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Greek relief for now, but what about the US?

EDITION 20 – 20 JUNE 2012

Key points

- The Greek election has averted a messy Greek default and euro exit for now - however, European problems remain intense. The market will be looking to the June 28-29 European Union leaders' summit to provide some lasting solutions.
- The US economy has also been slowing lately and faces a 'fiscal cliff' from the start of next year. However, odds are that the US will do whatever it needs to keep its recovery going.
- Investors remain caught between near-term uncertainty and risks, but good value in shares and the prospect of more policy stimulus. We still see shares higher by year-end.

Introduction

The Greek election has provided some relief for global investors with the 'pro-bailout' New Democracy party prevailing over radical left wing Syriza, and likely to form a coalition government. As such, the prospect of an imminent Greek default and a disorderly exit from the euro spreading contagion across Europe has substantially reduced, at least for now. Of course, Greece is likely to continue to be a source of volatility – not only is it a long way behind in terms of its bailout agreement which will have to be renegotiated anyway, but its population is also very divided. More broadly, Europe's problems go well beyond Greece, encompassing Spain, Italy and maybe France. The June 28-29 European Union leaders' summit will be looked to for clear signs that Europe is heading down a more sustainable path. This would involve less austerity and some sharing of risks (maybe via a redemption fund that gradually replaces national debt above 60% of Gross Domestic Product (GDP) with Euro-zone wide debt) as a trade off for a banking and fiscal union along with economic reforms and more support from the European Central Bank.

However, while the focus has recently been on Europe, the US economy shouldn't be ignored. After all, it's worth noting that the 15% share market correction of 2010, and the 20% correction of 2011, both had their origins in Europe and Greece but they morphed into concerns about the US. At the same time, America's budget deficit and overall level of public debt is higher than that of Europe. Whatever happened to America's sovereign credit rating downgrade and the worries around that?

There are two key issues of concern for the US – the recent flow of economic data has been softer and it faces a 'fiscal cliff' from year-end as various stimulus measures and budget savings kick in on January 1 next year. This may result in a big contraction in America's budget deficit and a hit to growth.

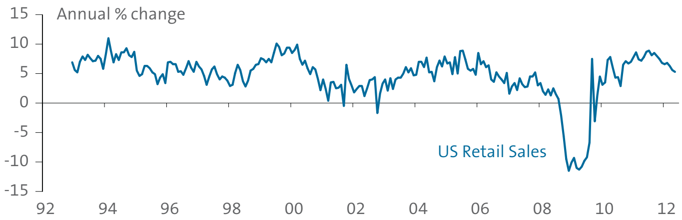
The US economic cycle

Reflecting post financial crisis caution, particularly on the part of the US corporate sector, the US economic recovery since 2009 has been anaemic and fragile, subject to periodic setbacks and fears of a 'double dip' back into recession. These soft patches were evident in both mid 2010 and mid 2011, and the economy appears to be going through another soft patch this year.

From the December quarter last year until about two months ago, US economic data surprised on the upside, but recently it has started to surprise on the downside again:

- Retail sales have been soft for the last few months.

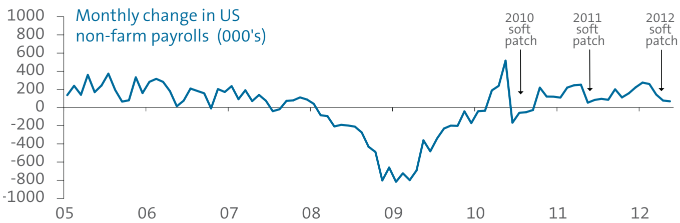
Slowing momentum in US retail sales



Source: Bloomberg, AMP Capital.

- Consumer sentiment has been adversely affected by bad news out of Europe and share market falls.
- Labour market indicators, including non-farm payrolls, have shown a slowdown in the rate of growth (although in the chart below it looks normal, even compared to pre-GFC patterns, investors are more nervous now).

Another soft patch in US employment growth



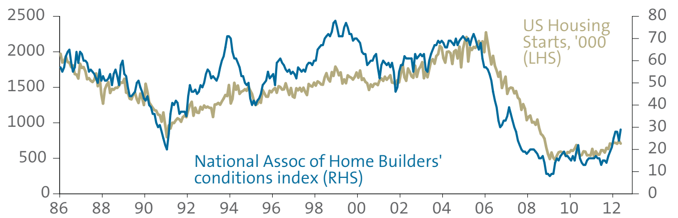
Source: Bloomberg, AMP Capital

- While the national ISM manufacturing conditions indicator has held up reasonably well, regional surveys have softened and these sometimes lead the national survey.

To be sure, the current soft patch may have further to run, causing consternation for investors. However, there are several reasons to believe that the slow grinding fragile US recovery of the last few years will continue:

- Firstly, the Federal Reserve (Fed) is likely to respond with more monetary easing and already appears to be heading in this direction.
- Secondly, while recent data has been a bit soft there are three key positives for the US: Housing seems to be gradually on the mend which is good for economic activity and household wealth (see chart below); the manufacturing sector is benefitting from a structural turnaround as companies are relocating production back to the US; the shale oil phenomenon is driving employment in the mid-west and flooding the US with oil and gas.

Home builders' conditions point to stronger US housing starts



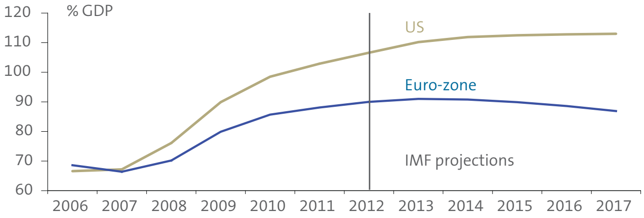
Source: Bloomberg, AMP Capital

- Thirdly, the US normally needs some sort of shock to go into recession. So far, there is no sign of this, but beyond Europe, the biggest threat is the 'fiscal cliff'.

Fiscal cliff approaching

It's well known that the US has a larger public debt problem than the Euro-zone in aggregate. However, it is able to get away with this as it is a strong fiscal union with plenty of credibility that it won't default - unlike peripheral Euro-zone countries. Also, there is strong demand for US dollars and US bonds from countries such as China. In addition, the Fed has been a strong buyer of US bonds (now holding about 15% of them).

US and Euro-zone Gross Public Debt



Source: IMF, AMP Capital

In August 2011, ratings agency Standard and Poor's cut America's AAA rating to AA+, and warned that the US risks another downgrade in 2014 if it doesn't bring its debt under better control. Other ratings agencies have the US on a negative outlook.

Basically, what the US needs is a long-term plan to reduce its budget deficit, by slowing growth in health and social security entitlements and reducing tax breaks. The trouble is that under current law the fiscal cutback in 2013 will occur too quickly and threaten the economy.

The main measures that will result in the fiscal cliff from January are the expiration of the Bush-era tax cuts on income, dividends and capital gains; the payroll tax cuts and extended unemployment benefits that were part of President Obama's stimulus measures; and cuts to Medicare and defence that flowed from last year's debt ceiling agreement.

The US Fiscal Cliff - Fiscal Drag in 2013

Budget item	$bn saving 2013	% GDP in 2013
Bush era tax cuts	221	1.4
Payroll tax cut	95	0.6
Unemployment benefits	26	0.2
Budget Control Act 2011	65	0.4
Payment rate for physicians	11	0.1
Other items	188	1.2
Total	**606**	**3.9**

Source: Congressional Budget Office

Taken together, these plus other measures will result in a fiscal drag equal to 3.9% of GDP in 2013. Of course, the actual economic impact may be less than this depending on so-called output multipliers. However, with GDP growth running at an anaemic 2% per annum, it may be enough to plunge the US economy into recession next year.

The US needs a plan to reduce its budget deficit over the long-term, but this would see it reduce very quickly – from around 7.5% of GDP for the Federal budget deficit in 2012 to around 4% of GDP in 2013.[1]

The other problem is that the US debt ceiling will also be reached again late this year, although it's likely the US Government will be able to survive into early next year. So, it is likely that any negotiation about reducing the fiscal cliff will also have to cover the debt ceiling. Of course, memories are still fresh from the dysfunctional negotiations that occurred last year in terms of the debt ceiling. These dragged on till the last minute and ultimately saw the US lose its AAA sovereign rating from Standard and Poor's.

However, there are several points worth noting. Firstly, neither side of politics seems keen to do anything about the problem prior to the November elections.

Secondly, both sides understand that if they allow the economy to plunge into recession, the backlash from voters could be significant. Ultimately, therefore, a deal is likely to be done, albeit at the eleventh hour.

Thirdly, the 'fiscal drag' is likely to be much less as some form of compromise is reached. Most scenarios see the drag being reduced to around 2% of GDP with the Bush-era tax cuts likely to be extended along with some other measures. The smallest drag, of around 1.3% of GDP, is likely to occur if the Republicans gain the presidency and both houses of Congress. Since a Republican president wouldn't gain office till January, the US may initially fall off the fiscal cliff for a few days or weeks before current laws can be reversed.

Either way, there could be a period of uncertainty for the US into year-end. That said, investors are likely to take a view on the likely outcome in the run-up to the elections. Once the results are known, past experience suggests some form of deal will be reached and the debt ceiling will be extended.

It's also worth noting that the Fed is more than aware of the fiscal cliff concerns. It may play a role in introducing more monetary easing over the next six months if the Fed comes to the view that the fiscal cliff or uncertainty around it will threaten the US economy.

So what does this mean for investors?

Although the current soft patch in the US and fiscal cliff concerns may result in ongoing bouts of volatility, the US economy will continue to recover gradually. Worries around Europe and the US mean investors remain caught between near-term uncertainty and risks, but good value in shares and the prospect of more policy stimulus. The latter would result in higher levels for shares by year-end. For long-term investors, the current environment provides great opportunities. For those who can't take a long-term perspective, our view remains that strategies around outcome-based investment approaches, or a focus on investment yield beyond the diminishing returns from bank deposits, are worth considering.

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[1] Allowing for other levels of government adds around 1% of GDP.

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