Economic and Market Outlook 2009

Economic data is pointing towards a worsening global recession in 2009. The scale of the slowdown in economic activity, the damage done to the banking system, the losses accumulated in residential real estate and the impairment of household balance sheets call for extraordinary policy measures. A more or less global though not entirely concerted policy for dealing with the ailing banking system is already underway. It is not working as well as expected or intended.

Similarly, **monetary policy has become more accommodative globally** in an effort to revive rapidly slowing economies. Monetary policy on its own is insufficient as it addresses the ability and not the intention to spend or invest. At the extreme, monetary policy has direct inflationary consequences.

In a slowing economy, it is individually rational to increase saving at the expense of consumption, and to cut back on investment in capacity, even though it is collectively irrational to do so. Enter government. **Governments will have to spend and invest on behalf of households and companies** to stabilize economic growth. This approach addresses demand directly but is not without its risks. Developed markets now operating below full potential output, are less at risk of direct crowding out. Inflationary risks are another matter and may raise funding rates to cause de facto crowding out.

There are several ways to fund fiscal deficit spending. Taxation is one. Developed world taxation is already high and the scope for increases is limited. It is risky to argue that increased economic activity may result in increased tax receipts. More immediately, cutting taxes may be necessary. Raising taxes on the rich has limited use as the rich are a marginal taxpayer given globalization and the prevalence of tax arbitrage. Borrowing through the issuance of public debt is another avenue. This can create the so called crowding out of private investment. A third way, is seignorage, which is of course inflationary and historically untenable. Enterprise and investment, a technique established in the form of sovereign wealth funds is another way. It is unlikely that deficits will be funded by taxation in the middle of a recession. If so, it might take the form of highly targeted taxation, or cosmetic taxation, such as an increase in top rate marginal taxes. If anything, marginal tax rates on consumption and lower income earners is likely to be reduced on the rationale that the marginal propensity to consume out of income decreases with increasing income and wealth. This would havea negative impact on tax receipts.

Financing deficit spending through the printing of money is directly inflationary but has the advantage of immediately supporting asset prices. The cost is in a weaker currency both internally and externally. The inflation cost can be high and depending on the prevailing inflationary conditions might not be viable. The natural route is financing deficit spending through borrowing, effectively from future generations. This is the most likely approach most nations will take. The impact in the US for example is higher interest rates. Once again, the crowding out effect is unlikely to bite as the US economy is clearly below potential.

Inflation is a risk. We have seen the path of the oil price rising from 20 USD per barrel in 2001 to 147 USD per barrel in the summer of 2008 before falling below 50 USD again. Similar patterns are seen in coal, metals, agricultural commodities, soft commodities, energy. Markets overshoot on both the upside and downside. The equilibrium price ex speculators, that it paid for by people who would like to burn the oil is probably in the 60 – 70 USD range. At these prices, inflation does not decline as much as policy makers would hope. Alternative sources of energy are not commercial once development costs are included. US CPI inflation would probably settle at around 4% while PPI inflation might be slightly higher from 4 – 6%. These levels are not overly concerning but they are not low by any means. (As an aside, if inflation does increase, the need for pensions and endowments to meet their obligations will likely bring them back into the market for risky assets). All this assumes of course that in the course of fiscal reflation, banking bailouts and other extraordinary measures, governments do not debase their currencies.

If currencies are debased, such as in banking bailouts or where fiscal deficits are funded by printing money, for example, inflation pressures will be exacerbated. The likely candidates where this scenario is likely can be found by an examination of public finances. This is a different analysis from looking at public balance sheets. Developed countries with budget deficits will likely be in this group. They will likely face weakening currencies and inflationary pressures. This could lead to a vicious cycle of rising commodity prices and rising inflation. Where the public sector balance sheet is weak, quantitative easing is not feasible as it is highly inflationary.

Monetary policy across the globe is currently extremely loose, and, given the expected depth of the slowdown, interest rates are likely to be driven further down to zero. This is likely to result in steep yield curves as public debt issuance is increased and inflation expectations are revived. Generally, the market expects little to no inflation and there are even expectations for deflation risk. It is likely that there will be volatility at the long end of the curve. The likely evolution is an early 1980’s yield curve as the expectations oscillate between inflation and recession.

Apart from developed countries where economic dogma eschews the direct allocation of credit by a central planner, developing countries do have the option to lend directly where their banking system may be paralyzed. In particular, in Communist countries operating market economies, the banking system can be directed to lend. Without the burden of economic dogma, certain countries have full freedom to deploy a host of economic tools to revive their economies. They can spend on behalf of consumers, they can put cash in the hands of consumers, they can invest in place of companies, they can print money to finance fiscal deficits, they can borrow to create a normalized yield curve and provide the banking system with a carry trade, they can tax selectively and tactically to synthesize inflation, if it was called for, they can invest in infrastructure, in improving the capital stock, in improving the knowledge base, in human capital. These measures may terrify the free marketer, but ever since the slew of blanket bail outs and ad hoc rescues in the West, criticism is unlikely to arise from those quarters.

Current policy remains short term and focused on disaster control. In the medium to longer term, disaster control policies are inappropriate. The time to be reactive has passed and it is now time to be pre emptive. The current policy of encouraging credit creation on a grand scale needs moderation and fine tuning. Failure of the policy is a poor outcome. Suc

cess of the policy risks the reflation of the credit conditions that precipitated the crisis in the first place. Quantitative easing can be highly inflationary. Some economies will have little choice but to print money to fund fiscal deficit spending.

If as we expect, policy remains inflexible and continues down the simple reflationary path, a real economy recovery would precipitate the need for central banks to shrink their balance sheets, reduce credit lines and raise interest rates in reaction or risk hyperinflation. **History has shown that such action would have a strong negative impact on asset values.** The various scenarios and options are indicative of further uncertainty and thus volatility in asset values.

Further implications:

It is impractical to have a macro view without considering the social impact of economic recessions and their policy responses. Globalization has created a complex web of relationships linking the economies of developed and developing nations. This creates correlation in economic growth, employment and prices across nations. Unemployment driven by the global financial crisis is likely to result in social unrest across the globe. Less diversified economies with concentrations in particular industries are particularly at risk. In some countries, there may be military solutions (China); in others there may be anarchy (India, Russia.)

Emerging market proactive solutions are likely to take the form of some sort of nationalization of substantial parts of industry either explicitly or implicitly. Such measures may not be acceptable in developed capitalist economies. **There may, however, be little choice in the face of social turmoil except for government to become the employer of last resort in de facto nationalizations.** Sovereign risk will be highly differentiated and priced.

The US auto sector is an example of a possible manifestation of this theme. The financial sector, and in particular the banking system is also likely to become regulated as utilities. **Protectionism is a likely consequence.** If large swathes of economies become nationalized, they will take on a new political dimension and will influence trade policy. Globally, agriculture is a dire example.

Return on investment is likely to suffer in industries facing de facto or formal nationalization. An example is the banking industry where it is likely that in recovery, banks will come to be regulated as utilities and returns are likely to converge to those of utilities.