THE NETWORK
OF LEADERS
CRITICALEYE

2009 and the Decisions You Should Take – Part II

Discussion Group

Date

8 September 2009

Chair

Charlie Wagstaff, Founder and Managing Director, Criticaleye

Key Take-aways

- Commodity prices are trending upwards indicating recovery
- Lenders are not restricting cash as much, there is money available but only to those with strong balance sheets
- The effects of the recession are still visible:
  - → The UK will see moderate growth in Q3 between 0 and 0.3 per cent and 0.3 - 0.5 per cent in Q4 but there won't be much traction in Q1 and Q2 (2010)
  - → There will be further rise in unemployment peaking in Q3 2010 and by early 2011. Unemployment usually peaks nine months to a year after the recession reaches the end
  - → Bankruptcies will accelerate and peak mid-2010. These will occur when companies prematurely 'gear up' for a recovery for which they aren't prepared
- There will be draconian effects on public spending. Research, development and education will be badly affected, as cuts cannot be made to infrastructure investment
- The deficit cannot be reversed in a couple of years, it will take between 10 - 20 years to bring it down to low single figures, when it should be growing at the same rate as trend GDP (around 2 per cent)

- There has been a strong pick-up in Asia, but Australia or Norway are likely to be the first of large developed economies to raise interest rates
- The UK's future lies in competing better in the world market
- Europe is a mixed bag. There are problems in Eastern Europe, but high levels of productivity in France and Germany
- With Brazilian, Asian and the Middle Eastern economies doing well, it is evident that emerging markets are driving global growth
- There is renewed activity in the equity markets; capital is leaking into the speculative markets
- The currency market is looking very volatile:
    - → The US dollar looks weak against the Euro, but it is predicted to strengthen
    - → The GBP will remain weak; but must do so in order to aid recovery. There is a risk to the GBP due to borrowing from overseas

Discussion

It has been a long, tough year for most leaders, and although there have been green shoots of late, the 'alphabet soup' of letter shapes that recession may take has left many leaders perplexed and unconfident about where the economy is headed and when a recovery, if any, is expected.

Coming off a period of huge volatility participants were able to gain insight from **Trevor Williams**, Chief Economist, **Lloyds TSB Corporate Markets**, about the current state of the economy and what they might expect in the coming months/years.

"We are clearly seeing signs of an upturn," said Trevor. Commodity prices, especially metal, have increased, which is a sign that things are looking up. Lower interest rates, increased fiscal spending, large purchases of market instruments and increased liabilities by central banks are evidence that the stabilisation efforts by governments are working.

Both the French and German economies saw increases in Q2, probably helped by their car scrappage schemes, which were larger than the UK. However, Q3 and Q4 may not look so good for these economies.

But, he warned, this will not be a quick recovery because the downturn was so widespread and impacted a wide range of sectors, particularly the banking sectors in developed economies, where there simply will not be the cash available to lend from risk-weighted capital. Moreover, the G20 finance ministers discussed forcing banks to set aside even more capital during their last meeting in London.

Surveys of lending intentions in the UK, Europe and the US show that financial institutions are tightening their credit standards and widening their spreads on cash loans, but is it also the case that some borrowers are now unwilling to take out loans at past levels.

Borrowing habits aren't readily understood. The UK experienced its first net repayment of debt in the household sector on its consumer loans in July.

The £1.2 trillion in mortgage debt and consumer loans of £300 billion brings household borrowing to more than the annual turnover of GDP, which is why the recovery will be muted in the UK and consumer spending strained.

"We will be bumping along the bottom for a while," said Trevor. This bumping, which he categorised as small increases and decreases each quarter, may be seen as the dreaded W-shaped recession. A model Trevor believes is unlikely to take hold. It is expected that the UK will experience moderate growth in Q3 of between 0 and 0.3 per cent but there won't be much traction through Q1 and Q2 of 2010.

Lasting effects of the recession

Although the recession has hit bottom, the effects are still visible and will be for some time to come. According to Trevor, there will be a continued rise in bankruptcies, business failures and unemployment.

Unemployment, which typically peaks nine months to a year after a recession bottoms out, is predicted to hit a high by the last quarter of 2010 or early 2011.

Bankruptcies are also expected to peak at that point. This acceleration will come from those companies that gear up for recovery and then realise it is not possible.

Remarkably, retail sales have held up better than expected but consumer spending has not held up as well as many thought it would.

The withdrawal of the cut in VAT and the expected 50 per cent rise in income tax in the coming months are expected to keep consumer spending down.

The election to take place before May 2010 will also be a big factor in a recovery. There will be large fiscal deficits, close to £200 billion, this year with government borrowing expected to peak at 13 to 14 per cent of GDP.

One problem the UK economy is facing is the lack of funding from low domestic generation of cash relative to high demand. This means overseas borrowing is putting the currency at risk. The next administration will face a significant challenge putting in place the policies needed to control the budget deficit.

With a new government, we will be entering a draconian period of public spending control. Some budgets are looking at 10 to 20 per cent cuts. Research, development and education are going to be badly affected by cuts. The government is likely not to touch infrastructure, as it is critical to the economy performing. It will probably look at selling off some roads, which opens up a host of opportunities for the private sector. But the public opinion of such endeavours is never good.

Balancing the economy

There is evidence that the economy is re-balancing as imbalances are being painfully addressed. The corporate sector has been repaying debt at unprecedented levels, in July large organisations repaid close to £8.4 billion. It is also raising money through equity, fixed income and bonds issuance, using this capital to repay bank debt.

The rising public sector deficit is being funded by the decrease in household debt, which may soon become a surplus. The corporate sector surplus is balanced out by reduction in the current account, which is fuelled by slower growth and a more competitive currency.

The ratio of household savings will increase, therefore decreasing spending and constraining economic growth.

The drag on the economy will also be coming from the public sector. The current deficit, which is mainly a product of borrowing to bail out the economy, will take generations to pay down and at least a decade to get down to single digits assuming tough action is taken.

Global markets

The recovery will be much more muted than recoveries of the past, especially for those economies that were severely impacted by the financial crisis, ie, the UK and US.

Results from Q2 are indicating that emerging markets with demand from China are bouncing back particularly strongly. There are strong pick-ups and growth in Singapore, South Korea, Taiwan, and Indonesia, which has not had a quarter of negative growth. There are also considerable signs of growth in Australia. It is believed that it will be amongst the first of the large developed economies to raise interest rates.

There will be a strong global upturn, but the UK and US will lag behind it. The UK's future lies with improved performance on the world market; it should be focusing on innovation, technology and skills because that is where its strengths lie.

Europe is a mixed bag, with problems in Eastern Europe. There is potential for bank collapses in Eastern Europe and new member states, but their growth rates will be strong when they begin to recover.

Asia and the Middle East are doing very well. Russia also has a strong economy with a highly educated workforce. It has a large market with many oil and energy reserves but it is a politically risky country in which to do business and highly dependant on the oil price.

Brazil is a ‘great place for the future’ according to Trevor, it is well run, it has an oil basin that has just been discovered and if managed properly could push their economy onto the next level and increase growth rate considerably.

Markets

There is renewed activity in the equity markets. The capital that was used to bail out economies is seeping into speculative markets because these instruments offer great returns.

The cash markets have seen yields drop off considerably, the huge injection of public money has calmed them, but the real challenge will come when it is withdrawn. In the UK, the repayment of debt means that money supply growth will be too low to sustain recovery, therefore to boost it the central bank will have to keep buying gilts issued by the government. They may have to keep doing this until growth is sustained.

Currency markets are still highly volatile.

The US dollar is undervalued against the Euro based on Euro Zone and American predictions. The dollar is expected to strengthen as some of the bail out money is set to come through next year in time for the mid-term elections.

The GBP cannot be allowed to appreciate because it is not helpful to recovery. There will not be any significant recovery against the Euro or US dollar. Due to low inflation rates this is the ideal time to have a weak currency, said Trevor.

The Japanese Yen needs to become more competitive as Japan’s growth comes completely from external demand.

Recommendations

Interestingly, Trevor had not made any predictions for a possible swine flu pandemic. “We aren’t really interested in it per se as a major negative event, at worst it could take 0.25 per cent off of GDP, but economies always bounce back from such natural disasters.” He admitted that the only model they have for such a pandemic is that of Spanish flu.

THE NETWORK
OF LEADERS
CRITICALEYE

What should organisations be focusing on?

Trevor thought that companies dealing with UK demand are going to have a hard time. They will see much less growth in the coming decade than that to which they were previously accustomed. Companies should be focusing on innovation, R&D, and creating new products thereby creating new tastes and new demand.

To do this, organisations should be keeping costs down, accentuating positive cash flows, paying down debt and fixing the balance sheet. “If you are in a cash rich position, look for opportunities through M&A or in the global market,” he said adding:

“Now, it is important to gear up for recovery and ensure your firm has a sustainable and manageable balance sheet.”