research notes

Economic growth, global rebalancing and the labour market

9 February 2010

Recent global growth and labour market data have been viewed somewhat benignly, even negatively, by equity markets. We're not so pessimistic.

Last year we made sweeping statements about the likely path of the economic recovery in key developed markets. We said that:

- developed markets had consumed too much and need to "under-consume" for a while;
- developed markets need to deleverage;
- growth needs to rebalance;
- growth needs to be productive sector led;
- the recession was structural, so the recovery needs to be structural too;
- some belt-tightening would be required and, in some countries, the pathway back to fiscal sustainability would be somewhat fraught;
- building a sustainable recovery would be hard work; and
- job growth would be a lot slower than the job losses.

We are now starting to see how some of this is playing out in reality.

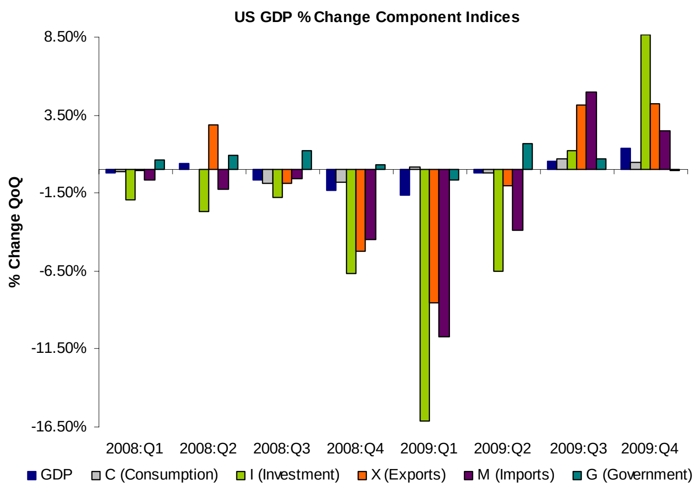
We have seen recovery emerge in most developed countries. The growth is strongest in those countries that have the most economic flexibility and tend to take adjustment on the chin. This includes the United States where 8.4 million jobs have been lost since January 2008.

Others are slower to adjust and hence have been slower to move through the recession and into recovery. The United Kingdom and Spain are good examples of these countries.

At this point we are less concerned with the magnitude of the recovery than we are with signs of economic rebalancing and, perhaps more importantly, that we've learnt some lessons. The early signs, in our view, are quite promising.

What, specifically, are we looking for? We've written about this many times before. To recap: we want current account deficit countries to consume less and export more. It is in these countries that we need to see production picking up first with consumption following later in the process. In order to facilitate this we need current account surplus countries to consume and import more.

Let's look at recent data out of the United States. The December 2009 quarter came in at a seasonally adjusted annual rate (saar) of 5.7%. The result was met by equity markets as disappointing on the back of relatively weak consumption and obvious signs that the growth is still being driven by government stimulus measures and the inventory cycle.

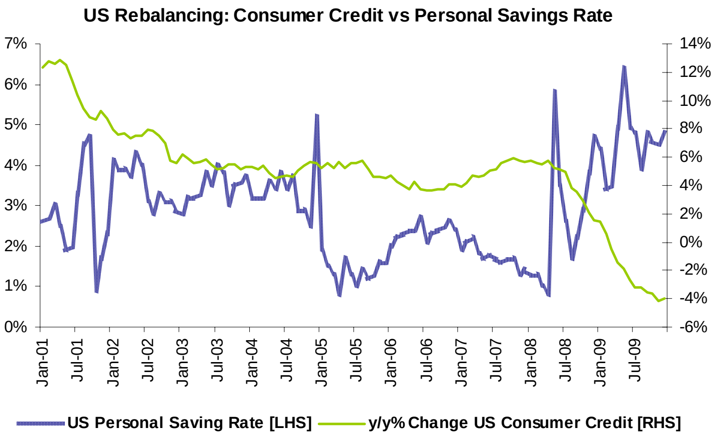


Source: US Bureau of Economic Analysis

We were not as disappointed in the result. We view a weak consumption number positively. This is in line with our views of how the recovery needs to play out if some degree of rebalancing is to occur.

We were also happy to see strong plant and equipment investment (up 13% saar). This strength was masked by weak non-residential construction. We're ok with that. Furthermore, net exports were strongly positive in the quarter.

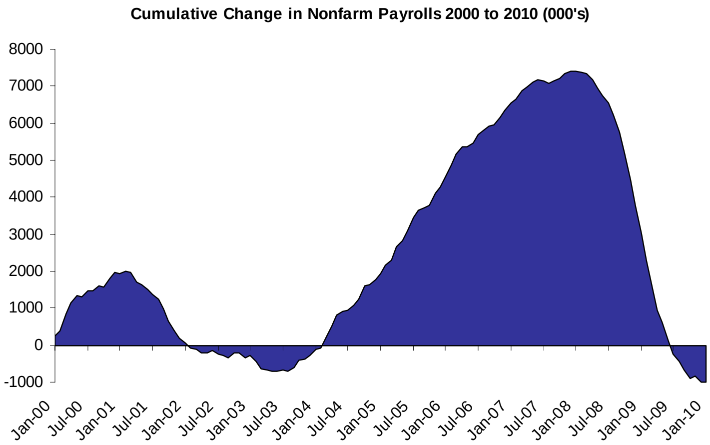
To us, that combination of factors driving GDP can be read as the early signs of economic rebalancing. This is further supported by factors like weak personal lending figures and a sharply higher household savings rate. Sure, all of these things mean a different and slower recovery, but that's actually a good thing.



Source: US Federal Reserve & Federal Reserve Bank of St. Louis

In short, this time around consumption needs to lag rather than lead the recovery. We want consumption to rise on the back of greater productive effort and higher export incomes. While we're at it, we would also like housing construction to be driven by real economic fundamentals such as demographics (including net migration) and not speculative activity. Is this too much to ask?

A slow structural recovery also means the labour market will take longer to recover than in a "normal" recession. But concerns of a jobless recovery are unfounded at this early stage: it's simply too early to be expecting to see strong job growth. Economic rebalancing means new jobs won't be old jobs.



Source: US Bureau of Labour Statistics

There will be a significant proportion of low-skilled workers who have lost their jobs during the recession. Low skilled jobs will be scarce and will therefore have high levels of competition for them. That will inevitably keep wages depressed at the low-skill end of the market.

However, at the same time, we could see skills shortages in some sectors. It will take time for people to retrain, so in the meantime, wages may be bid up in some sectors.

Economic recovery is going to be hard work. The early signs are positive, but it is too early in the process to be expecting anything more. Indeed it is still the case that as the stimulus runs out, that growth in the second half of the year could be weaker than the first half. But even with that, it will be right at some point over 2010 to start moving monetary and fiscal conditions back to normal, wherever that may be. Equity markets just have to get used to the fact that this time it's going to be different.

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