

Economics Report

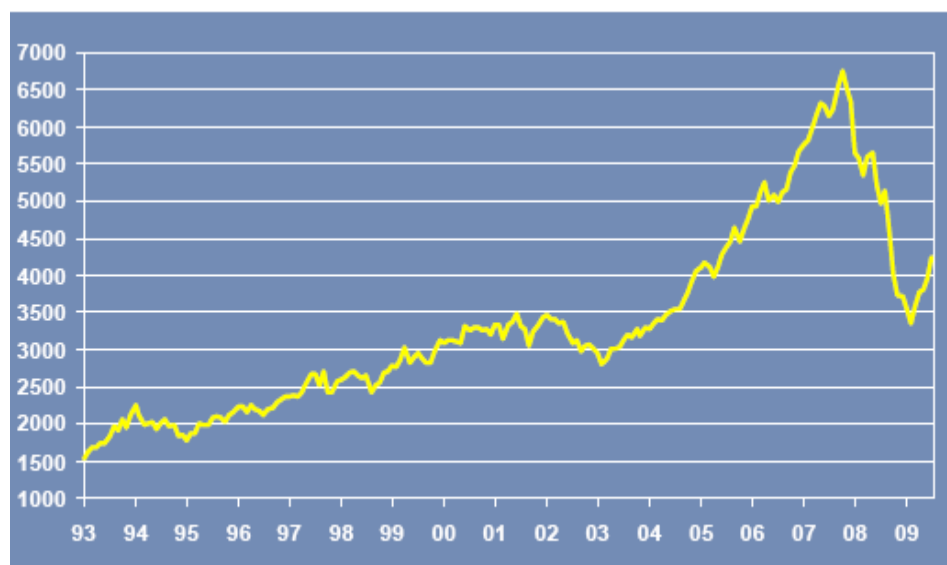
1 August 2009

Caton's Corner- August 2009

A great start!

Well that was close! For a few days in early July I thought that the Caton curse was operating again. My piece last month said that the share market would do quite well this financial year. No sooner had I published than the ASX200 proceeded to fall by more than 5% in a few days, as investors around the world worried that about the strength of the global economic recovery, and about earnings. A relatively poor labour-market report in the United States was the catalyst for much of this. But markets then turned sharply as the view emerged that the "glass was half full" rather than half empty. So much so that by end-July, the ASX200 was already above my end-2009 target of 4200. Not for the first time, I will have to raise that target, which is something I'm always happy doing. For the month, the ASX200 index rose by 7.3%, which makes it the best month since June 2000.

The ASX200 index—now up for five months



Source: Bloomberg

Markets can still do better in my opinion. In 2006, there was a widespread view that the booms, in both markets and economies, were going to go on forever. After all, what could possibly stop them? That view was always going to be wrong. Early this year, as pessimism continued to mount about the GFC, there was no shortage of seers proclaiming that the recessions would last two, three or even five years. After all, what could possibly stop them? That view, also, never had a chance of being correct. So markets have done better not because there is suddenly a lot to be optimistic about, but simply because pessimism was overdone.

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This change in mood will continue. As I type, the recession in the United States is ending. You probably don't believe this and that's OK. When the economic cycle turns, there is always a "recognition lag". Here's a forecast you can stick on the fridge: some time before mid-2010, the "scorekeepers" in the US (possibly the only country to announce officially the start and end dates of recessions) will announce that the Great Recession ended around July 2009.

But it's not just the US. Around the world, forecasters are raising their expectations for economic growth in 2010. These upward revisions have been small so far, but they have further to go. It is true that there is justifiable concern about the pace and longevity of the recoveries, given the adjustments that still have to be made by consumers, by financial sectors and by governments as the extra-ordinary fiscal measures are unwound, but **none of these preclude a year or so of surprisingly strong growth**. If this occurs (and it's not a certainty), then the "sweet spot" in equity markets can continue.

Meanwhile, back in Oz

There have been some interesting developments on the home front. The general tone of the economic news has been better than expected, and the view that **the Government's budget-time forecast was too pessimistic** has gained credence. The labour market is not deteriorating as fast as many feared, for example. House prices seem to have stopped falling. The Governor of the Reserve Bank has acknowledged that **it is easier now to see upside risks to the economy as well as downside risks**.

This has led to a marked shift in the view about the future of interest rates. Even in early July, the RBA signalled that it had more rate cuts in the locker if it needed them. The Bank won't be sending that message this month. Rather, it now appears likely that the next move in interest rates will be upwards.

Exactly when this happens is still open to question. It's not hard to make the case that it won't be for a while. Even in the best of circumstances, unemployment in Australia (currently 5.8%) is set to rise until mid-2010 (when it will probably exceed 7%). And **it would be unprecedented for the RBA to begin to raise rates before the unemployment rate has clearly peaked**. But it's also unprecedented for the RBA to be starting at 3%, and rates clearly can't stay unnaturally low forever. In the Q and A following a recent speech, the RBA Governor clearly left room for a decision to raise rates before the peak in unemployment (a lagging indicator, it must be said). It would depend, he said, on what else was going on, and that means in the rest of the world, in economic growth, and in inflation.

Right now, financial markets have priced in a full percentage move in the next twelve months. That seems excessive to me, but I know one thing. As a rule of thumb, once rates do begin to rise, they generally go up more than is expected on the day of the first rate rise. So it may take a bit longer, but we are probably looking at an extensive period of rate rises, with the short-term cash rate eventually hitting 6% or higher. This may take a few years, however.

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The views expressed herein are those of the author and should not be otherwise attributed.

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