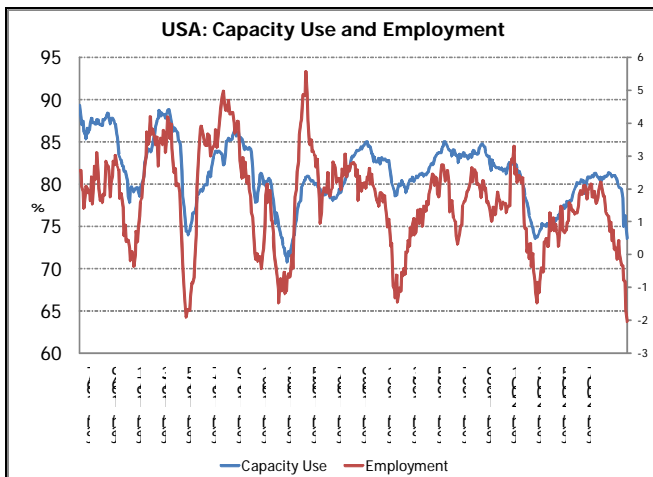


The Next Shoe To Drop: Global Unemployment

Over recent weeks, as we have visited and reviewed a number of seemingly quite disparate economies around the globe, one of the features that has stood out most clearly has been the extent to which implied labour productivity rates have tumbled of late in many countries around the world. Although in the US companies in the manufacturing sector have been relatively swift in *attempting* to protect productivity rates by adjusting their payrolls rapidly to the change in the production environment (hence the Atlanta Fed has reported that job losses are occurring at a proportionately faster rate than in previous recessions), companies in many other countries have not been so 'cost conscious' and aggressive in their labour shedding.



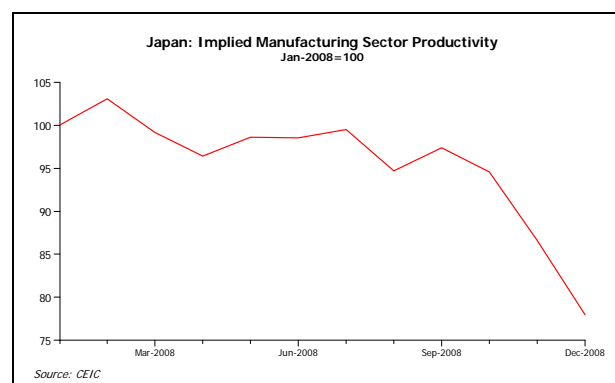
For example, in Brazil, we find that implied labour productivity had declined by a distressing 10% compared to a year ago and in Japan we can estimate that implied labour productivity has fallen by a massive 20% in the last six months alone. In Europe, companies also appear to have hoarded labour even as production rates have declined, with the result that notional German manufacturing sector productivity has probably declined by 5-6% over the last six months. In the Southern European economies – the PIGS - the data appears to be even worse.

The implied hoarding of labour by European companies, which of course will have been at the acute expense of their profits, is perhaps not overly surprising given the region's legendary 'social' and

legal environment but we are intrigued to find that many Asian countries - not only Japan – have also decided to retain staff even as production has fallen away.



It seems that despite their much lauded entrepreneurship and despite their recent awful production trends and the still high level of inventories, Asian companies have so far been relatively slow to adjust their labour costs to the new demand environment. For example, although the majority of Korean companies are reporting the existence of substantial levels of excess capacity according to the Bank of Korea's monthly surveys, employment levels were essentially stable in the year to December. Consequently, we find that the bulk of the financial burden of Asia's economic slowdown is falling *primarily* on private sector's rates of profit at present; the corporate sector's reluctance to lay off staff and close factories has implied that corporate profits have declined rather than household incomes.



Presumably, the rationale for Asian companies' failure to lay off staff is some form of 'long termism'. Companies are evidently expecting a recovery in either world trade or domestic demand and therefore they are attempting to maintain their current levels of capacity in anticipation of this event. However, we must wonder just how 'long

term' a view companies will want to take – and more importantly will be able to take.

In reality, we suspect that if there are not clear signs of either a global or domestic improvement within the next few months, thoughts of long termism will have to come a distant second best to the concept of corporate survival. Indeed, although we do not yet have the complete fourth quarter flow of funds data for Japan, we believe that it is highly probable that Japan's companies will have become significantly cash flow negative over the quarter as a result of the collapse in sales receipts and the companies' failure to reduce labour costs. This situation will of course not have been new to Japan; during the 'phoney' part of the early 1990s recession companies were also prepared to sacrifice their own financials rather than lay off staff. However, we must note that the extent of the slowdown in Japan's economy at that time was very much less than that which exists today; companies probably had no inkling at that stage just how long the recession would ultimately last; and bank credit, even then, was probably more readily available than it is today.

Therefore, rather than waiting years to adjust their labour force as they did in the early 1990s, we suspect Japan's companies may feel obliged to act earlier with regard to their potential surplus labour positions. Similarly, given their experiences in the Asian Crisis of 1997 and the subsequent Y2K bust, other Asian companies may also not feel inclined – or even be able - to take a long term view.

Returning to Europe, we are not surprised that companies have 'felt obliged' to retain staff and indeed the institutional / legal framework of the Continent can make labour shedding difficult and costly. However, at the same time, we must note that Europe's corporate sector entered the current recession profoundly cash flow negative and with even ECB Governor Trichet now finally admitting that the financial crisis in the Euro Zone is deepening, it may be that cash flow concerns will cause European companies to act rather faster than they might have done in the past with regard to cost reductions. It therefore seems to us that given the poor quarter that we are currently enduring and the low probability of a meaningful improvement in production trends in 2009Q2 given current inventory levels, we may be on the cusp of a major and profound shift in global labour market conditions, with all that this will entail for both politics and economics.

We like many have been working on the assumption that the global economy will look better in 2009 and even we share Fed Chairman Bernanke's view that the technical recession may indeed end in the US and elsewhere in 2009H2. By the second half of the year, it is true that savings rates will in all probability have moved back

towards their historical norms (thereby implying that expenditure levels will no longer have to fall relative to incomes), household cash flow *may* have been improved by effective mortgage rate cuts and various government's fiscal initiatives and, in the corporate sector, inventory positions will presumably have been brought down. We have even gone so far as to suggest that consumers, who will presumably have been conditioned to expect a better second half by recent government prognostications, may even begin to 'borrow' some growth from the second half over the next few months (i.e. by spending some of their anticipated tax rebates even before they arrive).

However, what concerns us with this now relatively consensus view of a better second half is that, given the declines in productivity noted above and the now increasingly widespread view that the global economy could suffer a relapse in 2010 as the various government fiscal policy 'life support' effort is scaled back, companies may not be prepared to run with surplus labour in anticipation of this expected second half 'recovery'.

As we have noted, with corporate cash flow remaining under intense pressure and the global banking system still profoundly compromised, companies may simply not be allowed to hoard labour in anticipation of this event and so there is therefore a risk that, in many countries, the *hypothesised* improvement may either come too late to save domestic employment trends. Indeed, there is even a risk that the now widely expected second half recovery is somehow thwarted by a sharp rise in unemployment in the near term, and consequent drop in wage incomes, that overwhelms the effects of the fiscal response.

In fact, we increasingly see the probability of a second half recovery becoming the product of a race between rising unemployment rates and government spending and we must admit that with corporate cash flow deteriorating and governments still evidently thrashing around in search of a concrete policy framework, the middle part of the now widely expected 'w' slump-recovery-slump scenario is beginning to look under threat. The second half global recovery story is now beginning to look rather shaky and thus we see the way clear for further rate cuts by central banks – and further currency weakness in cyclically sensitive currencies such as the NZD.

Andrew Hunt, London

The “D” Word

On a few occasions in 2008, colleagues pointed out the “recklessness” and “inappropriateness” of commentators mentioning the possibility of the global economy slipping into a “depression”. Certainly, there is still a body of vocal activists on the internet that attack journalists for mentioning that word, based on the belief that if it gets published enough, it might actually make it happen.

There is actually an index that measures the number of times the word “depression” is mentioned in various newspapers. The chart below came from the Economist a while ago, but it certainly shows the increase in mention of “depression” as the crisis has unfolded.

But what exactly is an economic depression? Surprisingly, there is no accepted definition, such as we have for “recession”. A recession is defined as two consecutive quarters of negative GDP growth. New Zealand’s September quarter GDP was the third consecutive negative quarter, so we have been in a recession since the start of 2008.

Incidentally, the US, as they often do, have their own different definition. They have a range of factors that are applied retrospectively to say, well, that was a recession. That is why, late in 2008, people started saying that the US had been in a recession since December 2007.

But, what makes a bad recession turn into a depression? There is the joke definition, “A recession is when your friends lose their job – a depression is when you lose your job”, but a better possible definition for a depression is a fall in GDP of 10% and/or a recessionary length of three years.

Both these events happened in the Great Depression. It started on Black Tuesday, October 29, 1929 in the US, spread to almost all countries and lasted to sometime in the 1930s or early 1940s, when World War II intervened. Some accounts have the Great Depression ending in 1932 after 43 months (in the US) and a 33% fall in GDP, followed by another major recession in 1937/38; others have it as one long continuous depression.

Regardless, it was a far cry from the comfortable world we now live in. For those whose parents or grandparents have related stories of life in the Great Depression, the hardship was unimaginable. For a small agricultural exporting country, the drastic fall in prices and volumes for our commodities meant that New Zealand was severely affected.

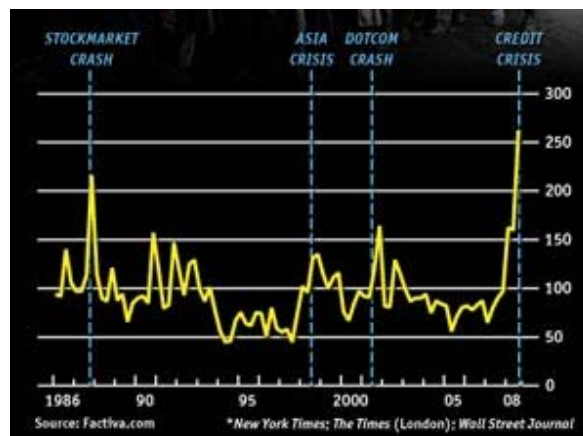


Here, there was no dole and with unemployment at extremely high levels, people had to turn to work relief schemes just to put food on the table. Although a lot of these programmes did not amount to much, there were some that have contributed to making New Zealand a better place, such as the Homer Tunnel, the planting of trees in the central North Island to create the forestry industry and the establishment of many parks throughout the country.

Before 1930, though, there was another recession that was referred to as the Great Depression – this was what is now called the Long Depression and lasted from 1873 to 1896.

It occurred at the same time as the Second Industrial Revolution and, while volumes did not fall, prices most certainly did. The UK was probably the worst hit country, losing its large competitive edge over the rest of Continental Europe. While this depression is usually deemed to last for 23 years, GDP actually increased over the 1880s and 1890s as a result of the increased production. The actual recessionary nature in the US only lasted around 65 months, which is still a very long time.

And so, the \$6.4 trillion question is: what is the chance that this current global recession will turn into a depression? Well, 2008 was the second-worst of all equity markets in the US since 1871. The only worse month than last year’s 38% drop was 1931, when the S&P 500 fell a staggering 47%. Of the seven previous years since 1871 when the S&P500 fell by more than 20%, all of them except two responded with a positive 20%+



rise the following year. The exceptions were 1930 and 1931, with 1932 falling by 15%, before 1933 rose with a stunning 44%, the second-best rise on record. I suspect that this long historical cycle of recoveries from large market falls is why some commentators are predicting large bear market rallies over the course of this year. I do not believe it will happen this year, though (the US market has already fallen 19% for the first two months of 2009). However, what it shows, though, is that when markets recover from such a rout, they do so with a vengeance.

The average length of a recession is around 10-11 months. We are already at 14 or 15 months into this recession, with no real end in sight – in fact, things seem to be getting worse. So this recession will be both longer and deeper than most other recessions. I found an article from a Seattle newspaper about a subprime mortgage lender, Merit Financial, going bankrupt in May 2006, which was possibly the first casualty of the current credit crisis. That is over two and half years ago. Things seem so bad because it has been going on an awful long time.

The key, though, to whether this will turn into a depression will be global GDP figures, particularly for 2010. This year (2009) has already been written off (after only two months) as almost certainly being the second consecutive year of negative growth. Most economic “base case” scenarios have a very small amount of growth (GDP of less than 1%) for 2010. However, you would have to say that the chance of 2010 being another negative year is relatively high, at around 30-40%. Growth, then, would not likely recur until 2011.

By that stage, we would have had three years of recession and, by some definitions, that would constitute a depression. BUT, I am not suggesting that it will be anything like the Great Depression. The circumstances of the early 1930s were significantly different, including:

- Interest rates in the early 1930s were actually raised, rather than being lowered as currently
- Similarly, 1930s US fiscal policy was to reduce spending, rather than increase it as we are seeing with the bailouts and stimuli
- Governments in the 1930s were unable to print money (as they are now) because currencies were tied to the gold standard

One thing to watch out for, though, is the rise of protectionism. In 1930 the US introduced the Smoot-Hawley Tariff Act that resulted in a major

increase in tariffs. The resulting trade war prolonged the depression far more than it would have otherwise. There is now a general understanding of how undesirable protectionism is, but some governments just cannot help themselves. Even in the big US Government Bailout 2.0, the initial draft had an element of protectionism in it, but mercifully that was removed. Similarly, Gordon Brown has been making comments about saving jobs for UK citizens. So, although protectionism is known to be economically bad, sometimes politically it seems the right thing to do.

The other thing to watch out for is social unrest. If unemployment rises to significant levels, protesting and civil disobedience could rear their ugly heads. It is likely to most prevalent in places like Spain, where unemployment is expected to reach 30% and Eastern Europe, which is actually suffering worse than Asia did in 1998. In fact, the financial crisis in Eastern Europe is so severe that it would be making front page news, if only there wasn't so much else making financial news in the developed

world.

There doesn't seem to be a lot of good news out there at the moment. It is likely, though, in a couple of years, we will be over this and, more importantly for investment funds, sharemarkets will be substantially higher than they are now. At that time, you will probably look back at 2009 and think, why did I not invest so much more in shares? The reality probably will be that, at the time (that is, now), you had no idea how much weaker things would get.

There will continue to be a lot of volatility. Hence, investors will need to hold on and ride it out. It takes a brave person at the moment to increase their equity weightings, as we probably have not reached the bottom yet. Similarly, it takes a brave soul (some say foolish) to reduce equity weights at the moment, as the recovery, when it eventually comes, will likely be swift. After suffering so much loss already, you would be reluctant to sacrifice potential large upsides just to avoid any further losses in the interim. Unless you know how to time markets (and I am still waiting to meet someone who is successful at that), you would be relying on luck to time your re-entry point.

Peter Lynn, CFA
Head of Strategy
4 March 2009

***“Once upon a time you dressed so fine
You threw the bums a dime in your prime,
didn't you?
People'd call, say, "Beware doll, you're
bound to fall"
You thought they were all kiddin' you.
You used to laugh about
Everybody that was hangin' out
Now you don't talk so loud
Now you don't seem so proud”***
Bob Dylan, 1965, “Like A Rolling Stone”