New Minerva Report

The Shape of the Slowdown

It is universally accepted that the US economy has experienced a sharp slowdown. The great debate is now on as to what happens next! The majority of economists have dismissed an outright recession. By that they mean two consecutive quarters of negative economic growth. The consensus from economists is that the US economy will grow by 1.6% in 2001, followed by a rise of 3.4% in 2002. On the face of it, those sort of forecasts look fairly benign. The question that the stockmarket is asking itself is whether the economy is going to produce a 'V' shaped slowdown, or a 'U' shaped slowdown. In the last few weeks, the consensus has shifted away from the 'V', towards 'U'. As we mentioned last month, one or two have been asking if it will be 'L' shaped, like the one Japan has experienced over the past 12 years.

How the economy evolves is of vital importance to us as investors. A 'V' shaped economic recovery will produce the same shaped recovery in the stockmarket. A 'U' will be a different story. A lot will depend on how broad the base of the 'U' is, and also how far in advance the market anticipates the upward leg. Remember that the stockmarket acts like a barometer on the economy. It can predict changes in the economy at least six months in advance. This was seen last year, when the stockmarket fell before any slowdown in the economy was being experienced. It is also why often in the past, we have seen the stockmarket soaring upwards at the same time as mass redundancies are being announced on the television, and the economy seems to be at its worst. However, we believe that the economic shape will be a 'W'.

You might think that we are playing with words, or rather letters, here. But it is vital to understand the dynamics of the economic potential, if we are to gain an insight on share price moves now. To have a 'V' shaped move, we would expect the reduced interest rates to be sufficient to stimulate the economy. The consumer and the corporate spenders will be back into the spending habit in no time, and all will be well. But this slowdown is different from those we have seen in the past 50 years. All other slowdowns/recessions have been policy induced. The economy gains a head of steam, inflationary signs start to emerge, and governments take action to slow the economy by raising interest rates. This causes the economy to move into recession. Then the whole cycle starts again.

This slowdown has not been created by higher interest rates reacting to higher inflation. This slowdown has its routes in an investment boom. These are old fashioned slowdowns, not seen for decades in the West. Basically, you start with investment picking up, and historically this would have been into factories. The investment into these induces a virtuous cycle, with investment creating more investment. The profitability of companies increases, as more capacity is created, and so on, until the profits growth starts to falter as competition increases because of all the new factories. The excess borrowing taken out to finance the new factories starts to look poor and expensive. With a large gearing up of production, and falling prices, a retrenchment becomes automatic. It all depends on the nature of the over capacity, and how the authorities react, as to the outcome of the correction. That correction will first be seen in the stockmarket, which is ahead of the economy.

The Negatives

A worst case scenario has been demonstrated by Japan. Their collapse in the past 12 years is a classic investment boom mis-handled. Firstly, their markets are inefficient. Their markets have been rigged and manipulated, and so many companies and banks held shares in each other. Also their markets were not fully open to the outside world. Secondly, their investment was into factories and tangible assets. These take many years to write down. Thirdly, the bureaucrats and politicians who managed the economy failed to respond correctly, and even 12 years later are still disagreeing on the appropriate response. We will come back to Japan later.

As we have said before, in the US the biggest negative is the size of indebtedness, in both the private and the corporate sector. This is best demonstrated by the Trade Balance, which is negative to the tune of $445bn. The rest of the world is financing this. The US has a negative savings ratio.

The Positives

Unlike Japan, the US has a very active Central Bank and chairman. Greenspan has already sanctioned three cuts in interest rates, totalling 1.5% . That takes rates below the level

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seen before the 1998 crisis. The investment boom in the US has been in the technology sector, which includes telecommunications. Unlike factories, investment in IT is written off over a three year period. There are fears that some companies' products will turn from: "we don't need to buy this at the moment!" to "why would we ever want that?". To many shares, this is a very real problem. However, in IT there will always be companies with "we must have" products, even if investment is postponed for a year. If you look at the NASDAQ index, you can clearly see the similarities with the collapse of Japanese shares in the last decade, and the collapse of US shares in 1929/30. These were both caused by investment booms.

Why a 'W'?

We think the economy will show a 'W' shaped recovery because many will not have understood what is happening to the economy. Initially, the stockmarket will respond as if a 'V' shaped recovery will be in place. This will restore confidence to the consumer, and to corporate decision makers. The reality will then set in that the economy will not suddenly get back onto a growth trend above 3%, for maybe two or three years. The stockmarket will retrace its rise, confidence will fall with it, and the slowdown will be with us again. However, the second 'V' of the 'W' will be at least six months away, and could even be later next year. In the meantime, the lows of the