

# That's the end of that

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**It's been a long time since we've been so glad to see the last of an Old Year and to welcome in a New Year. 2008 was an *annus horribilis*, not just for Australian cricket, but also for investors.**

The Australian share market fell by 42%, its worst calendar year performance ever. The market fell in nine of the year's twelve months. In the United States, the S&P 500 index fell by 38.5% over the course of the year, and there were even larger falls elsewhere, particularly in developing markets.

The Caton's Corner I wrote a month ago attempted to farewell 2008 and took a speculative look ahead to 2009. A second farewell still seems appropriate, just to make sure 2008 has really gone.

Everybody now knows the reason for the shocking performance of investment markets. What apparently began as a relatively small issue in sub-prime mortgages in the United States metamorphosed into a major credit crisis, with consequent massive dislocation to the performance of economies around the world. One thing that 2008 has reminded us of is this: that credit is the oil in the economic engine; you may not need much, but when there is not enough the whole thing seizes up. So American consumers stop buying cars, and businesses everywhere find it harder to finance legitimate capital spending. For this and other reasons, the world now finds itself in the first true global recession for many decades, with much speculation that we are in the early stages of the first depression since the 1930s.

Let me say that I think this is way too pessimistic a view. Policymakers now understand more about how economies operate than they did in the 1930s, and they have made it clear that they will do whatever is necessary to keep economies afloat. These policies will eventually be successful, although there will then be the issue of 'fixing the fixes' (do you support the US auto industry for ever, for example?) once economic growth has resumed.

## Tough times to continue

Of course, there is still a lot of economic dislocation to come. Around the world, including in Australia, economies will get worse before they get (slowly) better. For years, particularly in the English-speaking world, economic activity has been sustained because consumers have lived beyond their means, spending not only out of their income, but also out of their accumulated wealth. Suddenly that wealth isn't there anymore, and consumers need now to earn more than they spend, rather than the other way around. Highly-paid financial-sector workers find that not only is their wealth diminished, but their year-end bonuses are a fraction of what they have come to expect. This makes the mortgage unaffordable even with lower rates, with consequent effects for house prices.

House prices are also likely to be held down by growing uncertainty about job prospects, although there is no reason to expect anything like the falls that have occurred in the United States and elsewhere. Lower interest rates will help, as will Australia's strong demographics.

Greater uncertainty about jobs; soft or falling house prices; a massive hit to household wealth; sensible reaction to all of these: these are the ways in which slowdowns feed upon, or reinforce, themselves.

We have one more thing going against us: falling commodity prices caused by the weakness of the world economy, particularly China. It's clear that the Australian economy has already slowed a lot, and that 2009 will be the toughest year since the early-1990s recession. Whether or not we (officially) experience a recession may become a matter of definition; for many people it will feel like a recession.

### **Reason to be hopeful?**

I have made the point before, however, that future worsening of the economy doesn't have to mean that share markets continue to fall. This is because markets are forward-looking, and have already priced in a good deal of future bad economic news. There are thus two reasons to be hopeful. First, it may well be that the news, while bad, is not as bad as currently 'priced in'. Second, at some stage, and possibly earlier than many think, markets will begin to look to the other side of the valley, and begin to price in economic recovery. In my view, both of these considerations will help share markets in 2009, but it will be a good year rather than a great year. Of course, we also know that markets overshoot, and it is possible (although not likely) that markets will yet plumb new lows.

### **What else can we expect in 2009?**

Rising unemployment and further falls in interest rates seem almost certain. It is difficult to say how much unemployment will rise, while interest rates should fall by at least another percent. Some recovery in the Australian dollar, from 70 cents as I write to the mid- to high-70s, seems likely, although there are many with contrary views and forecasts below 60 cents.

One thing we shouldn't have to worry about this year is inflation. It is difficult to remember, but just six months ago, policymakers both here and elsewhere were concerned about inflation. Now the concern is deflation (falling prices) or inflation that is just too low for the efficient performance of economies. It won't happen in Australia, but the threat of deflation may well be an issue for much of 2009.

### **One final note**

Almost all readers have lost wealth in the past year, and I am frequently asked where it's all gone. It is a difficult question to answer completely. Some of the wealth wasn't really there in the first place, but some of it hasn't been so much lost as transferred. One could, for example, argue that nothing has happened in the past year to change the likely value of world share markets (and the nation's housing stock) in a suitably distant year (say 2020). If that's the case, then 2008 has seen a transfer of wealth from current shareholders

and house owners to future shareholders and house owners. In a broad sense, this may be from the mature (I stopped using the word 'old' some time ago) to the young. Of course, if current shareholders are also prepared to be future shareholders, then the hit to their wealth is mainly temporary.

In any case, mature or young, allow me to wish all readers a Happy New Year, both on a personal level and as investors.

**Chris Caton**

Chief Economist

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**BT Insight**

**2009 will be the toughest year [for the Australian economy] since the early-1990s recession.**

**Chris Caton**  
BT Chief Economist