A dot on the horizon

A STEADY STREAM OF UPBEAT DATA HAS SIGNALLED THE START OF RECOVERY IN THE DEVELOPED ECONOMIES. BUT IS IT SUSTAINABLE? AND IF IT IS, WHAT SHAPE WILL THE RECOVERY TAKE? **TREVOR WILLIAMS** CONSIDERS THE FIGURES.

Executive summary

- **GDPs for the developing economies are bouncing back and even the UK and the US are widely predicted to shake off recession by the end of this year. But we're not out of the woods yet. The recovery, in the UK at least, could be long and protracted.**

Ever since the depth of the financial crisis became fully apparent, governments around the globe have been expanding liquidity to try and kickstart economic recovery. The strategy appears to be working. A range of countries have recorded a rise in economic growth in the second quarter of this year, including Germany (0.3%), France (0.3%) and Japan (0.9%). For many of them, it was the first rise in economic activity in over a year, after sharp consecutive quarterly declines. It is noticeable that emerging market economies are bouncing back more quickly than developed economies, with annual GDP in Q2 up by 7.9% in China and 6.1% in India, and quarterly increases in Singapore of 20% and 9.7% in South Korea.

In short, there are solid signs that conventional and unconventional policy loosening are helping to foster a global economic recovery. That said, though, the US (-0.3%) and the UK (-0.7%) still recorded falls in economic activity in Q2.

CLOSER TO HOME The predominant message from recent economic data in the US and the UK is that both economies are likely to exit recession in Q3. Focusing just on the UK, the services Purchasing Managers Index (PMI) for August rose to 54.1, up for the fourth month in succession to its highest level since September 2007. And although the manufacturing PMI fell from 50.2 to 49.7, the construction PMI was 47.7 (from 47.0 in July). A composite index of all three PMIs suggests that the economy will expand in Q3. A similar story can be told for the US, albeit less based on the services ISM than on the manufacturing ISM and other indicators.

SAILING THROUGH THE STORM? While the signs are positive, any sustained recovery hinges on the continuation of the various liquidity schemes that have been implemented globally (Figure 1). In the UK, quantitative easing appears to have kickstarted recovery, but sustainable recovery will also depend on sentiment among consumers and businesses continuing to rise, particularly in the corporate sector. Both the household and business sectors have implemented significant balance sheet repair programmes over the past 18 months, paying down debt at the expense of spending. And although this is a positive move in the long run, in the short term it may slow the pace of recovery as spending remains under pressure.

It is also worth remembering that this economic downturn has been characterised by the rapid pace of deterioration: the pace at which GDP declined (5.5% between Q2 2008 and Q2 2009), the pace at which companies reined in investment spending (18.4% between Q2 2008 and Q2 2009) and the pace at which unemployment rose (by 2.2 percentage points between August 2008 and August 2009). And although recent positive data has

Figure 1: Central banks expand liquidity

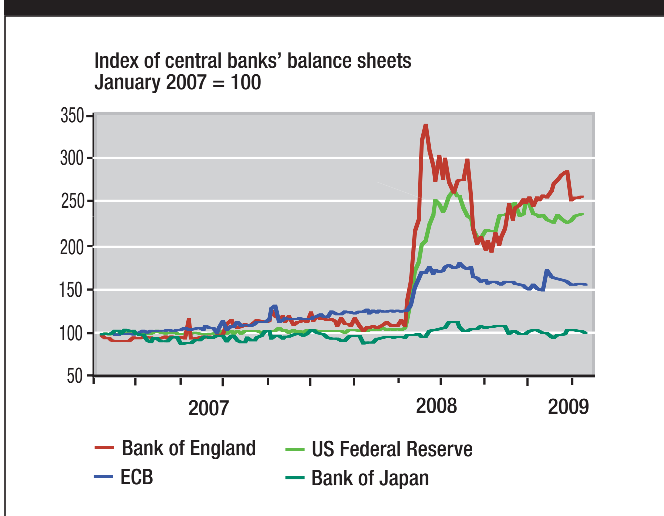
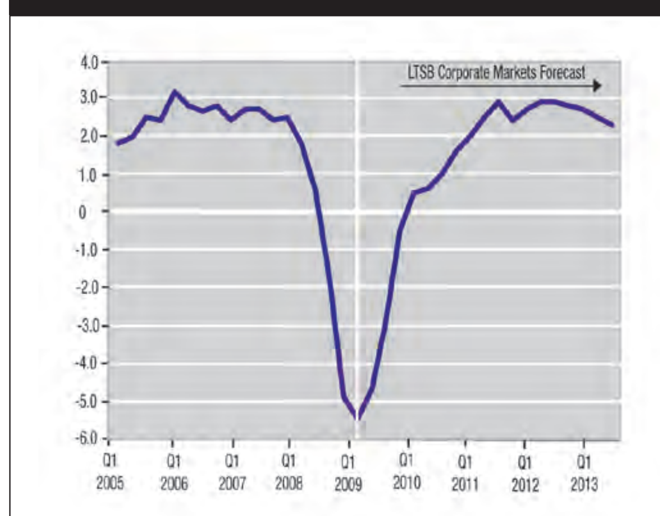


Figure 2: Real UK GDP growth forecast



THE HIGH DEGREE OF CORPORATE DEBT SUGGESTS THAT THE PROCESS OF CORPORATE DELEVERAGING IS ALMOST CERTAIN TO CONTINUE.

helped halt these rapid declines, further cutbacks and deleveraging can be expected if the positive momentum is not carried into the quarters ahead. However, the pace of the recovery will be less rapid as companies try to repair their damaged balance sheets.

ENGINE ROOM OF RECOVERY Through the wages and taxes it pays, and the profits it generates to fund dividend payments and productive investment, the non-financial corporate sector lies at the very heart of the UK economy. Without a sustained improvement in business investment, there can be little prospect of a recovery in employment and manufacturing output.

So what does the state of the corporate sector's balance sheet tell us about the prospects for corporate recovery? On a positive note, the legacy of strong profitability over the past decade and the accumulation of retained earnings have left the corporate sector relatively flush with cash: accumulated assets amount to £186bn. From an economic perspective, the net surplus run by the corporate sector has helped to fund net deficits elsewhere. But the sector's net financial surplus has been driven by the efforts of companies to rein in their investment spending during the recession and historically high levels of corporate debt as a share of GDP.

In itself, the weakening in the profit outlook augurs no rapid recovery in business investment. The overhang of corporate debt is a significant constraint. Outstanding corporate sector debt, at around 110% of GDP, exceeds that of the household sector. Indeed, the reason why firms have scaled back on investment spending as sharply as they have done over the past year appears motivated in large part by their desire to pay down debt. During the course of April and May, the sector repaid loans amounting to nearly £5bn.

The relative resilience of corporate profits to date suggests that companies have acted more swiftly and aggressively than in previous recessions to cut costs. The sharp rise in unemployment, the marked slowdown in private sector wage growth and the scale of the recent destocking are evidence of this.

The high degree of corporate debt suggests that the process of corporate deleveraging is almost certain to continue. Although profitability remains resilient for now, internally generated funds that might otherwise have been directed towards productive capital spending are likely to continue to be used, in the main, to repair the corporate sector's balance sheet. Taking into account the importance of the non-financial corporate sector, the implication of this analysis is that the recovery will be long and protracted in the UK. Indeed, we are not forecasting a return to pre-recession levels of GDP until 2012 or 2013 (Figure 2). Clearly, we've come a long way, but there is still a long way to go.

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Box 1: A new horizon?

There are four broad scenarios that capture the recovery picture (the Lloyds TSB Corporate Markets central forecast is the final one):

Policymakers save the world: aggressive fiscal injections and the use of quantitative easing restore confidence and the economy quickly returns to trend growth in 2010.
Deep V recession: quantitative easing proves insufficient, and consumers and businesses retrench sharply. A sharp rise in defaults ensues and financial market conditions deteriorate. China falls into recession, with no recovery until late 2010.
Deflation: falling asset prices drag prices in the economy lower, unemployment rises sharply and the output gap widens. Monetary and fiscal policy is ineffective against worsening deflation. Protectionism measures are enacted and the economy declines in 2010 and beyond.
Gradual sustained recovery: recession bottoms out in the second half of this year. The aggressive use of quantitative easing works. Oil prices remain stable and credit markets normalise by the end of 2009. Confidence returns and a gradual recovery gathers pace in 2010.

Box 2: Rates and currencies

The view of Lloyds TSB Corporate Markets is that interest rates will remain exceptionally low until a sustained economic recovery leads to the implementation of exit strategies from central banks.

Sterling – usually considered a pro-risk currency because of its historic high-yield status – has been weaker than the euro and the dollar. Despite signs of recovery, lower rates and a weaker currency, the Bank of England may still expand its quantitative easing programme at its November meeting. This is because the Bank is still concerned about the slow pace of the recovery and its sustainability against the backdrop of rising unemployment and weaker wage growth. The effect may be to cap any gains for sterling over the coming months.

Increased confidence that the global economy is emerging from recession has also seen the demand for dollar assets as a safe haven wane as the yield attraction of the US currency's global counterparts rises. The dollar index fell last month to its lowest level in a year. Although this trend could persist for some time, other more fundamental drivers of currencies, such as productivity and growth prospects, favour the dollar. For this reason, of Lloyds TSB Corporate Markets expects a broad-based recovery in the dollar over the coming six to 12 months.

Meanwhile, many of the emerging market economies, unencumbered by the same financial crisis that has hit the developed countries, are recovering strongly, boosting their currencies and commodity prices. Rising confidence about global economic prospects and comments by G20 finance ministers to suggest that policy measures will remain in place until recovery is more firmly established have buoyed investor appetite for higher-yielding alternative investments in emerging markets, which helps to underpin their currencies. The risk of a near-term sharp correction remains, primarily reflecting the extent and pace of appreciation and the continuing uncertainty around global economic prospects. However, the improved relative merits of some economies versus their developed counterparts suggest further gains over a more medium-term horizon.