US to lead growth back up

- US tech bust led to a global plunge in capex and trade
- Aggressive policy ease in the US is helping it to lead the way back up
- This will be reflected in trade, business and consumer confidence and investor risk appetite
- But US is set to return to the top of the G7 growth league
Corporate gloom vs. economists’ joy

- Striking contrast between rising optimism of economic forecasts and continuing corporate gloom.
- Consensus forecast for GDP in 2002 has risen to 2.7% from 0.9% in Jan…
- …while analysts’ estimates of profits continue to shrink.
- Greenspan is worried about the latter…
- …but suggested the conflict may be resolved in the next 2-4 months.

Markets face a “wall of worry”

- Bears are still worried that stock markets are overvalued…
- …and that plunging stock prices could trigger a panic about heavy debt loads…
- …and a drop in spending that could trigger deflation, debt deflation and systematic collapse.
- BUT
  - underestimates potential for cyclical recovery in profits
  - debts small in relation to wealth
  - low inflation gives scope for policymakers to avert this threat with low interest rates.
Protectionist threat exaggerated

- US steel tariffs have raised the threat of a global trade war
- Bush Administration's free trade instincts compromised by mid-term elections
- Immediate impact minimal, and wrangling within the WTO likely to be protracted...
- ...meanwhile, recovery in manufacturing sector will reduce protectionist pressure

US base case - 'V'-shaped at last

- GDP jumped 5.8% in Q2, boosted by an inventory swing and 3.7% rise in final demand
- Inventory contribution has further to run...
- ...But can final demand take up the running?
  - Despite expiry of auto deals, consumption is resilient
  - Even capital expenditure is bottoming out
  - Fed is in no great hurry to raise rates, and fiscal policy will stay loose
...consistent with the outlook for profits

- Fundamental backdrop for profits is improving
  - Volumes are recovering
  - Lower wage costs
  - Productivity is surging
- Despite lack of pricing power, margins are set to improve further
- Profit rise provides the cash flow for accelerated capex later in 2002

US consumers keep spending

- After 4Q01 surge, pullback in spending becoming evident...
- ...But has been smaller than expected
- Greenspan cautions against lack of "pert-up demand"
- Spending will be supported by
  - rising confidence
  - low inflation and interest rates
  - tax concessions
  - cashflow from earlier mortgage refinancing
  - signs that worst of labour shedding is over
Fed in no hurry to raise rates... yet

- Fed has managed down interest rate expectations
  - Caution on growth
  - Subdued inflation
  - Worried about profits, capex and the stock market

- ...but may tighten aggressively once it starts
  - If recovery confirmed, 'emergency cuts' will be reversed
  - Would help limit pressure on long-term yields

Japan - another cyclical upturn

- There are some early signs of a turning point, if financial meltdown can be avoided
- Inventories been run down aggressively, particularly in electrical machinery sector
- More inventory correction needed before production bottoms out...
- ...BUT cycle may trough in 2Q02
- Drop in business confidence and exports may be set to turn
The OECD Leading Indicator vs Industrial Production

- Eurozone activity has begun to pick up in response to better news from the US
- US remains the key to upswing
  - business confidence
  - consumer confidence
  - labour market
  - financial markets
- Domestic factors will also help
  - inventory adjustment
  - real wage rises
  - intra-regional demand
- Growth will underperform the US again in 2002
**Euro - 'hope springs eternal'**

- Is the bullish consensus finally about to be proved right?
- US equity market setback or terrorist threat could give the euro rally more impetus...
- ...BUT more likely, US recovery in H2 will place the euro on the defensive
- Domestic economic and political situation limits the euro's upside

**ECB decides to 'wait and see'**

- Next move in rates is clearly upwards
  - GDP back to potential this year
  - Upside risks to inflation
  - M3 growth still high
- ECB is in no rush - 4Q hike
  - Uncertainty over pace of upswing
  - Inflation reflects temporary factors
  - M3 growth already moderating
Latin currencies shrug off Argentina shock

- The dramatic flotation and depreciation of the Argentine peso and Venezuelan bolivar have obscured the resilience of other Latin currencies.
- In late September 2001, the Argentine contagion that had devastated the Real for a year dramatically lost effect.
- Shortly thereafter, the Chilean peso's eight-month collapse, linked partly to Argentina, ended.
- Unrelated to Argentina, the Mexican, Colombian and Peruvian currencies firmed gently as well.

Mexican peso - at a more sustainable level

- Recent MXN weakness was triggered by an unexpected monetary easing.
- Although the central bank claims not be targeting the currency, it may not be unhappy with the reaction.
- Earlier appreciation has eroded the competitiveness of Mexican exporters.
- Nevertheless, confirmation of robust US recovery should limit the MXN's downside.