

## Global and Australian growth and the interest rate outlook



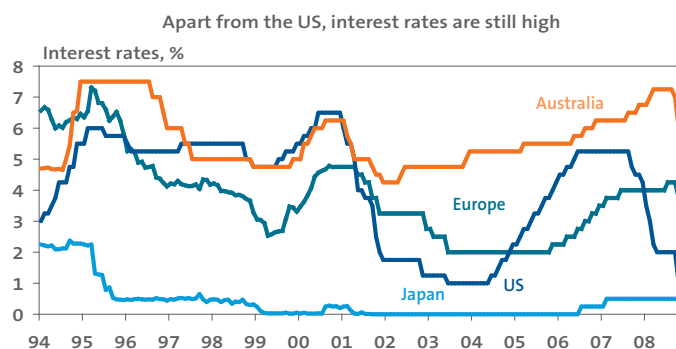
### Oliver's insights

#### Key points

- The intensification in the global financial crisis over the last two months has led to a further deterioration in the outlook for global and Australian economic growth.
- Against this backdrop, and the consequent plunge in commodity prices, inflation is now a non-issue.
- As a result interest rates are heading substantially lower with the US and Japan likely to be in a race to zero, UK and European interest rates are likely to reach 2% and Australian interest rates are likely to fall to 4% or below, with another 0.5% cut next week.

#### Introduction

The decline in global interest rates is continuing with the US Federal Reserve (Fed) announcing another 0.5% reduction in its key Fed Funds rate to just 1% and China cutting its benchmark lending rate for the third time in two months. While interest rates have declined significantly in the US, they have fallen far less in other countries as indicated in the chart below.



Source: Thomson Financial, AMP Capital Investors

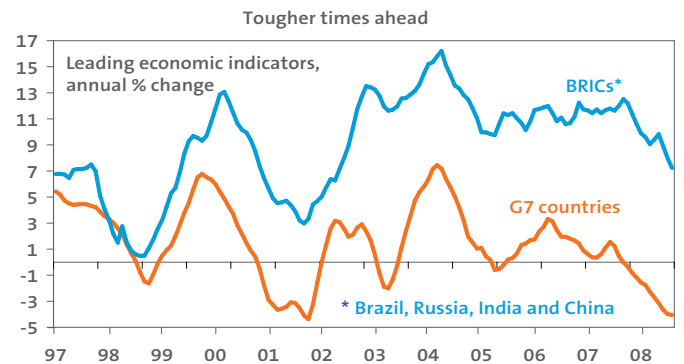
Our assessment is that interest rates in most countries are set to fall significantly further, probably taking them back to the lows reached earlier this decade or even lower.

#### Reasons why interest rates will fall further

There are a few reasons why rates are set to fall in most countries:

- Firstly, the threat to global economic growth is now looking even more serious than was the case earlier this decade.

Even prior to the turmoil in September and October leading indicators for the G7 economies were pointing to a recession at least as bad as that seen earlier this decade. See the next chart.



Source: Thomson Financial, AMP Capital Investors

However, since Lehman Brothers was allowed to go bust in mid-September, triggering a further loss of trust, the financial crisis has taken another turn for the worst leading to a further tightening in credit flows, a further loss of business and consumer confidence and of course a further sharp fall in share markets and wealth. Furthermore, the crisis has now spread to a range of emerging countries, via lower commodity prices in the case of some and capital flight. This has been all made worse by the guarantees on bank borrowing in developed countries. Recent data has confirmed that even China is looking a lot weaker. As a result, the outlook for global growth has deteriorated further over the last two months. In fact, it now seems likely that the recession in the developed world that probably started in the June or September quarters this year will last a year or so and the slowdown in the emerging world will now be sharper than previously expected.

- Secondly, the collapse in global growth will lead to excess capacity and this, along with the slump in commodity prices since mid year, will lead to a sharp decline in inflation pressures. If anything deflation is likely to return as a worry next year or in 2010, particularly with excess capacity in China's export focussed factories likely to rise significantly.
- Thirdly, the credit crunch has had the effect of pushing up the level of private sector borrowing rates relative to official cash rates and government bond yields. While the situation is improving in money markets, a complete meltdown or long and deep recession is not on the way, they are still a long way from normal and credit markets are likely to remain difficult for some time. To reduce private sector borrowing rates to a given level it will be necessary to cut official interest rates by more than normal. For example, in Australia's case the gap between the mortgage rate and the cash rate is now around 0.5% greater than was the case earlier this decade.

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- Finally, normally in an economic downturn the yield curve (the gap between 10 year bond yields and short term cash rates) needs to become steeply positive, i.e. short term borrowing rates need to fall well below long term expected returns to encourage investors to borrow. In a banking crisis it's even more important that the yield curve become positive as banks borrow short and lend long, so a positive yield curve helps strengthen the financial position of the banks. In the US the yield curve is quite steep already (i.e. +2.8%) but normally it becomes even steeper in a slump. In Europe the yield curve is still flat to slightly positive and in Australia it's inverse, with the cash rate still above the bond yield. So rates still need to fall a long way.

## Further rate cuts

The bottom line is that further interest rate cuts are necessary and likely over the next few months:

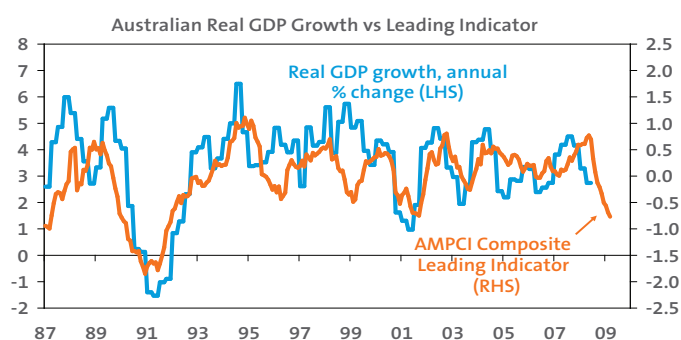
- US interest rates are likely to reach 0.5% or lower;
- The European Central Bank has signalled further rate cuts ahead, with another 0.5% cut likely next week and they are likely to fall at least as low as their 2003 low of 2%. UK rates are likely to fall to the same level.
- The Bank of Japan is likely to take rates back towards zero given the growing severity of its recession.
- Rates are likely to head lower across Asia, including China as the focus shifts from inflation to growth.

## What happens when interest rates hit zero?

As interest rates approach zero there will be debate about what next. As noted by the Fed in 2003, there is still much a central bank can do including resorting to the printing press. While this won't be undertaken lightly, it shouldn't be seen as inflationary if people aren't responding to low rates and not spending.

## What about Australia?

Australian growth is likely to slow significantly over the year ahead reflecting slowing export demand, the slump in commodity prices, the blow to confidence from the turmoil in financial markets and the loss of wealth that has resulted from falling share prices and softening house prices. Against this there is still a big pipeline of pending investment projects, we have a shortage of houses in contrast to the US which has an oversupply and the plunge in the A\$ will provide a huge boost to exporting and import competing industries. What's more the Government has recognised the threat and is already undertaking fiscal stimulus and interest rates can fall a lot further. Our leading indicator points to Australian GDP growth slowing to around 1.5% in the year ahead, but it's still falling. While Australia should have a softer landing than the US, Europe and Japan, **the odds are now tipping in favour of a mild recession, probably in the June and September quarters next year** after the one-off payments to low and middle income families with children and pensioners in December have worked through.



Source: Thomson Financial, AMP Capital Investors

Given the uncertainty, the table below indicates what has happened in the past four recessions in Australia.

## What happened in past Australian recessions?

Recession	Fall in GDP, %	Length, qtrs	Fall in inflation % points	Rise in unemployment, % points	Fall in cash rate, % points
1975	-2.1	2	-11.2	+3.2	-14.1
1977	-0.6	2	-5.4	+2.3	-2.4
1982-83	-3.8	7	-5.7	+4.9	-12.4
1990-91	-1.7	5	-4.6	+5.2	-13.5

Source: ABS, RBA, AMP Capital Investors

A sharp rise in unemployment to at least 6% is likely over the year ahead and inflation is likely to fall sharply. During the last easing cycle in 2001 the cash rate fell to 4.25%. This time around the economic threat is greater and given the blow out in mortgage rates versus the cash rate it may be necessary to ultimately cut the cash rate to a lower level (say to 3.75%) by the end of next year. Another factor pointing to a sharp further reduction in Australian interest rates over the next six to 12 months is that the household sector is more vulnerable today with much higher debt. The likelihood is that rising unemployment will trigger a desire to reduce debt and hence spending. Much lower mortgage rates will be necessary to make sure this does not turn into a downwards spiral – of rising unemployment, falling house prices, reduced spending, and rising unemployment, etc. But it's hard to escape the likelihood that house prices will fall over the year ahead.

## Concluding comments

The economic outlook is now pretty gloomy. The recent turn for the worst in money and credit markets has led to a further weakening in the global growth outlook, which in turn has led to a deterioration in the outlook for Australian growth and hence the need for much lower interest rates. For shares the slide towards recession globally will ensure that the ride will remain rough over the next few months. It's still too early to say for sure that we have hit bottom. However, several points are worth bearing in mind. Shares are highly oversold after the recent panic. At the very least, they appear to be due for a reasonable short term bounce possibly of around 30%. Shares have had their worst calendar year (so far) since 1931 in the US and their worst calendar year (so far) ever over the period since 1876 in the case of Australia and as such they are already +discounting a lot of bad news, including a 40% slump in profits. Just as share markets peaked before the world went into recession they will also trough before the economic news turns good again.

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

## Contact us

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Financial Planners	AMP Capital's Investment Representative on 1300 139 267
Private Clients	Private Client Services on 1800 188 013
Wholesale Investors	AMP Capital's Client Service Team on 1800 658 404