

Greece, the US slowdown, China – how serious is the threat to the global outlook?

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Key points

- Worries about Greek debt as well as a slowdown in US and China have seen shares fall significantly since April's highs. After a bounce to relieve oversold conditions, helped by improving news regarding Greece, further weakness is possible over the next few months.
- However, we remain of the view that the global economic recovery will continue, as some of the temporary factors weighing on growth begin to fade. With shares still undervalued, and monetary conditions likely to remain easy, we expect shares to recover into year-end.

Introduction

In May 2011, we became concerned that the worry list facing investors was getting longer, with woes around European debt, softer global data generally and shares vulnerability to weakness in the months ahead¹. This has indeed been the case. From their April highs to recent lows, global share markets have had a correction of 7%, but Australian shares fell over 10% on added concerns about rising interest rates and the strong Australian dollar. We also thought the current rough patch would prove temporary and, as we saw last year after a similar rough patch, growing confidence in the global recovery would result in a recovery of shares into year-end. Is this assumption still justified?

The worry list remains worrying

Over the last month or so the worry list for investors has included a renewed intensification around European debt problems, fearing the European Central Bank tightening monetary policy, Japan's possible return to recession, high oil prices, monetary policy tightening in China and other emerging countries, slowing growth indicators in the US, the end of June 2011 quarter and US debt ceiling negotiations. With so many worries, it's little wonder share markets weakened. At its core, there are three key concerns for markets right now: Greece, the US slowdown and China.

Why all the concern about Greece again?

Greece's public debt woes first hit the headlines in late 2009. It received assistance in May last year from the European Union, European Central Bank and International Monetary Fund (IMF). However, it has run into trouble again as austerity measures weakened the economy, necessitating more spending cutbacks, which are now meeting intense Greek opposition. At the same time, Germany in particular has been insisting private investors share part of the Greek debt pain by extending the term of loans. This has pushed Greek bond yields to exorbitant levels (e.g. the 10 year bond yield touched almost 18% last week) making it impossible for Greece to roll over private debt as assumed under the original bailout. Several points are worth noting:

- The direct threat to a global economy slump from the Greek debt problem is non-existent as Greece accounts for less than 0.5%

of global gross domestic product (GDP). Rather, the worry is that defaults might set off a global credit crisis much as Lehman's failure did in 2008. French and German banks have Greek debt exposure of US\$53 billion and US\$34 billion respectively, which is manageable. The real concern is French banks' US\$590 billion exposure and German banks' US\$499 billion exposure to Ireland, Portugal, Spain and Italy debt. An uncontrolled Greek default could lead to a sharp rise in funding costs for these problem debt countries, making it harder for them to reduce debts, possibly leading to a run on of exposed banks. Banks may then stop lending to each other, as occurred in the global financial crisis. All of which could lead to another credit freeze and disruptions to global economic activity, as occurred after Lehman's failure.

- The situation has been worsened by opposition to bailouts in Germany, conflicting communication from European officials and political compromise in Europe that tends to come only after a market panic.
- However, with Germany winning a confidence vote by dropping its requirement that private bond holders be forced to rollover their loans, Greece appears to be on track to gain another bailout package. Nevertheless, there are still more potential upsets along the way including a Greek vote on the austerity measures next week and issues around what sort of voluntary private debt rollover will be required.
- What is clear is that Europe wants to avoid unleashing a Lehman-style event with German Chancellor Merkel stating "We all lived through Lehman Brothers... I don't want another such threat to emanate from Europe."
- While Greece looks on track for another bailout package, a Greek default looks inevitable. Despite four years of austerity, its public debt to GDP ratio is projected by the IMF to be 152.5% in 2014, which will be higher than the 127% it was at when it ran into trouble in the first place in 2009. Europe is likely to continue trying to delay a default until Spain and Italy are in better shape and a default can be better managed in terms of its impact on the European banking system. This suggests that whether it's Greece, Ireland, Portugal, Spain or Italy, European sovereign debt problems will be a source of volatility in financial markets for some time to come.

The US slowdown

While the latest iteration in the Greek debacle has been unnerving markets in the last week or so, a broader issue has been a softening in global economic indicators. This is most clearly evident in the US. GDP growth slowed to an annualised pace of around 2% in the March quarter, the current quarter isn't looking a lot better. The Institute for Supply Management (ISM) manufacturing conditions indicator fell sharply with a further decline in prospects this month based on regional manufacturing surveys and a slowdown in the US labour market over the last few months. However, much of the soft patch can be explained by temporary factors:

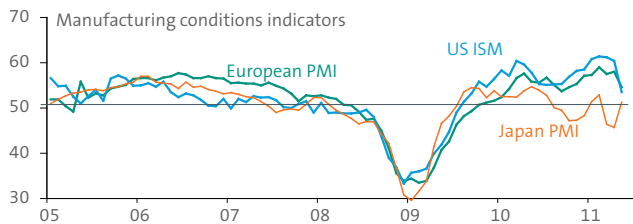
- Disruptions to Japanese production, following the March earthquake has adversely affected global supply chains, particularly in the auto and IT sectors across numerous countries.
- The 20% or so surge in world oil prices earlier this year is likely to have knocked 0.5% or so off global growth.
- Bad weather in the US has likely accentuated the weakness with snow storms earlier this year followed by floods and more recently tornados.

1. See "Here we go again – another round of global growth worries", Oliver's Insights, 27 May 2011

In terms of the first two there are good signs:

- Japanese production is returning to normal, shown by a rebound in Japanese manufacturing conditions in June, reflecting a return to normal supply levels. US auto production is scheduled to rise 19% next quarter to make up lost production, which could add 1 percentage point at an annualised pace to US GDP growth.

A recovery in Japanese manufacturing points to a recovery in US and European manufacturing in the second half



Source: Bloomberg, AMP Capital Investors

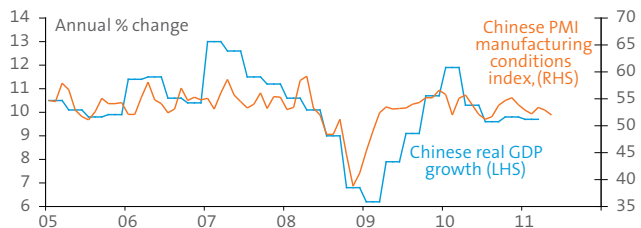
- The oil price has now fallen back below US\$100 a barrel, pushing down gasoline and petrol prices

US indicators for June are likely to remain soft, which would suggest stronger growth in the second half of the year. Another round of quantitative easing in the US is only likely if this rebound fails to materialise by end of the September 2011 quarter.

China

China is in a sour spot of its economic cycle. Growth and property price momentum is slowing, but high inflation is maintaining pressure for monetary tightening and posing the risk of a hard landing. However, there are several reasons why we see a Chinese hard landing as unlikely. Firstly, thanks to slowing economic and money supply growth, and a topping in food prices, inflation is likely to slow over the next six months allowing the authorities to take their foot off the monetary brake. Secondly, while excess housing is apparent in some cities and in some categories, overall China has not been building enough houses to warrant fears of a property crash. Thirdly, China will likely support its banks should the investment loans associated with the 2008-09 stimulus go wrong. Finally, given the risk of social unrest, Chinese authorities will do all they can to avoid a hard landing. In a semi-command economy with very low public debt and huge foreign exchange reserves, they have plenty of fire power to do just that. So far while growth indicators have cooled there is no sign of a hard landing.

China's economy has slowed but no sign of a hard landing

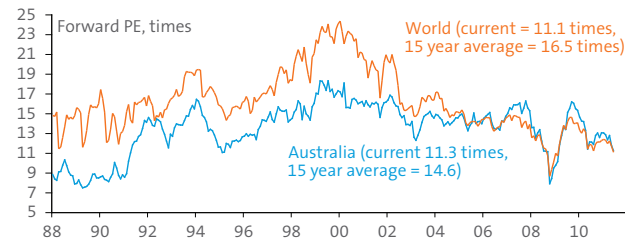


Source: Thomson Reuters, AMP Capital Investors

Outlook for shares

After sharp falls since April highs, shares are again good value with global and Australian shares falling below forward price to earnings multiples that were applied at the end of the correction mid last year. Continuing corporate takeover activity (including a bid for Fosters in Australia) appears to recognise this.

Shares very cheap again



Source: Bloomberg, AMP Capital Investors

However, just because shares are cheap is no guarantee shares will rise in the next few months. The September quarter is normally the weakest quarter of the year and ongoing worries about Greece, Europe, the US and China could push shares lower still in the next few months. Nevertheless, it suggests that there is scope for shares to rebound into year-end if we are right and the global economic recovery ultimately continues, and Greece is given another bailout. This is particularly so with global monetary conditions likely to remain very easy.

Concluding comments

With uncertainty around the global recovery likely to linger for a while, we could see more volatility and weakness in shares in the coming months, although with a low price and favourable monetary conditions, shares are likely to recover into year-end. We remain of the view that a blow up of Greek debt will be averted for now and the global economic recovery will continue, with stronger conditions through the second half of this year. More broadly, the continuing volatility in financial markets highlights the changed world we live in. The global financial crisis has left the world with a hangover of excessive debt levels and extreme monetary policy settings in advanced countries, excessively easy monetary conditions in emerging countries and very skittish investors prone to jump at the slightest hint of any potential problem. This indicates volatility will remain high for some time, highlighting the increased importance of asset allocation for investors compared to stock and manager selection.

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