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. ■

Savings-led recession could be long but not deep.

The global economy has slid into a recession that we suspect may not be deep but which may prove to be relatively long. This recession has been brought on by worldwide credit excesses that have led to the systematic compromising of private sector balance sheets across the globe. For example, US consumers are now the most indebted that they have been - relative to their incomes - in the post war period - and perhaps ever in the history of the country, (the only other contender for the all-time historical record being 1929). Unfortunately, this peak in indebtedness has occurred just as house prices have declined and employment prospects have deteriorated. These factors may now cause consumers to wish to repay debts, reduce their gearing ratios and strengthen their balance sheets rather than extend them further. Thus, the usually spendthrift US consumer has begun to save.

Unfortunately, it is not only the US consumer that has fallen into this trap. Debt ratios are stretched and savings rates are tentatively on the rise in Denmark, the UK, France, Spain, Italy, Ireland, South Africa, Australia, Canada - and even to an extent in Japan and parts of Asia. Thus, global consumer demand is weakening in these countries and companies are increasingly finding that they are amassing unwanted stocks of unsold goods. This alone can be expected to signal even weaker production trends ahead. ■

Companies experience the 'Paradox of Thrift'

Meanwhile, following a prolonged spell of mergers and acquisitions, the private equity boom and the trend towards equity capital retirement, US companies are also the most indebted that they have ever been. Unfortunately, corporate sales revenues have begun to decline as households (i.e. customers) have started to save rather than spend. The natural reaction for companies in this situation is also to 'save' by shedding inventories, reducing capital spending and cutting wage bills. Unfortunately, the corporate sector's wage bill is also the household sector's income. Any reduction in income further decreases the household sector's ability to spend. This, in turn, increases the pressure on corporate receipts in a vicious cycle which is more formally known as the 'Paradox of Thrift'. With everyone saving and no one spending, US nominal retail sales growth has turned negative for the first time ever and corporate earnings growth has plummeted accordingly.

Once again, we find that it is not only the US economy that is affected. The UK and Japan - to name but two - are experiencing the same dynamics. Consequently, we find the probability of a savings-led recession has increased around the world. In fact, for those countries on the periphery of the Euro Zone, the situation is deteriorating even more rapidly on account of these countries' fundamentally weak competitive positions - the unwelcome by-product of years of credit-driven inflationary booms that occurred following their Euro entry. Economic conditions in Ireland, Spain and Italy could soon begin to resemble a depression. ■

China's economy is weakening

Even the supposed economic powerhouse of China has not proved immune. As Western consumer demand has slackened and the Chinese currency has appreciated against some of its competitors, China has experienced a very sharp contraction in its profit margins. China's high domestic inflation has collided with the changing global economic situation to yield an intense profit squeeze. This is now leading to weaker investment and production trends. Indeed, by 2009, China's economy may be so weak as to require a devaluation of its currency. ■

Lower inflation clears path for rate cuts

On the positive side, this coordinated economic deceleration - and the signs that the Asian currencies could soon begin to fall - implies that the recent global inflation scare is over. Weakening global growth should undermine commodity prices and lead to weaker corporate pricing power. These two events should lead inflation rates to tumble in 2009, to the palpable relief of the central banks who, we believe, are now free to reduce short-term official interest rates at will. Indeed, we expect to see substantial rate cuts in the US, Europe and perhaps even Asia before too long.

It would be surprising if the world's equity markets did not react positively to these rate cuts when they are announced. But we suspect that these rallies may prove short-lived. Given the weakened state of the world's financial sector (despite the recent bailouts) as well as the private sector's new-found desire to save more, it is most unlikely that higher interest rates will be able to foster a new round of credit growth and discourage saving. As a result of the compromised state of both financial and non-financial sector balance sheets around the world, it seems that lower interest rates are unlikely, by themselves, to generate an economic recovery. But lower rates would at least help in cutting existing interest burdens and in financing a public sector response to the crisis. Therefore, we expect them to be enacted shortly. ■

Government intervention is the only solution

In practice, we would suggest that the only realistic way in which this rapidly spreading 'Paradox of Thrift' cycle can be arrested is if people and companies are essentially 'given' cash by some outside entity, enabling them to discharge their debts without first having to reduce their expenditures relative to their incomes. Unfortunately, the only entities that can conceivably provide this 'charity' to the private sectors are the governments. It is for this reason that we believe that the global real economy can only be stabilised through further massive fiscal injections, such as those that we saw earlier this year in the USA and which we expect to see repeated, time and again within the next few months, across the globe. Unfortunately, such generous action by the state seems set to lead to wide government budget deficits. (We are forecasting a deficit of USD 1 trillion for the USA in 2009.) Some taxpayers and analysts may find this hard to stomach, but we believe that these interventions offer the only reliable solution to the current crisis in the real economy and in the financial sectors – and thus they should be welcomed by investors rather than feared. ■

Financial sector hardest hit

With regard to the specific crisis in the financial sector, we believe that determined government action has been and will remain necessary in the medium term – whatever the perceived cost to the tax payer. For a variety of reasons – some of them regulatory – many global investment banks have transformed their businesses in recent years. From being 'agents' of their clients within financial markets, they have become principals in their own right. Hence, the 2000s saw a dramatic rise in the size of the balance sheets of these institutions, both in absolute terms and relative to such yardsticks as the level of their national GDPs. In fact, by 2007, the US investment banks alone had grown their balance sheets to such an extent that their notional on-balance sheet assets were around USD 3 trillion and their total balance sheets may have been over a hundred times this amount. These numbers made them the largest investors by far in the global financial system.

In order to expand their assets, these institutions employed aggressive capital gearing ratios. Total assets relative to total capital were well over thirty times (ratios that would make aggressive 'hedge funds' look conservative). Moreover, this massive growth in the investment banks' balance sheets was concentrated in the mortgage bond derivatives sectors. Moreover, it relied on the use of incredibly complex mathematical models that were nevertheless remarkably dependent on a number of basic and naive – assumptions. Unfortunately, as we now know, these derivative assets were constructed very poorly. The mathematical models that had been employed were simply wrong and, as every high school student knows, you either get maths right or wrong. There is no 'a bit wrong'. As the flaws in the mathematical models have become apparent, these instruments have been revealed to be almost worthless. It is this issue that now lies at the centre of the global banking crisis.

At first sight, there is clearly an incentive to say to the investment banks that it was they who made the mistakes, they who wrongly specified the mathematical models and they who purchased the faulty assets. Therefore, they should be left to suffer the consequences with no assistance from the state. But, if the investment banks had been left to suffer the consequences of their actions, the forced deleveraging and asset price falls would likely have bankrupted the entire financial system. This would have destroyed real people's wealth and encouraged even more saving – leading to an even more aggressive 'Paradox of Thrift' crisis in the real economy than we are already facing. Therefore, unpalatable as it may seem to some, we expect large amounts of public money to be continually added to the financial system over the next few years. But for financial markets, this represents the 'least-bad' – and an occasionally positive – scenario. ■

Prospects for investments?

Certainly, it seems that the next few months will be a trying time for the global economy but with inflation falling away, central banks will be free to cut interest rates and we expect further fiscal initiatives from the authorities that should fend off the worst of the crisis. In this environment, we would favour fixed-income instruments, although we do expect to see occasional – and quite powerful – equity rallies from time to time. Within the currency markets, we believe that the dollar's problems are now well known but that any rescue packages will be dollar favourable, particularly as the news flow with regard to the Japanese and Euro Zone economies continues to deteriorate. ■