

Viewpoint

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Viewpoint is our regular research bulletin for private investors. This review of topical investment issues is written by our chief economist, Peter Bickley.

Musings on Recovery

Last month's Viewpoints have – so far – stood the test of time. My restrained comments on a budget redolent of clouds and cuckoos were nicely trumped by a deluge of derision from all sides, latterly including the Treasury Select Committee. The cautiously worded suggestion that equity bears should not push their luck has been rewarded far more impressively than I could have dared hope as, indeed, has the renewed endorsement of the emerging markets. I guess that it must therefore be right to sound a note of caution; it is not all plain sailing from here. Markets which have started to be driven by capitulating bears do not have the most solid foundations. Meanwhile, though, a recovery in share prices is certainly something to celebrate.

Back to the real world; is that an economic recovery that is peeping at us from beyond the shadows? The evidence of directional change in the UK economy continues to accumulate, albeit only slowly and patchily. The brighter stuff is still generally confined to forward-looking series like the Purchasing Managers' Indices, Consumer Confidence, the Leading Economic Indicators and the like and so there may be an element of wishful thinking. Hard current data is less encouraging though by no means all as gloomy as - in a recession - it should be. For my part, I buy the idea that something really is changing.

We are still a long way from resumed growth but both here and in the USA I'm now confident that catastrophic slump is giving way to a somewhat more orderly pace of decline. I have been looking for these two economies to bottom out during the second half of 2009 and the prediction is thankfully now starting to feel much more secure. I have also been arguing that recovery would be very slow, with barely perceptible growth in 2010 and many years of sub-par growth thereafter. I stay with the second part of that but some further research and reflection makes me think the initial recovery phase could be rather more eventful than that.

I used to be a bit in denial about this but looking for precedents to today's recession the 1930s do make the best match. It absolutely does not follow that we are ordained to follow the exact same patterns but it does mean that some of those long ago events offer useful test beds for today's policy responses. With the world already in trouble 1931 brought the collapse of the US banking system, precipitating two years of economic free-fall. With the world already in trouble September 2008 brought the collapse of Lehman Brothers, precipitating two quarters of the nightmare we have all endured. When the banking system cannot function the economy implodes. Way back then, 1933 marked the turning point; 1933 deserves further study.

The popular view is that fiscal policy – the New Deal – drove the recovery but this is incorrect; the initial contribution from fiscal policy was constructive but not large. Monetary policy was eased too but the evidence does not support the idea that this was the catalyst either. If you plot the growth in the money supply against GDP you do find a positive correlation but unfortunately it is the wrong way round. Growth in the economy preceded the rise in broad money (as, incidentally, did inflation). In effect the money supply increased to accommodate higher activity rather than directly stimulate it. This feels somewhat counterintuitive but it does make sense once you apply some basic economics.

Trying to correlate GDP and the money supply to demonstrate a causative relationship is what in the jargon we refer to as a mug's game. At any point in time money is a fixture. At the next point in time it may be greater or smaller but the critical fact is that it is a physical stock of a physical asset. GDP is not an asset, nor is it a stock of assets; it is technically a flow, a quantum of activity. In a sense, money supply belongs on the balance sheet while GDP sits in the P & L. Their lives are intertwined but not in a way that is informative for the current purpose. Thus quantitative easing will facilitate economic recovery but it alone cannot be the catalyst.



Instead we have to look at credit, the most overt indicator of the state of the banking system. Actually we have to sidestep the same logical trap and look not just at the growth in credit itself but at the second derivative, the change in the rate of change of credit (yes, really). If we plot that variable against GDP through the entire depression episode we can see a remarkably close and causal relationship. That this is not just some statistical freak is borne out by the pragmatic logic. If the banks stop functioning economic activity implodes and you start to build a reserve of pent-up activity that wants to happen but cannot. Fix the banks and the pent-up activity is released.

This is exactly what happened. In 1933 Roosevelt not only stabilised the banks, he managed also to re-establish confidence. Credit flows resumed (the second derivative soared) and the economy roared. Unfortunately – as the history shows – this moment of excitement is just that, a transient joy. The stimulus from renewed credit flows and the release of pent-up activity passes, leaving you dependent on the more ponderous interventions (conventional policy responses) to take over the heavy lifting. This is what was behind the renewed slump in US aggregate demand growth after 1936 – the much feared ‘double dip’.

There’s good and bad news here. If the chaps in charge can fix the banks and then (whether it is true or not) convince all concerned that they have done so an economy that looks out for the count can spring back to life with unseemly vigour. This will engender considerable bonhomie and likely send share prices rapidly upwards. This will be fun but it will not last; however skilful policymakers may be the chances of avoiding the ‘double dip’ are slim. This will not be fun. Asset prices, though, should eventually calm down once this volatility in the economy eases off.

How likely is this? We need the banks fixed but above all we need belief, so we need people in whom we can believe. Both the US and UK have done much good work to stabilise the banks and both Governments have twigged that ‘banker bashing’ isn’t terribly helpful. But if credibility is the key you would have to think the US stands alone; assurances from any of the usual suspects in the UK would likely fall on stony ground. And in Europe, of course, they haven’t even started.

It is quite possible – probable, even – that we could see this much more dramatic run of events in the US; the US is rather big so would influence events elsewhere despite different local circumstances. So the transition from recession to the slow, drab resumed growth that I still expect may be quite a bit more interesting than I have been saying. Living in interesting times is not always something to be recommended and these would be conditions in which the financial markets may become very dangerous places to be. But if we can read this right and be sufficiently nimble markets should also give us abundant opportunities to gain from it all. With a lot of Dull to come, some nearer term action would be welcome.



Peter Bickley

Peter has been in the investment business since 1970. Initially working in private client stock broking he spent 12 years running a large private sector pension fund before joining Tilney in the pension fund team in 1991. In 1993 he became Head of Research. He is now our Chief Economist and is also a member of the Deutsche Bank Private Wealth Management Global Investment Committee, responsible for the direction of Deutsche Bank’s dynamic multi asset-class investment process. Peter is a popular writer in the media and is noted for being probably the only UK Investment Strategist to run an alpaca farm in his spare time.

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