

## Global recovery watch – what's the risk of another mid-year growth scare?

### Oliver's Insights



#### Key points

- > The last two years have seen a solid start for shares give way around May to worries about a double-dip back into global recession and 15% plus falls in share markets.
- > Could the same happen this year? Risks clearly remain, but there is also a good chance that after two disappointing years shares will surprise on the upside.
- > Key indicators to watch are Italian bond yields, the US Institute for Supply Management (ISM) index, Chinese money supply, the Australian dollar (A\$) and oil prices.

#### Introduction

So far this year we have seen solid gains in global share markets. Economic news has been positive with receding tail risks regarding Europe, greater confidence of continued growth in the US and some lessening of worries about China. But there was also a burst of confidence in early 2010 and early 2011, which gave way through the June and September quarters of both years to worries about a dip back into global recession. As a result many naturally fear the same will happen this year. This note looks at the risks.

#### The double-dip worries of 2010 and 2011

In 2010, shares rose solidly into April with Australian shares rising above the 5,000 level. However, shares fell sharply in the June quarter on the back of worries about the ending of the first round of US quantitative easing (QE1), the intensification of the European debt crisis, a fall in business conditions in the US and China, and worries about the impact of central bank tightening (in China, several emerging countries and Australia). From their highs in April to mid-year lows, US shares fell 16%, global shares fell 15% and Australian shares fell 15% before rallying solidly into year-end.

Similarly in 2011, shares started the year well with US shares making it above pre-Lehman levels and Australian shares getting back to 5,000. However, once again shares and other risk-related assets were hit, starting in the June quarter and this time continuing into October. The drivers were: the Japanese earthquake and resulting supply chain disruptions; a surge in oil prices in response to civil wars in the Middle East; rising inflation particularly in emerging countries; the end of the second round of quantitative easing in the US (QE2); monetary tightening (in China and Europe); falls in business conditions indicators globally; America's debt ceiling impasse and debt downgrade; worries about significant US fiscal drag in 2012; and a renewed intensification of the European debt crisis. This time the correction was even more severe with US shares falling 19% from their April high to their October low, global shares falling 21% and Australian shares falling 22%.

#### So what's the risk of a re-run this year?

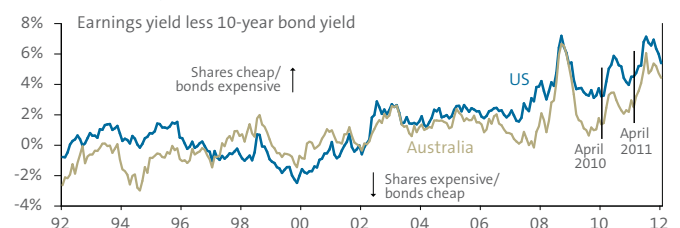
Several considerations suggest there is a risk of a re-run of the last two years:

- > Yet again, share markets have started off the year strongly with US and global shares up 12% year-to-date and Australian shares up 5% (Australian shares are up but still lagging thanks to relatively higher interest rates, the strong A\$ and worries regarding China).
- > Oil prices have surged on the back of strong emerging country demand and tensions regarding Iran.
- > There is still uncertainty regarding a hard landing in China, Brazil has slowed to just 1.4% and India has slowed but still has inflation issues.
- > The Eurozone has now likely entered recession.
- > Greece may still have a messy default and there is a risk that Portugal may follow the same path as Greece.
- > Investors might start to fret about the US election, particularly the huge fiscal drag equal to 3.5% of gross domestic product that will occur next year as the Bush-era tax cuts expire and various other stimulus programs end.
- > Alternatively, investors might start to fret about another US rating downgrade if it's thought the Presidential election will result in an outcome that makes it hard for agreement on a long-term plan to get the deficit down.
- > Bond yields are starting to rise and this may pressure growth and share markets.

However, there are a number of counters to this:

- > Shares are cheaper than at their early-2010 and 2011 levels in terms of the earnings yield pick-up they provide over Government bonds. This can be seen in the next chart:

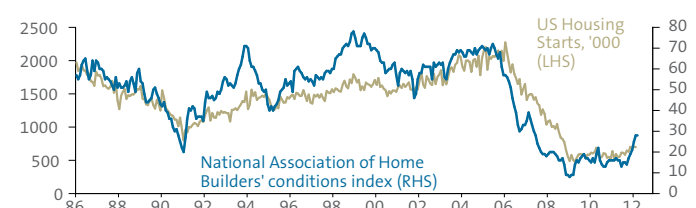
#### Shares are very cheap relative to bonds



Source: Thomson Reuters, AMP Capital

- > The US housing sector looks like it's bottoming, with a rise in home builders' conditions pointing to a further improvement in housing starts ahead and falling delinquencies pointing to a peaking in foreclosures.

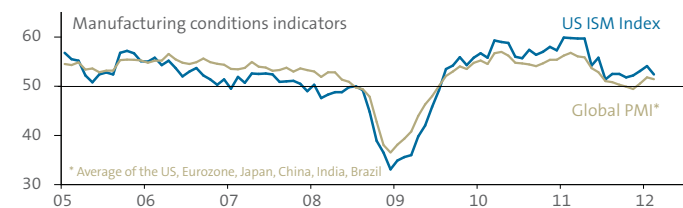
#### Home builders' conditions point to stronger US housing starts



Source: Bloomberg, AMP Capital

- > Business conditions indicators, notably the US ISM index, have improved after last year's falls but haven't yet reached the cyclical highs they got to a year ago. In other words, there could still be plenty more upside.

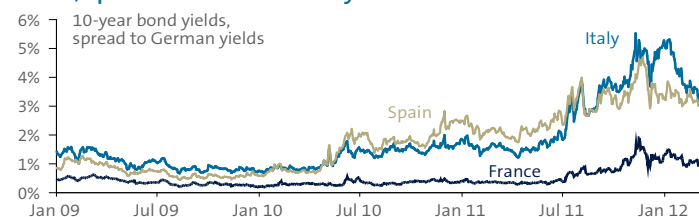
## Global business conditions indicators have stabilised, but are still well below cyclical highs



Source: Bloomberg, AMP Capital

- > US politicians are likely to come to some sort of agreement to slow the short-term fiscal drag – just as they did last year.
- > The situation in Europe is improving. The European Central Bank (ECB) has provided cheap three-year funding to Eurozone banks heading off the risk of a funding crisis such as that seen during the global financial crisis style. Greece has received a second bailout and the portion of its debt owed to private bond holders has been cut by more than 50%. While risks surround Portugal it is much smaller than Greece, and given that Portugal has followed its bailout terms precisely Eurozone officials appear more open to supporting it. The European debt firewall looks likely to be expanded by combining the remaining €240 billion in the existing bailout fund (the European Financial Stability Facility) with the €500 billion to be in the new bailout fund (the European Stability Mechanism) which should clear the way for additional International Monetary Fund support. So if Greece does enter a messy default its impact on the rest of Europe should be manageable. Reflecting all this, the spreads between Italian, Spanish and French bond yields on the one hand and German bond yields on the other have narrowed.

## Italian, Spanish and French bond yields have continued to stabilise



Source: Bloomberg, AMP Capital

- > Global monetary policy has been easing. Bank reserve ratios have been cut in China and India. Interest rates have been falling in emerging countries including Russia and Brazil, and in Europe and Australia. The ECB, the Bank of England and the Bank of Japan have all expanded their quantitative easing programs (pumping cash into their economies). The US Federal Reserve (Fed) has undertaken Operation Twist to keep long-term bond yields down and has been undertaking a mild form of quantitative easing via the provision of cheap dollar funding. The Fed has also extended its commitment to keep interest rates to near zero until late 2014. This is very different to a year ago when global monetary conditions were actually tightening.
- > While the generational lows and in some cases record lows seen in bond yields, combined with extreme investor positioning in bond funds, point to the risk of a 1994-style bond crash this seems unlikely. The rise in bond yields in 1994

was underpinned by a significant rise in official cash rates in the US, Europe and Australia, but that is extremely unlikely this time around. If anything the Fed is likely to intervene at some point to ensure that the rise in long bond yields doesn't go too far if it looks like adversely affecting the economic outlook. It's also the case that so far bond yields are still well below year-ago highs. For example, the US 10-year bond yield at 2.4% compares to a high of 3.6% last April and the Australian 10-year bond yield at 4.3% compares to a high of 5.7% last April.

- > Finally, it seems everyone is talking about the rally in shares as being unsustainable and the likelihood of a re-run of the last two years. When everyone expects something, sometimes it doesn't happen.

On balance, while there will likely be bouts of volatility and the period from May to October is often weak, we remain of the view that this year will be far better for risky assets such as shares than the last two have been.

## What to watch?

Nevertheless, it's still early days yet, so we suggest watching the following indicators:

- > Bond yields in Italy, Spain and France as a guide to whether the European debt crisis remains under control – so far so good with Italian spreads to Germany actually falling though the recent back-up in global bond yields. See the previous chart.
- > The US ISM index – again so far so good with the ISM trending higher but remaining well off the virtually impossible to beat highs it reached early last year.
- > Chinese money supply growth as a guide to the Chinese economic outlook. This has slowed from around 30% year-on-year (yoy) in 2009 to around 15% yoy, but does appear to be stabilising.
- > The A\$ – again so far so good. The A\$ is a good barometer of global health and while it has come off its recent highs it remains strong.
- > World oil prices – at present the rise has not been enough to choke off global growth. But if oil prices rise another US\$20 a barrel or more it could become a problem.

## Concluding comments

Behavioural finance reminds us that investors have a tendency to give more weight to recent experience than is rationally justified. The last two years have seen an outbreak of double-dip worries from around April/May resulting in 15% plus falls in share markets, so it's natural to assume the same this year. But things are rarely that simple and while some sort of correction is almost inevitable in the months ahead there is a good chance that after two years of disappointing returns shares will surprise on the upside this year. Given that shares are cheap relative to alternatives, monetary conditions are very easy and there is lots of money piled up in bond funds that could flow into shares my bias is the latter. But it's early days yet and so worth keeping an eye on Italian, Spanish and French bond yields, the US ISM index, Chinese money supply growth, the A\$ and oil prices.

**Dr Shane Oliver**  
Head of Investment Strategy and Chief Economist  
AMP Capital

## Contact us

If you would like to know more about how AMP Capital can help you, please visit [ampcapital.com.au](http://ampcapital.com.au), or contact one of the following:

### Financial Advisers

Your Business Development  
Manager or call 1300 139 267

### Personal Investors

Your Financial Adviser or call  
us on 1800 188 013

### Wholesale Investors

AMP Capital's Client Services  
Team on 1800 658 404

**Important note:** While every care has been taken in the preparation of this document, AMP Capital Investors Limited (ABN 59 001 777 591) (AFSL 232497) makes no representation or warranty as to the accuracy or completeness of any statement in it including, without limitation, any forecasts. Past performance is not a reliable indicator of future performance. This document has been prepared for the purpose of providing general information, without taking account of any particular investor's objectives, financial situation or needs. An investor should, before making any investment decisions, consider the appropriateness of the information in this document, and seek professional advice, having regard to the investor's objectives, financial situation and needs. This document is solely for the use of the party to whom it is provided.