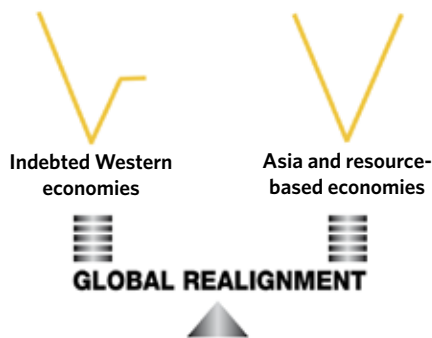




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What shape recovery? Global bond and currencies

The debate rumbles on about what type of economic recovery is likely to occur. Here we suggest that one size (shape) does not fit all.

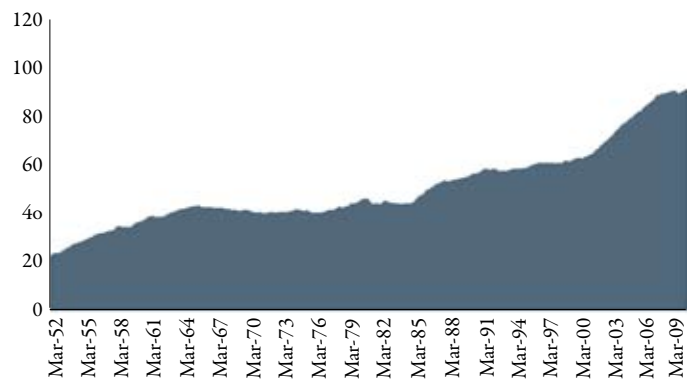


Market forecasters are using different letters of the alphabet and symbols to describe their forecasts for economic growth around the world. The shape of the recovery should dictate the timing of authorities' policy 'exit strategies'. However, one size (shape) does not fit all. Those economies that are still saddled with high debt levels (both government and private) will need to 'exit' from policies in a different way from those countries that have little debt 'overhang' and monetary policy that is too loose. Asia looks set to enjoy a 'V'-shaped recovery, while the West could be heading for a saxophone- or backwards-square-root-shaped recovery. In other words, there is likely to be a 'decoupling' of some economies' fortunes from those of others.

In the U.S., the growth in private-sector debt during the credit 'boom' times never ceases to amaze us; household debt rose dramatically from 1990 as a proportion of GDP (see chart below). The concept of 'equity withdrawal' was probably the most misleading part of the whole process. Equity withdrawal sounded like a windfall, but it equated in fact to an increase in debt which sustained the consumer boom for several years. It is old news, but the growth of household debt during those boom times will take a long time to be reversed and, while that reversal occurs, the U.S. consumer is likely to remain very subdued for several years.

The knock-on effect of this debt build-up was also felt in the public sector and in the banking system; it remains the principal reason for the scale of toxic assets still sitting with Western governments and banks. The healing process has already started, but the debt overhang continues to dampen new lending and, in response to it, governments will have to focus on fiscal exit plans rather than on monetary tightening plans. The price for the home-equity binge will almost certainly be paid in fewer government services and higher taxes.

U.S. HOUSEHOLD DEBT/GDP



Source: Bloomberg

Contrast the sombre outlook for the West with the more optimistic outlook coming out of Australia this week. Resource-rich countries such as Australia entered the financial crisis with a much better fiscal position and a less leveraged economy than many of their Western counterparts. Exposure to the right export markets also helped. In 2007, Australia's largest export markets were Japan, China, the United States, the Republic of Korea and New Zealand.

This recession is unlike others as it has not led to a sustained weakening of commodity prices. The unwinding of a debt-led consumer boom has been offset by the continued industrialization of China after only a brief pause (and the

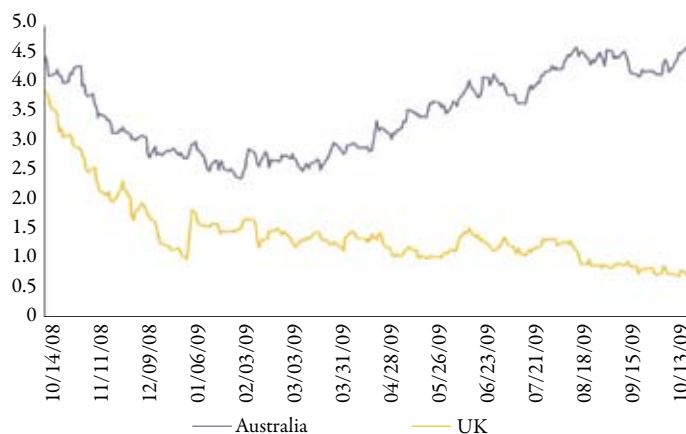
corresponding transfer of wealth from the resource-poor to the resource-rich).

One of our more dominant themes over the past two years has been *all change*, which explores the effects of deleveraging in the Western economies and highlights the likelihood that, owing to the subdued nature of the developed-world consumer, any recovery is likely to be anemic. Another theme that helps us understand the different shape of recovery in Asia compared with the West is our *global realignment* theme. In response to the late 1990s Asian crisis, central banks in Asia built substantial dollar reserves as their trade surpluses grew. The growth in global official reserves has exploded in the last decade principally as a result of dollar accumulation by those Asian central banks. This has determined our currency approach during the last ten months. We have focused on 'resource-rich' countries, but also on 'reserve-rich' nations.

The outlook for bonds is becoming clearer, but at the same time it is becoming more diverse. Differences in the UK and Australian bond markets over the last six months, for example, illustrate how the world's economies are 'decoupling'. The Bank of England has reminded the markets how unstable the UK economy is and the Australian central bank has started to tighten monetary policy in the face of stronger growth. The UK recovery should be 'saxophone'-shaped (and reliant upon low interest rates), while Australia, which should benefit significantly from growth in Asia, is likely to enjoy a 'V'-shaped recovery.

For the time being, the Australian experience is not the blueprint for the UK, the U.S., or even for European bond markets. In the U.S. and the UK, the emphasis has turned well and truly towards tackling fiscal deficits (which is likely to take some time). The bond market in the UK remains attractive, being supported by low official rates, low inflation and, lately, by talk about fiscal austerity.

AUSTRALIAN AND UK TWO-YEAR GOVERNMENT YIELDS OVER THE LAST 12 MONTHS



Source: Bloomberg
Past performance is not a guide to future performance.

Conclusion: The varying fiscal and monetary 'exit strategies' from the financial crisis are likely to lead to different bond and currency market responses. Bond markets in countries that have to tackle large-scale fiscal challenges are likely to offer better value than those where rate rises are key to authorities' exit strategies. The outlook for currencies is the opposite.

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