Edition #9 – 19 March 2010
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# Revisiting the 'worry list' for investors


## Key points

- It seems that there are still plenty of things for investors to worry about: a double dip in the global economy; high private and public sector debt in key countries; policy tightening; a resurgent US dollar (US$); and a possible China collapse among them. Fortunately, most of these are not as worrying as they appear.
- More broadly though, it is actually a sign of a healthy market when there is still so much scepticism and fear around. It indicates there are still plenty of buyers sitting on the sidelines that will help push share markets higher over time.

## Introduction

It is human nature to worry about what may go wrong. Maybe it has something to do with our evolution in the Pleistocene era when the main trick was to avoid being attacked by a woolly mammoth or a sabre-toothed tiger. In relation to this, it is frequently said that shares climb a 'wall of worry', in that shares rise when there seems to be lots to worry about. The logic is simple – if everyone is worried, then it is quite easy for events to unfold better than expected. This note looks at the current list of worries – why some may not be worth worrying about and why others are worth keeping an eye on. Addressing the main worries in turn:

## "The US/global recovery is not self sustaining and will double dip once the stimulus is over"

A double dip back into recession would be bad news. This is less of a direct issue in Australia and Asia where employment growth has recovered, underpinning private-sector spending and re-starting the cycle of demand growth. However, the risk cannot be ignored in most advanced countries. In the case of the US, the housing sector has yet to start recovering and employment is yet to improve.

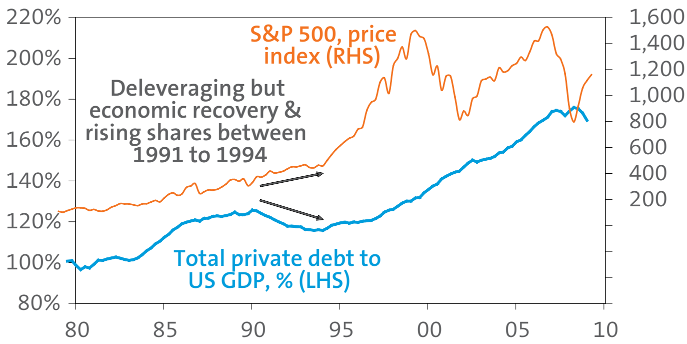
Worries about a double dip are common during the early stages of a recovery. The fear is that 'once the policy stimulus wears off, growth will collapse anew'. However, there are signs that the US recovery is becoming self sustaining. Retail sales in the US have picked up and, significantly, many forward looking indicators suggest that US employment will soon start to grow again. Thanks to strong productivity growth and a rebound in profits, US companies are now generating record cash flows and this should flow on to higher capital spending and employment. This should support future consumer spending and take over from stimulus measures in driving the recovery going forward. Overall, we see the risk of a global double dip as being low – with around a 25% probability.

## "A lack of credit will prevent a sustainable recovery"

A common concern is that the recovery can't become sustainable with private-sector credit still falling in the US. This, of course is related to double dip worries. However, US consumers are increasing their spending – retail sales have picked up and auto sales are also trending higher.

Additionally, the experience in Australia and the US post the early 1990s recession highlights that debt de-leveraging won't necessarily stop a recovery, as shown by the next chart. In fact, it is the acceleration or deceleration in the change in debt that affects growth. Of course a rise in the savings rate will detract from growth, but once the savings rate is at a new higher level (and debt is still falling) spending can then rise in line with income and so the continuing reduction in debt doesn't stop growth from resuming.

**US private-sector debt versus the share market**




Source: US Federal Reserve, Thomson Financial, AMP Capital Investors

Therefore, although we see high levels of private debt being a longer-term growth constraint in the US, UK and Australia we don't see it as a barrier to a continuation of the recovery.

## "Premature tightening will trigger a double dip"

Based on the experience of the US in the 1930s and Japan in the 1990s, some fear that moves to wind back the fiscal stimulus and/or tighten monetary policy will trigger a renewed global downturn. However, the general impression from policy makers is that they will only move to tighten once it is clear that recovery is self-sustaining. Witness the US Federal Reserve's continuing commitment to keep interest rates low for an "extended period". We rate the risk of premature policy tightening as low.

## "A fiscal crisis in key advanced countries is imminent"

Moves to deal with high public-debt levels in the US, Europe and Japan by raising taxes and cutting government spending will constrain growth over the long term. The concern, however, is that investor impatience at the lack of action to cut deficits in the short term will create a 'fiscal crisis', as has recently occurred in Greece, forcing key advanced countries into fiscal tightening before the economic recovery has become entrenched. However, for now, at least, the risk of a fiscal crisis seems low: contagion from Greece seems to have been averted by the pledge of support from the European Union; there is little competition for funds from the private sector; inflation is low; and there are lots of buyers for bonds (e.g. banks). That said, this is the most serious worry on the worry list and is definitely worth keeping an eye on. Watch long-term bond yields for signs of it becoming a real concern.

## "Easy money will push the US to hyperinflation"

Some still seem to see a surge in inflation as inevitable. But until US credit starts to pick up (rather than sitting in bank reserves) and spending returns to normal levels, inflation will not be an issue. And by then, central banks are likely to have wound down their stimulus. It's that simple. Talk of hyperinflation remains nonsense.

## "The US$ will surge, making life harder for US companies, commodities and emerging markets"

Last year, there was much concern that the US$ was about to collapse as central banks diversified their reserves away from US dollars. This year, the concern has swung full circle. There are now fears the US$ is staging a comeback which will be bad for US shares (as many have overseas exposure), bad for commodity prices and bad for emerging country share markets. However, just as it was hard to see the US$ collapsing last year, it is hard to see it really taking off either. Rather, what seems to be occurring is the US$ going in different directions against currencies from different regions – up modestly against the euro but potentially down against stronger Asian currencies and commodity currencies like the Australian dollar. So the outlook for the US$ is a lot less definitive than many claim and big moves are unlikely.
As such, we see it as a low risk to the investment outlook.

## "Financial re-regulation will stop the recovery"

Yes it could slow it, but as we are seeing with financial re-regulation in the US right now, the path will likely be slow and faltering. Additionally, some might argue that economic growth was actually stronger in the 1950s and 1960s (when post-depression financial regulations were in force) rather than in the financially de-regulated 1980s, 1990s and 2000s.

## "China is a bubble that will burst in response to policies to slow inflation"

Many fear that China has overinvested and its assets are in a bubble that will soon burst as policy is tightened further to head off inflation. However, although such a scenario cannot be ruled out, it is unlikely. At a national level there is no evidence that China has overinvested, there is little evidence of a bubble beyond a few cities and its inflation problem is overstated – with most of the rise in inflation due to higher food prices. Yes, further tightening in China is likely as inflation continues to rise. However, an aggressive tightening is unlikely and around 10% economic growth is expected for this year. Worries about China will remain for the next few months but fade through the second half of the year. From a six- to 12-month view, the China outlook is low risk.

## "US/China trade tensions are likely to escalate"

Economic tensions between China and the US seem to be intensifying with China rejecting calls for a renminbi revaluation and some in the US intensifying calls for retaliation. Never mind that China's trade surplus has been shrinking and that the US may not benefit from a renminbi revaluation anyway. This could become more of an issue, but trade tensions between the two have been around for years and both countries have too much at stake to allow the issue to cause fundamental damage. We judge this as low risk.

## Our assessment

The table below shows our view of the risk posed by the worries discussed above in terms of the outlook for the global economy and shares over the next 12 months.

**Assessing the worry list**

| Worry | Risk rating – next 12 mths | | |
|---|---|---|---|
| | Low | Medium | High |
| US double dip | √ | | |
| Private sector debt in DMs | √ | | |
| Premature policy tightening | √ | | |
| A fiscal crisis in DMs | | | √ |
| Inflation | √ | | |
| A US$ surge | √ | | |
| Financial re-regulation | √ | | |
| China tightening | √ | | |
| China/US trade tensions | √ | | |

DMs = Developed markets. Source: AMP Capital Investors

We think many of the worries are overblown and will not prevent solid gains in shares over the year ahead, although they may lead to bouts of volatility. A public-debt crisis in key advanced countries is unlikely in the short term but it is the risk worth watching. Fortunately, it's not directly an issue for Australia and emerging countries. Importantly, the fact that there is still so much caution is a positive thing because it makes it easier for events to pleasantly surprise and suggests there are plenty of investors sitting on the sidelines.

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## Contact us

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