

EUREKA *report*



Brace for a hard landing

By Gerard Minack
December 17, 2008

PORTFOLIO POINT: The Australian economy is heading for a recession, possibly a deep one. Expect the ASX to dip to 3000, interest rates of 2.5% and house price falls.

Australia is probably the only major developed economy where there is still a debate about whether there will be a recession. Many think it can be avoided. I am more convinced than ever that there will be a recession, possibly a deep one.

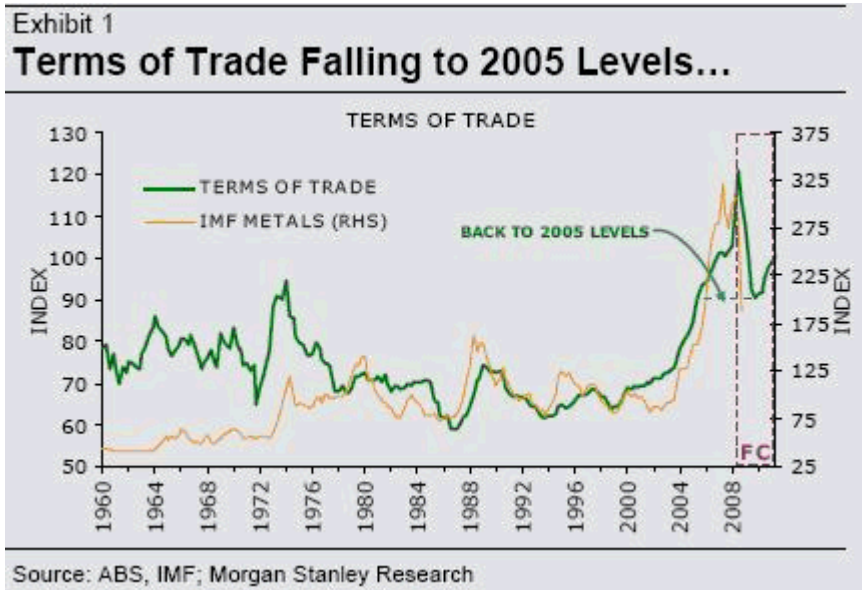
The Australian economy will land hard because of two factors. The first is the likely significant decline in the terms of trade (export prices relative to import prices). On my numbers, this will lead to a crunching 10%-plus reversal in real national income growth. The second is the historically large private sector financing requirement. Notably, the private non-financial corporate sector recorded its largest-ever net lending deficit as it entered the severest credit crunch in decades.

Either of these factors could single-handedly cause a recession. Combined, a deep recession is a risk. The only material offset is that policy-makers have front-end loaded aggressive policy easing. I don't think this will be enough to avoid recession; however, I expect policy-makers will do more: I expect the budget deficit to hit 3.5% of GDP, and the cash rate target to be cut to 2.5%. This will cushion the downturn, not prevent it. Moreover, the risks are to the downside, given the possibility that the global recession could have a larger impact than I am now factoring into my numbers.

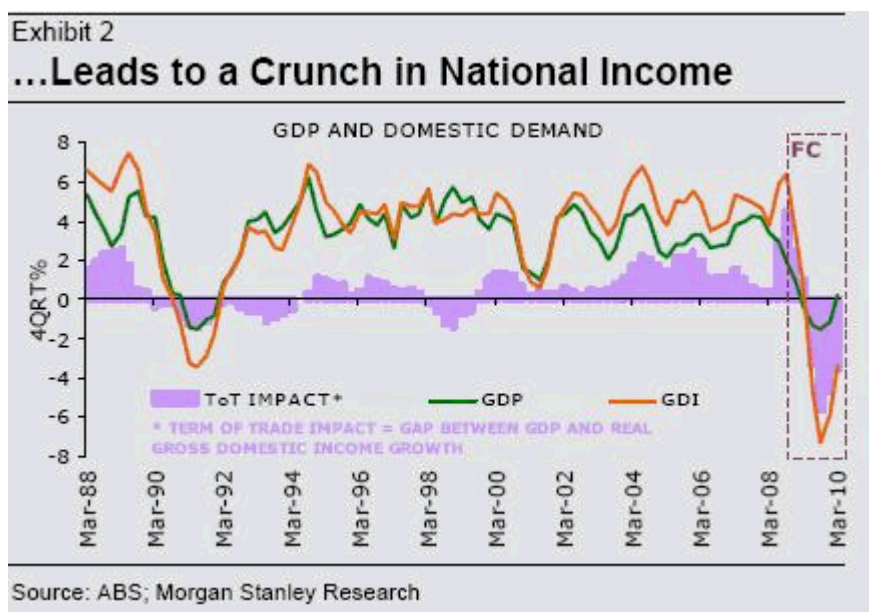
I have argued in my daily notes that the risk-reward in global markets is more balanced now than it was a year ago. For Australian markets, however, downside risks dominate. The economy boomed higher, so the risk is it will bust harder. For markets, that means lower interest rates, and likely a lower Australian dollar. Our global foreign exchange team expects the dollar to fall below US50¢. Domestic risk assets will remain under intense pressure. I think I made a mistake earlier this year when I lifted my ASX 200 target to 3500; I'm now reverting to the prior target of 3000. Australia is also the only economy that had a housing bubble where there is still a debate about whether house prices will fall. I continue to expect double-digit declines.

Achilles' two heels

Australia faces two major problems. The first is the likely significant decline in the terms of trade, which will feed into an almost unprecedented reversal in real gross domestic income. (RGDI is GDP adjusted for the income impact of a change in the terms of trade. If the terms of trade rise, this does not directly register on real GDP. But Australia is better off because it requires fewer volumes of exports to buy a given volume of imports. RGDI captures this effect.)

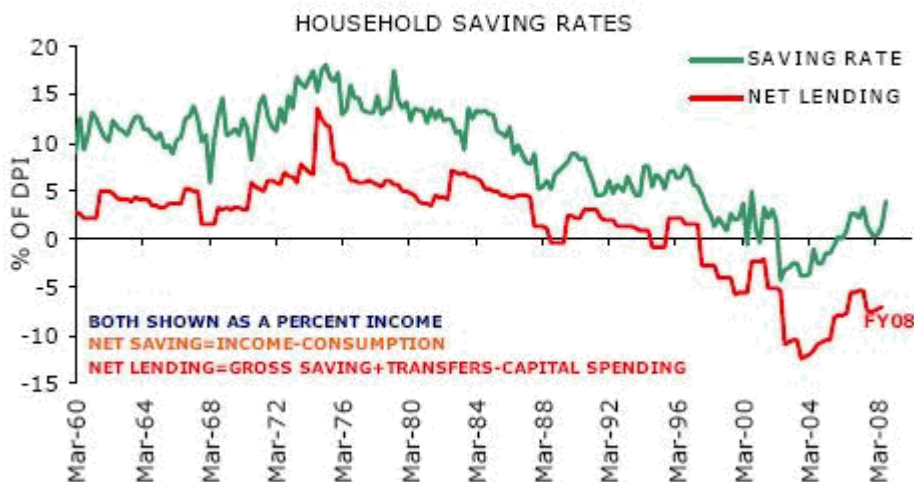


I expect that the terms of trade will fall to 2005 levels in the next 12–18 months. By historical standards, this would be a very high level (Exhibit 1). But the impact of the terms of trade falling from current exceptionally high levels to ‘only’ the high levels of 2005 is to cause a 10-percentage-point-plus swing down in RGDI growth (Exhibit 2). Importantly, the risks to this forecast – given the prospect of potentially the deepest global recession in the post-war period – are to the downside.



The second risk is the impact of the global credit crunch on a private sector that last financial year ran an unprecedented net financing deficit. The net financing deficit is the macro equivalent of a cash flow deficit: the requirement by a sector to fund its consumption and capital spending. Here’s the key statistic: In 2007-08 (this data is available only annually), the non-financial private sector’s net lending requirement was an unprecedented 11.5% of GDP.

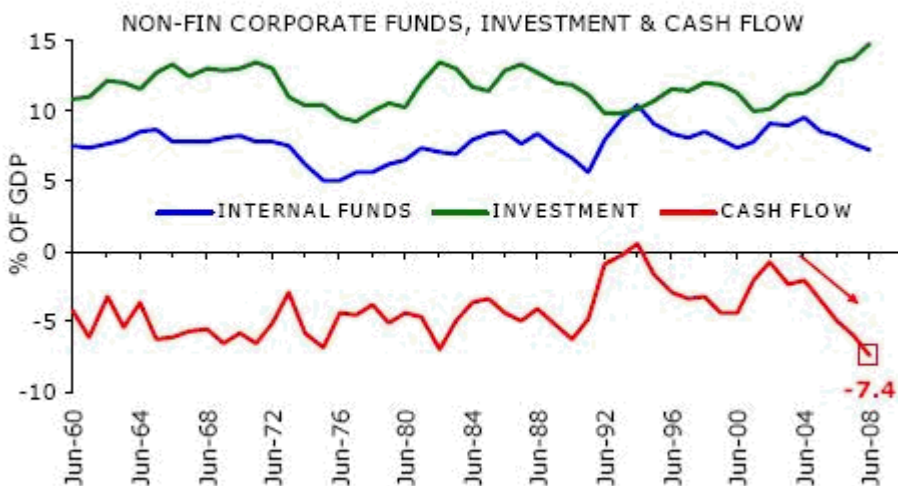
Exhibit 3
Household Sector Still a Big Borrower



Source: ABS, Morgan Stanley Research

The non-financial private sector is the household sector and the non-financial corporate sector. Both were big borrowers. Exhibit 3 shows the net financing requirement of the household sector, along with the more commonly used household saving rate. The reason the financing requirement is negative while saving is positive is that the saving rate includes a number of non-cash items and excludes the financing of investment spending (for households, largely residential construction).

Exhibit 4
Corporates' Unprecedented Funding Need



Source: ABS, Morgan Stanley Research

The corporate sector's financing requirement blew out to an all-time extreme in 2007-08, reflecting a rise in investment spending and a decline in internal funds (as a share of GDP). The corporate sector's funding requirement was almost 7.5% of GDP in the year to June 30 (Exhibit 4).

Corporate Australia could not have picked a more inopportune time to have a record financing requirement: just as the globe entered the most severe financial crisis since the Great Depression. The upshot is straightforward. With debt financing either very expensive or unavailable corporates have three choices: cut expenses (capex), raise equity, or go broke. So far, we have seen a sharp increase in capital raising. We are also starting to see a significant scaling back of investment spending. Next year we will likely see a sharp increase in corporate failures.

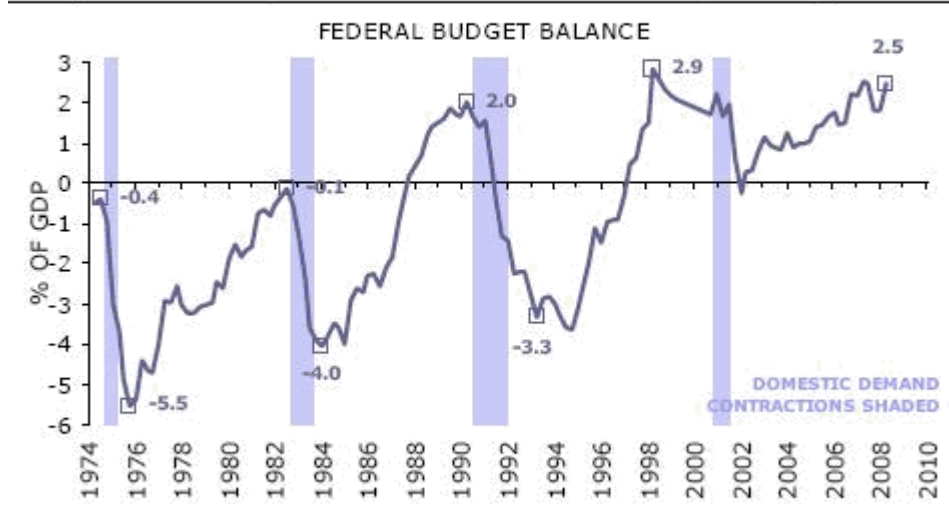
The policy response

Either of these two factors could single-handedly cause a recession. The big offset, as many see it, is that policy-makers have a lot of scope to respond to these risks, and have moved aggressively and pre-emptively. A falling Australian dollar has enhanced the discretionary easing of policy. A few comments on this:

First, fiscal policy will cushion this downturn. But it's important to remember that the starting position for fiscal policy now is not better than it was in the lead-up to the last recession (in the early 1990s). More to the point, fiscal policy has almost never been constrained by its starting point: Whether the budget has been in surplus or deficit on the eve of recession, it has always moved sharply into deficit. As Exhibit 5 shows, it is normal for a budget balance to deteriorate by 4–5% of GDP in a downturn. But that has not prevented recessions. I expect the budget balance to swing by almost 6% of GDP in this cycle.

Exhibit 5

Forget Starting Position – Fiscal Always Responds



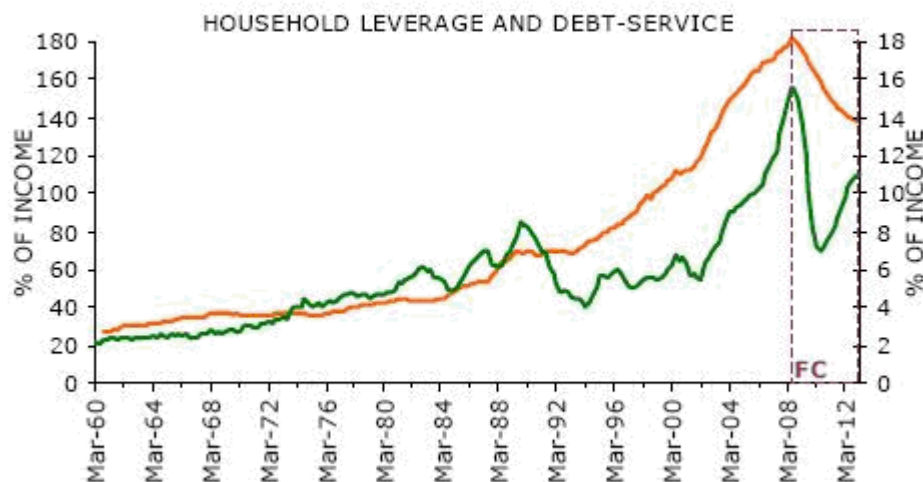
Source: ABS, Morgan Stanley Research

The Reserve Bank has aggressively eased policy. This is also normal for a recession. Unusually, however, this easing has been front-end loaded. This may make some difference.

In terms of upside risks to my forecasts, this is the key area of focus. I have assumed that much of the income benefit of lower cash rates – which will flow quickly through to mortgage rates, and hence debt servicing – will be saved by the household sector. On a medium-term view this is good: It means that the great imbalance in the household sector – too much debt, too little saving – will start to be corrected (Exhibit 5). Falling interest payments (and forecast tax cuts) will boost disposable income, even as gross income weakens. If the household sector spends most of that windfall, then growth will be better than I am forecasting now.

Exhibit 6

The Healing Starts



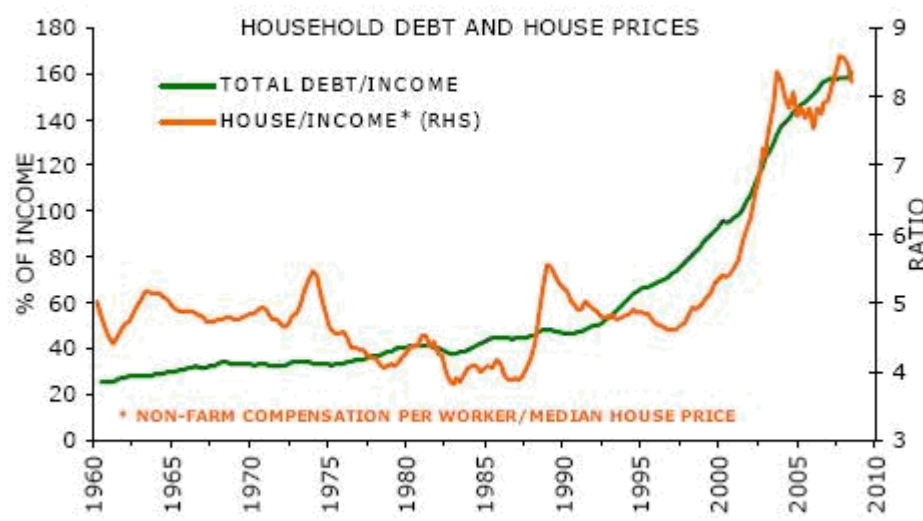
Source: ABS, Morgan Stanley Research

One important reason for expecting the household sector will save a large share of its windfall from policy-makers is the extent of wealth destruction. Using marked-to-market asset prices, I think household wealth has fallen by 75 percentage points relative to income, an unprecedented decline. This predominantly reflects the decline in equities. However, house prices are now starting to fall. I expect substantial declines, around 25–30% across-the-board declines. Non-metropolitan prices will likely fall furthest (halving, as a base case), while metropolitan prices will fall 15–20%, in my view.

This prospective decline is the flipside of the healing process. My view is that the single most important reason house prices have moved so high is the willingness and ability of people to leverage up to buy homes (Exhibit 7). If – as my forecasts assume – households move to reduce leverage, then house prices are likely to fall. Over time, the house price/income ratio could fall 30–40%. In a moderate downturn, that adjustment could occur over an extended period, and require relatively minor nominal house price declines (with the adjustment largely due to inflation eroding real house value and incomes rising). But with unemployment likely to rise sharply – to about 8% on my forecasts – I expect meaningful falls in nominal house prices.

Exhibit 7

Borrow Me a House



Source: ABS, Morgan Stanley Research

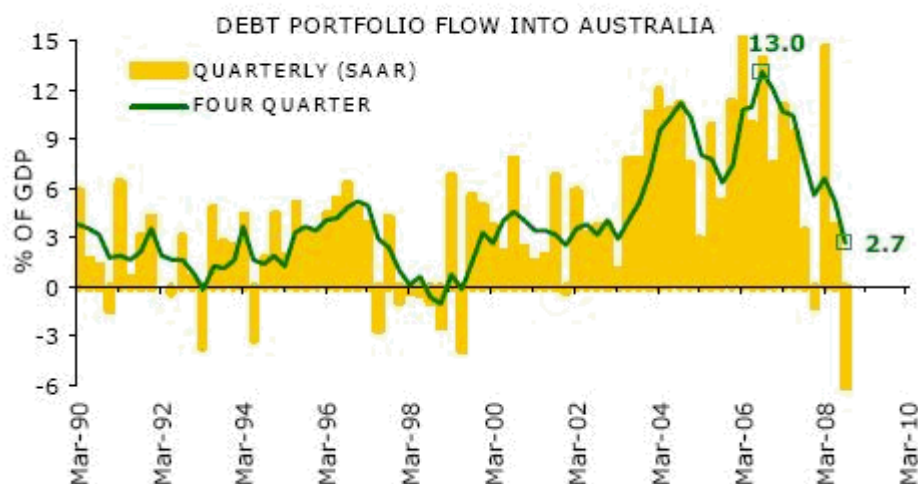
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The implications of my outlook are relatively straightforward, at least for policy: more stimulus will be applied. I have the federal budget moving into significant deficit next financial year. The Reserve Bank will likely cut further. I had expected a trough for the cash rate at 3%; now I expect 2.5%.

The outlook for the Australian dollar remains poor. The key point to remember is that the principal way Australia financed its external deficit was through the sale of financial paper. This is not a good time to be selling bank debt. Indeed, in the September quarter the rest of the world was a net seller of Australian debt (Exhibit 8). Although the federal government is now offering to guarantee bank issuance, this is currently nothing special in the global market. For many potential buyers, the key risk is not credit risk, but currency risk.

Exhibit 8

Not a Buyer; Now a Seller

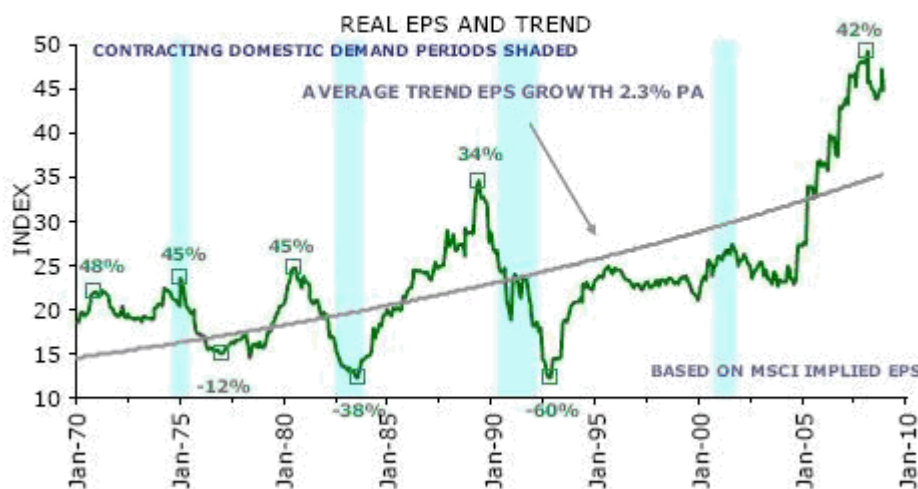


Source: ABS, Morgan Stanley Research

The combination of domestic and global recession points to a substantial decline in corporate earnings. Earnings are now running well above trend, and always fall significantly below trend in a recession (Exhibit 9). Earnings seem set for a peak-to-trough decline of a half to two-thirds.

Exhibit 9

Earnings Running Well Above Trend



Source: MSCI, ABS, Morgan Stanley Research

On that basis, the Australian equity market remains expensive. One measure that captures both the above-average earnings and above-average valuation is market capitalisation relative to GDP (Exhibit 10). This need not mean-revert, because a growing portion of the Australian economy is now listed relative to history, but it remains at elevated levels.

The outlook for the domestic equity market will in part depend on the outlook for global equities. I am not as bearish on global equities as I was a year or two ago, but I still think the risks are slanted to the downside. However, I think the risks are more aggressively slanted to the downside for the Australian market. At a minimum, that points to the Australian market being a significant under-performer relative to global peers next year. If global markets also decline, then the domestic market is set for further significant losses. On that basis, I'm reversing the upgrade I made earlier this year (see *Australia: The bear view*) when I lifted my ASX 200 target to 3500 from 3000. I expect that the low will be around 3000.

Exhibit 10
Still Not Cheap



Source: MSCI, ASX, ABS, Morgan Stanley Research

New forecasts are shown below.

Exhibit 11

A Deeper Downturn

	FOUR QUARTER CHANGE TO:			
	Dec-09 E		Dec-10 E	
	NEW	PRIOR	NEW	PRIOR
COMPONENTS OF GROWTH				
Real GDP	-1.2	0.0	4.2	4.3
Private consumption	-1.1	-0.9	2.1	2.0
Business equipment Δ	-14.2	-9.7	3.0	5.6
Business construction Δ	-12.4	-6.8	-4.9	7.2
Residential construction	-7.8	-7.8	13.6	13.6
Total private investment Δ	-10.8	-7.6	3.6	7.9
Domestic final demand	-2.7	-1.8	2.5	3.5
Exports	4.7	6.7	9.0	8.1
Imports	-4.6	-3.3	4.6	6.4
Net export contribution*	2.0	2.1	1.0	0.4
Real Gross National Income	-5.9	-5.0	5.8	5.6
ECONOMIC INDICATORS				
Current account balance	-90.7	-83.0	-83.0	0.0
CAD/GDP %	-7.7	-6.7	-6.7	0.0
Terms of trade	-19.8	-20.0	7.7	4.4
Consumer price index	1.7	1.7	1.9	2.2
Employment	-2.4	-1.5	1.3	1.9
Unemployment rate	8.0	7.1	7.8	6.3
Wage cost index	2.9	2.9	3.0	3.0
Unit labour costs (non-farm)	2.0	2.0	0.8	0.8
Corporate profits (non-financial GOS)	-15.1	-20.8	21.5	7.2

Source: ABS, Morgan Stanley Research

Gerard Minack is chief market strategist of Morgan Stanley Australia.