

Movement of Market Indices for the December 2008 Quarter

Index	31 Dec 2008	% Change
All Ordinaries	3659	-21.0%
Banks	4226	-21.9%
Materials	8699	-19.0%
Industrials	3348	-23.9%
Real Estate	2063	-34.8%
US S&P 500	903	-22.5%
UK FTSE 100	4434	-9.6%
Japan Nikkei	8860	-21.3%
German DAX	4810	-17.5%
Shanghai Comp	1820	-20.6%
Hang Seng	14387	-20.1%
RBA Cash Rate	4.25%	-175bp
90 Day bill rate	4.30%	-275bp
10 year bond	3.99%	-141bp
Oil (WTI) \$US	\$39.25	-61.02%
Gold \$US	\$884.30	0.40%



Deflation v Inflation

Will the price of assets, commodities and goods & services continue to fall or will inflation make a comeback?

The answer is vital to the outlook for financial markets.

Lonsec investigates...

The IMF's latest estimate of eventual total losses, as a result of the global credit crisis, is US\$1.4 trillion. Other respected commentators estimate that total losses are more likely to exceed US\$2 trillion.

Losses suffered by financial intermediaries deplete capital reserves, which in turn support loans (assets of the Banks) worth between 10-20x the value of the capital base. Accordingly, a \$2 trillion reduction in capital reserves could mean a \$40 trillion reduction in global credit. However, US\$762bn in fresh capital has been raised so far (including public money), so the reduction in credit should not be quite so large, but much will depend on how big the total losses become against how much new capital can be raised.

The blow to global credit is more likely to be between US\$10-20 trillion. That is still a massive figure equivalent to 15-30% of global GDP (US\$65 trillion in 2008).

As this credit is withdrawn from the global financial system, the money supply shrinks and aggregate demand declines. The price of assets (stocks, property, commodities) and goods & services decline as supply exceeds demand. Prices must fall to clear the excess supply.

Deflation is bad for economic growth because falling prices mean consumers delay consumption and businesses delay investment. These delays worsen the situation as increasing numbers of jobs are lost and eventually business failures increase. It's the exact opposite of the growth cycle.

The task ahead for Governments and Central Banks is to reflate the money supply by getting Banks lending, consumers buying and businesses investing. There has been some action in these areas but the results so far have been inadequate against the scale of the problem.

In fact, the task of reflating the money supply is so huge that the US Federal Reserve is starting to talk about quantitative easing (another name for printing money). This has many crying out that hyper-inflation will be the end result.

However, the printing of money may be required to help fix the hole in the money supply and stabilise the financial system. Until Banks resume normal levels of lending and consumers resume spending, the multiplier effect is muted and inflation is unlikely.

The timing of the recovery will depend heavily on the effectiveness of the policy response and the level of co-operation and co-ordination between the major G20 economies. This is because all the major economies are inter-linked via trade and investment. A return to nationalism and protectionism would be self-defeating as history has shown that living standards subsequently decline.

Conclusion

Deflation is most likely in the short term, with inflation returning sometime later. Careful monitoring of Bank lending and consumer spending should mitigate the risks of hyper-inflation occurring when the spectre of inflation emerges again.

Lonsec estimates that it will take at least 1-2 years to get the system re-capitalised and functioning again. This means that economic growth and hence company earnings are likely to trend down over 2009 and 2010.

The implications for financial markets are that investors continue to flock into cash and bonds, despite low interest rates, to protect capital against deflation. Growth securities are likely to test new lows as 2010 earnings forecasts are ratcheted down below 2009 estimates. Gold could also fall as its role as an inflation hedge will be reduced and USD weakness is also unlikely while other major economies continue to deteriorate further.

A recovery in growth assets will come when the financial system is stabilised, excess supply has been absorbed and companies have largely re-capitalised their balance sheets.

The challenges are great but the global economy (and the environment) will emerge on a much firmer footing once the imbalances and excesses of the past 15 years are rectified.

Global Economic Outlook

Global economy to enter recession during 2009, led by the US

The World Bank forecasts global growth to slow to 0.9% over 2009. Lonsec has a similar view with global growth expected to slow to 0.8% over 2009, made up of -1.8% growth from the developed economies (which represent about 65% of global GDP) and 5.5% growth from the developing economies (35% of global GDP).

The US economy (26% of Global GDP at market exchange rates)

The US officially entered recession in 2008. The Dec 08 quarter growth figure is yet to be released but expectations are for an annualised figure of -6.0% - the worst decline since WWII. The US Federal Reserve has cut interest rates to zero while new President, Barack Obama, is preparing a second and much larger stimulus of around US\$800bn. In addition, the US Treasury and Federal Reserve have been busy bailing out the US financial sector which is swaying under the weight of credit losses. A US\$700bn Troubled Asset Relief Program (TARP) has been approved to support the troubled finance sector. According to Treasury forecasts, the US Budget Deficit will likely exceed US\$2 trillion by 2010 while total Government debt will reach \$8.1 trillion (58% of GDP).

The global financial crisis has sparked a de-leveraging cycle and demand shock that has led to asset and consumer prices falling. The US share market fell 39% during 2008 while US house prices fell on average 18%, on the rolling year to November 2008. The large decline in consumers' net wealth coupled with tight credit conditions have led to a sharp pull-back in consumer demand. In turn, the price of goods and services have declined sharply and production has been cut back. Inflation has been vaporised with the CPI falling to 0.1% pa, indeed deflation now looks likely. Industrial production fell 7.8% over 2008 while the unemployment rate increased to 7.2%. Lonsec expects negative growth of 1.9% over 2009 with fiscal stimulus likely to improve the headline figure.

The European economy including the UK (23% of Global GDP)

Europe has also slid into recession surprisingly quick resulting in the ECB (finally) slashing the cash rate by 125bp to 2.0% over December 08 and January 09. European growth is widely expected to come in at an annualised rate of -2.0% in the Dec 08 quarter. Inflation fell to 2.1% in November 2008 and the ECB expects it to fall to 1.1-1.7% over 2009. The European Commission recommends a €200bn stimulus package (1.5% of GDP) but individual countries continue to debate the details. It seems the member states outside France and Germany have deeper economic troubles particularly Ireland, Spain and Greece. Lonsec expects European growth to decline by -1.3% over 2009.

The UK seems to be in a deeper recession than Europe because debt levels are higher and the decline in the housing and financial sector has been greater. The BOE has slashed the cash rate to 1.5% while the Government has been busy providing support for the Banking sector and recently announced a £20bn stimulus package. The Government's Budget deficit is set to rise to £118bn (8% of GDP) over the year. Lonsec expects the UK economy to shrink by 1.6% over 2009.

The Asian economy (21% of Global GDP)

As Warren Buffet says, "when the tide goes out, you can see who has been swimming naked", well the tide is going out and unfortunately it is exposing Asia as still heavily reliant on US and European demand and capital.

Japan entered recession during 2008 meaning the G7 are now in a synchronised recession making it very hard for any one country to export their way out of the slowdown. Japanese machinery orders fell a record 16.2% in November 08 while factory output dropped 8.1% and exports fell 26.7%. Japan looks to be headed for a deep recession with some analysts predicting the economy will shrink by 3% (12% on an annualised basis) over the Dec 08 quarter. The Nikkei sank 59% over 2008. The Bank

of Japan has cut interest rates to 0.1% from 0.3% and the Government is mulling a stimulus plan, although with a public debt to GDP ratio of 158%, its options are limited. Deflation will probably re-emerge as a problem for the Japanese economy during 2009. Lonsec expects the Japanese economy to shrink by 1.5% over 2009.

China's economy was also exposed during 2008 with exports slumping and its property boom ending abruptly. Foreign capital is retreating as US and European Banks withdraw funding. GDP is expected to grow by an annualised rate of 6.8% over the Dec 08 quarter down from 9% in September. The Chinese Government has announced a 4 trillion yuan (\$585bn) stimulus package that is focused on developing new infrastructure over the next three years. However, the immediate impact on growth is likely to be minimal so GDP is likely to fall further over 2009. Lonsec expects China's growth rate to fall to 6% over 2009.

Key global issues to watch over 2009	Lonsec view
Global credit conditions	Credit conditions likely to remain tight until the Banking system is re-capitalised
G7 economic growth	US to drag the G7 into recession; depth and length dependant upon global policy response and co-ordination
Inflation/Deflation	Deflation likely in the short to medium term due to a massive reduction in credit and reduced spending
Asian economic growth	Japan recession to worsen; China to slow to 6% growth rate
Commodity prices	Likely to remain weak until demand stabilises and surplus production is absorbed

Domestic Economic Outlook

“The Australian economy is expected to slow sharply with the major risks being global recession, gradual withdrawal of foreign capital and falling commodity prices.”

Australia is holding up well to the first wave of the global financial crisis tsunami but the second wave, a global recession, threatens to breach the sandbanks. The Australian economy grew by 0.4% in the June 08 quarter and a tiny 0.1% in the September 08 quarter. The economy is clearly slowing sharply with the last two results equivalent to an annualised growth rate of just 1.0% pa.

The Reserve Bank of Australia (RBA) has moved swiftly to cut the cash rate from 7.0% to 4.25% since September 08 while the Government implemented an \$8.4bn stimulus package over the Christmas period. Earlier in the year, the Government continued to lower income tax rates and moved to effectively guarantee the Australian Banking system. The RBA has also been active in providing increased liquidity for the Banking system.

Will Australia enter recession?

Australia seems to be well positioned relative to most developed economies. Consider these positives points:

- The Banking system is stable and functioning
- Monetary policy has been more effective in Australia – mortgage rates have come down with cash rate
- The Government is in a relatively strong financial position to provide stimulus given a Budget surplus and no net debt
- The unemployment rate remains low at 4.5%
- House prices have proven fairly resilient to date
- The oil price decline has led to cheaper petrol prices and inflation is now declining
- The lower AUD helps exporters remain competitive

During 2009 it is likely the RBA will continue to cut the cash rate given the deteriorating global outlook (including Asia) and the rapid retreat in inflation. Lonsec expects the cash rate to fall to 3.25% by June 30 and to 2.75% by year end. The Government is also likely to materially increase spending to help buffer the fall in consumption and business investment that is expected. Lonsec expects the Budget will move into deficit as tax revenues decline from slower growth and spending increases. Note the Government will be going into deficit from a position of relative strength (relative to most developed countries) in that current public debt levels are negligible.

What then are the negatives that could tip the Australian economy into recession during 2009? The global credit crisis has led to tight credit market conditions, falling asset and commodity prices and a sharp fall in consumer and business confidence. Consumer spending has slowed sharply while business investment also shows sign of falling sharply. The Banks have reduced mortgage rates but business lending rates still remain relatively high as the Banks seek to increase margins. This could be self-defeating if business investment slumps.

The Australian share market fell 43% during 2008 wiping \$700bn in value (hence investor wealth) from market capitalisation. And with house prices falling in the UK and US, Australians would be worried that the Australian housing market could be next. Concern about falling wealth is obviously having a major negative impact on consumer spending. But if consumers don't spend, business suffers and jobs are eventually shed which worsens the situation further. Rising unemployment could be the straw that breaks the back of the Australian housing market.

So the key is for Government to try and keep spending at high enough levels to contain job losses. The trouble is commodity weakness has already seen job losses in the mining sector while the finance sector is also shedding jobs rapidly. If business investment falls rapidly more jobs will be lost because one company's capital expenditure is another company's revenue. The decline in consumption and business expenditure could swamp any increase in Government expenditure and the economy would shrink.

Another area where the Australian economy is vulnerable lies in the current account deficit; most of the current account deficit relates to interest payments on net foreign debt totalling \$657bn. Australian Banks and Companies have borrowed most of this debt and it will need to be refinanced or repaid in coming years. The global financial crisis has made this task much harder and the Government has already had to lend its AAA rating to the Banks to help them roll their debt while Australian companies will increasingly need support from Australian debt and equity markets to replace their foreign debt.

All in all, it seems that Australia's exposure to the global economy, via commodity exports and foreign debt, means the economy won't be able to avoid recession over 2009. The two key sectors of the economy – mining and finance – will be under great stress. The Government can lessen the pain but the scale of the global recession is too overwhelming to resist. The best that one can hope for is a recession that is not too deep and not too long. Lonsec expects the Australian economy to decline by -1.0% over 2009.

Key local issues to watch over 2009	Lonsec view
Cash rate	Cash rate to decline to 2.75% by year end
Unemployment	Unemployment rate to climb to 7% during the year
House Prices	House prices to decline by 10% over 2009

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