a window for recovery?

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Are equities on course for significant recovery? Simon Ward, New Star's chief economist and strategist, offers his view.

The seizure of money and credit markets following the collapse of Lehman Brothers in September sent the global economy into a tailspin. Investors are uncertain about the depth and length of the recession and whether equity markets have yet priced in all the bad news.

Let us start with the current economic evidence. Industrial production in the G7 major economies is a useful summary measure of global economic activity. As of September, output was down by 3.5% from a year before. This rate of contraction has been exceeded on only three occasions during the post-war period – the mid 1970s, early 1980s and early 2000s. These previous severe recessions should provide some guidance about current prospects.

important insights

An examination of the fall and subsequent recovery in industrial production during these episodes reveals two important insights. First, the initial decline in activity was over after a year in all three cases. The current output slide began in February 2008 so this suggests the economy will bottom out by early 2009.

Secondly, the speed and strength of the recovery was inversely related to the scale of the output fall. There was a V-shaped rebound after the deep recession of 1974/75 when G7 industrial production fell 12% from peak to trough. By contrast, the milder 1980/81 downturn, which involved a 5% output drop, was followed by a lacklustre and temporary recovery, with output sliding again to new lows in 1982.

We can take the comparison further by calculating an average of output performance during these three previous recessions and recoveries. The chart, right, shows how the current cycle would play out based on this 'three-cycle average'. Output continues to slide steeply into early 2009, bottoming out after a 7-8% fall. It then embarks on a recovery over the remainder of 2009, retracing about half of the peak-to-trough decline. This revival, however, gives way to renewed weakness in the first half of 2010, with sustained growth occurring only from late 2010.

This 'forecast' is obviously simplistic but its rough shape looks plausible. A consideration of fundamental forces operating on the economy supports the expectation of an output trough in early 2009 but there are also reasons for believing a subsequent recovery will prove a 'false dawn', with further weakness emerging in 2010 (see panel).

why will economic recovery be delayed?

Support from fiscal stimulus and lower inflation is one-off in nature and will unwind in 2010. Even assuming recent rescue measures bear fruit, banking systems will remain fragile, implying continuing credit constraints. In addition,

four factors, in particular, offer support to activity during 2009:

• Official rate cuts and other measures to ease the financial crisis

G7 interest rates spiked up after Lehman failed but have since fallen to new lows. Credit remains tight but lower rates will support the income and spending of existing borrowers. G7 M1 money supply – currency and instant-access deposits – is picking up and usually leads the economy by 6-12 months.

• Much lower inflation

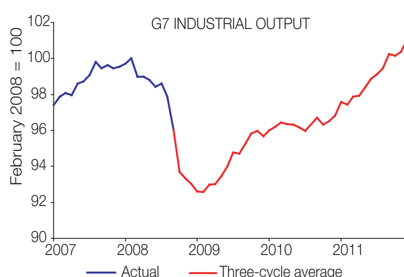
Soaring prices last summer contributed to economic weakness by squeezing real incomes. This effect is now reversing – G7 headline consumer price inflation should drop from its recent peak of more than 4% towards zero by spring 2009, largely reflecting lower commodity costs.

• Fiscal loosening

The G7 'structural' budget deficit – adjusting for the effect of the economic cycle – rose by about 1% of GDP in 2008 and a similar or larger gain is likely in 2009, judging by recent policy announcements. Comparable increases occurred in 1974/75 and 2001/02 and preceded economic recoveries.

• The US stocks cycle

US firms have cut inventories to low levels relative to sales. This behaviour is typical of the late stages of recession – a turn in the stocks cycle should lift activity some time in 2009.



business investment may continue to fall in 2010 – global capital spending follows a roughly nine-year cycle and a new upswing phase is not expected to begin until 2011.

The bottom line is that investors should brace themselves for a sustained period of below-par economic performance. The recession phase may be over sooner than many expect but it will take time to rebuild balance sheets and lay the foundations for the next upturn. A return to strong growth is unlikely until the second half of 2010 at the earliest.

offering hope

On the face of it, this scenario looks negative for equities. The recent crash, however, has sent valuations to historically low levels, suggesting that much of this bad news is already discounted. For example, an index of inflation-adjusted US equity returns is now further below its long-run trend line (from 1800) than at any time since 1984. Of course, there is no guarantee this gap will not widen but long-term investors who bought at similar levels historically earned impressive returns.

Equity performance during previous recessions also offers some hope. Investors who bought six months before the trough in industrial output in 1975 and 1980 enjoyed a hefty gain over the subsequent year. This wasn't true in 2001 but valuations then were still extremely high by historical standards. Assuming output bottoms out in early 2009, as suggested above, and given current modest prices, equity markets may now be entering the time window for a significant recovery.

Economic prospects are cloudy and there is a risk the current recession will be deeper and/or longer than its predecessors, undermining the above comparisons. Equities are priced for gloom, however, and are likely to rally well before the economic cycle trough.

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