October 19, 2011

Market Insight

ING MARKET PERSPECTIVES

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In the Midst of Mere Mediocrity

The global economy remains sluggish, as the post-crisis recovery in advanced countries has been disappointing. Investors continue to be jittery amid heightened uncertainty about the global economy and financial conditions. In spite of investor fears, however, the U.S. economy will not collapse and a recession is entirely avoidable, particularly if policymakers focus on supporting aggregate demand.

Though a replay of the financial crisis is unlikely in the near future, U.S. economic performance will be mediocre and subpar. Median annual household real income has declined sharply since late 2007, resulting in deterioration of the typical U.S. household's standard of living. Growth in annual median real income is likely to be tame.

The European Central Bank's (ECB) asset purchase program and the euro zone's initiatives for the recapitalization of European banks — if done properly and in a sufficiently large scale — can stabilize government bond yields in the currency bloc's periphery and restore confidence in the region's financial system. Government bond yields in the major advanced economies with sovereign monetary regimes — such as the U.S., the U.K. and Japan — will stay low.

Downside risks to global growth and U.S. growth have increased in recent months, but the outlook for the U.S. economy is that of mere mediocrity rather than outright contraction.

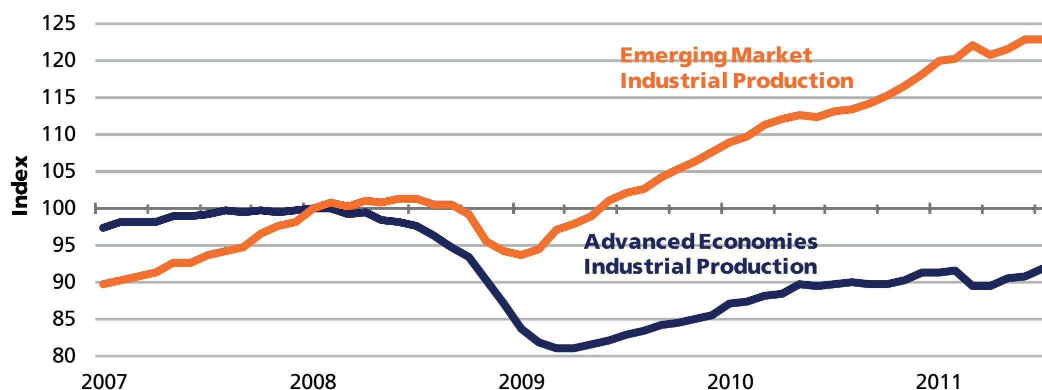
Global Economic Conditions Remain Challenging

Growth rates in the major advanced economies were disappointing in the first half of 2011. The U.S. economy grew less than 1%, while the euro zone saw growth of only 2%. Japan, where output declined nearly 3% in the first half of this year, has been in recession since late 2010, and the earthquake and tsunami earlier this year not only further dampened economic activity at home but also led to a disruption of auto, auto parts and electronics production worldwide.

The levels of industrial production in the major advanced countries are still below pre-crisis levels. In contrast, production in emerging market economies like China and India are noticeably higher now than before the crisis. As you can see in Figure 1, industrial production is currently 25% higher in the emerging market economies but down about 5% in developed markets.

In recent months, growth in industrial production has slowed in both advanced countries and in emerging markets. The recent softening is much more pronounced in advanced countries and in some Latin American countries, while Asia ex Japan and select emerging market economies have continued to generate a decent pace of expansion.

Figure 1. Post-Crisis Industrial Production in Emerging Markets Has Impressed



Note: January 1, 2008 = 100

Source: Reuters EcoWin

The U.S. Economy Can Avoid a Recession and Is not Likely to Collapse…

The slowdown in global growth and a downgrade of the U.S. government's credit rating has spurred discussion about the possibility of debt default, recession and even financial collapse. We don't expect any of these outcomes.

In early August, Standard & Poor's downgraded U.S. long-term debt from AAA to AA+, citing political risks and a rising debt burden. However, S&P's rating decision failed to distinguish between 1) the U.S. federal government's *ability* to service its debt and 2) its *willingness* to service its debt. A sovereign issuer of debt in its own currency, such as the U.S. government, always retains the *ability* to pay and service its debt.

It is important to differentiate between countries that are issuers of debt in their own currency (such as the U.S. and Japan) and those that issue debt in currencies that they do not control (such as the member states of the euro zone and a variety of emerging market economies that choose to borrow in foreign currencies). According to distinguished monetary theorist and economist Michael Woodford, the former's debt "is a promise only to deliver more of its own liabilities. (A Treasury bond is simply a promise to pay dollars at various future dates, but these dollars are simply additional government liabilities that happen to be non-interest earning.) There is thus no possible doubt about the government's technical ability to deliver what it has promised…"[1]

While the ability of the U.S. to pay its debt is without question, it is possible to argue that its willingness — which is contingent on self-imposed legal constraints (i.e., the debt ceiling) — has deteriorated of late or could deteriorate in the foreseeable future. It could even be plausibly maintained that higher public debt might under certain circumstances lead to inflation and currency depreciation. But these matters are entirely different from the federal government's operational ability to service its debt. Thus, the danger of the U.S. government failing to service its debt is quite remote.

From the macroeconomic point of view, some key questions today are whether the U.S. economy is headed to a replay of the financial crisis, a growth slump, a slowdown, a recession or even a collapse. A sharp decline in real GDP can be characterized as a collapse. Between second quarter 2008 and second quarter 2009, real GDP in the U.S. fell by 5%, from $13.31 trillion to $12.64 trillion. As of second quarter 2001, real GDP of $13.27 trillion remains slightly below the pre-crisis level. While the real GDP growth rate has been disappointing since the end of the financial crisis, the prospect of a collapse in the coming months is contained due to cyclical and structural conditions and polices.

Cyclically sensitive sectors — namely, housing and autos — are already weak and are unlikely to contract much more. In the years before the financial crisis, these two sectors amounted to nearly 8% of GDP; this figure now amounts to less than 5%. Household balance sheets have improved since the global financial crisis. Lower rates over a considerable period of time benefit net borrowers, such as households. Financial obligation ratios and debt service ratios have declined due to several factors, including lower rates, an increased personal saving rate, the adjustment of household balance sheets and a rise in mortgage defaults, delinquencies and bankruptcies, which has resulted in households reducing their debt serving. Net dissaving on the part of the government enables the domestic private sector and the rest of the world to increase their saving. The trade deficit is likely to remain narrow due to slower import growth, a decline in energy and commodity prices, and a trade-weighted dollar that has been weakening until recent months; a narrower trade deficit lifts real GDP growth. Meanwhile, a decline in commodity and energy prices — crude oil prices have declined markedly from their recent peaks in early 2Q11, resulting in noticeably lower gasoline prices — will check headline inflation and could lift household purchasing power. Of course, investor sentiment remains an overhang, as the unpleasant memories of the not-so-distant global financial crisis continue to color investor behavior.

Meanwhile, the accommodative policies that remain in place ought to prevent a collapse in output. At nearly 9% of GDP, the federal budget deficit supports aggregate demand. Monetary policy is exceptionally accommodative; the Fed is committed to keeping the fed funds target rate exceptionally low until mid-2013, implying that short-term rates are likely to remain low. And the Fed's asset purchase programs are designed to keep long-term interest rates and mortgage rates low. Moreover, the authorities are unlikely to allow major inter-connected financial institutions to fail at this time.

In spite of a weak economy, aggregate private sector nominal labor income, as measured by wage and salary disbursements, has risen. So, too, has real disposable income (albeit quiet slowly) and real net worth, which has supported growth in real personal consumption expenditures.

…but Growth Should Remain Mediocre

Though the U.S. economy has tepidly recovered and aggregate real disposable incomes have risen, most U.S. households have not benefited. A study of household income trends by Sentier Research showed that real median annual income declined more in the recovery period of June 2009 to June 2011 (-6.7%) than during the December 2007 to June 2009 recession (-3.2%). Over the full period between December 2007 and June 2011, real median annual household income is down nearly 10%, resulting in the serious deterioration of the quality of life for the typical U.S. household. Despite declining real annual household income, American shoppers are holding their ground. Nominal retail sales, after adjusting for autos, gasoline and building materials, are still rising on both a year-ago and a month-ago basis.

The U.S. economy should be able to avoid a recession, but growth will remain mediocre. ISM surveys of both manufacturing and non-manufacturing sectors show that the U.S. economy is still expanding but at a fairly subdued pace, a point confirmed by regional manufacturing surveys.

Job growth is likely to be slow. The U.S. economy has barely added any jobs since the beginning of the 21st century, and what little job growth there has been was entirely wiped out by the financial crisis. The number of people officially unemployed has risen from less than 8 million in late 2007 to 14 million as of mid-2011; this translates into an official unemployment rate a bit above 9%, which is likely to stay elevated. The U-6 unemployment rate — which takes into account persons marginally attached to the labor force, including those who are employed part time but are looking for full-time work — is even higher, above 16%. The employment-to-population ratio stands at its lowest level since 1990.

[1] Woodford, Michael (2001), "Fiscal Requirements for Price Stability," Princeton University Working Paper, October, http://www.columbia.edu/~mw2230/jmcb.pdf, cited in Tcherneva, Pavlina (2010), "Bernanke's Paradox," http://www.levyinstitute.org/pubs/wp_636.pdf

House prices shall continue to decline, possibly by more than 10% this year, due to poor demand and the overhang of excess inventories. The decline of house prices is widespread; the most recent Case-Shiller index release, which reflected July 2011, showed a year-over-year decline in 18 out of 20 metropolitan areas it tracks.

Fiscal restraint will act as a drag on economic growth, particularly toward the end of this decade. I believe the unwillingness of policymakers to embrace fiscal stimulus that is labor-intensive and that directly creates public sector jobs is a mistake. Meanwhile, in the midst of a liquidity trap, the scope of monetary policy — including large-scale asset purchases — in stimulating demand and long-term growth is limited. The private sector remains reluctant to commit to investment in fixed assets despite low nominal long-term interest rates. The ratios of monetary aggregates — such as M1, M2 and MZM — to the monetary base have declined severely since the global financial crisis, while the velocity of money based on these aggregates has waned. Commercial and industrial lending activity has resumed, but lending activity is still fairly refrained and credit conditions are tight.

Core inflation is contained, even though headline inflation has risen. Market-based measures of inflation expectations, such as Treasury inflation-protected securities (TIPS) inflation compensation, are well anchored. Growth in unit labor costs is restrained. A continued decline in commodity prices, particularly energy prices, could check headline inflation.

The ECB's Asset Purchase Program Could Help

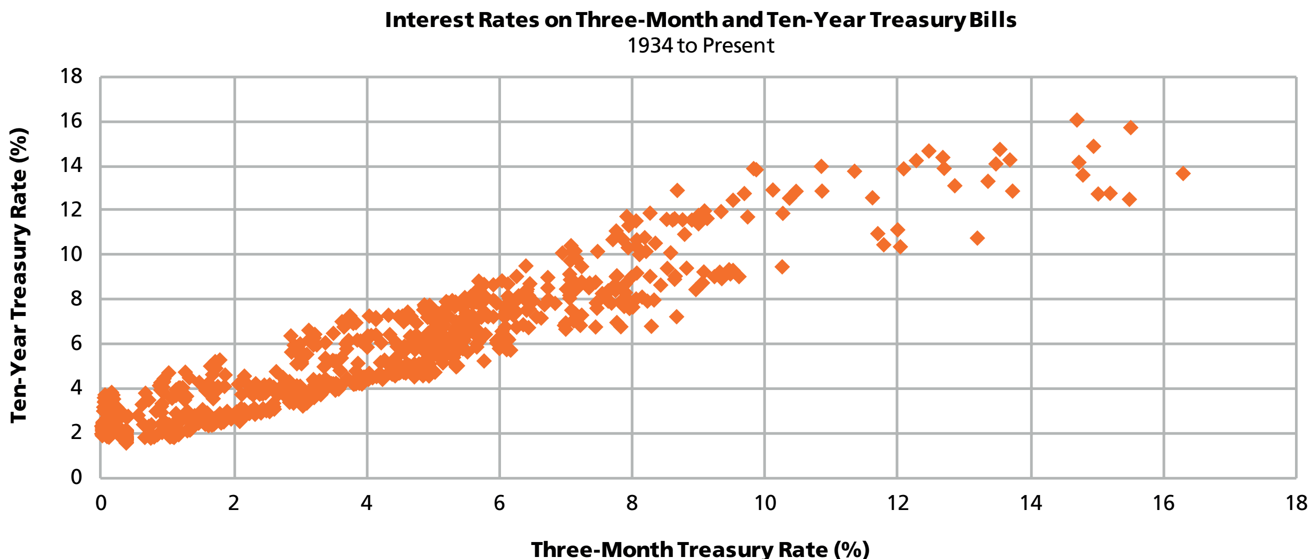
The debt and deficit crisis in the euro zone periphery continues to hamper the European financial system and global financial markets. As noted earlier, it is important to distinguish between countries that are issuers of debt in their own currency and those that lack monetary sovereignty over their debt; the PIIGS countries — Portugal, Ireland, Italy, Greece and Spain — fall into the latter category and are thus particularly susceptible to crises when debt gets out of hand. Given investor concerns that any one or more of these countries might default on their debt obligations, the periphery nations have seen their government bond yields, interest rate spreads to German bunds and credit default swap premiums all widen.

Slowing regional and global economies and rising unemployment rates in several PIIGS countries are also contributing to the vulnerability, which is shared throughout the currency bloc due to large holdings of PIIGS debt by European financial institutions, synchronized financial markets, global and euro zone financial flows, and trade linkages.

While policy mistakes could trigger a financial crisis, the ECB and euro zone authorities can and should act decisively to contain the issues currently plaguing the region. A credible program — which likely would include providing financial institutions with liquidity and the large-scale purchase of peripheral government bonds, and doing so rapidly[2] — could stabilize conditions and create the basis for institutional reforms that could foster a more prosperous and stable economic union.

[2] See Minsky, Hyman (1966 [1970]), "Financial Instability Revisited: The Economics of Disaster," http://fraser.stlouisfed.org/historicaldocs/dismech/download/59037/fininst_minsky.pdf

Figure 2. Long-Term Rates Stay Low When Short-Term Rates Are Low



Source: Reuters EcoWin

Figure 3. Declines in Short-Term Rates Imply that Long-Term Rates Will Not Rise

Source: Reuters EcoWin

Long-Term Rates to Stay Low

Long-term interest rates in the U.S. and other major advanced economies are likely to stay low, at least until mid-2012 if not later. The "extended period" of the low federal funds rate keeps getting extended by the FOMC, which is now committed to keeping the target rate in the range of 0–25 bps at least through mid-2013 based on its assessment of current economic conditions and prospects. Short-term rates are the import determinant of long-term rates — as shown in Figure 2, long-term rates stay low when short-term rates are low. The decline in short-term rates implies that long-term rates are unlikely to rise noticeably anytime soon (see Figure 3). Moreover, both short- and long-term rates generally tend to stay low when core inflation is low. With economic activity likely to be mediocre through at least the end of 2012, the global macro environment should be supportive of low long-term rates in the U.S. and most advanced countries.

Downside Risks to Economic Growth Have Increased

Risks to U.S. and global growth are tilted to downside and have increased of late. Risks could be exacerbated by protracted weakness in household financial conditions, which would lead to slower consumer spending; larger-than-expected near-term fiscal tightening, which would lower aggregate demand; financial and economic spillover from the euro zone's inability to contain the region's debt crisis; and a spike in crude oil prices in response to an escalation of political turmoil in the Middle East. Investors should be particularly mindful of policies designed to rapidly curb public expenditures in advanced economies with sovereign monetary regimes, as they can pose serious downside risks to sustaining a recovery that thus far has been unimpressive. ■

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