

Economic Review

By Andrew Hunt

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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. ■

Global slowdown nears critical levels for some economies.

Although many global equity markets have regained their poise over recent weeks, we remain concerned that the global credit crisis is intensifying and that the global slowdown - referred to in previous reviews - is spreading. Despite the equity markets' apparent optimism, we find that financial sector share prices have begun to under-perform their peers in other industries. Furthermore, the credit growth numbers in countries as disparate as the US, UK, Spain, Ireland, Germany, Eastern Europe, South Africa and New Zealand have all begun to slow, in some cases to levels which we regard as critical. ■

Lack of wage growth and credit availability will impact on spending levels.

For example, in the UK, the monthly lending figures to the household sector have now dropped below £8.5 billion per calendar month - the level that we regard as necessary simply to allow the UK consumer sector to 'stand still' in terms of spending. UK consumers, like their US and other counterparts, experienced remarkably pedestrian rates of real disposable income growth during the 2000s. Their response - until recently - was to supplement their earned income by borrowing heavily. Thus, they could spend much more than they were earning on a cash flow basis. Indeed, we find that in both the UK and the US, the total level of household spending during 2007 was around 106% of their incomes. While other countries (most notably Spain, New Zealand and Australia) have been even more aggressive in their 'overspending' behaviour of late, the level of overspending seen in the UK and US is unprecedented in the available histories of these economies. However, this situation implies that in the absence of strong real wage growth, households in these countries will only be able to spend as much this year as they did last year if they continue to borrow heavily. Since last year's spending was 106% of incomes, funds must be borrowed in order to again 'top up' disposable incomes if this year's level of spending is not to fall.

Through the use of such cash flow statements and a little mathematics, we can calculate that US consumers need to borrow more than \$600 billion this year and UK consumers more than £110 billion. In Australia and New Zealand, the numbers are smaller in absolute terms, but larger relative to income levels. However, we are increasingly finding that the current level of credit growth in each of these economies is dropping below these (pro-rated) rates. The result may be that some very real cash-flow-binding constraints will affect consumers' ability to spend as much money this year as last year. Moreover, with food and fuel prices now notably higher, the amount of 'spare money' that is available for discretionary spending is very much reduced. Therefore, we are not surprised to be witnessing an avalanche of weaker consumer data in the global economy at present. Households simply do not have spare money at present. Many may be struggling to finance even last year's level of spending in nominal terms, let alone to find sufficient extra money to increase real (inflation-adjusted) spending totals. Hence, we have entered what may prove to be a sharp slowdown in Western and (some) Emerging Market consumer trends that we believe will persist for some time to come - and at least until 2009.

China exports its domestic inflation to the West.

In fact, the present situation with regard to 'real' levels of Western consumer spending may be becoming even more acute as a result of events both in the energy markets and in China. ■

Over the last 18 months, China has experienced a wage-price spiral. (The higher rate of Chinese inflation was initially caused by higher food costs, but rising prices have now become endemic in the economy.) As a result, China has been obliged to raise the prices of many of the consumer goods that it exports around the world. This is, of course, very significant for the global economy. For the last 15 years, we in the Western economies have benefited. The fall in Chinese export prices allowed (or in some cases forced) price reductions for the clothes, consumer electronics, toys and other goods available from our shops. 'Wal-Mart' in the US, 'The Range' in the UK, 'The Warehouse' in New Zealand, and a host of similar shops in Europe and elsewhere, were able to offer their customers seemingly ever cheaper goods while China continued to cut its export prices.

But China's economy has overheated over the last year. Food shortages have pushed up not only living costs but wages as well. Consequently, China has begun to raise its export prices and to export inflation to the West at precisely the time when Western consumers may be cash-flow constrained. Hence we see not only signs of a global slowdown in nominal (i.e. cash value) consumer activity but also of higher inflation rates in many countries that could further undermine real growth rates.

This situation is likely to influence more than just the fortunes of the household sector. As consumer spending slows, corporate receipts will tend to suffer. At a time when input prices have also been rising, there will clearly be an impact on corporate profitability. If we were to take a more 'general' view of the situation for companies, we might suggest that in the middle of the 2000s (at a time when consumers were spending considerably more on companies' products than they were earning from the wages that companies gave them), it would have been almost absurdly easy for companies to make large profits. But now, as consumers save by spending less of the wages they are given, it will become notably harder for companies to produce profits. It is with this in mind that we remain cautious over the outlook for global equities, despite their recent rallies. ■

Moves in official interest rates could be good news for bonds and the US Dollar.

The outlook for bond markets remains mixed. Higher inflation is clearly an unattractive proposition for bonds, but we suspect that the direction of these markets will ultimately be determined by the direction of official interest rates. Following our extensive travels of recent weeks, we remain convinced that official interest rates will continue to fall around the globe this year. Although most central banks remain wary of the threat from higher inflation, most recognize that events in China and even in the energy markets are effectively beyond their control. Thus we continue to expect the major central banks to reduce interest rates further this year – providing, of course, that their domestic wage inflation indicators remain benign. Since we expect such an outcome, we remain positively disposed towards fixed-income investments.

Currency markets have, of course, been volatile over recent months. However, we do wonder whether we are now due a change in sentiment towards the US dollar. Clearly, the US is either in, or close to, a credit-crisis-driven recession. But this may now be old news. The fact that Japan may also have fallen into a near recession, and that parts of Southern and Eastern Europe now appear beset by financial crises of their own, may soon force a change in expectations – not just over regional growth rates but relative interest rate moves as well. This could prove beneficial to the USD. Even the Emerging Market and

Australasian currencies could soon prove vulnerable to a correction as the extent of the global slowdown becomes more apparent. ■

Conclusion.

Overall, despite the optimism suggested by the recent behaviour of global equity markets, we remain cautious over the outlook for global economic growth over the next 12-18 months. The additional concern is that inflation rates may prove to be a source of further bad news for markets – at least until China’s economy joins the slowdown later this year or early next year. We do, however, continue to expect further substantial interest rate cuts in the OECD area this year. ■

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