Green shoots or rotten weeds?

BRITAIN'S RECOVERY DOESN'T LOOK TOO BAD IN THE SHORT TERM BUT FURTHER OUT THERE ARE STILL DARK CLOUDS ON THE HORIZON, AS JAMIE DANNHAUSER, CHRIS TURNER AND STEFANO DI DOMIZIO EXPLAIN.

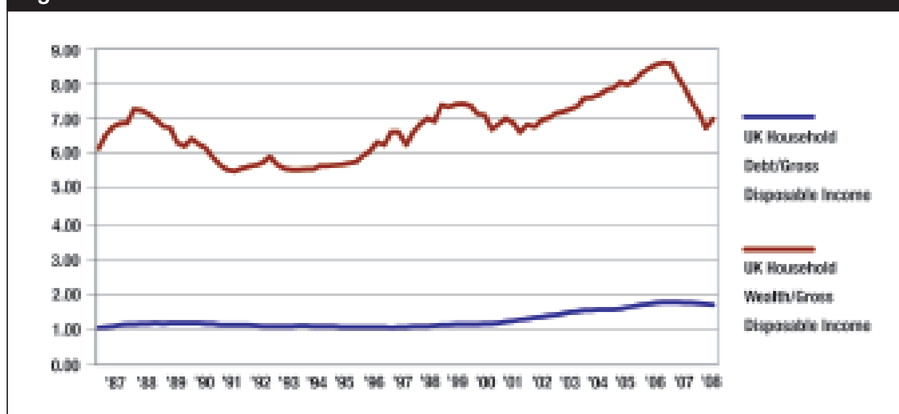
The steep decline in global trade volumes and output now appears to be behind us. Extraordinary state support for the banking system has averted financial Armageddon. Stock markets have bounced back strongly, albeit prices are still 30% below their pre-crisis peak. Those countries most exposed to high-value added manufacturing sectors (such as Germany and Japan) were initially hardest hit. But after Lehman Brothers collapsed, the supply of credit became heavily constricted. With businesses across the world struggling to finance the stock they were holding, inventories were liquidated at record rates in the ensuing months.

As panic faded, the level of global economic activity stabilised, and in parts of Asia, output now seems to be growing healthily. Bulls argue that domestic demand-led growth in the developing world should pull the advanced nations from their malaise. But there is little evidence that these green shoots reflect a sustained rebalancing of global demand towards the excess savers (those nations running large and persistent current account surpluses). Instead, the impetus is coming from two transitory factors: inventories and temporary fiscal stimuli.

Like the US, Britain was a conspicuous excess spender in the run-up to the crisis. The greatest excesses were in the household sector. Debt levels hit 175% of disposable income, a record for the UK and one of the highest levels in the developed world. Rapid increases in house prices occurred alongside this debt build-up. The apparent improvements in net worth encouraged lower savings and by Q1 2008 the savings rate had turned negative. Households' balance sheet adjustment will take several years. Ultra-low interest rates slow this process down, by encouraging individuals to bring forward spending, but as monetary stimulus is withdrawn the debt burden should begin to bite. Despite the lowest mortgage rates on record, aggregate debt servicing costs still appear worryingly high.

Figure 1: Annual change in UK broad money

Figure 2: UK household debt and wealth



SHIFT IN COMPOSITION The medium-term adjustment in the UK requires a shift towards exports and investment. The collapse in sterling should be a major help. Local firms are now more likely to buy parts and supplies from domestic producers, while exporters should be able to recoup share in global markets. The positive growth impetus from net trade should offset the weakness in household spending and housing investment.

But there is a dark cloud on the horizon, if not closer: the banking system remains extremely fragile. Although capital buffers have risen substantially over the last two years, the major UK banks face many problems. The large shortfall of liquid assets on their books will need to be rectified in coming years. Furthermore, banks' wholesale funding is still heavily dependent on government support, via the special liquidity scheme (a facility allowing banks to swap their illiquid RMBS/ABS for gilts) and the credit guarantee scheme (a guarantee of banks' medium term debt issues). As and when that support is withdrawn, banks' funding costs could rise sharply.

It all suggests a less favourable lending environment going forward. Since banks' private sector credit expansion is normally the major source of money supply growth, monetary conditions may remain too

tight for a sustained UK recovery.

Over the next year, the outlook is fairly bright though. Britain had the most severe stock cycle of the major economies, so its bounceback should be intense. There still seems to be plenty of fiscal stimulus in the pipeline. Another bit of good news is the state of the corporate sector. Corporate profitability has held up remarkably well. The drop in non-financial trading profits has been smaller in this recession than in either of the previous two and is broadly on a par with that seen in the 2001/02 slowdown. From a balance sheet perspective, businesses do not appear overleveraged; what debt was taken on in the boom was largely to buy financial assets. More recently, large companies have been able to tap capital markets, often to pay down their expensive bank borrowings.

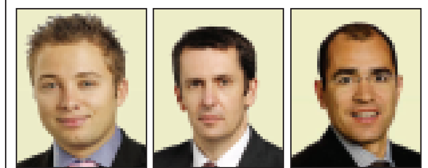
BULLISH SHORT-TERM VIEW An aggressive monetary policy response is another reason for our relatively bullish short-term view. Since March, the Bank of England has been buying assets from the private sector on a huge scale. The vast majority of these have been gilts, leaving the Bank with holdings of close to one-third of the outstanding gilt stock (net of government holdings). Long-dated gilt yields are around 50bp lower than they otherwise would have been.

More importantly, the asset purchases have directly injected money into the economy. Although money growth has been sluggish this year, the Bank's actions have prevented a damaging monetary contraction. Targeted interventions in the corporate credit markets also appear to have improved marked functioning and reduced liquidity premiums, making it cheaper for large firms to issue new debt and equity.

The Bank forecasts a rapid recovery in 2010. Its central projection has real GDP growth at close to 4% by the end of next year, albeit the risks are weighted to the downside. Our own view, which is less bullish than the Bank's but sits at the high end of City forecasters, is for output to be growing at around its long-run average by the second half of next year. Despite this, there will continue to be significant downward pressure on inflation into 2011 given the large degree of spare capacity. While headline inflation will be volatile over the next year, the underlying pulse of inflation should be at 1% or below by the end of next year.

Since the Bank needs a sustained period of above-trend growth to remove the downside inflation risks, monetary policy will be stimulative for some time. It is possible, but unlikely, that quantitative easing will be extended further in the first half of this year. Our central view, though, is that in late 2010, the MPC will aim to remove some of this extraordinary stimulus. So we look for the Bank's rate to end the year at 1.5%.

Our forecast for the Bank's official rates is roughly in line with the amount of tightening currently priced into the UK money market curve (75bp at 100% probability). With the UK economic recovery gaining momentum and the Bank unlikely to overreact on rates, the flattening of the UK yield curve could be relatively slow. At the same time, unless larger term-premiums are discounted at long maturities on higher refinancing risk, we do not see long-dated gilt yields having much scope to rise further.



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In fact, given the current high level of long-term break-even inflation, we see nominal yields as more likely to move lower, at least relative to equivalent real yields.

Sterling has had a volatile year. The inexplicable position the European Central Bank has taken on inflation, coupled with comments from the governor of the Bank of England, Mervyn King, aimed at keeping sterling "competitive", have offset bouts of currency strength when the UK economy appeared to be recovering ahead of the rest of Europe. In 2010, sterling should be more stable on a trade-weighted basis if our growth forecast materialises.

The main valuation misalignments in foreign exchange are the euro (dear) and emerging Asian currencies (mostly cheap). With chronic problems on the periphery of the euro area and in emerging Europe, the euro should ease back next year. Our central scenario would be for sterling to rise a little against the euro, but fall modestly versus the dollar and currencies of the more resilient emerging markets.

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