

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. ■

No Place to Hide as Credit Crisis Impacts Global Economy

The global economy has begun to slow, potentially quite sharply. Unsurprisingly, given the problems now affecting the credit system, the US economy has probably already entered a recession. For many years, the US private sector has operated on a cash flow negative basis, always needing to supplement its level of income through borrowing in order to fund its existing level of expenditure. But, now that the supply of credit has become restricted, both companies and households have become obliged to spend less. Hence, we expect that the economy's growth rate has turned negative and we further suspect that the UK, which in many ways resembles the US economy, has also begun to feel the effects of a credit market debacle. Canada, too, is also showing some signs of an adverse reaction to the events within the credit markets, although it seems destined to be less severely affected. However, it is not only these economies that have been affected by the recent change in financial market conditions. ■

An End to the Pan-European Property Boom

The problems within the international credit markets have also led to a reduction in the volume of funds flowing within the Euro Area. Previously, Spanish, Portuguese, Greek, Irish and even Italian banks had been able to draw on the surplus funds within Germany and others' relatively soft economies and then use these funds to finance extremely aggressive lending campaigns in their local property markets. Unfortunately, these property booms became so intense over recent years that they led the local populations to demand higher wage awards, so that the residents could afford the rapidly inflating house prices. Consequently, these countries, through a mixture of wage and property price inflation, have become fundamentally uncompetitive within the context of the Euro Area. However, now that the credit flows have been reduced, the property booms have each ended and this has generated a very significant headwind, negatively impacting the domestic household sector's ability to expand its level of expenditure. In fact, most of these countries are now suffering both from weaker domestic demand and from their fundamental lack of competitiveness, a situation that has been made worse by the recent strength of the Euro on the foreign exchanges.

Consequently, we regard it as highly unlikely that the Euro Area will provide an "oasis" of growth in the current environment. Instead, it seems that with Germany still relatively weak and other parts of the system suffering from an unhealthy combination of weaker domestic demand and poor competitiveness (within the context of a weakening world trade environment), the risks to Euro Zone growth remain firmly on the downside.

Moving eastward, we find even more cause for concern. During the peak of the global capital flows boom between 2003 and mid 2007, many of the former Eastern Bloc and Soviet republics borrowed very aggressively in foreign currencies in order to fund their own rampant housing booms, strong domestic consumption spending growth and widening current account and trade deficits. Now, as global risk appetite wanes and the capital

No Escape for Emerging or Commodity-Driven Economies

flows subside, not only has the financing for the domestic booms dwindled, so too has the financing for the current account deficits. As a result, currencies are under pressure in the region and some of the central banks are being obliged to defend their exchange rates through higher interest rates, or face sharp falls in their currencies that could bring instant insolvency to the many households and institutions that have borrowed abroad. In such an environment, financial crises and economic recessions are fostered. We would also note that South Africa is facing a similarly challenging situation, as is Iceland. ■

In Latin America, and indeed in Australasia, the countries have naturally benefited from the recent upward price trend for many of the commodities that these areas produce (a trend that seems to have been exaggerated by high levels of speculation in some cases). The terms of trade improvements implied by these higher prices have, of course, provided a boost to the economies but we find in many cases – and particularly in Brazil, Australia and NZ – that the commodity price boom has been mortgaged many times over through the aggressive borrowing from international capital markets that has occurred. While it is natural that people receiving higher prices for their (commodity) output should want to spend more, it seems that the populations of these countries have taken this reaction to an extreme, supplementing their income gains by recourse to substantial and consistent borrowings. Hence, these countries each possess strong rates of credit growth and large current account deficits that have arisen as a result of the strength of domestic spending – and despite their increased commodity wealth. But, with the international capital flows that funded this ‘extra’ borrowing now at risk, and local funding costs rising, the credit booms (and hence the economic booms) in these regions are also at risk in the current environment. Indeed, in the case of NZ, we may already have seen the first signs of an approaching significant economic slowdown and we suspect that Australia will not be far behind.

In Japan, the combination of a weakening global environment, a still convalescent domestic credit system and a sharp tightening of the government’s fiscal position has probably already delivered a recessionary situation and as yet there has been little or no policy response to this outcome. Elsewhere in Asia, we find that – contrary to popular belief – India’s economy has already seen its rate of growth moderate following last year’s move to a tighter monetary regime and a modest slowdown in its rate of export growth. China’s economy is also now showing signs of having reached a peak. Indeed, China’s growth / inflation mix has recently deteriorated quite substantially as a result of: a reduction in capital inflows, a rise in nominal wage inflation rates and a potential decline in export growth caused by the problems now afflicting many of China’s trading partners. In addition, Korea’s economy has also shown some recent signs of softness, as has Taiwan’s. The Asian Region clearly does not face a repeat of its 1997 Crisis (that fate may befall Eastern Europe), but growth rates are clearly moderating. ■

Outlook Uncertain for Equities, But Global Bonds in Demand

Thus, it would appear that the outlook for world growth is not an attractive one at present. Moreover, the fact that this growth is being led by a credit slowdown, which will imply that people will have to save more on average, does not bode well for corporate profitability. When people save rather than spend, corporate revenues will tend to decline relative to wage bills, with the result that profit margins become depressed at a time during which sales growth can be lacklustre. Hence, the near term outlook for equities remains one of uncertainty, although in the near term, a technical rally may be due.

Naturally, as global growth subsides and inflation worries abate (a process that has already begun in the US, UK and elsewhere), more central banks will begin follow the US

Federal Reserve not only into reducing interest rates, but also into utilising more inventive 'quantitative measures' in an effort to resuscitate their economies. Indeed, by the second half of the year, we would not only expect interest rates will be falling globally – including in the Euro Zone – but that many of the central banks will also be offering collateral injections to the troubled investment banking community which lies at the centre of the current credit market storm (as Bear Stearns recently proved). Since these collateral injections into the investment banks are likely to take the form of 'loans' of government bonds (which the investment banks can then offer as collateral to their creditors), we believe that the central banks will first have to become significant buyers of government bonds (so that they can lend them) and it is this, coupled with the prospects for lower short term interest rates, that leads us to assume that global bond markets may rally further in the near term, despite their already rich valuations.

Finally, with regard to the outlook for the currency markets, we would suggest that with both the credit market debacle and its implications for growth now 'going global'; some of the pressure on the hitherto beleaguered US dollar may be reduced. Indeed, although we expect the Yen to remain strong as result of its huge trade surplus, we suspect that the signs of weaker growth in Europe and Asia will tend to place some downward pressure on these areas' currencies. Meanwhile, the weaker global outlook may also begin to cap and perhaps reverse some of the commodity currencies, such as the Australian and New Zealand dollars. ■

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