

FAREWELL TO THE GROWTH CYCLE?

Low inflation and high interest rates may prove that fears about a 1989 recession are misplaced

The current downtrend in world equity markets stems from worries about recession in 1989. Two features, the low level of inflation and the relatively high level of real interest rates over a long period, appear to prove that equity markets' fears are groundless.

The length of the current economic cycle and, paradoxically, the high level of real interest rates are no coincidence. High interest rate costs associated with rapid developments in technology have done much to remove one of the major swing factors, inventories, from the traditional economic cycle. Large inventories used to be a hedge against inflation, were cheap to finance with low real interest rates and were necessary to ensure continuous production in a less technological, more regimented working environment.

When a slowdown in demand occurred, companies stopped orders and slowly ran down their huge inventories. However, the damage had already been done, with the standstill in orders having

knock-on effects through the economy. The initial slowdown in demand quickly translated into a slowdown in production, which could not pick up until inventories had fallen to levels that restricted production.

Inventories have been actively reduced by management using computer storage methods. The process continues with the aping of Japanese just-in-time inventory control. This process has been aided by a reduction in traditional labour power.

At the same time, industrialised countries continue to change in structure, with service industries gradually replacing manufacturing. This again reduces the general level of inventories in the economy because services cannot be stored.

Smaller inventories mean that economies are much more resilient to downturns in demand. The recent slowdown in US demand after the October crash, which had little effect on US growth, is a good example of this new relationship. Further evidence is offered by Japan's

stable medium-term growth path. Because of a relatively quiescent labour force, high stock levels have been less of a necessity, thus the economy has avoided the damaging influence of volatile inventories.

The second factor suggesting that the current growth cycle will continue is the very low level of inflation worldwide. It is worth remembering that both recessions in the 1970s were the result of sharp monetary tightening after the two oil "shocks" to the system. Further tightening of monetary policy, outside of the US, is unnecessary in fighting this as yet unsighted "inflation genie".

An oil price trend towards \$10 a barrel now looks far more likely, with the price likely to remain below \$15 a barrel through to the mid-1990s. Inflation, therefore, is not a worry and monetary policy can easily be relaxed in the face of a more moderate growth path.

What are the benefits of this scenario in terms of asset allocation? Equity markets will continue to hold that the world economy is heading towards recession and this will be accentuated when growth rates slow from current levels. At that time, it will be sensible to maintain an underweight position in equities.

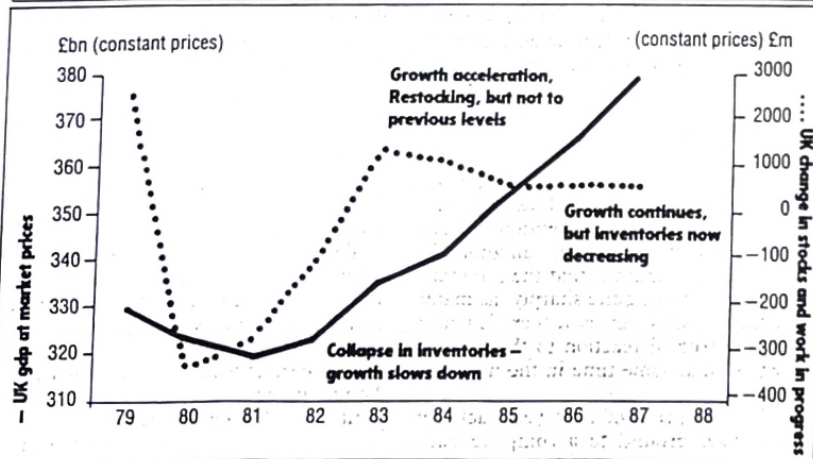
Bonds, however, should benefit greatly from a slower growth environment, especially if oil prices stay weak. With the US election out of the way, lower inflationary expectations should warrant a fall in yields worldwide. That period should also represent an opportune time to increase weightings in equities, as belief in the sustainability of the growth period becomes more widespread.

Although the growth cycle appears to have been extended by the reduced influence of inventories, other features quickly manifest themselves, ensuring the growth cycle is maintained. Most worrying is the level of unsecured debt that has accumulated in the US, whether it be corporate or consumer debt or the institutions dealing in debt, such as the savings and loans institutions. This is often a feature in long-growth periods when bad debt is able to accumulate in the absence of a "cleansing" recession.

The above analysis has studiously avoided the issue of government policy. A lax fiscal stance from the new US president could still result in the forced over-use of the monetary policy tool in the US, resulting in higher interest rates worldwide. A world recession on the back of debt default would then be a very real possibility.

Jonathan Harper
& Dr Gerard Lyons
SBCI Savory Milln

GDP GROWTH AND CHANGE IN STOCKS



The conclusion is that lower inventories give less scope for recession

CLOUDS ON HORIZON FOR PORTFOLIO INVESTORS

Monetary overkill may turn out to be the biggest risk to investors, once fears about inflation have subsided

The outlook for portfolio investment remains clouded and depends crucially on the policy responses adopted by the major nations. Despite the current worries about inflation, by the year-end, the major global worry will be that of sluggish growth.

In spite of the current strength of corporate profits and healthy demand, the expectation is that either growth and profits will slow of their own accord, or that anti-inflationary policies will depress activity. Equities thus remain depressed and, notwithstanding the anti-inflationary strategies, bond yields remain at high levels.

The paradox for financial markets is that, unless the tightening in monetary policies which has occurred in the major nations over the summer is reversed, recessionary fears are likely to re-emerge with a vengeance. But even if interest rates do fall, the global current account imbalances are likely to remain the dominant feature overhanging world financial markets. Thus, in spite of the healthy state of institutional cashflow and liquidity, financial markets are likely to remain jittery.

The realisation will soon dawn that inflation is not a major global problem.

First, oil prices are falling and are likely to weaken further as Opec supply continues to outstrip demand. Second, non-oil commodity prices are continuing to weaken. Third, unit labour cost growth, which is an indication of underlying inflationary pressures, is still low in the majority of industrialised economies.

With inflationary pressures easing, the biggest threat must be the prospect of a monetary overkill. Yet the current disinflationary environment allows substantial scope for policy easing. And such easing could be forthcoming by year-end, as economic growth begins to slow globally. Then, of course, the new US president will have been elected and there will be increased pressure on that country to tackle its budget deficit.

The extension of the growth cycle and, hence, continued support for world equity prices, will then be very much dependent on action from the new president. He must introduce fiscal measures to remove excess demand from the US economy. This would allow an easier monetary stance from the Fed, reducing the dollar's attractiveness and removing pressure for higher interest rates outside of the US. The possibility of

a monetary overkill taking place would thus be prevented.

Two risks emerge. First, if the fiscal measures are not forthcoming in the US, the Fed will be forced to raise interest rates to slow down US demand. Not only would this force the dollar to unsustainable levels, exacerbating the outlook for the US current account deficit, but it could force interest rates higher worldwide, increasing the risk of too sharp a slowdown in world growth.

There is, of course, the additional problem of over-indebtedness, both in the Third World and for the US corporate and consumer sector. These factors indicate that harsh monetary tightening runs the risk of a recession far deeper than investors currently fear.

Second, as the US economy pulled the world out of recession in the early 1980s and has acted as the locomotive for the world economy, any fiscal tightening there must be offset by fiscal easing elsewhere, notably in West Germany. If it is not, then the prospects of recession grow. Even so there is still likely to be a sting in the tail.

The global current account imbalances remain. Japan's and West Germany's surpluses show no signs of falling, despite recent appreciations in their currencies; while the US and the UK both have large deficits. These imbalances appear to be explained by structural features and will take time to unwind.

The usual self-correcting mechanism for sizeable deficits would aim for further currency adjustment, with the dollar and sterling both depreciating. But such currency depreciation could be delayed by policy changes and may not, even then, solve the imbalances.

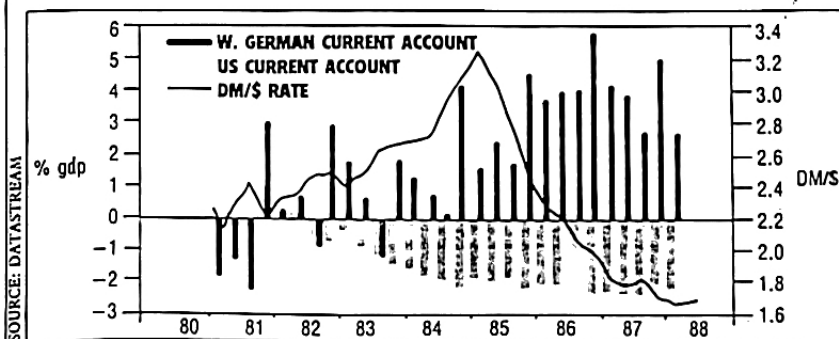
What is clearly needed is continued co-ordination in global economic policies. Not only must these policies be consistent, but they must also appear credible to financial markets. If such imbalances are set to remain there is a clear risk that matters will force the policy-makers' hands, pushing the dollar and sterling lower. So, after experiencing reasonable stability this year, currencies could move sharply in the period ahead.

In a global investment environment, the successful fund managers will not necessarily be those who invest in their home-currency base. But fund managers who invest in overseas markets should hedge against possible shifts in currency.

The clear message is: although there is the possibility of movement towards a better global environment, the risks are likely to remain high.

*Dr Gerard Lyons
and Jonathan Harper,
SBCI Savory Milln*

WEST GERMAN AND US DEFICIT MOVEMENTS



Current account imbalances remain despite substantial currency adjustments