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Floating through the ice age

Who wins and who loses as the market freezes over

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The ructions in the financial markets are deep enough and persistent enough to now require a re-think of our global economic and financial market forecasts. The carry trade is lost, liquidity has left the building and a painful de-leveraging process is underway.

Evaluating economic and financial market prospects in the midst of a crisis is far from straightforward. There are several scenarios that could unfold, each with a similar probability attached. This note presents our base case scenario, and some lesser but still probable scenarios on either side of our central case. As a base case, our view is as follows:

- The housing slump we have been expecting in the US economy will unfold; as this was our expectation, our growth forecast is unchanged at 1.9% in 2007 and 2.9% in 2008. Consumption is expected to remain below a 2% annual growth rate until mid-2009. Our real change in view is on interest rates, where we now expect the US Federal Reserve will cut interest rates at its September and possibly its October meeting.
- The European growth forecast is also unchanged, but our forecast had been below consensus until this week. However, we have also shifted our interest rate expectations by removing the ECB rate hike that we had pencilled in for September. The European housing market as a whole is not vulnerable to the US subprime fallout, but European financial institutions have been active buyers of the securitised mortgage assets that are rapidly devaluing.
- We have shaved slightly our Japan growth rate from 2.2% to 2.0% for this calendar year, not so much because of market turmoil as weak recent data. We have also moved the date for the next BOJ rate hike from September 2007 until March 2008, so that the BOJ target rate only reaches 1% by end-2008.
- Outside of the G7, the winners out of the present turmoil are likely to be the economies that are not dependent upon US liquidity, and that trade mainly with China. This includes most of East Asia. Countries that are more vulnerable to current conditions are those that have significant current account deficits, which are simply an expression of a negative savings rate that has required foreign funding for domestic investment. Significant countries in this camp include: Australia, New Zealand, India, South Africa and Turkey.
- Oil and base metal commodity prices have taken a hit from the turn in market sentiment and are expected to fall further in the coming year. In contrast, the underlying fundamentals are little changed for bulk commodities, with strong Chinese demand expected to underpin large price rises in 2008.

With the above representing our base case scenario, the risks are clearly now more weighted to the downside than the upside. The swing factor will be the actions of the US Federal Reserve in the coming weeks and months. If the Fed's actions over the past few weeks succeed in stabilising the markets – and particularly the US equity market – the risk that the Fed does not cut interest rates in September rises. In that case, the outlook for the US economy deteriorates, raising the risk of sharper asset price deflation and substantially slower global growth. Conversely, if the Fed cuts interest rates either more or sooner than we have envisioned, there is a chance of a return to stronger risk appetite and higher global growth.

Our Vision:

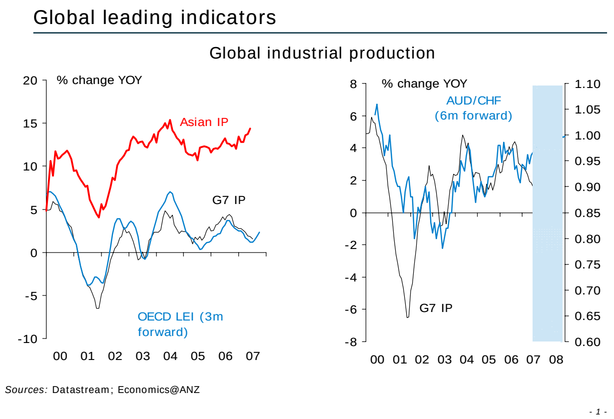
For Economics@ANZ to be the most respected, sought-after and commercially valued source of economics research and information on Australia, New Zealand, the Pacific and Asia.

World growth forecasts intact

We have kept our world GDP growth forecast intact at 4.9% in 2007 and 4.7% in 2008. This view is based on our expectation that G7 growth will remain at or above 1.5% per annum. Under this scenario, in our view, China can continue to expand at a robust pace given strong domestic demand. As long as China grows at more than 9% per annum over the next 18 months, which we view as highly probable, it is difficult for global growth to slow to below the historic trend level of 3.6% per annum.

Within the global growth forecast, we expect US economic growth to slow to around 2% from 2.9% in 2006, and for growth in the European Union to slow to 2.6% in 2007 and 2.2% in 2008 from 2.8% last year. These forecasts are in fact unchanged, which may seem counterintuitive. However, prior to the events of August, we considered the risk to our forecast as being firmly to the upside, as leading indicators showed global growth to be accelerating. In addition, our growth forecasts had been below consensus for the past six months. As intimated by the below chart at right, a return of risk appetite could go some way to restoring a more bullish global growth view. Where we have shaved growth slightly is in Japan, due to recent weak data.

Leading indicators stay positive



Our relative sanguine view of global growth in the coming months is also referenced to the last global slowdown of 2001 and 2002. In 2001, G7 annual growth slowed to below 1.0% from mid-2001 until mid-2002, bottoming at just 0.2% annual growth in Q4 2001. Over this period, global growth slowed to 2.5-3.0%. We do not believe the depth of this slowdown will be repeated, as there are several factors that make this period different. First, at this stage we do not expect G7 to weaken to sub-1%, as this would require a synchronised near-recession across the US, EU and Japan. Second, China's growth rate has accelerated and is increasingly dependent upon domestic rather than external demand. As China now contributes 15% of global GDP a PPP basis – as against 11% in 2001 – it is difficult for global growth to fall dramatically so long as China's growth rate is over 9% per annum. Finally, China's growth has put continued upward pressure on commodity prices. While these may ease from recent historic highs, relatively stronger commodity prices will be an important support for the economies of South America and the Middle East, as well as Australia and New Zealand.

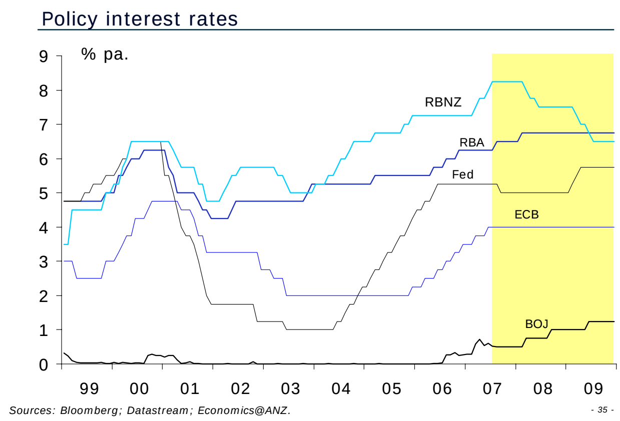
Current world growth forecasts

% pa	2007f	2008f	2009f	2010f
US	1.9	2.9	3.3	3.3
Japan	2.0	1.5	2.1	1.9
W. Europe	2.6	2.2	2.1	2.1
G7	2.1	2.4	2.7	2.6
China	11.3	10.2	9.0	8.7
East Asia (ex Japan & China)	5.4	5.2	4.9	5.0
World	4.9	4.7	4.5	4.4

Source: Economics@ANZ

The real change in our G7 forecasts is in the interest rate track. We now expect the US Federal Reserve will cut its target rate by 25 bps at its September meeting. Another cut at the October meeting is not in our forecast, but remains a possibility. Similarly, we now have the ECB on hold and have delayed the next BOJ rate hike until the first quarter of 2008. The change in interest rate view is an important plank of support for our unchanged growth forecasts; if the ECB moves rates higher in September or the US Federal Reserve fails to cut rates, we would most probably downgrade our global growth forecasts. Note that ANZ now does not expect the RBA to raise interest rates before 2008, and has moved forward an expected rate cut by the RBNZ from 2009 to early 2008.

Revised interest rate track



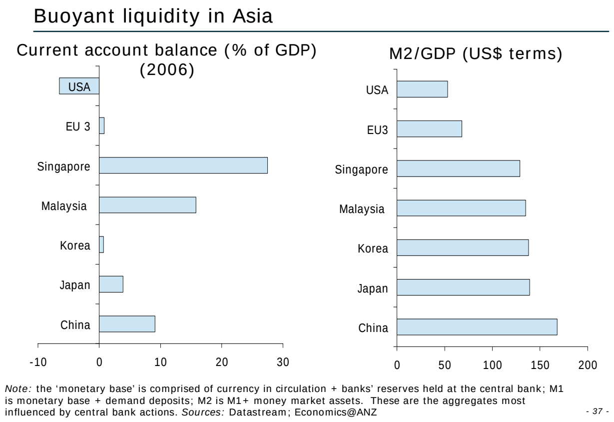
Asia floats on

So long as the G7 real GDP growth rate remains above 1.0-1.5%, we believe that growth in Asia will remain relatively strong. Trend growth for East Asia ex-Japan is 7.8%; the region achieved 9.0% per annum growth last year. Our forecast is for 8.5% regional growth this year and 7.6% next year, led by regional giant China.

There are clear reasons for our optimism about Asia, and these have to do with the channels through which problems in the US financial markets would find their way to the region. The first channel is falling G7 liquidity, which could potentially slow investment flows into the region. The second is real demand, as demand for exports to the US and Europe may slow. The third is through general market turmoil that would cause Asian equity markets to decline.

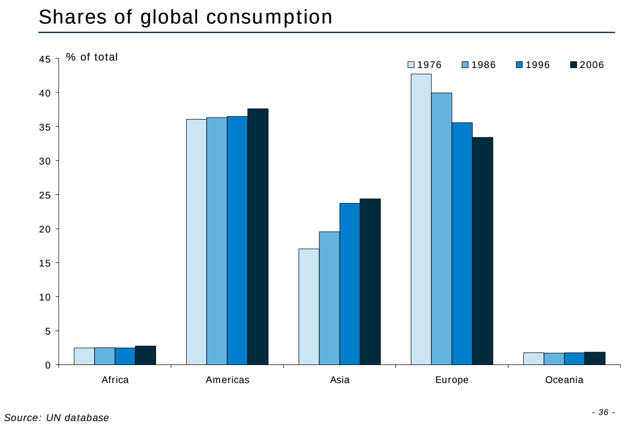
In our view, the first channel is of virtually no concern in East Asia. The region's current account surplus means that it is a net exporter of savings to other countries. While a drying up of liquidity in the US may cause some balance sheet shifts, funding should not be an issue for Asian banks. The Asian liquidity story is well known and documented, but just as reminder the below charts show current account balances and the size of the monetary base as share of GDP for major Asian economies. Unlike the late 1990s, when Asia featured current account deficits, liquidity is not an issue in Asia.

Strong liquidity in Asia



The second channel of demand for exports is a risk, but far less so than at any time in the past. The United States and Europe combined now account for only 30% of Asian exports in total; roughly half of all exports are inter-regional. While many argue that this is due to re-exports to the US – so that US demand is more important than may appear at first glance – the fact is that Asian domestic demand is a substantial share of global consumption.

Domestic demand in Asia is robust



Since domestic demand plays an increasingly important role in Asian growth, the final important channel is around consumer confidence. From an external point of view, this could most easily be affected by a falling stock market. At the same time, it is important to realise that the stock market is small relative to the economies in the region, with a few notable exceptions.

Financial stock relatively small in most Asian economies

Moreover, Asian governments can support economic growth with various policy options. Interest rates can easily be cut by central banks, especially in SE Asia. With public sector debt at decade-low levels in many countries, deficit spending is another option to support growth. Finally, currencies will weaken in a risk averse environment, thereby lending support to exports and demand for domestic goods.

Asia FX forecasts revised

We have revised our FX forecast for Asia to reflect a milder appreciation against the USD than we had had previously for most economies (except for the Thai baht and the Vietnamese dong). Short-term local currency weakness is still expected given increased volatility in the financial system. Nevertheless, we expect sound domestic economic fundamentals to prevent a substantial depreciation in Asian currencies.

Revised Asian FX forecasts

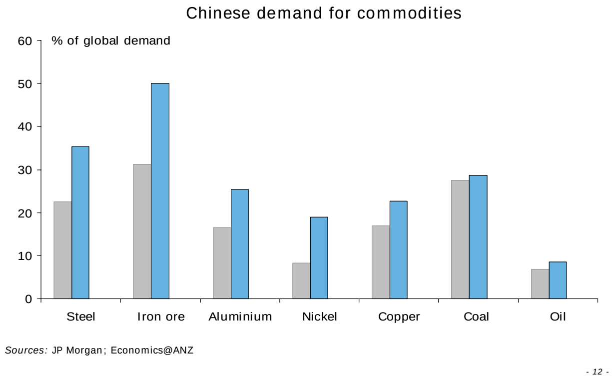
	Sep 07	Dec 07	Jun 08
USD/JPY	117	118	120
USD/CNY	7.50	7.397	7.22
USD/KRW	940	935	928
USD/TWD	32.87	32.5	32
USD/HKD	7.8	7.81	7.81
USD/IDR	9,200	9,000	8,850
USD/MYR	3.49	3.45	3.43
USD/PHP	46	45.5	46
USD/SGD	1.51	1.50	1.49
USD/THB	34	34.5	33.5
USD/VND	16,200	16,220	16,282

Source: Economics@ANZ

Commodity prices take a hit

Given our relatively sanguine view of global growth, it is no surprise that we also remain relatively optimistic on resource commodity prices. The engine of these markets remains domestic demand in China which, as we have already outlined, is not expected to experience any material slowdown from recent events. This source of demand is particularly important for bulk commodity prices and as such, our outlook for strong price gains in iron ore and coal next contract year, remain intact.

China's role in commodity markets



In contrast, slower industrial production growth across the G3 confirms that base metal prices have now peaked. Given the increasing role of investors in these markets, it is no surprise that metal prices have fallen sharply in the last few weeks. Despite some 'relief-rally' in markets in recent days, we expect these prices will continue to fall in the coming months. Nevertheless, continued strong demand in the developing world, across Asia, Latin America and emerging Europe, should ensure that these price falls, on aggregate, remain modest (see table below). Across the base metals, we remain most optimistic over the outlook for copper given continued tight supply conditions in this market.

Where we have made a change is in our oil price forecasts. After hitting record highs above US$79/bbl in late July, the negative sentiment in global markets saw oil prices drop sharply to US$70/bbl. In recent days this fall has been extended on market specific events with an unexpected rise in US petroleum stocks prompting prices to fall further to US$69/bbl. In contrast to metals and bulks, the fate of the US, and in particular the US consumer, remains the key demand driver for oil markets. While we have not changed our forecasts for the US economy, the balance of risks has deteriorated. This has prompted us to downgrade our view on oil which we now expect to fall further to US$68 by end-2007. Apart from US economic conditions, weather and OPEC remain the key risks to this outlook.

Commodity price forecasts

	Sep 07	Dec 07	Jun 08
Aluminium - US$/t	2,540	2,560	2,510
Copper - US$/t	7,500	6,940	7,050
Nickel - US$/t	3,310	3,280	3,200
Zinc - US$/t	3,310	3,280	3,200
Lead - US$/t	2,870	2,470	2,200
Gold – US$/oz	675	690	680
Oil – US$/bbl	69.0	68.0	68.0
Thermal coal – US$/t	55.6	55.6	65.0
Hard coking coal – US$/t	85.0	85.0	110.0
Iron ore fines – US$/dltu	81.7	81.7	98.1

Source: Economics@ANZ

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