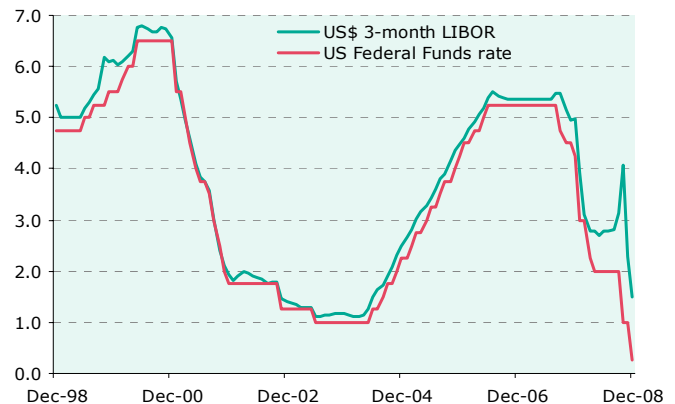
Following the bankruptcy of the investment bank Lehman Brothers in September, the credit crunch intensified, steepening the economic downturn that had already been in progress since December 2007 (according to the NBER's Business Cycle Dating Committee). Originally perceived as basically a subprime housing problem and a housing finance problem -- as highlighted by the transfer of Fannie Mae and Freddie Mac into conservatorship in July -- it became clear in 2008 that the crisis had much wider origins: the huge build-up of debt in the household and financial sectors since 2002. The prolonged credit crunch raised interest spreads and curtailed the availability of credit to all sectors. From April until September there was virtually zero growth of bank credit, and since then there has been a phase of intense credit and debt liquidation.

These events, together with further high profile bankruptcies (e.g. AIG) have triggered a series of strong policy responses by the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC), the Treasury on behalf of the Federal government, and the Congress. Not only has the Federal Reserve cut interest rates very aggressively -- ultimately to a range of 0-0.25% on 16 December -- but since mid-September it has expanded its balance sheet from \$940 billion to over \$2.2 trillion by means of a series of different lending and acquisition programmes. The Federal Deposit Insurance Corporation (FDIC) has enlarged and extended its deposit guarantees, and offered guarantees to the interbank market. In October the Treasury proposed and the Congress eventually passed the TARP (Troubled Asset Relief program), a \$700 billion scheme originally to buy illiquid, hard-to-value mortgage-backed securities and other toxic assets from financial institutions. Subsequently \$250 billion has been redirected to bank recapitalisation -- half for larger banks and half for smaller regional banks and other savings institutions. In addition the Federal government under President-elect Obama is expected to introduce a massive fiscal stimulus plan early in 2009, even though this

may lead to a record-breaking budget deficit in excess of \$1 trillion.

Can these government stimulus plans offset the decline in private sector spending? The brief answer is probably not in 2009. The problem is that Federal spending programmes and central bank lending schemes depend for their effectiveness on the willingness of consumers and businesses to pass on the new spending, or on banks to pass on the new central bank lending. However, if the priority for consumers and businesses is to restore sound balance sheets by repaying debt (not taking on more debt), then the standard "multipliers" will not work. That in turn implies that recovery may not come until household and financial sector balance sheets have been at least partially repaired. Consequently it may take a couple of years or more before normal spending patterns resume.

Federal Reserve slashes interest rates (%)



Source: Datastream, Dec 98 to Dec 08.

Looking forward, the large wealth losses from falling house prices and falling equity prices are creating substantial negative wealth effects, and will constrain consumer spending in 2009-10. In addition, financial sector losses from securitised credits and mortgages, together with the "normal" losses from the recession will mean that banks and other financial institutions will need to raise more capital. This will mean that banks will be reluctant to extend credit. In the face of weaker demand and persistently tight credit businesses will be cutting capital expenditure, trimming inventories and limiting new hiring, as well as laying off existing employees. Higher unemployment will further restrain consumer spending.

If there is any silver lining in this somewhat sombre prospect, it is that inflation will fall quickly, and official interest rates (for Federal funds and Treasury bills and bonds) will stay low for an extended period. This should provide a very favourable environment for fixed income investment, and build a base for an extended upturn in equities.

Eurozone

The eurozone economy moved into recession in 2008 with declines in GDP in Q2 and Q3. As in the US, tighter credit, negative wealth effects, weaker housing market activity and greater uncertainty all contributed to lower domestic spending. GDP growth is likely to remain below potential for longer than in other regions, in part because the ECB has



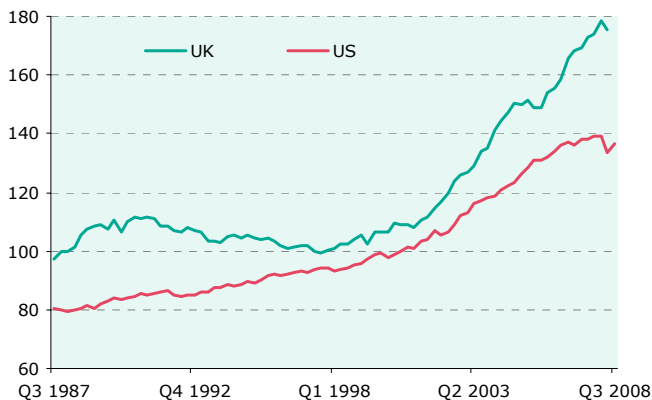
been slow to cut rates. However, when the recovery does come, the lower levels of indebtedness across most of Europe, together with the effects of more moderate monetary easing should enable the eurozone to have a more durable expansion. Weaker commodity prices and the emergence of substantial excess capacity will dampen inflationary pressures. We expect headline inflation to fall to around 1.4% during 2009.

With inflationary pressures already easing, there is scope for the ECB to cut rates further below the 2.5% set on December 4th. Nevertheless, the economy is likely to remain in recession for most of 2009. In response to the recession, which has produced lower tax revenues, and following emergency actions to deal with the financial crisis, most eurozone governments have devised moderate-sized fiscal stimulus plans. This means budget deficits in the single currency zone are likely to escalate, causing spreads on the bonds of the weaker member countries to widen further.

United Kingdom

Economic conditions deteriorated abruptly during the final quarter of 2008 as consumers and businesses cut back sharply on spending and investment. Forward-looking indicators such as manufacturing and service sector orders together with new mortgage lending and house-building data suggest a further sharp weakening in activity over the next couple of quarters. The urgent need to reduce borrowing by UK households, falling house prices, negative wealth effects, along with the weaker pound are all likely to curtail consumer and business spending severely. The large size of the financial sector and the drastic reduction in incomes and employment in this sector will also contribute to weaker domestic spending.

UK and US household debt-to-income ratios (%)



Source: Datastream, Jan 87 to Dec 08.

In response to the credit crunch and the early signs of banking problems such as the run on Northern Rock in 2007 the government was initially somewhat hesitant, but since October 2008 the authorities have become much more aggressive. However, the lesson of Japan in the 1990s suggests that the transmission of government spending or monetary stimulus to the rest of the economy is dependent on the willingness of the private sector to spend or take on more debt. From a starting position as one of the most heavily indebted household sectors in Europe, it is hard to see how the UK householder will quickly regain an appetite for more debt and hence vigorous spending. This means that

growth may not recover until 2010. Meantime, unemployment is likely to rise rapidly. Inflation is already falling quickly, reflecting the recent falls in energy and food prices. As spare capacity builds up and the output gap grows, longer term inflation pressures will also weaken, notwithstanding the weakness of sterling.

Japan

Japan's problem is that most of its growth since 2002 has been export-driven, relying especially on the boom in China, which itself was re-exporting most its production to the richer OECD economies. Although the domestic Japanese economy was growing modestly, it never really built up enough momentum to achieve self-sustaining growth. Even most capital expenditure was export-related. This combination has made Japan acutely vulnerable to the global economic downturn, a vulnerability that has been exacerbated by the unwinding of the yen carry-trade which has driven the yen to its highest levels since 1995. I expect Japan's GDP to decline through most of 2009, and any recovery in 2010 to be dependent on external stimulus, but yen strength will be a severe handicap in orchestrating a recovery. Japan will almost certainly relapse into deflation during the next two years.

Nevertheless the Japanese government has devised new fiscal spending plans to try to stimulate growth, and the Bank of Japan has lowered rates twice (from 0.5% to 0.3%, and then to 0.1% on 19 December) and announced plans to expand its balance sheet by buying more Japanese government bonds (JGBs). The BOJ also plans to buy corporate debt and commercial paper. These operations are reminiscent of the "quantitative expansion" strategy adopted in 2001-06 in a rather unsuccessful attempt to revitalise the domestic economy.

Non-Japan Asia

The export-oriented economies of East Asia have recently seen their exports fall off a cliff. For example, Korea's export growth in US\$ terms averaged 27.2% year-on-year in July-September, slowed to 8.5% in October, and then plunged in November by -18.3%. The experience in Taiwan (-23.3% in November after -8.3% in October) and China (-2.2% in November after 19.2% in October) is very similar. These figures are dramatic evidence of the sharp downturn in world trade and the difficulties of securing trade finance as a result of the prolonged credit crunch and its intensification in the wake of the failure of Lehman Brothers.

The collapse of Asian exports emphasises how dependent the East Asian economies are on final demand in the richer OECD economies. For despite the fact that Asian economies export heavily to China and China has become the largest trading partner for several economies in Asia, when the data are adjusted for the portion of trade that is re-exported from China, the OECD economies continue to be the major source of final demand. In turn this implies that domestic stimulus programmes in Asia are unlikely to do much to alleviate the impact of the global downturn. Growth in 2009 will slow across the region, and inflation will fall sharply, possibly even reverting to deflation in 2010 in some cases such as China and Hong Kong.

Latin America

Most of Latin America benefited from strong commodity prices in 2008, and Brazil's boom extended longer than most.



However the outlook for 2009 is much more subdued as commodity prices have fallen sharply and overseas demand for manufactured goods has weakened. In contrast to earlier decades Latin America generally entered the global downturn with its external accounts in better shape, although like other emerging economies the region has been vulnerable to substantial portfolio outflows. We expect growth and inflation to slow in 2009.

Commodities

Commodities have peaked and are likely to weaken further during the recession. If the central banks and governments are successful in reflation the world economy quickly (a proposition we are sceptical about – see above), commodity prices could rebound sharply, depending on how inflationary the environment is when the recovery comes. This is what is behind the continuing buoyancy of the gold price. However, for most soft commodities, base metals and other commodities consumed by the developed or emerging economies, recession implies an extended period of price weakness. In addition, global acreage and production capacity will likely be reduced, and corporate consolidation will be undertaken to reduce overheads – all in an effort to keep prices from falling further.

the process of balance sheet repair and generate economic recoveries.

The silver lining to this pervasive gloom is that inflation almost everywhere will decline, allowing central banks' expansionary policies to start to gain traction, and creating the basis for a resumption of real income growth. However, real economic recovery is most likely in 2010 and beyond, not in 2009.

19 December 2008

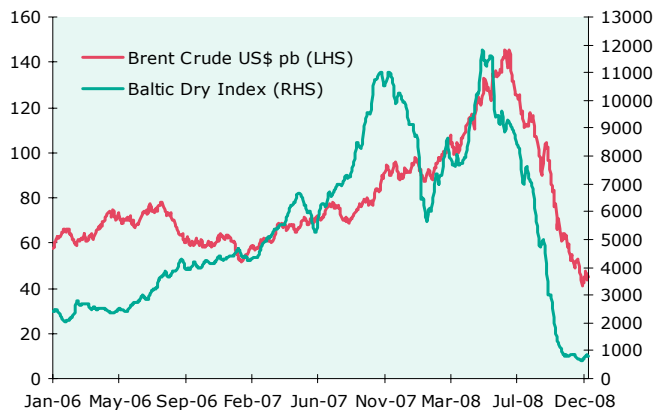
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Commodity price reversal has been severe



Source: Datastream, Jan 06 to Dec 08.

While lower commodity prices are benefiting commodity importing countries, particularly in Asia as well as eastern Europe, these economies have all had to reduce interest rates as a result of falling domestic demand. In other words, weaker demand is proving more powerful than lower supply prices.

Conclusion

2009 is likely to be a year of recession and rising unemployment across most developed economies, and slowing growth in many emerging economies. The convulsions of the global credit crunch over the past fifteen months have demonstrated that the world needs a much better managed credit cycle in the future, but those monetary and regulatory changes are unlikely to be attempted while governments and central banks are grappling with the immediate crisis. Unfortunately, however, the household and financial sector balance sheet problems created by excessive borrowing during the past decade cannot be wished away by newly devised government spending plans. It will therefore take time to work through