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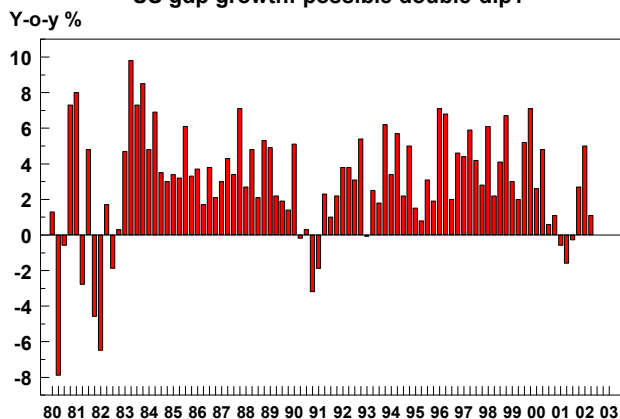
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GLOBAL OUTLOOK: AN UPDATE

The November 2001 Guide's feature article 'A global recession?' looked at the possibility of a prolonged downturn in the US leading to a global recession. It concluded that there were significant structural problems that needed to be resolved before the world's largest economy could return to trend growth. The events of 11 September were seen as a further factor exacerbating the outlook. While South Africa was seen as being relatively well placed to weather the storm, its open economy and markets make it vulnerable. Subsequent events initially led to hopes that these fears had been exaggerated. However, recent economic and financial trends are once again causing alarm.

US gdp growth: possible double-dip?



Optimists versus pessimists

In the months following 11 September it appeared as though the **optimists** were right. To recap, their position was that the downturn was cyclical in nature and would quickly be redressed by the usual cyclical medicine – stimulatory fiscal and monetary policies and the positive effects of a swing in the inventory cycle. Interest rates had already been slashed during 2001 and further cuts were effected after 11 September, bringing rates down to 40-year lows. Added to this was the reintroduction of deficit-style government spending in the US and increasingly elsewhere as well. In practice, monetary policy normally takes at least 12 months to affect the real economy and therefore the strong bounce in activity that took place in late 2001 and early 2002 did not

surprise the optimists. It was even initially reported that first-quarter US growth exceeded 6% on an annualised basis and soon the official declarers of business cycles in the US, the National Bureau of Economic Research, were under criticism for being too premature in announcing that a recession had commenced in March 2001. Many felt that there had been no downturn at all.

Over the past few weeks the mood has started to change, however. A series of corporate governance scandals started to force a reassessment of past corporate earnings strength. The Enron and WorldCom scandals underlined that the drive to post good results to boost equity performance had taken on new dimensions in the late 1990s. At the same time the economic news began to become more mixed. While industrial production staged a reasonable recovery from 2001 lows, consumer confidence started to falter. Most damaging, though, were the significant downward revisions to earlier estimates of gdp. Not only was the stellar performance of the first quarter modified, but the new figures also showed 3 consecutive quarters of contraction in 2001, underlining that a recession had taken place under any definition. Overall gdp growth in 2001 was reduced to just 0,3% from the originally reported 1,2%.

Elsewhere problems have also surfaced. Markets are focusing on the quality of earnings in Europe as well, together with the strong likelihood that several EU governments, including giants Germany and France, would miss their stability pact fiscal policy commitments under Maastricht. Whatever growth there has been in Japan has been due to improvements in exports. The domestic consumer remains absent, making the country an unlikely candidate for a global growth locomotive.

Finally, difficulties in several emerging market economies have escalated. In particular, the Argentinean crisis has spilled over into neighbouring Brazil and others such as Uruguay and Mexico have also been affected, resulting in large rescue packages being arranged by the IMF.

The more **pessimistic school** sees many of these difficulties in the context of major structural deficiencies in the US. As outlined in the November feature, this view holds that excessive spending during the 1990s boom has to be fully digested before the economy can return to trend growth. Not only did

consumers run down savings in history's biggest consumption boom, but companies also invested heavily in new technologies and capacity, resulting in substantial overcapacity in certain sectors, most notably telecommunications. Although this boosted growth and employment and drove productivity improvements, it also led to a massive rise in corporate and personal debt over the past decade and resulted in large current account deficits and the necessity of attracting foreign capital. While this was easy - despite the vast sums required - in an environment of a strengthening dollar, rising equity markets and a miracle economy, it has become more difficult with the knowledge that the US is fallible and that the dollar itself might retrace.

A further problem remains the level of the stock market itself. At around 40 times historic earnings, prices on the US S&P 500 are far in excess of anything ever experienced. Optimists are quick to point out that there have been significant exceptional writeoffs and that this figure is therefore artificially high. However, these only serve to underscore the weakness of the quality of earnings in previous years, already a sore point as noted above. Even allowing for a massive rebound in earnings on technical grounds as well as two years of activity-inspired, above-average earnings growth, the market would still be well above its long-term average valuation (the 40-year average is under 17 times earnings). In contrast, if economic growth disappointed or a double-dip recession became a reality, the market would be extremely vulnerable despite the already significant declines experienced since early 2000. A miracle is therefore required, but most of these were used up in the late 1990s.

Three scenarios and their effect on South Africa

The first possible scenario is that the optimists are correct, a view that is close to the current consensus. Cyclical stimulus prevails in the short term and in the medium to longer term the US returns to trend economic growth of around 3,5%, spurred on by continued technological advances and productivity improvements. Under this scenario world markets would recover vigorously in 2003, commodity prices would do well, and South African exports would boom in both value and volume terms, given the undervalued rand, good external demand and excellent market access. Interest rates would ease on the steadier currency despite strong domestic demand. Such an extremely attractive scenario would quickly be reflected in very strong equity and bond prices.

The second possibility would be a 'mucking along' scenario. Here the US would avoid a double-dip recession, but limp along at a 2%-odd annualised growth rate until past spending and asset price excesses are sweated out. This scenario would be relatively benign for South Africa, but would delay needed foreign investments by making privatised entities less attractive.

The third would be a double-dip recession in the US that spills over into the global economy, followed by average growth. This scenario would have a negative impact on export volumes and values, retard government's privatisation programme further and carry further dangers for the rand and hence interest rates. Upward pressure on interest rates would be mitigated by falling rates elsewhere, however. Equity prices would move lower in sympathy with other markets, but would bounce back more strongly given their low valuations and reasonable domestic spending once an upturn commences. Much will depend on the severity and length of any downturn. A short sharp correction would leave South Africa reasonably well positioned, with domestic demand supporting growth in the short term. However, in a lengthy global slowdown this would not be sustainable and domestic growth would suffer.

What scenario is most likely? In November we felt that the 'mucking along' scenario was probable and that a more protracted period of slower global growth would ensue. Unfortunately, there is now a strong possibility of a double-dip unless some rabbit can be pulled out of the hat.

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