

## The Outlook for Financial Markets in 2008

The second half of 2007 was the first half year since 2002 during which global bond market returns exceeded global equity market returns. It was also the first half year since 2002 to see a fall in the OECD's leading indicators of global economic activity. This tells us two things. First, that developments in the global economy can still be important determinants of financial market returns and, second, that what happens in the US economy in the coming months will be crucial to the outlook for financial markets in 2008. This has been emphasised by developments in January, when equity markets have plunged on renewed US recession fears.

Make no mistake; developments in the United States are of the utmost importance. Much has been written in recent months about global 'decoupling' – the ability of economies in the rest of the world to grow at a rapid pace, even though the US economy was weak and 2007 seemed to provide some evidence in support of this theory. However, it is important to understand that the economic slowdown in the US in 2007 was concentrated in the housing market. Consumer spending and business investment continued to grow at a healthy pace. The US does not import many houses, but it does import a lot of consumer and investment goods. So it is not surprising that the US slowdown in 2007 had little impact on the rest of the world. But this does not mean that the rest of the world would be unaffected, if the slowdown broadens out into the rest of the US economy this year.

The US is still the world's largest economy. If it goes into a recession in 2008, there will be a substantial slowdown in economic growth in the rest of the world. This is not just due to trade links with the US. It will also be because the factors that are combining to weigh down on US economic activity – higher interest rates, reduced credit availability and record oil prices – will also have an impact in Europe, Asia and Latin America.

It is also important to realise how highly correlated global financial markets now are. If the US economy goes into a recession, then equity prices in the US will continue to fall. Given the high correlations between markets, it is almost inevitable that equity markets in the rest of the world would also drop sharply in such a scenario (adding, by the way, to the downside risks to growth outside the US).

So what is the outlook for the US economy in 2008? It seems there are three possible outcomes: moderate growth, a mild recession or a deep recession.

We can be reasonably confident that the US housing market will stay in recession throughout 2008. Prices have already fallen 5% from their peak and housing sales and starts are down 20% and 38% respectively over the last year. However, the inventory of houses for sale still represents around ten months' sales. The only way these houses can be sold is if prices come down further – perhaps a lot further. Falls of another 5 to 10% seem very likely during 2008. This will have a dampening effect on consumer confidence, which is important because the behaviour of consumers will determine whether the US goes into recession this year or not.

During 2007, US consumers managed to increase their spending, despite falling house prices, because income growth was strong and unemployment remained low for most of the year. Households' wealth has only a small impact on their desire to spend; households' income and the perceived risk of losing their jobs are far more important. In 2007 most households believed their jobs were safe, so they continued to spend, and companies believed that consumers would continue to spend, so they did not cut back on their workforces.

Towards the end of the year, though, signs emerged suggesting companies are beginning to doubt the ability of consumers to keep on spending. Business confidence dropped, especially in manufacturing. Employment growth slowed. And the unemployment rate rose from a low of 4.4% in March to 5.0% in December. As a result, we may be close to the point where consumer spending weakens. Households might have shrugged off falling house prices, but it will not prove so easy to ignore weaker income growth, rising unemployment and the higher energy and gasoline costs associated with the oil price at close to \$100 a barrel.

The odds, therefore, are tilting in favour of the US economy experiencing a recession in 2008 and already a few Wall Street economists have made a recession their central case. How bad will any recession be? That will depend, primarily, on the reaction of the Federal Reserve and of the banking system.

The prime responsibility for ensuring that any recession is mild lies with the Federal Reserve. The good news is it has already started cutting interest rates (from 5¼ to 3½%) very early into the slowdown, and it appears ready to make further cuts. The bad news is that higher food and energy prices have lifted inflation well above acceptable levels. If that leads to a rise in medium-term inflation expectations, then the Federal Reserve's ability to cut interest rates will be curtailed and the risk of a deep recession increased accordingly.

Even if US interest rates are cut aggressively in response to weaker growth, the economy may experience a serious recession if the banking system is unable to increase its lending. Modern economies cannot grow without a functioning banking system and the worry is that losses on sub-prime mortgages have been so great that banks need to spend time repairing their balance sheets and curtailing their lending activities. My guess is that the problems are not so large that they will cause a serious recession in the US, but we are in uncharted waters and it hard to be confident.

Let us assume the most likely outcome is that the US experiences only a mild recession in 2008. What will that mean for bond and equity markets?

Bond markets are already close to assuming such an outcome. With 10-year yields in the US around 3½% and in the UK around 4½%, it is hard to argue they offer any value on a medium-term basis. No one is going to get rich accepting such low returns. And yet, if the US economy does go into recession and the Federal Reserve cuts interest rates to, say, 2%, then in the short-term bond yields can fall further, offering the scope for decent returns.

Equity markets appear to offer better value, especially in relation to bonds, but investors need to be careful. Profit margins globally are at very elevated levels and valuation measures, such as price-to-earnings ratios may be misleading. If the global economy experiences a sharp slowdown in 2008, then we can expect to see margins return to more normal levels. This could involve sizeable downgrades to earnings expectations. It is quite possible that the level of earnings will fall for the first time since 2002. It is hard to believe that equity markets could produce positive returns in such an environment.

The most likely outcome, therefore, at least for the next few months, is that the US economic outlook continues to deteriorate and the economy slips into recession. Given this outcome, global bonds might be expected to outperform global equities in the first half of 2008. What happens in the second half of the year will then depend on the severity of the recession. If it turns out to be mild, equities might recover, perhaps quite strongly, in the second half on the hope of continued improvement in 2009. Alternatively, if the recession turns out to be a deep one, then



we may be on the brink of a serious equity bear market. It could be the behaviour of the Federal Reserve and the global banking system that determines the eventual outcome.

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