US economy is on the mend: now it’s Europe’s turn

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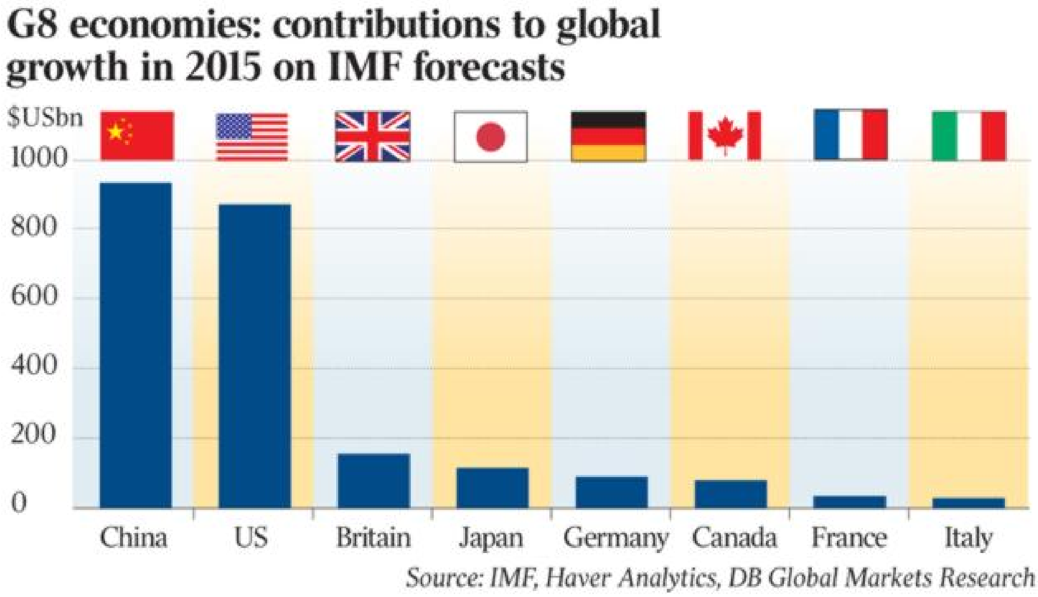

G8 economies. *Source:* TheAustralian

IN coming months, the words divergent and different are likely to be in heavy use in investment reports. Growth rates in the major economies are diverging. And differences in monetary policy across the big countries are widening.

The good news is the US economy is on the mend — indeed, it’s edging closer to a self-sustaining cycle of employment growth, rising total incomes, improving confidence and increasing spending by households and businesses.

The program of bond buying by the Federal Reserve ended smoothly; financial conditions remain accommodating.

Households and businesses have cut back on debt. Retail prices for energy have dropped by more in the US (because of low taxes and shale gas) than elsewhere. Corporate profits are high and rising. Inflation is negligible but modest inflation could soon re-emerge.

The major risks to the US economy and investment markets would be a worsening in global geopolitical concerns and — shades of 1994 — a sharp and excessive increase in bond yields as investors revise expectations for growth and inflation.

The recent cyclical slowing in the Chinese economy mainly reflects earlier moves to contain property speculation. The selective relaxation of monetary policy since early this year improves prospects China can avoid the much-predicted hard landing, and chalk up growth of 7 per cent this year and 6 per cent next year. However, the risks and uncertainties in China's economic outlook substantially exceed those for the US.

In contrast, the eurozone is close to slipping into its third recession in six years (brought on, in turn, by the global financial crisis, sovereign-debt problems, and Europe's lack of decisive action to create liquidity and recapitalise banks). When the more ambitious program of quantitative easing by the European Central Bank takes effect, Europe should be better placed to lift itself out of the deflation many investors have been anticipating. Nonetheless, low growth and high levels of unemployment seem likely to continue in the eurozone.

Japan's further moves to counter the nation's "deflationary mindset" and restore growth have stunned investment markets. The target for adding to base money is to be raised (to the equivalent of $US5000 a year for every person in Japan, or well above the US quantitative easing which peaked at $US3000 a person a year). And the national pension fund is to double its allocation to equities to 50 per cent and reduce the allocation to bonds from 60 per cent to 35 per cent.

The risks — for Japan and globally — are high and effects are uncertain.

My guess is that, for the next year or two, Japan will achieve modest growth, the yen will fall further and inflation will come in a bit above zero — but, later on, Japan will face the big risk of high inflation.

Should the major economies track along the sorts of diverging courses I've outlined, the broad implications for investors would be these:

● For some time yet, liquidity generation (but sourced from Japan and the eurozone), low cash rates and the search for yield will remain powerful influences on global investment markets.

● Even then, bond yields seem likely to move somewhat higher, as mild inflation re-emerges in the US and deflation fears subside in Europe, Japan and China.

● US shares should generally give a positive lead to sharemarkets in other countries including Australia — but with US shares outperforming most other markets and with all share markets experiencing bouts of severe volatility as bond yields rise or because sharemarket valuations become too stretched.

● The US and China will be the dominant contributors to global growth. While the risks in the economic outlook in China are much greater than those facing the US economy, investor sentiment towards China's economy seems to have turned too negative.

● The US dollar is likely to strengthen against other currencies, including our dollar.

Don Stammer chairs QV Equities, is a director of IPE, and is an adviser to the Third Link Growth Fund, Altius Asset Management, Philo Capital and Centric Wealth. The views are his alone.