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22 June 2010
Fixed Income Research
http://www.credit-suisse.com/researchandanalytics

Market Focus

Global Strategy

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Double Dips Are Hard To Find

- True double dip recessions are so rare as to be an almost extinct species, though you would not know it from the market chatter of recent weeks.
- To illustrate, we look at the level of US industrial production since 1884. We can only find three recessions out of 38 that seem to qualify as true double dips: one in the late 1880s, 1913/1914 and 1980-1982, though that is usually defined as two back to back recessions. See Exhibits 1 to 3.
- Moreover, these double dips occurred when the initial contraction was rather mild. There is no example of a double dip recession after severe downturns or banking panics, despite a huge variety of underlying circumstances.
- That is no coincidence: we believe the natural forces of recovery are much stronger and more self-reinforcing than often supposed, even when unemployment and spare capacity are very high.
- Indeed, the room for recovery is especially great when the output gap is large, because this normally means private sector savings rates have recently spiked up very sharply and can fall substantially as confidence, profits and income growth rebuild.
- This is very much the case now: the private sector financial balance (households plus non-financial corporations) soared by 8% of GDP in the US during the Lehman panic, by 10% of GDP in the UK and about 4.5% of GDP in the eurozone. That is huge, and totally unprecedented in modern times.
- The scope for lower private savings (reduced cash hoarding) is therefore very large, and should itself be the main driver of shrinking public sector deficits.
- It is tempting – but trite – to expect a tepid recovery by focusing only on the need for public sector austerity. The excuse is that it can be very hard to predict precisely private savings behaviour, while fiscal action is usually well telegraphed. Still, overemphasizing the impact of government action simply because it is easy to forecast is lazy economics.
- Conflating slower growth momentum with a double dip won't win you the Nobel Prize either. Recoveries follow a well rehearsed rhythm, with the first burst of production growth typically very fast and the first momentum peak occurring between 6 and 15 months from the output trough[1]. Almost without exception. As you can see by glancing through charts 1-3 and 16-21.
- In this recovery, we estimate that global IP momentum peaked around 15% p.a. at the start of this year – the highest level since the 1975 recovery. We believe the US will have a double peak in March and July around 11% p.a., a function of the winter snowstorms rather than fundamental forces. Chinese IP momentum on our measure peaked at over 30% p.a. in July/August 2009, and has halved since then, even as the level of output continues to expand.

[1] See also "Quantum of Volatility" by Neal Soss : http://research-and-analytics.csfb.com/DocumentViewer?language=ENG&format=PDF&document_section=1&document_id=855455101

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- Continued expansion at a slower pace is the typical pattern after the first momentum peak: US production rose by between 3 and 7.5% in the 12 months after the first momentum peak in six of the last seven recoveries.
- 1980 is the sole exception, and illustrates the potential truth behind what one might call the double dip delusion: when final demand is hit by a major new exogenous shock, then a second recession can occur unusually soon.
- In fact, before WW I, when banking panics were a regular occurrence relatively short intervals between recessions were the norm. There were no less than 10 recessions in the 30 years to 1914, including our first two true double dip episodes. But production reached new highs in each genuine recovery and trend growth was quite rapid i.e. growth was volatile but fast.
- We think it is very possible that future recessions might occur more frequently than we have been used to, reflecting more limited scope for private and public sector debt growth. But nothing in the historic record suggests a new recession is likely now: on the contrary it suggests once recovery starts to establish itself, it is not that easy to derail.
- Even in the pre WW I period a peak in equity markets was much more likely to occur around 28 months from the trough than after a mere 12-15 months, putting us nearer July 2011. For production, two of the post-panic recoveries peaked around two years after the production trough, also suggesting next summer. See charts 8-10.
- But history will mean nothing if some large new shock to final demand occurs very early in the recovery process: if it does the economy will likely contract again.
- Despite the rhetoric we have seen nothing in terms of concrete plans for fiscal tightening (outside the European periphery) which suggests that fiscal policy will deliver such a shock. Europe and banking reform are the two more legitimate concerns, in our view. A disorderly break-up or default within the eurozone in the near future would clearly have a very negative effect on bank capital positions – raising the spectre of another round of rapid balance sheet contraction – and on business confidence. Clumsy and punitive re-regulation of the banking sector could have the same result.
- We are in little doubt that a new and substantial forced contraction of financial sector balance sheets would be more like the 1930s when debt deflation was allowed to get an unstoppable grip as a result of major policy errors, (passage of the Smoot-Hawley Act in June 1930, and the Fed's sharp tightening of monetary policy in 1931 after the UK left the gold standard).
- Today, any new shock leading to bank balance sheet contraction and weaker growth could in turn lead to more bad loans and market losses within the financial sector, making it even tougher to raise new equity capital just when capital requirements are being raised, forcing further contraction and economic weakness etc. In these circumstances, even modest fiscal tightening would be madness, in our view. This would be a truly deflationary vicious circle.
- So we believe the immediate issue for investors is not whether there will be a "double dip" recession but whether policy errors will (inadvertently) create or allow a double dip "depression". (Snatching defeat from the jaws of victory).
- Our view on this is very simple: it is just about possible but not very likely. Whatever populist tendencies may drive congress or members of parliament, the most senior leaders within the G-20 – and this very much includes the Chinese – are aware of the risks, including to their political future.
- For markets to be freed from the paralysis induced by fear of a low probability but extremely bad outcome, we will need to see the final shape of US banking reform (the President wants to sign this on the 4th July) and a viable support package for Spain, (with or without use of the EFSF). More likely within weeks than months.
- Meanwhile, we hope that our mini-chartbook below will persuade you that double dips are very rare birds indeed – much talked about but seldom seen.

Exhibit 1: US IP (log level) with Recessions Marked 1884-1925

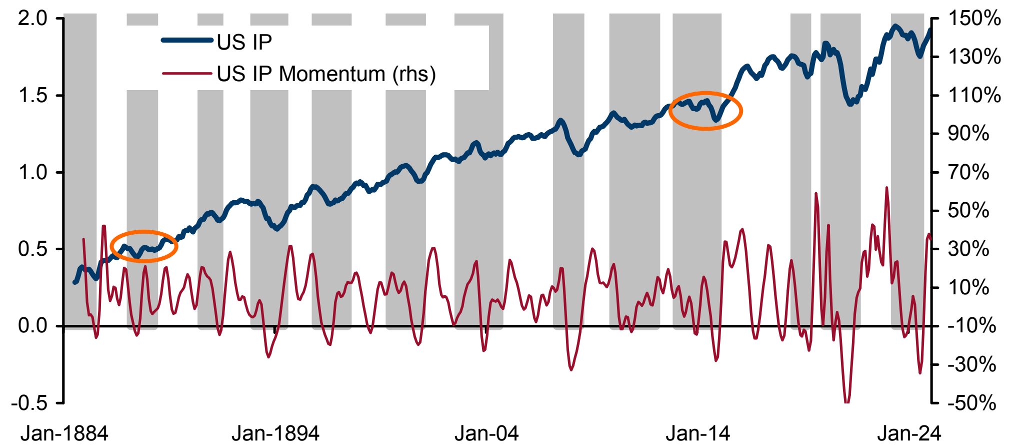


Exhibit 2: US IP (log level) with Recessions Marked 1925-1970

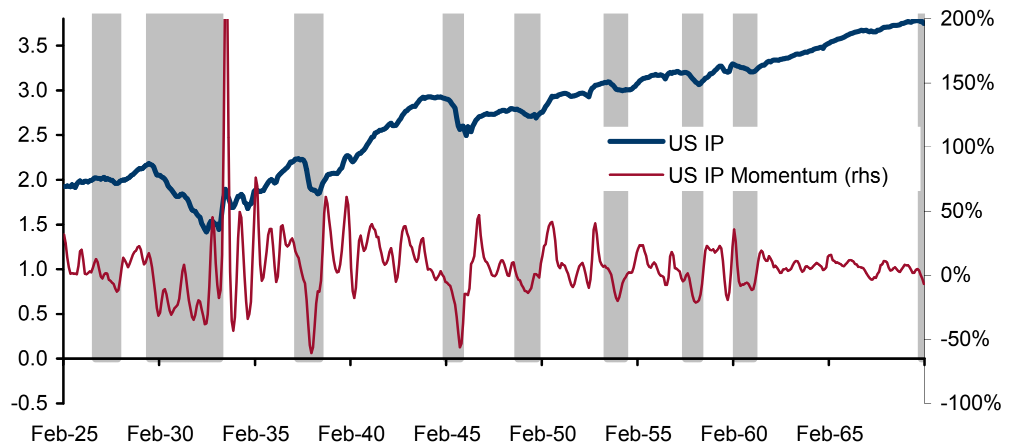
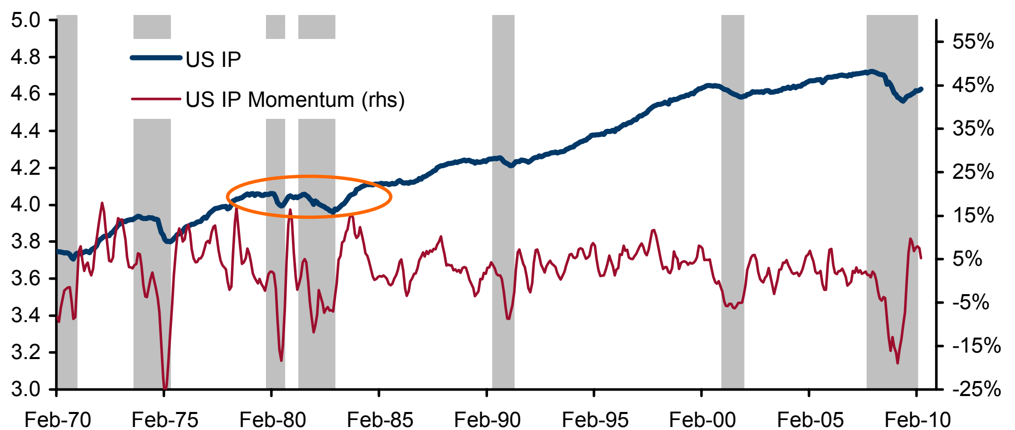


Exhibit 3: US IP (log level) with Recessions Marked 1970-Now



Source: Credit Suisse

Exhibit 4: US Real Equity Returns (log level) and US IP Momentum 1884-1925

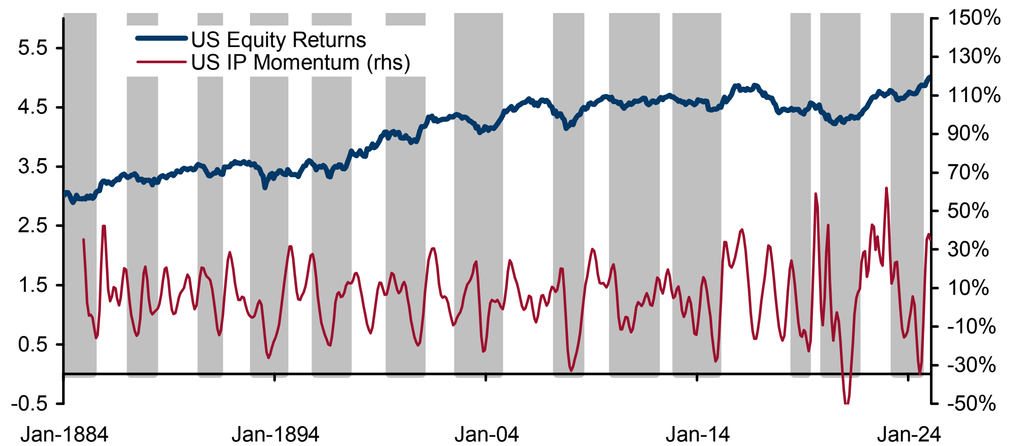


Exhibit 5: US Real Equity Returns (log level) and US IP Momentum 1925-1970

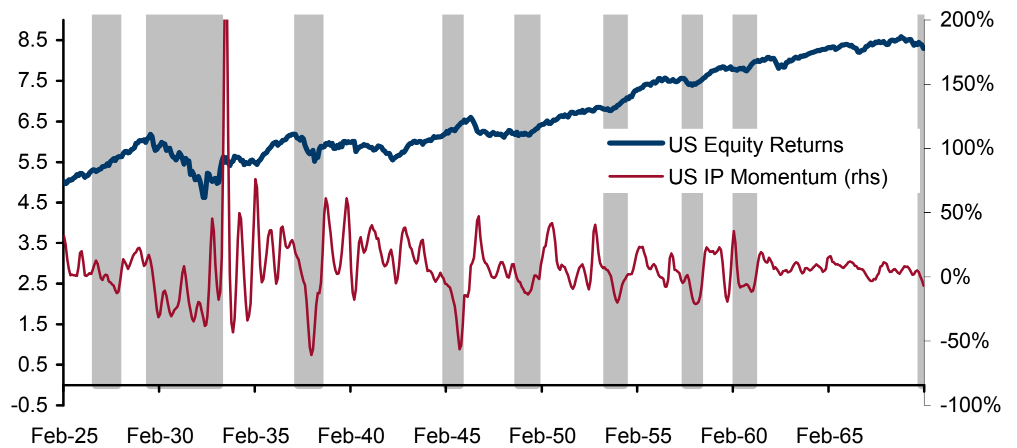
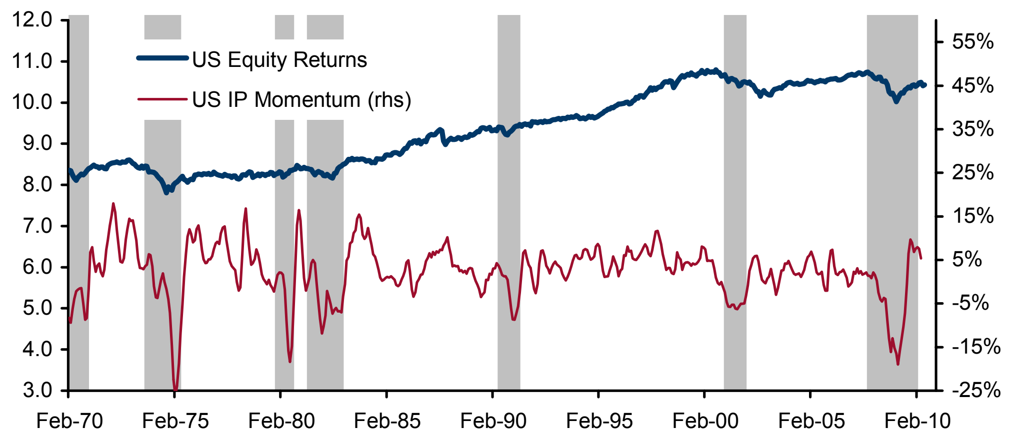


Exhibit 6: US Real Equity Returns (log level) and US IP Momentum 1970-Now



Source: Credit Suisse

Exhibit 7: US Real Equity Returns (log level) and Global IP Momentum 1970-Now

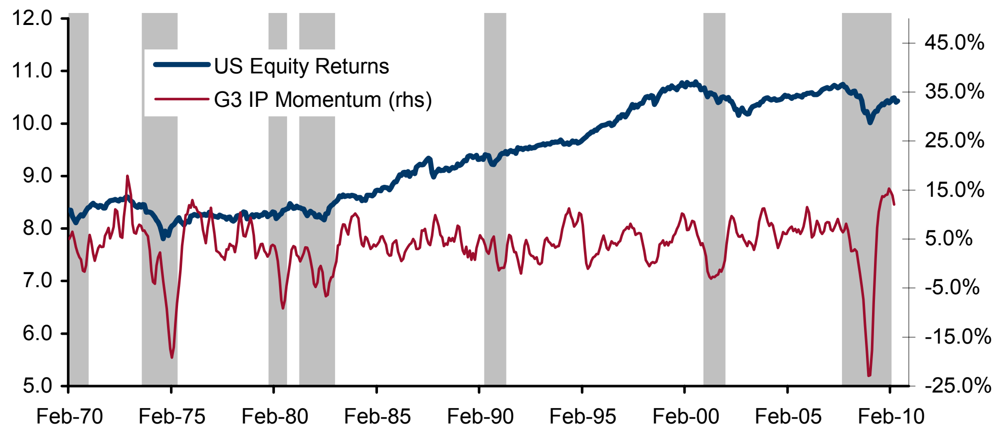


Exhibit 8: US Real Equity Returns: Average Recovery (1884-1914) vs. Current

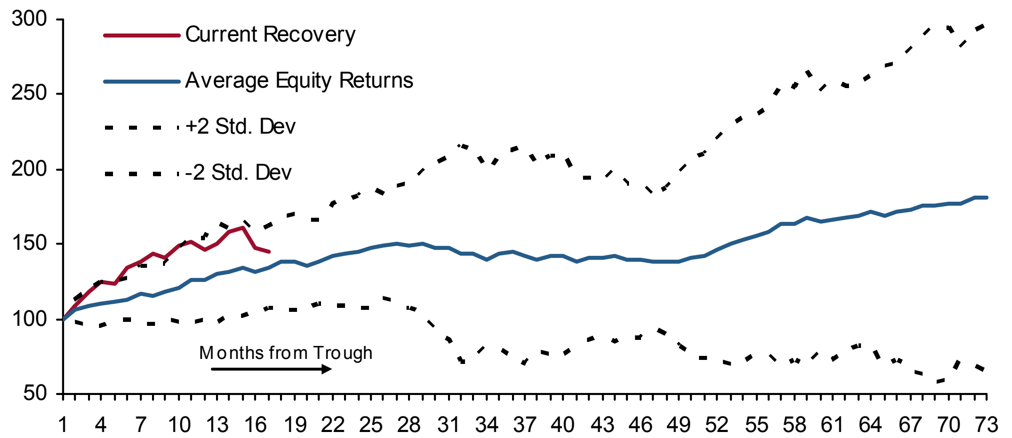
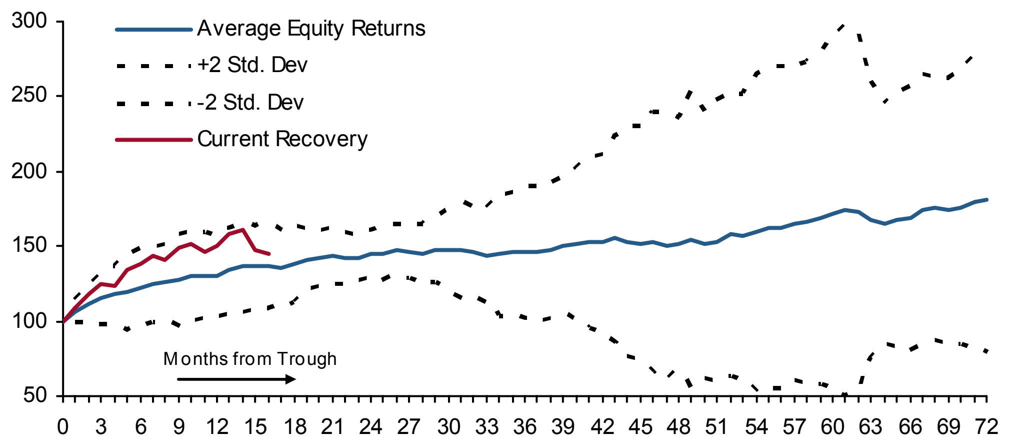


Exhibit 9: US Real Equity Returns: Average Recovery (1945-Now) vs. Current



Source: Credit Suisse

Exhibit 10: US IP Post-Panic Recoveries

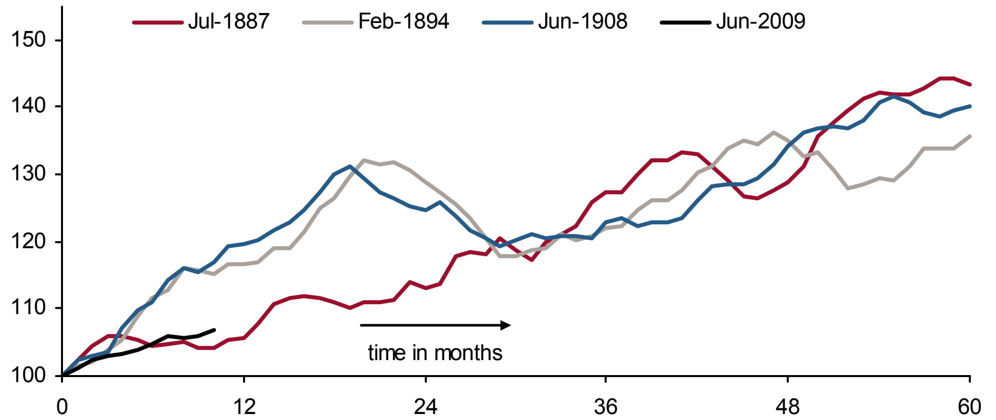


Exhibit 11: US IP Post-War Recoveries

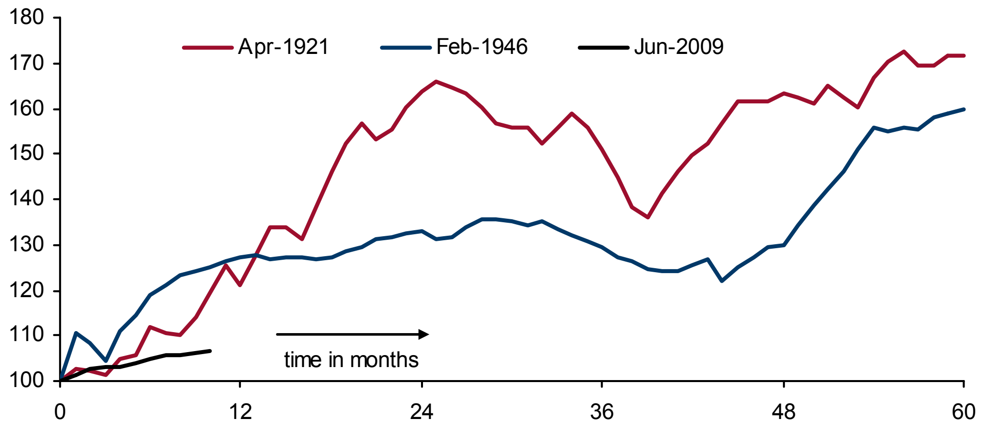
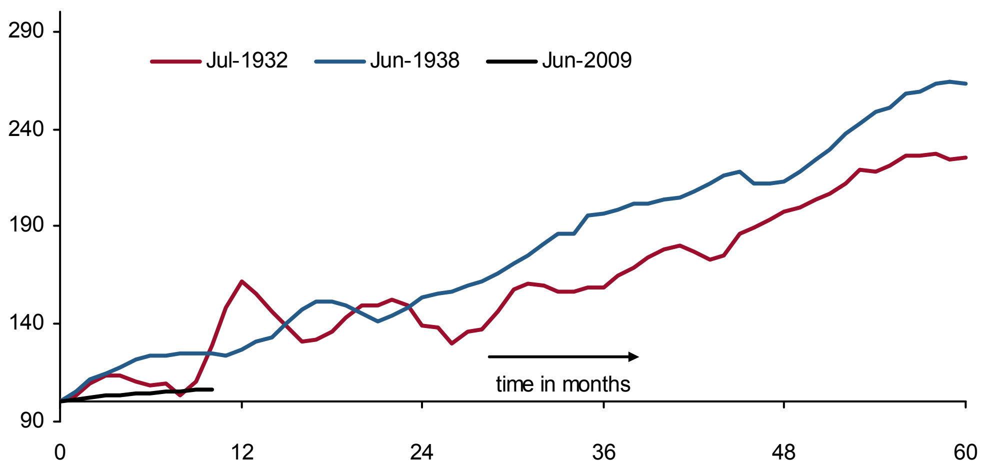


Exhibit 12: US IP Post-Depression Recoveries



Source: Credit Suisse

Exhibit 13: US IP Post-Recession Recoveries

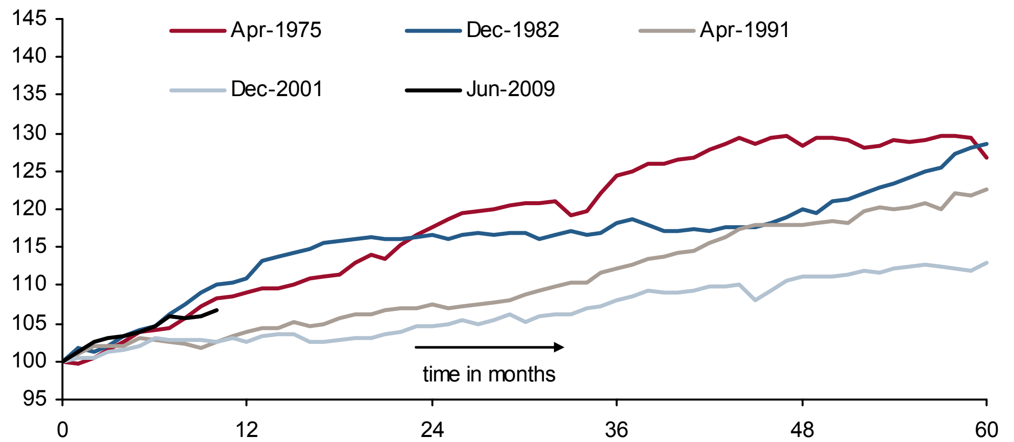


Exhibit 14: Severe Contractions and Rebounds in US IP

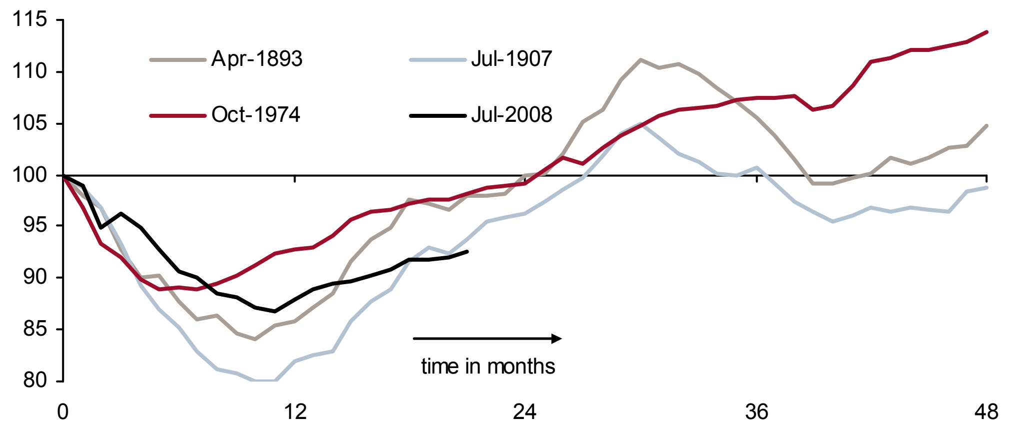
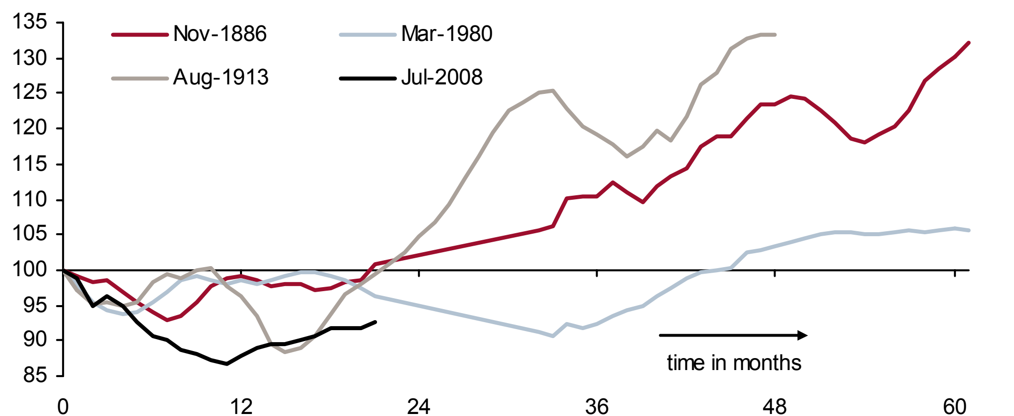


Exhibit 15: Double-Dip Cycles in US IP



Source: Credit Suisse

Exhibit 16: US IP Momentum during Post-Panic Recoveries

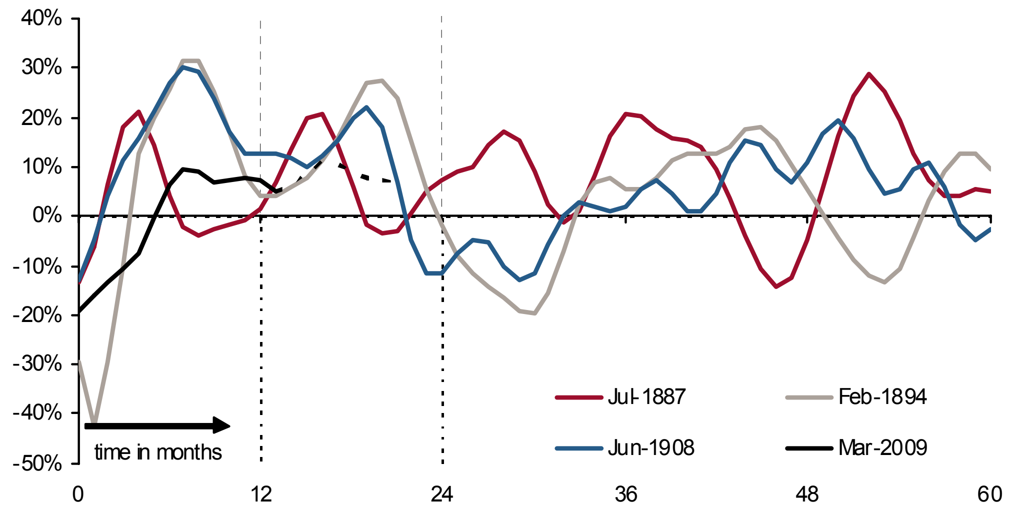


Exhibit 17: US IP Momentum during Post-War Recoveries

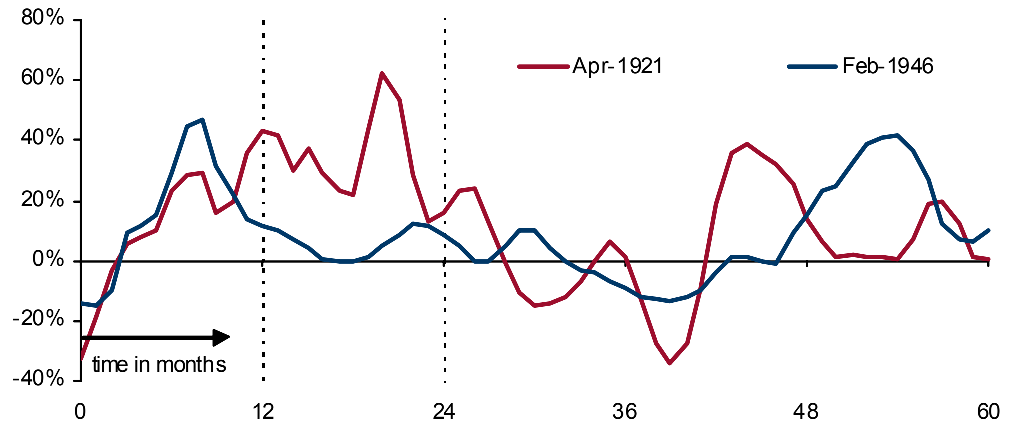
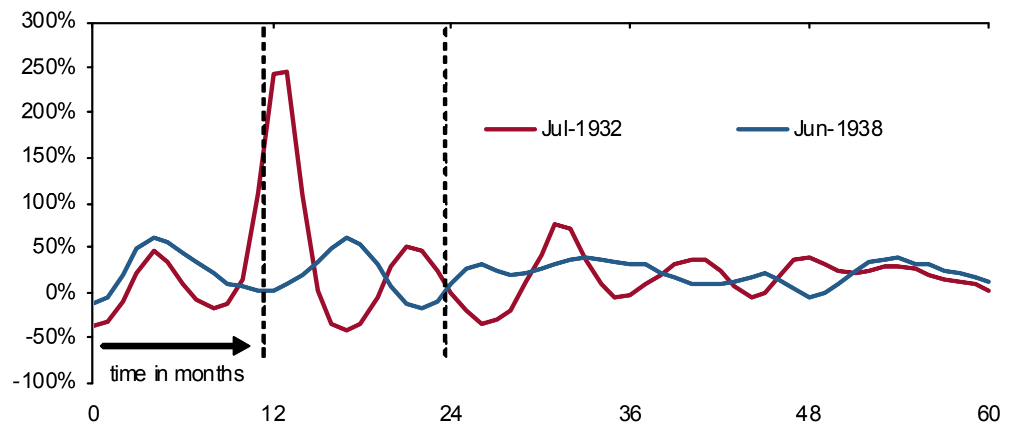


Exhibit 18: US IP Momentum during Post-Depression Recoveries



Source: Credit Suisse

Exhibit 19: US IP Momentum during Post-Recession Recoveries

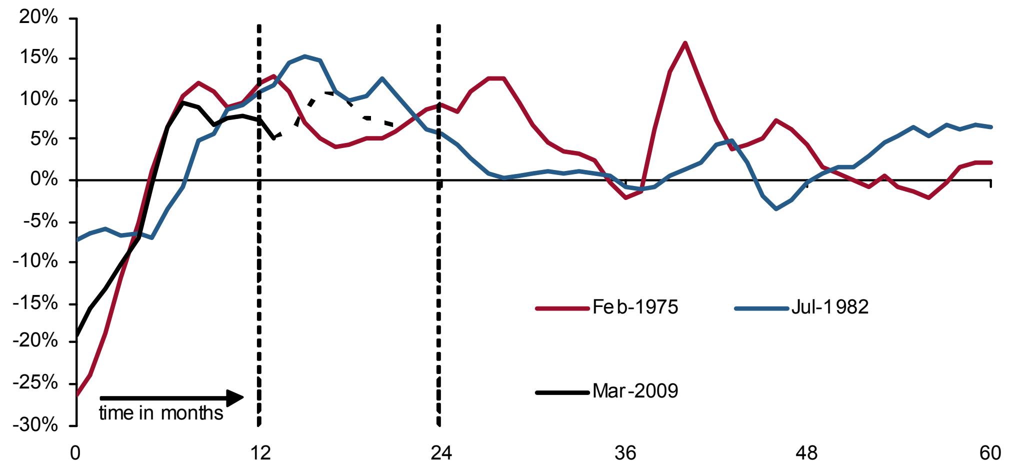


Exhibit 20: US IP Momentum during Post-Recession Recoveries

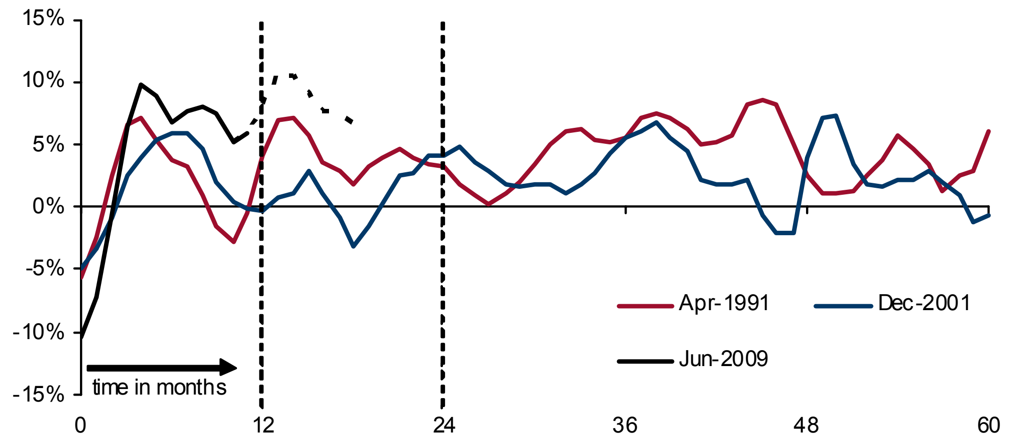
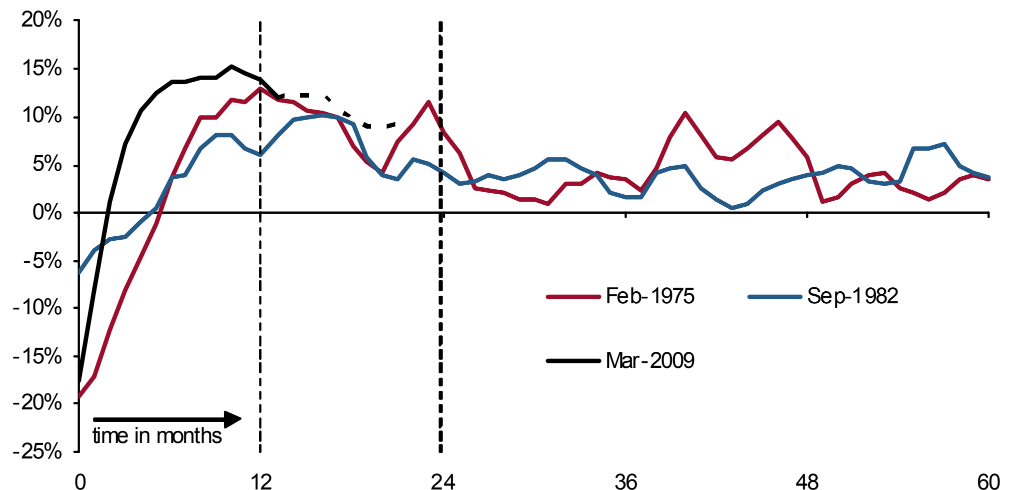


Exhibit 21: Global IP Momentum during Post-Recession Recoveries



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