

Aviva Investors - Economic Outlook

Q4/09 Update

Fiona Hayes

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Presenter: To discuss the economic outlook, I'm joined now by Fiona Hayes, Economist and Senior Fixed Income Fund Manager at Aviva investors. Fiona, there's a lot of talk about improving economic data, is this the start of a classic V shaped recovery?

Fiona Hayes: Germany, France and Japan emerged from recession far earlier than anybody dared predict, with positive economic growth in the second quarter. These economies are heavily dependant on exports as their main source of growth so they suffered disproportionately when global trade went into freefall this time last year but, on the flipside, they've been early beneficiaries from the recovery in global trade now. And saying that, the US is not far behind, then we think the US turned in positive growth in the third quarter, and China of course proved most resilient of all avoiding recession entirely. Throughout the world industrial sentiment indicators have shown a classic V shape, they've bounced strongly.

This is largely to do with the inventory cycle. When demand fell off a cliff this time last year, companies cut back sharply on their stock levels and they continued this process through the first half of this year as well. Now demand has levelled off and stocks are at more comfortable levels so they're no longer dragging on activity. In turn industrial orders and output have bounced strongly from their very low levels reached earlier this year. This is all very welcome news but it has to be stressed that it's a long road back to pre-crisis levels of activity. It might even take two or three years for production to get back to the 2007 level. Moreover, this V shaped recovery is really confined to the industrial sector, the broader economy is going to see a much more muted path to recovery.

Presenter: So is this recovery really just down to building up inventory?

Fiona Hayes: There have been some other positive indicators over the summer months. In particular several governments, including the US, the UK, Germany and France went through with their so called Cash For Clunkers schemes. These are basically schemes

which paid a subsidy when consumers replaced an old, high emission vehicle with a newer low emission vehicle, an environmentally friendly policy as well. They proved extremely popular with consumers. In fact the US scheme was so popular that it was oversubscribed in the first week and it was trebled in size eventually from one billion to three billion. The problem is consumers only have so much money to spend so they diverted cash away from other goods and services and brought forward the timing of their car purchase.

We're still a little bit concerned about the medium term outlook for the consumer; we don't think consumers are going to be big participants in this recovery. Household wealth has suffered colossal destruction over the last two years and that remains the case even though there's been a bounce in equities and some evidence of house prices finding a floor. More to the point, unemployment is still rising and those workers who have kept their jobs are working fewer hours than they would like to for less pay. They're also, consumers are also well aware that any subsidies or lower taxes they're receiving now are contributing to higher government deficits and these will have to be paid for in the form of higher taxes in the future.

Presenter: With so much debt in the system, should bond markets start to worry?

Fiona Hayes: Clearly rising government deficits are a medium term negative for bond markets because they mean governments are going to have to issue more debt. For now though central banks are key, and they're maintaining low official interest rates as well as capping longer term rates by purchasing bonds in the market. Many people think the central banks are in a bit of a bind now because eventually they have to exit these extraordinary policies, the question is when do they do that? If they move too soon then they risk choking off the economic recovery but if they're too slow, they might unleash inflation. I think we have to admit that the risks of these two are hardly equal, it's, even earlier this year it seems like another great depression was a very real risk and central banks are going to do anything in their power to avoid a double dip scenario, so we think they're going to be very slow to start raising interest rates.

And in fact they've told us this. The US Federal Reserve has promised to keep interest rates low for an extended period and the European Central Bank has repeated several times that now is not the time to exit, and the Bank of England in the UK was so concerned about the economy there that they've pumped extra liquidity into the economy as recently as August. So we at Aviva Investors think it could well be another twelve months before higher interest rates are a real threat to markets.

Presenter: Fiona Hayes, thank you.

Fiona Hayes: Thank you.

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