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Don't discount a V-shaped recovery

There is little need to remind investors of the glum economic outlook maintained by market consensus. The financial media is also tripping over each other in pronouncing gloomy economic news. It is no wonder the recent stock-market advance is being viewed as a bear-market rally. A recent Citywire survey shows 87% of 174 discretionary wealth managers demonstrate resounding scepticism about the prospect of a sustained rally in equity markets.

While one would easily find company in forecasting a weak recovery, reviewing past recessions shows that a prolonged and weak economic recovery is not the norm. Instead of the L- or U-shaped recovery as suggested by many, a V-shaped recovery is quite possible for the US economy, hence positive for the global economy. This would have important implications for investors and asset allocators.

A reason many believe any recovery will be weak is the financial shock that the economy experienced. The freezing-up of credit markets last September sent the global economy into cardiac arrest as financial transactions came to a halt. Not fully recovered, frail credit markets are seen as a drag on future economic growth.

Here is where I believe we can draw some lessons from the 1974 oil-shock-induced recession. The recession of 1974 was caused by Opec's oil embargo in October 1973, whereas the recession of 2008 started with the subprime crisis and was exacerbated by the bankruptcy of Lehman Brothers. Opec's embargo drove oil prices up four times to US\$12. In 2008, the cost of private-sector credit, as measured by the TED spread (gap between three-month London interbank market and the three-month US Treasury bill rate), rose to 400 basis points from 50 basis points. There was a shortage of oil in the US in 1974, whereas borrowers faced a scarcity of credit in 2008. Both energy and credit are key inputs to economic activity.



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When there is a sudden loss of supply in either, the decline in economic activity can be quite dramatic, as we have seen.

However, the key lesson of the 1974 recession is that despite the sharp and permanent rise in oil prices (which continued to rise to US\$40 by 1980), the US economy managed to bounce back in a V-shaped fashion. Industrial production fell off a cliff in late 1974 but managed a V-shaped recovery by mid-1975. Consumers and businesses, with the help of fiscal and monetary stimulus, managed to adjust to the oil shock and stage a recovery by April 1975. Similarly, with the record-breaking fiscal and monetary stimulus, today's consumers and businesses stand a good chance of adapting to the new environment of higher credit cost.

Proponents of the L- or U-shaped recovery point to the Japanese experience. The bursting of the Japanese credit and housing bubble in 1990 led to more than a decade of weak economic growth and a stock market that has gone nowhere but south.

But there are marked differences between Japan then and the US. For starters, the US policy response to the current crisis has been far swifter than the Japanese. The US Federal Reserve took 16 months to drop rates close to zero compared with nine years for the Bank of Japan. Injecting public money to recapitalise banks started within

a year in the US, while it took Japan eight years to do so. Finally, losses in US banks are being recognised much faster than in Japan, which allows for a faster recovery. Therefore, the comparison made with Japan's lost decade is rather weak.

It is also common to overlay the current economic outlook onto the Great Depression experience. However, the differences between the current crisis and the Great Depression are enough to convince me that we are unlikely to slip into such a scenario. One, the lack of deposit insurance then led to bank runs and a collapse in the banking system. Now, we have the Federal Deposit Insurance Corp, which provides deposit insurance of up to US\$250,000 (\$377,000) per depositor. Two, rising unemployment led to a vicious cycle of declining consumption, as there was no unemployment insurance. Today, unemployment benefits provide some solace to those out of work and acts as a countercyclical stabiliser. Three, monetary policy was tightened in 1930, whereas today, it is being loosened aggressively. Four, governments today have so far resisted protectionist measures. In the 1930s, these factors led to a collapse in global trade. All this suggests that a replay of the 1930s and a prolonged period of subpar growth are unlikely.

If a V-shaped recovery materialises, the implication for asset allocators is important. A stronger economic recovery is likely to drive equities higher, possibly prolonging the current rally. This year could turn out to be a year of strong gains. If growth returns, Asian equities and commodities should do well. Already, markets are starting to accept this scenario. The MSCI Asia ex-Japan made a low in October 2008 and has been making higher highs and higher lows. It is still not too late to be bullish, given that we are still at the early stage of a recovery. ■

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