

## What is the risk of a double dip?



### Key points

- There is much talk about a 'double dip' back into recession in the US dragging back down the global economy and hence shares and other assets.
- While it's important to be conscious of the risks, it is worth noting that talk of a double dip (or an aftershock) is common after recessions. Usually it doesn't happen and we think double dip fears are over blown.

### Introduction

In a note last week, I went through all the reasons why the cyclical bull market in shares has further to run: the economic and profit recovery has further to go; inflation and interest rates remain low; and there is still plenty of cash sitting on the sidelines. Of course, the outlook is not without risk, so this note looks at the risk of the much talked about 'double dip' recession for the US next year. A US double dip would be bad news for the global economy, including Asia and Australia, given the renewed weakness it would trigger in trade flows and confidence.

The first thing to note is that talk of a double dip is common towards the end of most recessions. For example, such talk arose after the early 1990s recession and was also rife in 2003 as the world emerged from the 'tech wreck'. Usually it doesn't happen, but of course there are notable exceptions to this, for example:

- the early 1980s traced out a W-shaped pattern in the US, with recession in 1980 followed by a brief recovery in 1981, only to return to recession in 1982;
- the 1990s saw back-to-back recessions in Japan; and
- the US went back into recession in the late 1930s after recovering from depression in 1934, 1935 and 1936.

All of these situations had one thing in common - premature tightening. In 1981, the US Federal Reserve (the Fed), led by Paul Volker, raised interest rates aggressively to squeeze out inflation. In the 1990s, Japan tightened fiscal and monetary policy before recovery became sustainable. Similarly, in the mid 1930s, US authorities moved to raise tax rates and tighten monetary policy (via tighter bank reserve requirements) before a sustainable recovery had taken hold.

Normally fears of a double dip prove unfounded. A range of factors are being cited this time around as potential drivers of a double dip in the US economy next year including: monetary and fiscal policy tightening too early; a US dollar crisis; rising unemployment cutting into consumer spending; the banking system being too weak to lend and potentially being hit by more shocks; households being too weak to borrow; the potential for another oil-price-driven energy crisis; and the 'mother of all carry trades' that will soon come crashing down. I will now address the main double dip drivers in turn.

### "Monetary and fiscal policy will be tightened too early"

This one is easy. The International Monetary Fund (IMF) and key governments have stressed the danger of premature tightening after studying the 1930s depression and Japan in the 1990s. With underlying inflation continuing to fall and unemployment very high, there is neither the inclination nor necessity to embark on premature tightening. This was most recently restated at the G20 finance ministers meeting where they "agreed to maintain support for the recovery until it is assured." Therefore, premature tightening seems unlikely.

There is no doubt there could be some gyrations in markets when authorities do move to seriously unwind the extreme fiscal and monetary stimulus, but that could be several years away. Similarly, new bank capital requirements agreed to globally will amount to monetary tightening, but the G20 has only agreed to implement them by the end of 2012, i.e. three years away.

There is a related concern that the recovery is solely due to monetary and fiscal stimulus and will quickly fade once stimulus is removed. This concern arises in most recoveries, but it's invariably the case that once stimulus has primed the pump, stronger confidence helps take over to make the recovery self sustaining. A turn in the inventory cycle is also playing a role in driving this recovery, which can also help fuel better confidence.

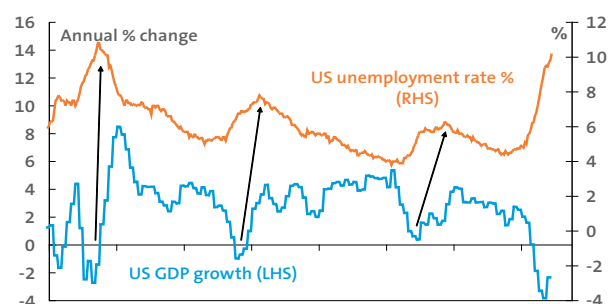
### "A US dollar crisis will force premature tightening"

Talk of a US dollar (US\$) crisis is common, but it's hard to see a collapse occurring. The two most traded alternatives (the yen and euro) are no more attractive than the US\$. Both have similar or worse public debt problems and, arguably, worse economic prospects. Additionally, the Chinese won't allow a sharp rise in the Renminbi. Regardless, it's doubtful that the Fed is overly concerned about a weak US\$ given the absence of inflation in the US. (While some observers fret about the Fed 'printing money', the reality is that until banks start lending more, and economic activity and capacity utilisation return to more normal levels, inflation will remain a non issue.)

### "Unemployment will drag the US back into recession".

Unemployment is undoubtedly a serious problem in the US and Europe, but it's worth noting that unemployment invariably lags the economic cycle. In the US, the unemployment rate peaked two months after the 1982 recession ended, 15 months after the 1990-91 recession ended and 21 months after the 2001 recession ended.

### Unemployment often doesn't peak until well after a recession ends



Source: Bloomberg, AMP Capital Investors

The reason it lags is that just as companies are slow to fire staff when heading into downturns, they are slow to hire in upturns, as it takes a while for companies to regain confidence. The key point is that **rising unemployment doesn't keep economies mired in recession or trigger double dips – it is just normally one of the last indicators to turn.**

Moreover, a range of indicators suggest that the US labour market may be on the mend. Leading labour market indicators such as falling unemployment claims, falling announced layoffs, rising temporary employment and rising employment intentions in business surveys, suggest that US employment will be growing again early next year. This, in turn, suggests we may be close to the peak in unemployment (although it could still go a bit higher).

It's also notable that US companies may have overreacted in laying off workers. The past relationship between a slump in gross domestic product (GDP) and the rise in unemployment suggests that unemployment should have increased to around 8.5 to 9%. Instead it has reached 10.2%. This may reflect panic in response to all the talk of a depression. It could also mean that companies will become short staffed more quickly than normal and hence may be compelled to lift employment more quickly than normal. As a result, the unemployment scare may also fade faster than usual.

### “Bank lending is continuing to weaken”

Bank lending is continuing to weaken in the US and the US banking system is still far from robust. Even in Australia, lending to the corporate sector is continuing to fall. However, there are several points to note:

- As with unemployment, private sector credit growth normally lags the economic cycle. This was the case in both the US and Australia after the early 1990s recession, with credit growth only picking up again a couple of years into the recovery.
- Medium to large corporates have been able to issue equity capital or access the corporate bond market to make up for reduced bank lending. It has been a lot tougher though for small business.
- Surveys by both the Fed and the European Central Bank suggest that banks' willingness to make loans is improving.
- Consumers do appear to be responding to fiscal stimulus and lower interest rates. This is clearly evident in Australia. Even in America there are signs of life, with weekly chain store sales picking up, car sales showing signs of improvement and housing indicators bottoming out.

But what about the risk of another shock to the banking system? There are three main risks on this front.

First, many fret about a further collapse in the commercial property market in the US. However, it increasingly looks like commercial property markets are bottoming. In fact, commercial property price indices for both the US and UK showed modest gains in values in the September quarter. Therefore, while bank losses are still rising on commercial property loans, they are likely getting close to their peak rather than set for another big leg higher.

Second, there are concerns about another wave of mortgage delinquencies as sub-prime mortgages issued in 2006 and 2007 come up for mortgage rate loan resets in the next couple of years. This is where the low honeymoon rate ends and borrowers have to start paying a higher market rate. While it's hard to get a handle on how big this problem is, it's likely the market rate may not be that much above the honeymoon rate given the fall in mortgage rates in the last two years.

Third, there are ongoing concerns about financial problems in Eastern Europe dragging down Western European banks. This is another issue that is hard to get a handle on, but a serious default crisis in such countries seems to have been headed off by IMF assistance. In fact, some countries, such as Lithuania, appear to be growing again. Also, the Western European banks involved are not as central to the global financial system as the big US banks.

### “There will be another energy crisis”

This is always possible, but it is hard to see the oil price returning to last year's highs unless there is a much stronger recovery in growth in advanced countries than currently expected.

### “It's the mother of all carry trades”

Finally, it has been argued that equities, commodities, credit markets and other risky assets have only surged higher because the Fed and other central banks have pushed interest rates to very low levels which can't last. This is true to a degree, but it is exactly what the Fed and other central banks have been hoping to achieve and is how monetary policy works. By cutting interest rates to very low levels, central banks have forced people into either spending or investing in more risky assets which has helped finance the recovery (for example by making equity capital raisings easier) and has added to confidence and perceptions of wealth as asset prices have increased. This is precisely what happens in most economic recoveries. It is also how most cyclical bull markets initially get underway before profit growth then kicks in and helps lead to a more sustainable phase in the recovery. In this sense, there is nothing unusual about the current surge in asset prices. While some asset prices may eventually be pushed to bubble-like levels, with shares, commodities and other risky assets still being below previous peak levels we are currently a long way from that.

### Concluding comments

After the worst financial crisis and worst global economic slump in the post-war period, it is natural to worry about aftershocks that could trigger a return to recession. While the risk cannot be ignored, our assessment is that a double dip back into recession next year is unlikely, particularly in the absence of premature monetary or fiscal tightening in the US.

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