

September 2009

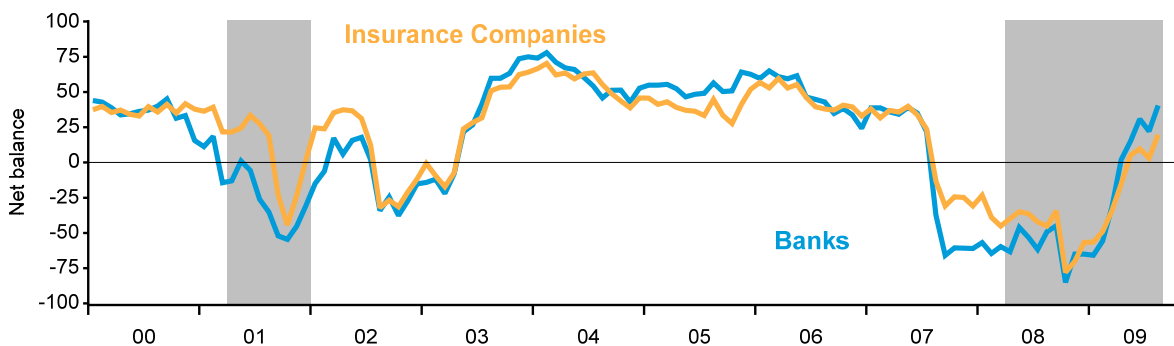
Recovery – But Is It Sustainable?

As we approach the anniversary of the financial market crisis in 2008, it is a good time to look at the current state of the global economy and the outlook as we move into 2010. Confidence indicators are improving rapidly, particularly with regard to financial markets and the corporate sector, suggesting that we are entering a period of growth, but how sustainable will this be?

Financial Market Confidence Returning

A year after the financial markets were on the verge of collapse, there are some encouraging signs which suggest that confidence is returning. One good measure of financial market confidence is Germany's ZEW Index which is illustrated below. In the case of both the banking and insurance sectors, this has moved back into positive territory in the last few months, reflecting a higher level of confidence.

ZEW Financial Market Survey



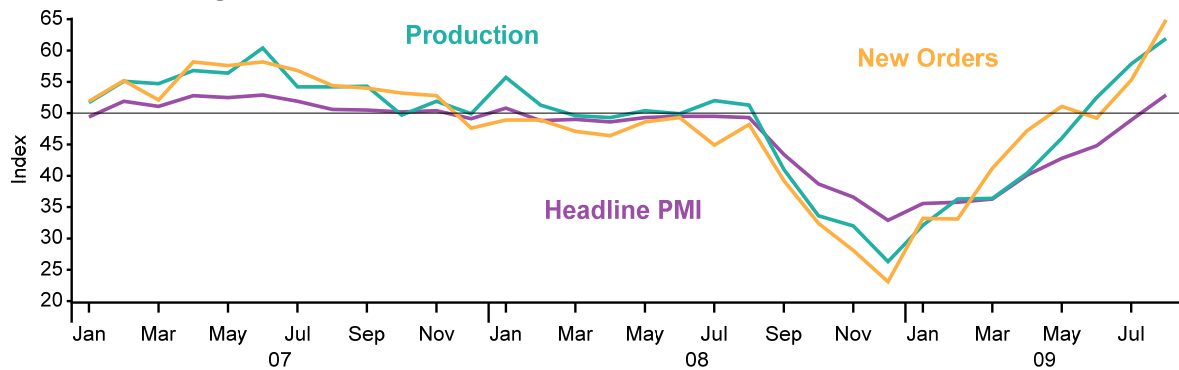
Source: Reuters EcoWin

Concerns about financial market collapse have been eradicated, and this is reflected in the steady increase in the level of confidence recorded since it reached a low last September. It is clearly a huge relief that financial markets have avoided collapse and this is one of the necessary requirements for the return of economic growth. However, this does not mean that the financial sector is in a strong enough state to help engineer a robust economic recovery. A large amount of debt is still outstanding in most sectors of the economy and banks, and other financial institutions, are expected to remain cautious in their lending for some time.

US Recovery – can it go anywhere without the consumer?

The improvement in financial markets and hopes that economic recovery will follow have had a positive impact on business confidence. The chart below shows the ISM Manufacturing Index, which is a measure of confidence among purchasing and supply executives, and provides a good lead regarding both orders and production over the next few months. In the latest report the headline index moved back above the level of 50 – which indicates expansion in activity – for the first time since January 2008. The improvement in the index was led by new orders, which suggests that production levels will improve over the next few months. Some of the orders coming through at the moment are to rebuild inventory which had been run down to exceptionally low levels while the global economy was on the verge of collapse.

ISM Manufacturing Index



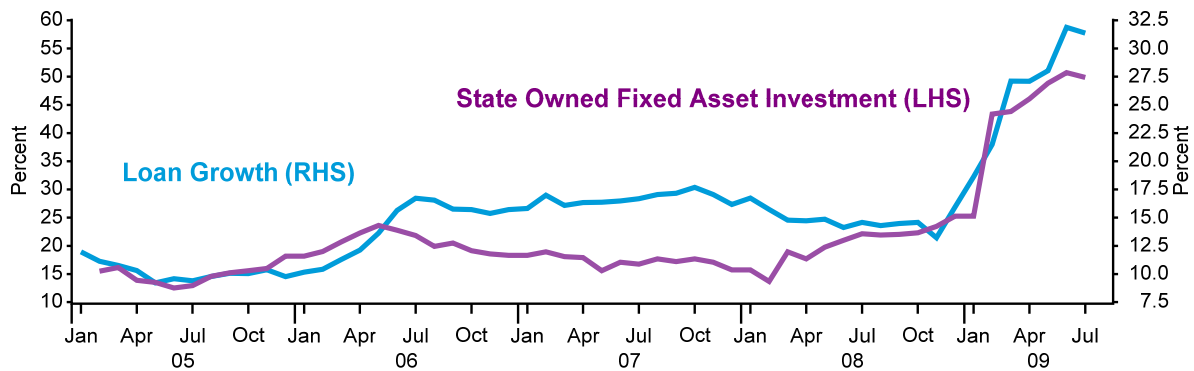
Source: Reuters EcoWin

Although it is reassuring to see this improvement in confidence, orders and production, there is no guarantee at this moment that the end demand is going to be strong enough to maintain these sharp rates of recovery. The consumer remains under a lot of pressure as long as the housing market remains weak, unemployment is rising steadily towards the 10% level and incomes are being cut. While we remain hopeful of positive growth over the next couple of quarters, we need to see some signs that pressures on consumers are easing and that they are becoming more inclined to spend, before we can be sure that this recovery is 'sustainable'. The US consumer still accounts for more than 70% of expenditure in the US and almost 20% of world expenditure, and is going to be a vital component in determining the shape of this recovery.

China – is a bubble being created?

China's policy makers have managed to shelter the economy from the worst of the global downturn by introducing fiscal stimulus on a large scale and by encouraging bank lending. China's fiscal stimulus package is worth Rmb 4trn, or 13% of GDP and new loans in this year had reached Rmb 7.73trn by the end of July, almost 26% of GDP. Although the loss of global demand has hit the export sector badly, this stimulus has found its way quickly into the economy, primarily through a rapid increase in state owned fixed investment.

Loan Growth and State Owned Fixed Asset Investment



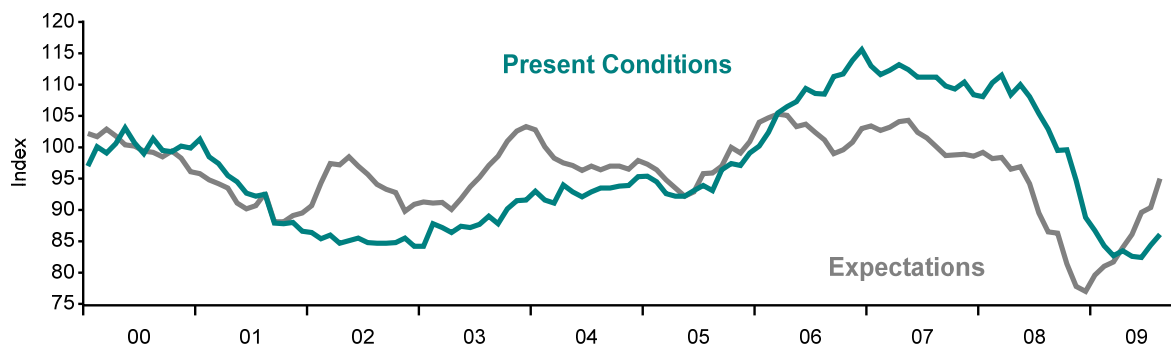
Source: Reuters EcoWin

This rapid increase in investment spending has helped the economy with economic growth recovering to a relatively respectable rate of 7.9% in the second quarter. Now, however, there are fears building that the stimulus may have actually gone too far and that an asset bubble may start to build. In an effort to prevent this from occurring, the authorities are beginning to restrict loan growth, are requiring that lenders raise reserves to 150% of non-performing loans by the end of the year and are asking banks to ensure that loans intended for investment in fixed assets go only to projects which support the real economy.

European Confidence – can recent strength be maintained?

Confidence has improved in Europe at both the corporate and consumer level. The chart below shows Germany's IFO Index of Business Confidence, which is a long standing and well respected measure. The sharp pick up in expectations suggests that the corporate sector now feels more optimistic about the future. Expectations moved above the assessment of current conditions in April, for the first time since February 2006, which is a move usually witnessed as an economy moves into a recovery phase. Germany registered positive growth in GDP during the second quarter, indicating that it has emerged from recession already.

IFO Index of Business Confidence



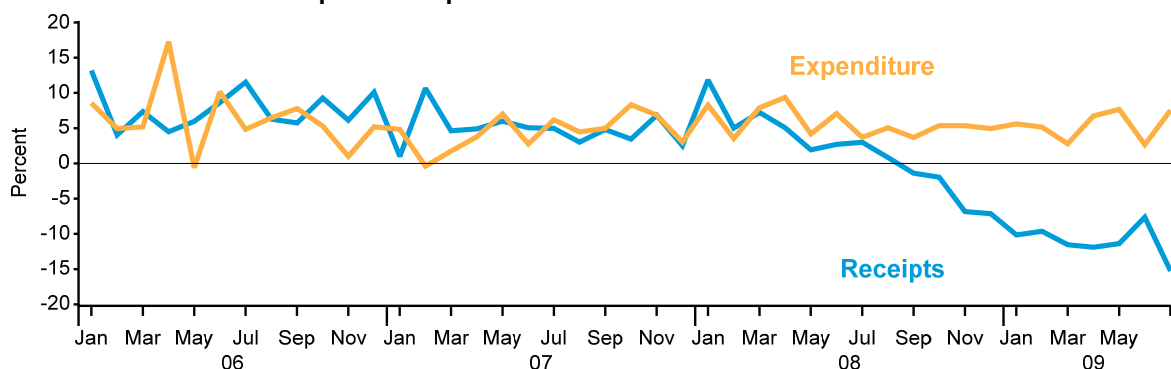
Source: Reuters EcoWin

However, as elsewhere in the world, there are some concerns about how sustainable this recovery will be. German employees are currently sheltered from unemployment by a 'short working time' scheme and car scrappage offers have been attractive and very successful. But these measures cannot remain in place forever and will have to be withdrawn at some point – possibly after the election in Germany later this month. There is still a risk that unemployment will increase, wages will fall further and spending will decline once more. The recovery could, therefore, prove to be more volatile, and subdued, than confidence surveys suggest.

UK – to what extent will deteriorating public finances hinder growth?

The UK has yet to emerge from recession and, until it does, public finances will continue to deteriorate. The chart below shows that public expenditure is increasing as unemployment rises, but tax receipts are falling sharply as activity declines. The fiscal deficit is expected to move above 10% of GDP and is likely to remain there until the situation is tackled by cuts in spending, increased taxes, or a combination of these two. All of these measures will dampen future growth and, as in Europe, the recovery could prove to be fairly muted.

Central Government Receipts and Expenditure



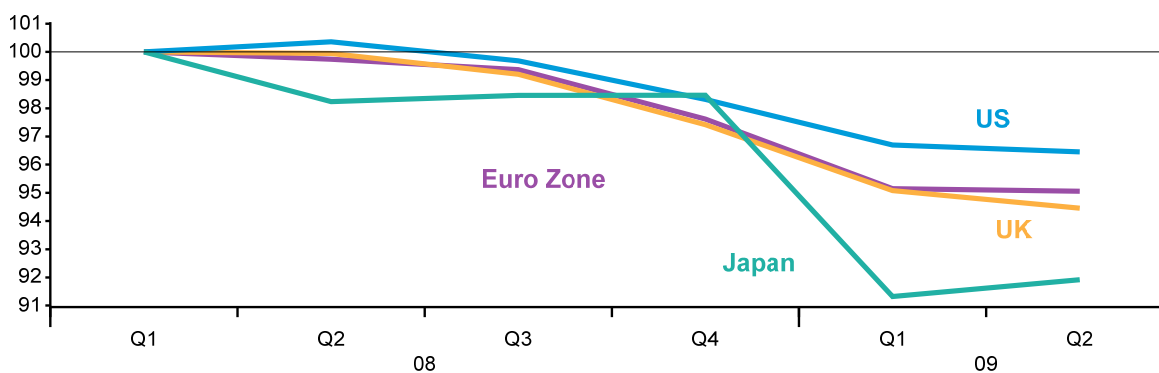
Source: Reuters EcoWin

Another challenge facing the UK is the withdrawal of the large-scale quantitative easing which has been put into place, totalling £175bn to date. This injection of liquidity was necessary for the health and confidence of financial markets but, as growth returns, it will need to be withdrawn in an appropriate manner, otherwise policy makers run the risk of letting inflation expectations build. The exit strategy will likely entail higher interest rates and bond yields, both of which are expected to dampen economic activity.

Spare Capacity

Over the last year we have seen unprecedented drops in activity, leaving all of the major economies operating well below their optimal levels, as can be seen in the chart below. In every case, the current level of GDP is 4-8% below its pre-crisis level. The US has fallen least, but Japan has been hit hardest, due to its high export exposure to all of the other major economies.

Nominal Levels of GDP (Rebased to Q1/2008=100)



Source: Reuters EcoWin

When spare capacity is high, production and output can be increased without additional resources. This might be good for corporate profitability but it implies little need for investment or employment growth in the short term and so economic growth could be lower than we have been used to in recent years. A high level of spare capacity also implies that inflation will remain relatively benign, at least until demand levels recover.

Conclusion

There have been many changes in the last quarter. Financial markets have improved sharply, business confidence has returned and some major economies have already exited recession. We expect this favourable news to continue in the short term while current fiscal and monetary policy remains unchanged, but we are concerned about the sustainability of this positive trend. Debt levels remain high, particularly in the public sector, and fiscal and monetary stimulus will have to be withdrawn at some stage, but that implies higher interest rates and taxes and cuts in government spending. We are hopeful that the global economy is entering a long term recovery phase but we do not expect the recovery to be smooth. Furthermore, trend growth over the next few years is likely to be lower than we had become used to before this crisis hit.

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