

## Economic Views for Investors

by Roger Nightingale

An anaemic, inventory-based, revival . . .

The world economy is proceeding much as expected. Industrial production slumped while the inventory liquidation was in progress, but rebounded moderately when it was ended. Nearly everywhere, therefore, GDP numbers in the second quarter were less bad than those in the previous three. In Asia, there was a resumption of growth in Japan and Korea; likewise in Europe in Germany and France.

. . . appears to be occurring on schedule

But nowhere, it seems, was there any improvement in final sales. Consumption continued to fall modestly and business investment sharply. The press made much of the better GDP numbers, but the central banks were generally cautious. They knew that the recovery in inventories would boost activity for only a few months. If there were to be a sustained revival, it would have to be driven by other elements of demand, principally consumption.

But consumption is weak and likely to become weaker yet

Sadly, the prospects for personal spending were not good. Unemployment was casting a long and debilitating shadow. High already, it looked set to rise much further. It was estimated that, while world GDP had fallen about 6%, employment had declined less than 1%. The disconnect couldn't last. In the next twelve months, there was likely to be a huge increase in joblessness. Disposable income would fall and consumption follow suit.

It's the end of the beginning of the crisis, not the beginning of the end of it

In Britain, Governor King acknowledged the long-term difficulties facing the UK economy—and, by implication, the analytical errors he'd made in the past. He let it be known that he'd try to lift spending appetites with protractedly easier credit, but noted that his efforts might be frustrated by the commercial banks. Why lend to bad risks, they were bound to ask themselves. Better to take cheap money from one part of the public sector and lend back expensively to another. A round-tripping exercise that was as profitable as it was riskless. It'd rebuild balance sheets on the one hand, bonuses on the other!

Interest rates will stay low and public spending be cut

The fiscal authorities might also be in the process of rethinking their strategy. Mindless spending was proving not just economically ineffective, but politically unpopular as well. Unsurprisingly so. To take money from one group (taxpayers) and give it to another (public sector departments) amounted to a zero-sum operation: the benefit to the one being matched by the detriment to the other. Its net effect was merely to impoverish the wealth creator at the expense of the wealth consumer. There was little doubt, therefore, that furiously high levels of public spending would shortly be discontinued; most probably after next year's election.

The bad news is that regulators will be given extra powers

What, though, was to be done about the banks? What would Cameron's Tories do after taking office? Would the bailout programme be reversed? Sadly no. Worse yet, regulators would be asked to do expensively and ineptly what markets would have done cheaply and competently. An enlarged FSA, supervised by the Governor, would tell bankers how much they could reward those of their employees who'd rendered industry bankrupt and pensioners destitute. Hallelujah: one set of *dozos* in pursuit of another!

Markets will rally nevertheless

The outlook for the economy may not be favourable, but that for the securities market is. Inflation is going to fall significantly further. And not just for a few months, but for a protracted period. The environment is one in which pay settlements, already moderate, will become negligible. Set that in the context of renewed softness in commodity prices, coupled with stability (or strength) in sterling, and the bottom line will be declining consumer prices. By early next year, the twelve month rate of change will be negative; a year later it might be dangerously fast.

Inflation low; profits strong

Corporate profits, meanwhile, will be strengthening. Modest pay rises and sizeable layoffs will redistribute GDP from labour to capital. The latter will be accorded a rising share of what will, arguably, be a shrinking pie.

Taxation just bearable

Taxation may be a temporarily constraining influence. But probably only temporarily. The fiscal deficit is huge and will have to be reduced. But the likelihood is that spending, rather than taxation, will bear the brunt of the burden.

Equities and bonds will both rally

Accordingly, the recent rally is thought likely to persist. Long dated government yields will fall by 25 bps in the remainder of 2009; a further 50 bps in 2010. Equities will fare better still: 12½% this year; 25% next. Prospective pensioners may breathe slightly more easily!

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