

How deep the recession?



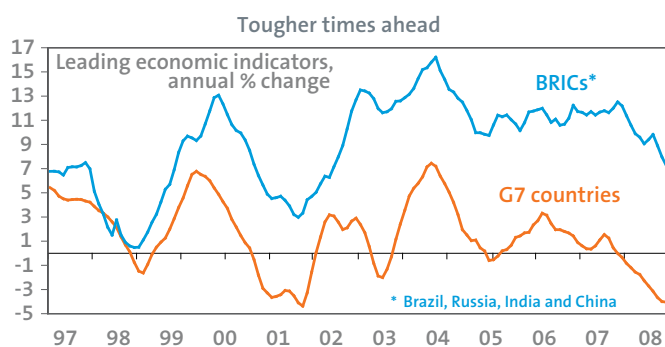
Key points

- Global recession is now a given. Australia is also headed for at least a mild recession.
- The key issue is the depth and duration of the slump. At the moment, leading indicators for global and Australian growth are still in free fall.
- Rapid policy action should help drive a recovery from the second half of 2009, but given the deleveraging now underway, the risk of a longer recession is high.

The coming recession

The collapse of Lehman Brothers in September and the resulting panic it set off in global money markets, and more broadly in confidence, has caused immense damage to the global economic outlook. In particular, it would seem that the efforts by the US Government to convince Congress to pass the bank rescue program last month, by arguing it is a Main Street problem as well as a Wall Street problem, has convinced investors and the wider global population of the seriousness of the situation. This has recently led to a sharp deterioration in economic data.

Recession is now a given in key advanced economies. Japan and Europe have already had two consecutive negative quarters and it is only a matter of time before it is 'officially' declared in the US. Recession is also likely in Australia. The emerging world will be running far enough below potential to qualify as a recession as well. Right now, leading indicators of economic growth are still pointing down and provide no indication as to when the slump will end or how deep it will be. Refer to the following chart.

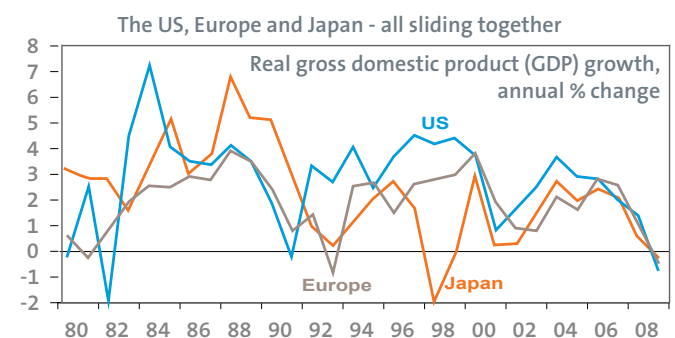


Source: Thomson Financial, AMP Capital Investors

Not a normal post-war slump

The current situation is very different to that going into past post-war recessions, for several reasons. Normal post-war recessions were part of a cycle which saw inflationary pressures build during an economic upturn, interest rates rise, demand slow and inventories rise. This resulted in a downturn which was ultimately reversed via lower interest rates. The cycle had run its course after de-stocking. The current cycle has some elements of this, and has been made worse by the huge surge in oil and commodity prices into mid-year. This has seen interest rates increased or maintained at higher levels than should have been the case. However, two considerations make this global slump potentially more serious and hence add to the level of uncertainty.

- Firstly, we are faced with significant systemic risk as the flow of credit has been radically impaired by a severe loss of confidence due to the sub-prime mortgage crisis and subsequent banking problems. The resulting pressure to reduce gearing (whether in hedge funds, real estate investment trusts or indebted households) has meant that the current slump has many of the signs of a debt-deflation cycle described by economist Irving Fisher in relation to the Great Depression. In a debt deflation spiral, distressed selling of assets leads to wealth destruction, which leads to falling spending, which leads to rising unemployment, and then more distressed selling of assets (including houses) and more falls in asset prices, etc. The UK and the US are already in a form of this.
- On top of this, most countries are weakening at the same time. For example, in the early 1990s, the US had a recession in 1990 and then recovered, but Japan and Europe did not really succumb until 1992. Refer to the chart below.

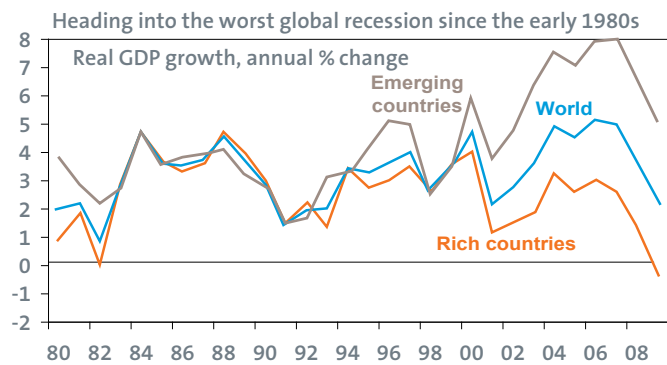


Source: IMF, AMP Capital Investors

The synchronisation in the economic downturns in the US, Japan and Europe is now making the global downturn a lot worse. As a result, weighted average growth in the world's advanced countries is now expected to contract for the first time in the post-war period. Refer to the next chart. While the emerging world is coming from a higher growth base than it was in the downturns of the early 1980s and 1990s, momentum here is also fading rapidly.

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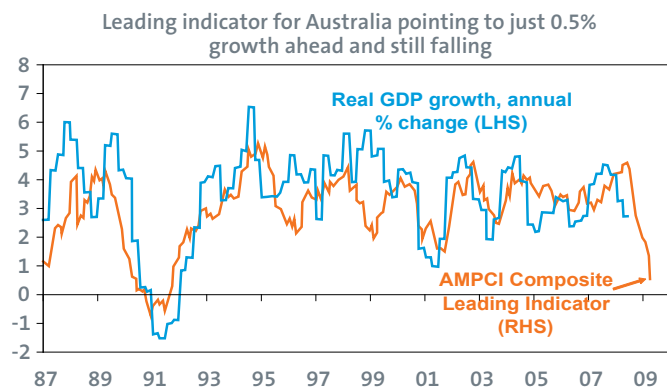
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Source: IMF, AMP Capital Investors

As a result, uncertainty is greater than normal. Our base case would see the global recession last to around mid-2009. But given deleveraging and the uncertainties it sets off, a longer and deeper recession stretching into 2010 is possible. Rapid government policy should head off a deep recession scenario.

Australia is currently better placed than many countries. Our financial system is less impaired, it has more scope for policy easing, growth in its trading partners is likely to remain above that in the advanced world and the fall in the Australian dollar (A\$) will provide a boost to domestic production. But even in Australia, the risks are considerable given our high levels of household debt and house prices relative to income, and Australia's high reliance on foreign capital. Our leading indicator for Australia now points to growth slowing to 0.5% over the next six months and it is rapidly falling to the levels associated with the early 1990s recession. This, along with the still deteriorating global outlook, plunging confidence and negative wealth effects, indicates that Australia will at least have a mild recession at some point in the next year.



Source: Thomson Financial, AMP Capital Investors

During the last two recessions in Australia, unemployment rose by five percentage points and inflation fell by an average five percentage points. **Inflation will fall sharply** as lower commodity prices and the slump in the economy feed through. Unemployment is likely to rise to between 7% to 9%.

What to watch

Given the uncertainty now regarding whether the world is facing a mild or deep recession, we are now looking for:

- A rapid further decline in short-term interest rates relative to long-term rates;
- More global rate cuts and more fiscal stimulus quickly;
- A slowing rate of decline in US house prices;
- US consumer spending to slow but not collapse;
- A stabilisation in consumer confidence in key countries;
- A modest pick up in corporate defaults;
- An easing in bank lending standards;
- A further improvement in money markets;

- A fall in private sector borrowing rates;
- An improvement in broad money supply measures relative to the monetary base;
- A stabilisation in global trade indicators;
- A stabilisation/improvement in China's growth;
- Weekly auction clearance rates are worth watching in Australia.

While there has been some improvement in some of these signposts, it is not yet enough to provide confidence.

Implications

The uncertain economic outlook has several implications:

- Short-term cash rates are likely to fall further. Japan and the US are in a race to zero. In Australia, the Reserve Bank (RBA) is likely to cut rates by another 0.75% to 1% next month and **the cash rate is likely to ultimately bottom out below 3% in 2009.**
- Just as shares led on the way down, they will lead on the way up. Having now had 50% plus falls, shares are already factoring in a recession. While they are great value from a long-term perspective, the uncertainty about the outlook means it is too early to say the bear market is over.
- Commodity prices and currencies lag the economic cycle. It is hard to see them moving higher until there is more confidence that global growth is back on track. Until then, further weakness in commodity prices and resource stocks is likely.
- Unlisted assets are now more vulnerable than financial assets, which have already been hit hard.

Concluding comments

While next year is likely to be pretty tough, all is not lost. Australia's long-term growth prospects remain bright given our exposure to China, which will resume its rapid industrialisation process after the current pause, and our financial system is in far better shape than many other countries. **In the short term, we should bear in mind that a lot of stimulus is being pumped into the household sector, with much more to come.** A middle income Australian family with a A\$250,000 mortgage, two children and two cars will be seeing their finances bolstered. Their mortgage interest bill will have fallen by about A\$375 a month since August, their monthly petrol bill will have fallen by about A\$95 since July and, if they qualify, they will get a one off A\$1000 per child payment next month. Of course, the uncertainty caused by rising unemployment will mean a big chunk of this will be saved. But it will certainly help avoid a big collapse in spending, and more importantly at some point later next year, will help drive a recovery.

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