

Risk of a double dip rises, but still not probable

Investment insights

Key points

- While the risk of a double dip for the global economy has increased we remain of the view it will be avoided.
- Shares may still see further weakness into September/October but are likely to experience strong returns on a six to 12 month horizon as it becomes clear the global recovery is continuing.

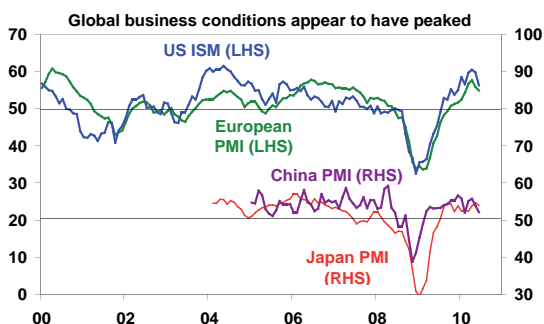
Introduction

Since the share market correction began in mid-April, investor sentiment remained skittish. Continued market volatility reflects still elevated risk aversion. The main driver of the latest turbulence is concerns the global economy will double dip back into recession. So the key remains whether the world double dips or just sees a growth slowdown after the surge of the last year.

Double dip unlikely

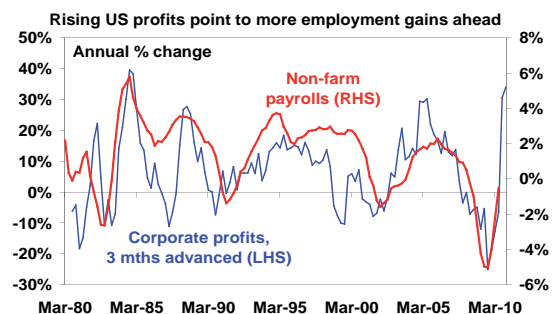
The European sovereign debt crisis, a premature shift towards fiscal tightening in several countries including Germany, the UK and maybe Japan, renewed weakness in the US housing sector together with China's aggressive measures to stop property speculation, have all boosted the risk of a dip back into global recession. However, while the risk of a double dip has risen, our view remains it will be avoided.

- First, business conditions indicators in the US, Europe, Japan and China appear to have topped out but so far their fall is consistent with a moderation in growth, not a collapse back into recession. After a strong bounce in the second half of last year to near cycle highs, some loss of momentum was inevitable. This is entirely consistent with past experience. For example, the moderation in 2004 after the recovery from the tech wreck recession. In fact a moderation in growth in some regions is desirable otherwise we would have seen a return to a boom bust cycle. This is notably the case in China.



Source: Bloomberg, AMP Capital Investors

- Second, double dips are unusual. Since 1925, the only double dip in the US economy occurred in the early 1980s when recession was followed by a recovery in 1981, only to see a return to recession in 1982 due to the US Federal Reserve's move to squeeze out inflation.
- Third, while fiscal policy is being prematurely tightened in Europe this is not the case in the US. And global monetary policy remains very easy with near zero interest rates in major developed countries.
- Fourth, the corporate sector in the US is in good shape with a surge in profits – which seems to have continued in the June quarter if recent earnings results are anything to go by. This is likely to underpin stronger employment and business investment going forward.



Source: Bloomberg, AMP Capital

- Finally, it should be recognised the emerging world is in a very different situation to the major developed countries. Emerging countries have experienced a typical cyclical recovery without the structural problems evident in the US, Japan and Europe. But with growth back up again – and becoming too strong in some countries – it was appropriate to reign it in. Led by China, we have seen the adoption of tightening measures in various countries including Taiwan, Malaysia, South Korea and Peru in the last few weeks and this has contributed to market jitters. However, this tapping of the brakes is perfectly normal and is unlikely to lead to a return to recession. In fact, China, which led the process, has now seen economic growth slow back to a more sustainable pace (with 10.3% growth over the year to the June quarter down from 11.9% in the March quarter, and inflation showing signs of topping out) and as a result it is likely to start easing up again in the next few months. The bottom line is that the emerging world will be a major contributor to global growth over the next few years, offsetting the softness in developed countries.



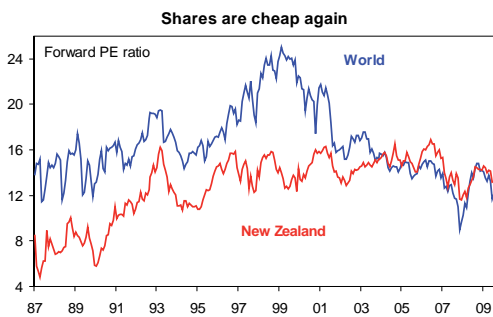
Source: Bloomberg, AMP Capital Investors

So although the risk of a double dip back into global recession has increased and cannot be ignored (and a double dip is high risk in Europe), the most likely outcome for the global economy is continued recovery, although at a more modest rate than seen over the last year.

So what does all this mean for shares and other growth assets?

The second 12 months in share markets after a bear market ends is usually more rough and constrained than the first 12 months of recovery, which is certainly proving to be the case this year. This often reflects worries about a double dip back into recession. On top of this the September quarter is traditionally the worst quarter of the year for shares. So with double dip fears likely to persist for a while yet, further weakness and volatility in share markets and other growth assets like commodity prices and the New Zealand dollar into around September/October is a high risk. Against this, we remain of the view that reasonable gains are likely in share markets on a six to 12 month horizon because:

- Shares are attractively priced with global shares trading on price to earnings ratios well below their longer term averages.



Source: Bloomberg, AMP Capital Investors

- Profit growth is likely to be strong at around 15 to 20% over the year ahead as still rising sales on reduced cost bases boost earnings. Obviously it may be a bit less than this in some developed countries and slightly more in emerging markets.
- Continuing near zero interest rates in major developed countries provide strong support for shares.
- Investor sentiment towards shares has fallen back to levels normally associated with market bottoms. In other words it's so negative that it is positive from a contrarian perspective.

So, overall, we remain of the view that, even though volatility will likely remain high and it's premature to say that shares have seen their lows for this year, the broad trend in shares is likely to remain up. Gains in share markets over the year ahead may well be led out of the emerging world, and China in particular if it moves to start relaxing its tightening measures in the next few months.

What to watch?

Admittedly the risks remain high, so several things are worth keeping on eye on. These include:

- Credit and money market spreads for signs of a renewed global credit crunch following the problems in Europe. So far the impact remains minor and the release of stress tests of European banks this week may help relax market concerns on this front to the extent that transparency around bank exposure to Greek and Spanish public debt will be improved.



Source: Bloomberg, AMP Capital Investors

- Signs that global business conditions indicators (as shown in the first chart) are starting to turn down significantly – so far it just looks like a moderation in growth and not a collapse.
- A more aggressive move towards fiscal tightening in the US and Japan.
- The continuation of tightening measures in China, even though growth is slowing.

Conclusion

After last year's strong gains, this year is certainly proving to be a lot tougher. Such a pattern is not unusual in a historical context with both 1992 and 2004 seeing a tougher patch in markets after initial recoveries from bear market lows in 1990 and 2003 respectively, only to see the recovery continue again in 1993 and 2005. In the very short term, further weakness in share markets cannot be ruled out, particularly into the normally weak September/October period. However, if we are right and global economic growth doesn't lurch back into recession then the rising trend in shares will resume, supported by solid earnings growth, attractive share market valuations and low global interest rates.

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