BEARISH SENTIMENTS ABOUT THE WORLD ECONOMY ARE TOO GLOOMY, ARGUES **GILES KEATING**.

Calling canny corporates

The final months of 2006 have set a sober tone for the world economy, with the US slowdown beginning to spread around the globe. But for those taking a longer-term view, this could be a positive development, a badly needed slowdown to refresh the expansion that began in 2003 and to set the scene for it to resume with added vigour during 2007.

Specifically, the slowdown is relieving pressure on the chronically overstretched energy and raw materials markets. It is also allowing interest rates to stay at levels low enough to bring relief to hard-pressed borrowers around the world. Canny corporates have already started to put longer-term borrowing in place.

BASIS FOR A SPRING REBOUND In the US, the slowdown in housing is now very clear (see *Chart 1*). Its effects will be compounded by production cutbacks at the major auto firms, bringing GDP growth well below trend in the fourth quarter. In China, the government's credit squeeze is causing a sharp decline in bank loan growth and implies an economic slowdown in coming months (see *Chart 2*). Japan and many other Asian economies will go through a soft patch as a result. Neither the UK nor continental Europe will be exempt, but the impact is likely to be more muted than in Asia, because domestic demand has proved surprisingly robust.

This slowdown allows metals and oil prices to be much lower than otherwise, giving a disinflationary nudge to the world economy just when it is needed to offset embryonic wage pressure. That, in turn, will allow China to ease off the brakes in the New Year and let the Fed and Bank of Japan prolong their rate pauses; as a result, bond yields will go lower, bringing relief to US consumers and other borrowers, and setting the basis for a growth rebound in spring.

THE THREAT TO GROWTH In bond markets, yields have been driven lower as growth has slowed. We expect lower rates to stay in place before rising again as the global economy re-accelerates in 2007. The low level of bond yields has made equities attractive as an asset class, with appealing valuations even on cautious earnings assumptions.

Meanwhile in the credit markets, demand has been very strong across the spectrum, allowing very low spreads to persist. But there are signs of a supply response to low yields and spreads, with high levels of corporate issuance and increases in gearing becoming more widespread. This may gradually result in widening spreads for high-grade, but the process could be slow given the strength of demand. Meanwhile for leveraged products, the strong demand is likely to remain the dominant factor for a prolonged period.

What could go wrong with this outlook? If labour cost pressures build unexpectedly and metals/oil prices don't weaken, central banks would have to become more aggressive. Or there could be a dollar crisis – indeed the consensus on the US is bearish, based on the scale of the current account deficit and fears of a significant US economic slowdown. However, the deficit is arguably more a signal of past and current demand imbalances, rather than a fundamental misalignment, and our estimates suggest it is the euro and sterling that are overvalued, not the dollar.

Executive summary

- The US-inspired slowdown may seem bad news but could turn out to be a positive development by helping the hard-pressed energy and raw materials markets and giving much needed relief to the world's borrowers.
- The demand for leveraged credit products remains strong.
- One risk is the possibility of a US dollar crisis.

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Chart 1. Surge in overhang on unsold homes in US

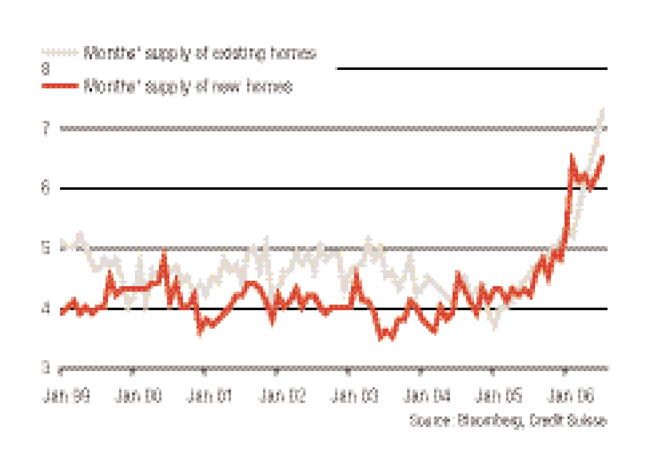

Chart 2. Chinese economy starts to slow