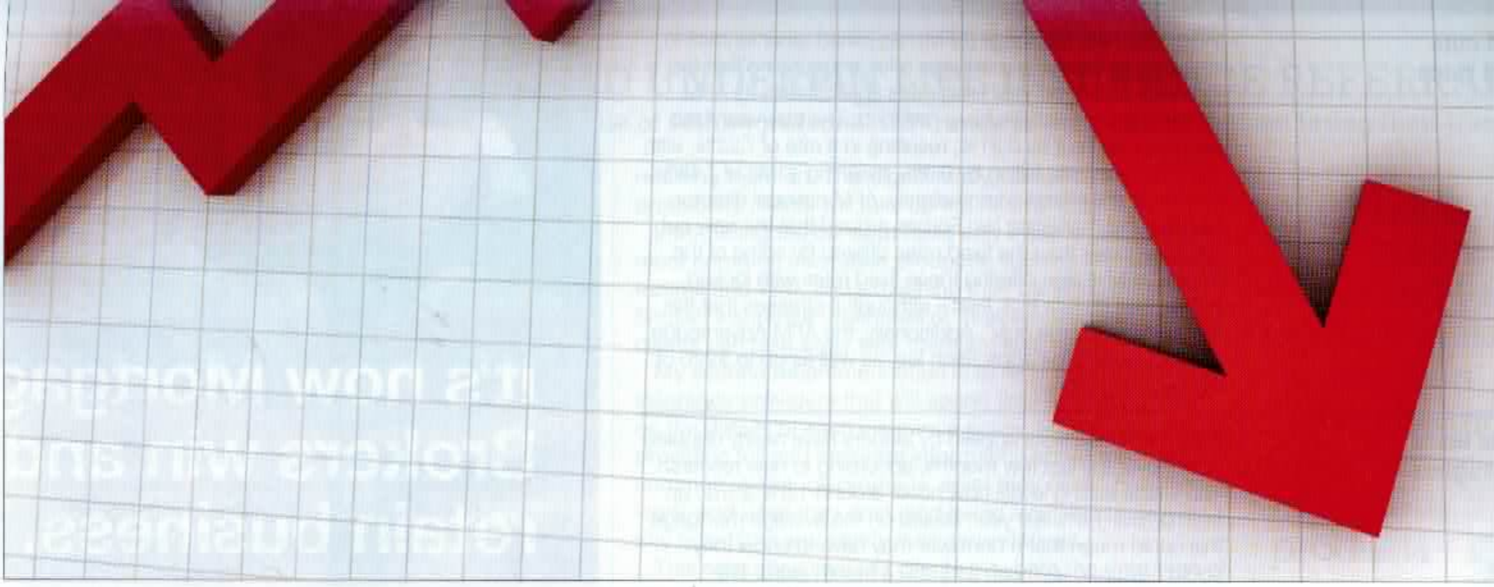

Are we set for a double dip

▶ AMP chief economist *Shane Oliver* looks at the stock market and leading indicators to see if the economy is heading for a double dip recession

Since April it seems the worry list for investors has expanded dramatically. Concerns about Europe, a hard landing in China, tougher bank regulations, a US housing sector relapse, tensions in Korea, the Middle East and Thailand, the oil spill in the Gulf of Mexico and the proposed Australian resources tax are all weighing on investors.

Signs the global recovery may soon pass through its fastest phase and is losing momentum have also led to concerns that we will soon see the dreaded "double dip" in global economic activity. But how worrying is the emerging loss of momentum in global growth – and what does it mean?

Leading indicators losing momentum

Signs of a possible top are evident in a range of leading economic indicators:

- The three-month rate of change in the OECD's leading indicators of economic activity for both OECD countries and for Brazil, Russia, India and China appear to have peaked
- Business conditions indicators in the US, Europe, Japan and China are showing signs of topping
- Even in Australia our leading indicator has rolled over reflecting, in part, weakness in business and consumer confidence and falls in building approvals

Signs of a topping in growth momentum have arguably added to market jitters over the last two months.

Hard versus soft landing?

However, what matters is not the peak in growth momentum, but whether the world settles into more sustainable growth or slides back into recession. While growth indicators may be losing some momentum, this is not necessarily a major concern.

First, some loss of momentum was inevitable. Most growth indicators had reached extreme highs and if they continued to accelerate it would have been consistent with a boom/bust scenario.

Rather, it is perfectly normal for growth to bounce strongly coming out of a recession or steep downturn, as stimulus measures take hold and production is ramped up to meet better-than-expected demand, and to then settle down into a pace more consistent with steady expansion.

This is particularly the case in China where growth became too strong early this year, prompting authorities to move towards slowing it down. This is now happening, suggesting the measures to bring the Chinese economy back under control are working a further aggressive tightening is unlikely. In turn th adds to confidence that China's growth will settle around 9–10%, rather than have the hard landing many fear.

Some moderation was also desirable in Australia. Moreover, some of the recent fallback in leading indicators for Australia is owed to uncertainty generated by the proposed resources tax.

However, with interest rates likely to stay on hold a while around long-term average levels, compromi over the resources tax looking likely and tax cuts a employment growth boosting household income, the growth outlook in Australia is likely to remain reasonable.

Second, fears of a double dip back into recession a common after all major recessions but the reality is double dips are unusual. If a double dip is defined a fallback into recession within two years, then the o US double dip in the last 85 years was in the early 1980s. The dip back into recession or depressi the late 1930s in the US doesn't really count, as it followed several years of growth in 1934–36.

Third, the biggest threat is premature policy tightening. This, via then-US Federal Reserve chairman Paul Volcker's move to squeeze out inflati is what drove the US back into recession in 1982 af brief recovery in 1981. There is certainly a very hig risk of this in Europe with Europe-wide fiscal tightening set to knock 1 to 1.5 percentage points o growth over the next few years. Against this thoug Germany is holding up well, helped by a lower euro

In addition, the euro-zone economies have contrib very little to global growth anyway over the last sev years. The US economy is muddling along reasonab well, helped by a stronger jobs market with absolut no sign of premature tightening by either the Feder Reserve or the US Government. Japan, Asia and Br are all surprising on the upside.

Market jitters

Growth cycle transitions usually result in tougher periods for growth assets like shares and commodit A good example was seen in 2004 when, after a stro rally from the tech-wreck lows seen in March 2003 early 2004, major share markets had six to nine mo of weakness as momentum in global leading economic indicators peaked and China and the US moved towards tightening. In fact, Asia (ex-Japan) shares had a 20% correction in April–May 2004 on worries that global monetary tightening would be negative for emerging markets.

Similarly, the move to higher US interest rates and concerns about the outlook for growth in Asia on the back of Chinese tightening triggered a correction in metal prices and the Australian dollar into May–June 2004. Despite US and Chinese monetary tightening causing corrections in growth-oriented investment markets that year, the broad trend in global shares, Asian shares, commodities, resources stocks and the Australian dollar remained up. Global and Chinese economic growth remained solid and fears of a hard landing dissipated.

So far, financial markets this year seem to be tracing out something like the 2004 experience – albeit with a bit more volatility reflecting greater-than-normal investor sensitivity this time around, given the well-known issues with high public and private debt levels in developed countries. More broadly, it's often the case that the second 12 months after a bear market ends will see more constrained and volatile gains in shares.

As shown in the table to the right, the average gain in Australian shares in the first 12 months after a bear market ends is 28%, whereas the average gain in the second 12 months is just 6%.

Similarly, the average gain in US shares in the first 12 months after a bear market ends is 39%, followed by an average gain of just 8% in the second 12 months. This reflects a combination of factors, including the bear market undervaluation being removed by the initial rally in shares, the shift in growth leading indicators from acceleration, to more sustainable expansion and the unwinding of stimulus.

Conclusion

After strong returns for the first 12 months out of last year's bear market lows it's certainly become a lot tougher, but provided we are right and global economic growth doesn't lurch back into recession, then the rising trend in shares will resume supported by solid earnings growth, attractive share market valuations and low global interest rates. Recent share market action suggests that shares have built a base after their April-May correction and are now starting to move higher again.

▶The second 12 months is normally tougher for shares

US shares - bear market lows	US, % gain in first 12 mths from low	US, % gain in second 12 mths after low	Australian shares - bear market lows	Aust, % gain in first 12 mths from low	Aust, % gain in second 12 mths after low
Jun 49	42	4	Dec 52	8	13
Oct 57	31	10	Nov 60	12	-2
Jun 62	33	-2	Jun 65	8	11
Oct 66	33	7	Nov 71	49	-25
May 70	44	11	Oct 74	54	16
Oct 74	38	21	Nov 76	6	21
Aug 82	58	2	Jul 82	39	9
Oct 02	34	8	Nov 87	35	5
Average	**39**	**8**	Jan 91	39	-9
Mar 09	69	?	Feb 95	25	8
			Mar 03	28	24
			Average	**28**	**6**
			Mar 09	53	?

Data covers post-war period. *Source: Bloomberg, AMP Capital Investors*