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Capital Spending Outlook: Dangers for 2008 (and 2009)

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The world in 2008/09 Red lights flashing

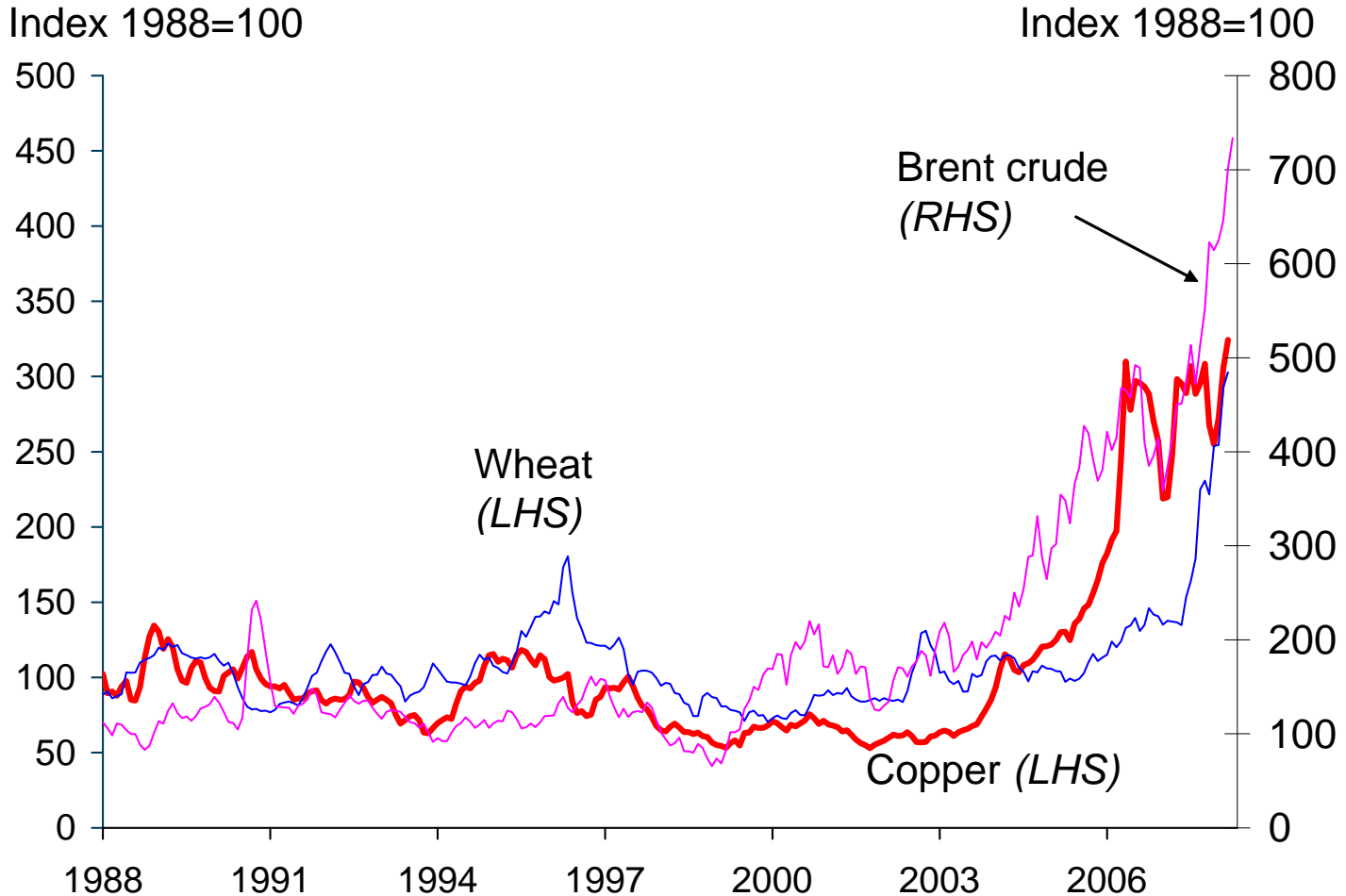
- Credit crunch and housing an issue for US (UK, Spain etc) but even in these countries high commodity prices are main reasons for lower consumer spending. But remember in the US an aggressive policy response
- Emerging market strength – strong domestic demand offsetting weaker US
- But high food and energy prices now making inflation a real danger 2008/9?
- If prices start to ease later this year then a soft landing still likely. But if prices continue to rise then many countries will need to tighten policy and this could lead to very weak growth next year

A Longer-term story

- Problems have origins in Asian crisis of 1997.
- Most emerging markets realised that risk of financial crises could be reduced by running sustained current account surpluses and keeping exchange rates “low”
- Lead to excess savings and low real long rates.
- Initially companies borrowed to finance an investment boom but excesses lead to dotcom boom/bust.
- Then consumers in US and elsewhere borrowed to finance a housing boom and ABS excesses lead to the credit crisis
- Latest cycle is commodity boom caused by speculation and overheating in many emergers.
- Only lasting solution is a rise in exchange rates across many countries (with benefits for the Euro as well as \$) or

Inflation from surging commodities

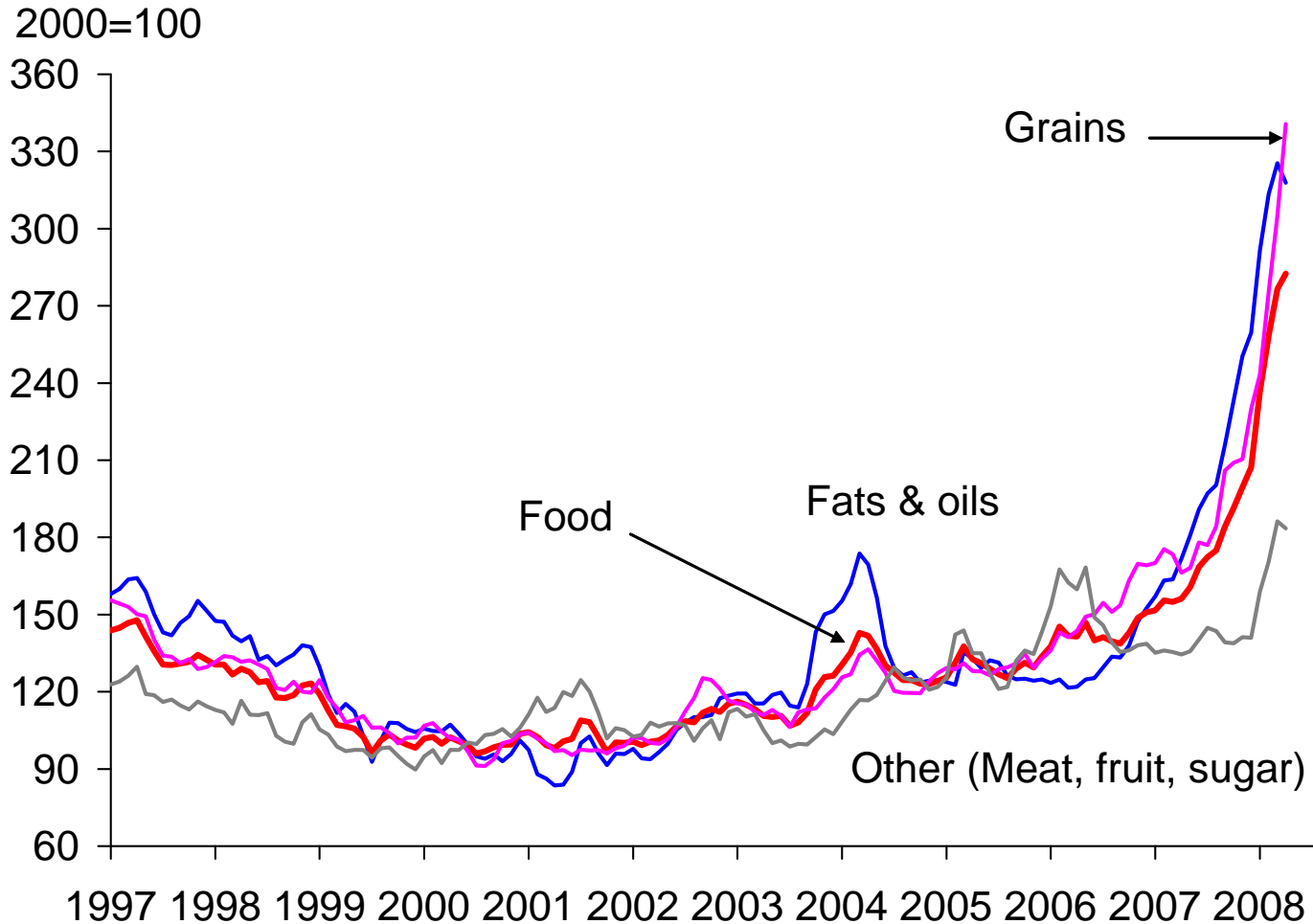
Key world commodity prices



Source : Oxford Economics/Haver Analytics

...and food prices in particular

Emerging markets: Food commodity prices



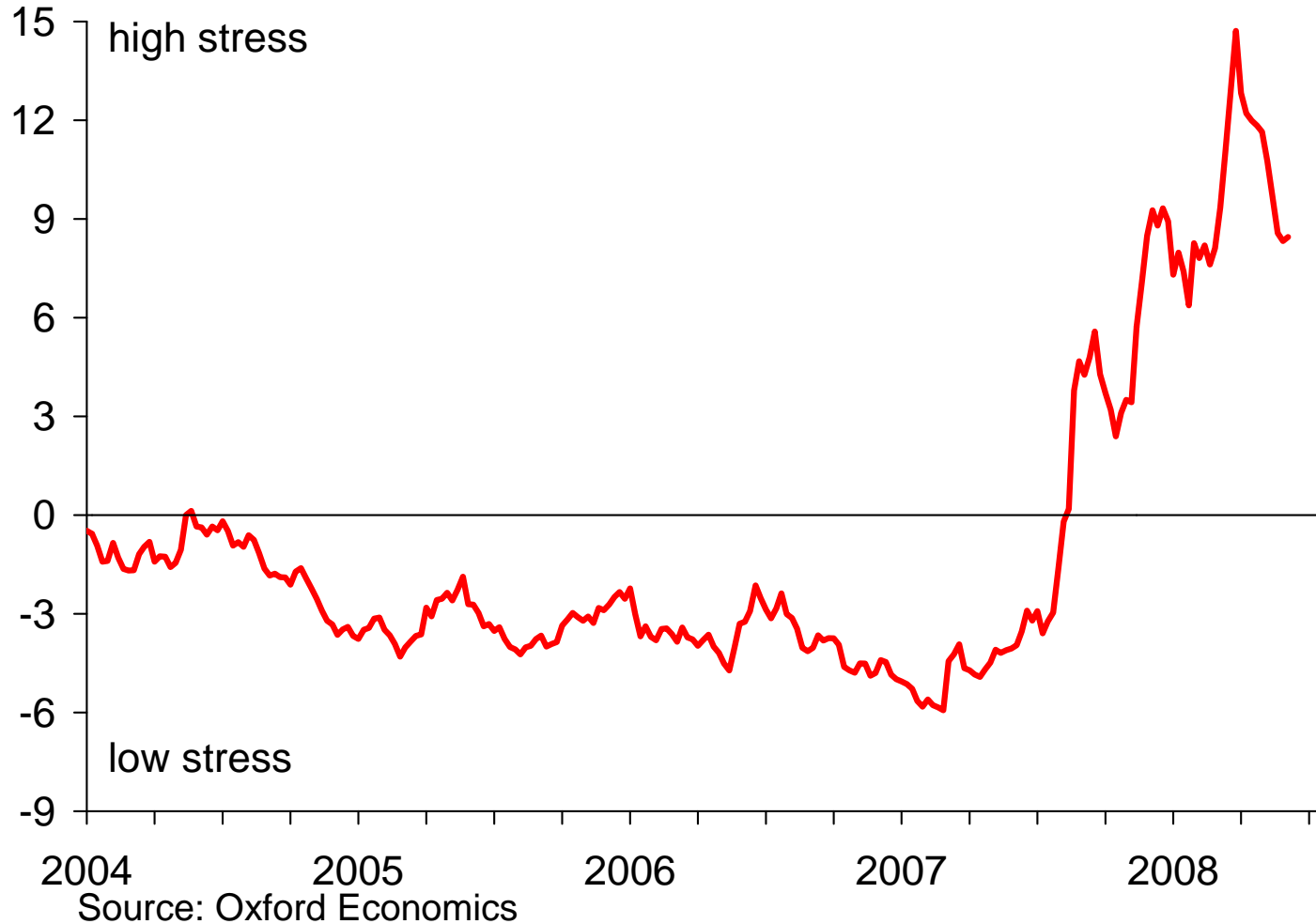
Source: Haver Analytics / World Bank

World GDP Growth

	% Change on previous year					
	2005	2006	2007	2008	2009	2010
US	3.1	2.9	2.2	1.6	2.0	3.5
Japan	1.9	2.4	2.0	1.5	1.4	2.1
Eurozone	1.7	2.9	2.6	1.7	1.4	1.9
UK	1.8	2.9	3.0	1.8	1.7	2.8
South Korea	4.2	5.1	5.0	4.5	3.8	5.1
China	10.4	11.6	11.9	10.6	8.8	8.4
Other Asia	4.7	5.3	6.0	4.5	3.8	4.6
Mexico	2.8	4.8	3.4	3.0	3.5	3.6
Other Latin America	5.2	5.6	6.1	5.6	4.1	3.9
Eastern Europe	5.7	6.9	7.1	6.5	5.7	5.4
World	3.5	4.0	3.7	3.1	2.9	3.6
World (PPP)	4.3	4.8	4.8	4.2	3.8	4.3

Credit conditions improve a little

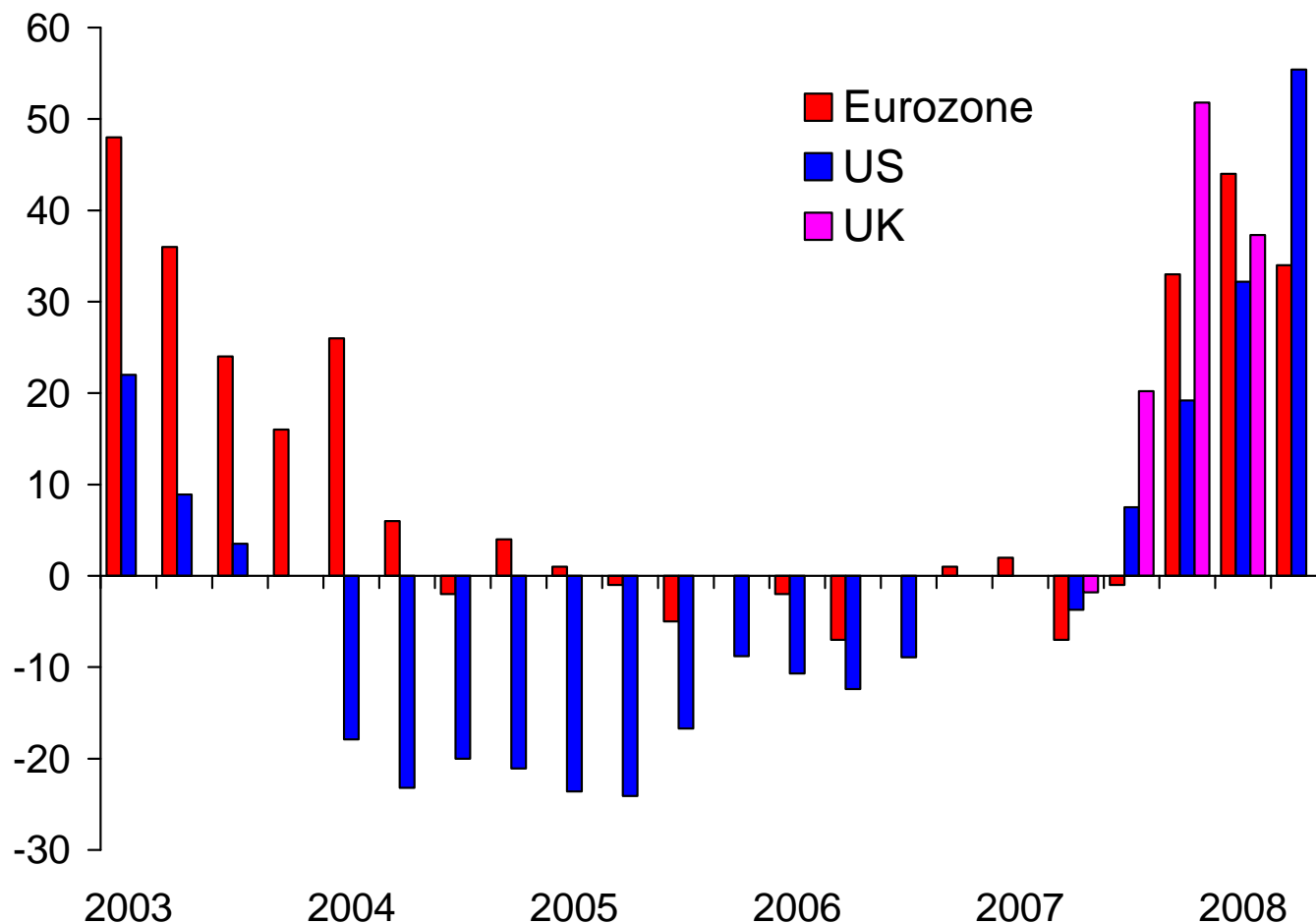
US: Financial stress indicator



...but credit standards still tightening...

Global credit standards surveys

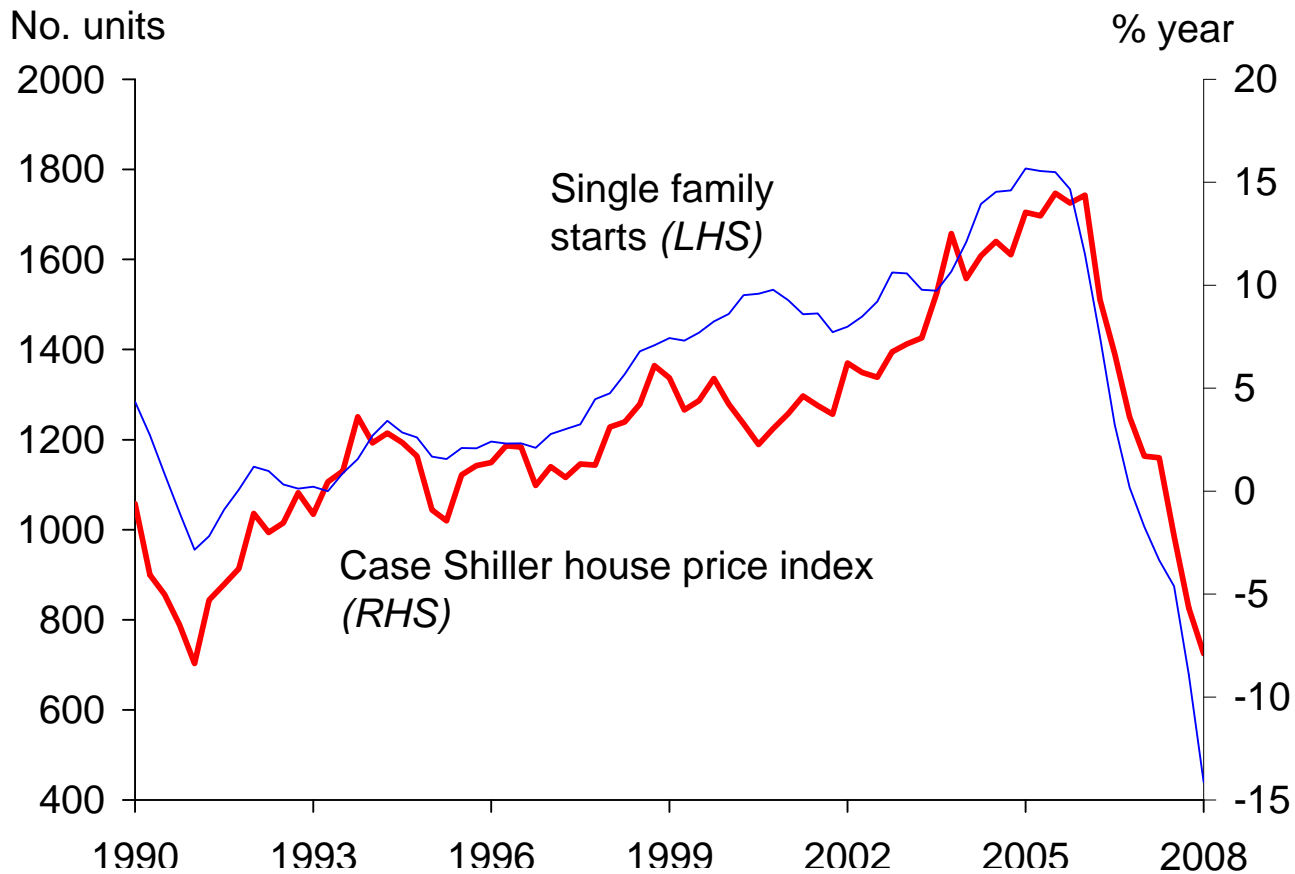
Balance tightening (+)/loosening (-) credit



Source : Oxford Economics/Haver Analytics

US housing distress continues...

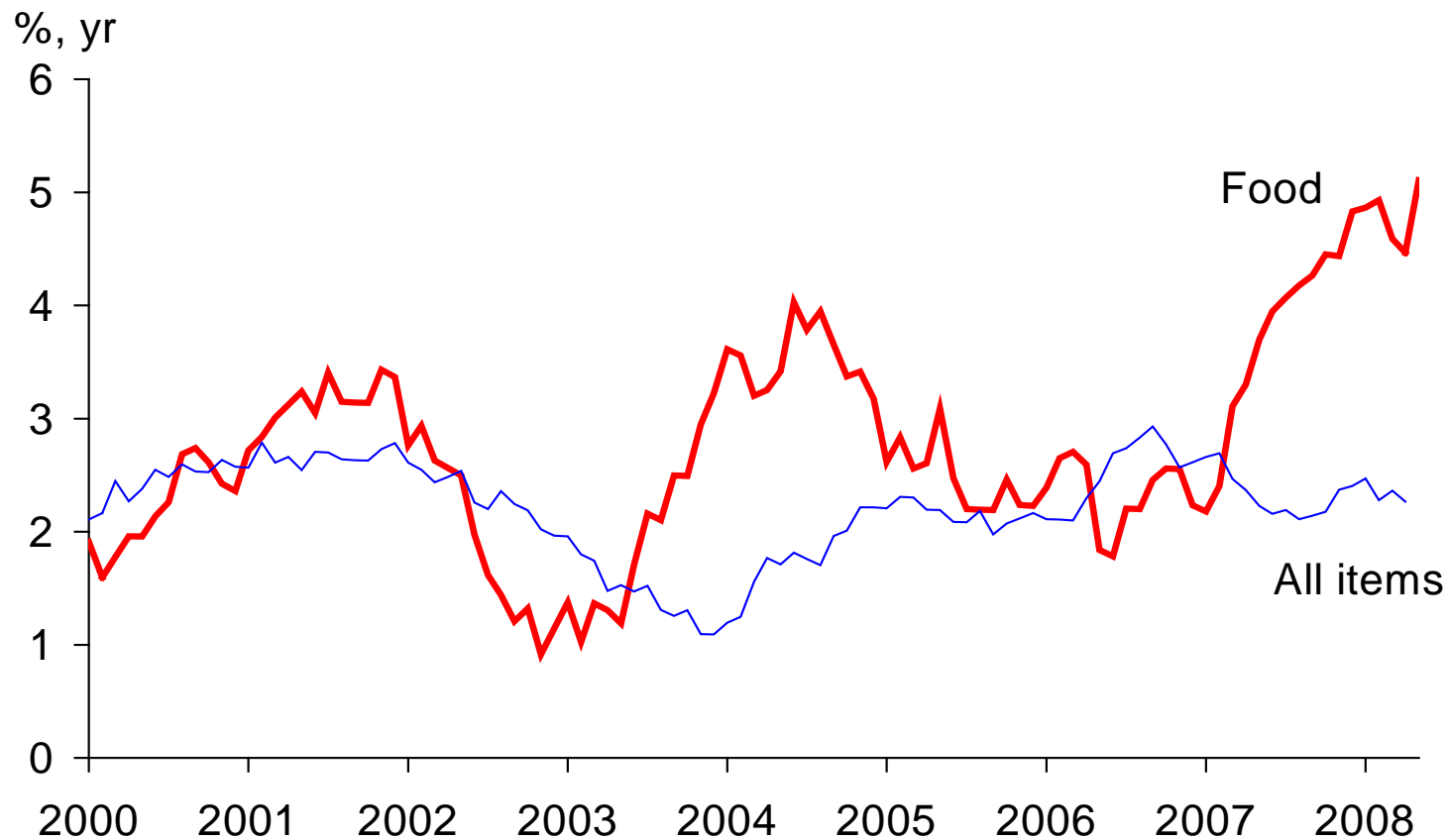
US: Housing starts and prices



Source : Haver Analytics

US food prices have taken off...

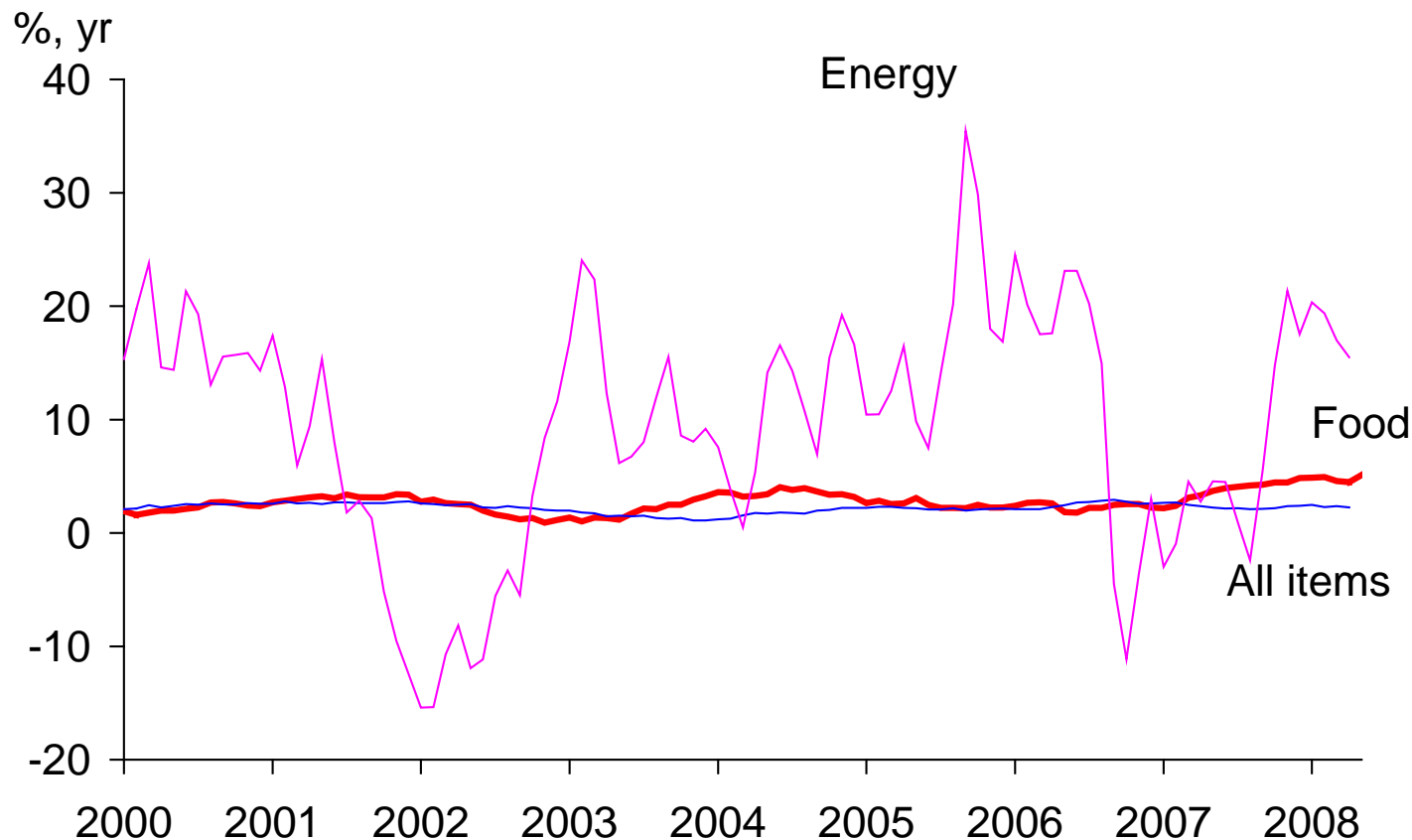
Consumer prices



Source : Bureau of Labor Statistics

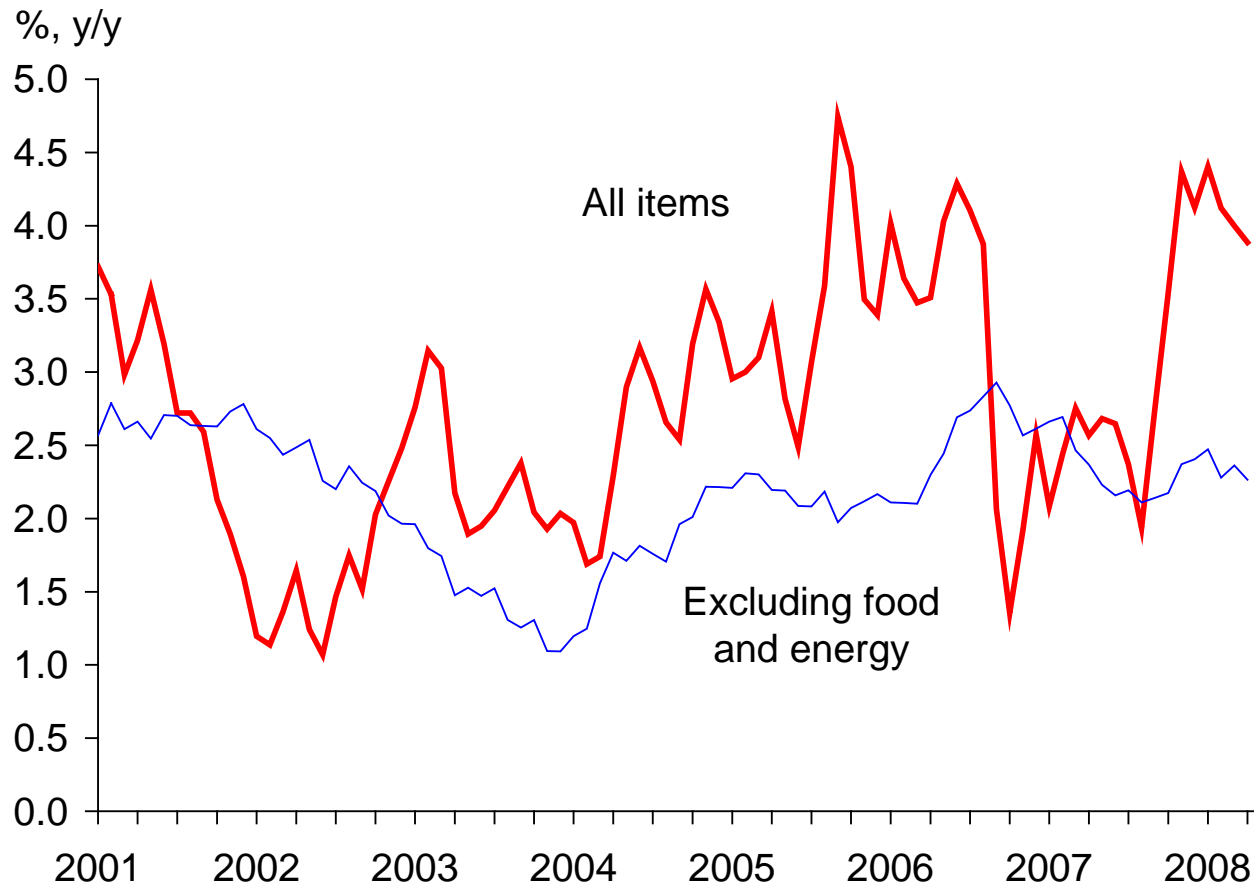
...but not as much as energy prices

Consumer prices



Source : Bureau of Labor Statistics

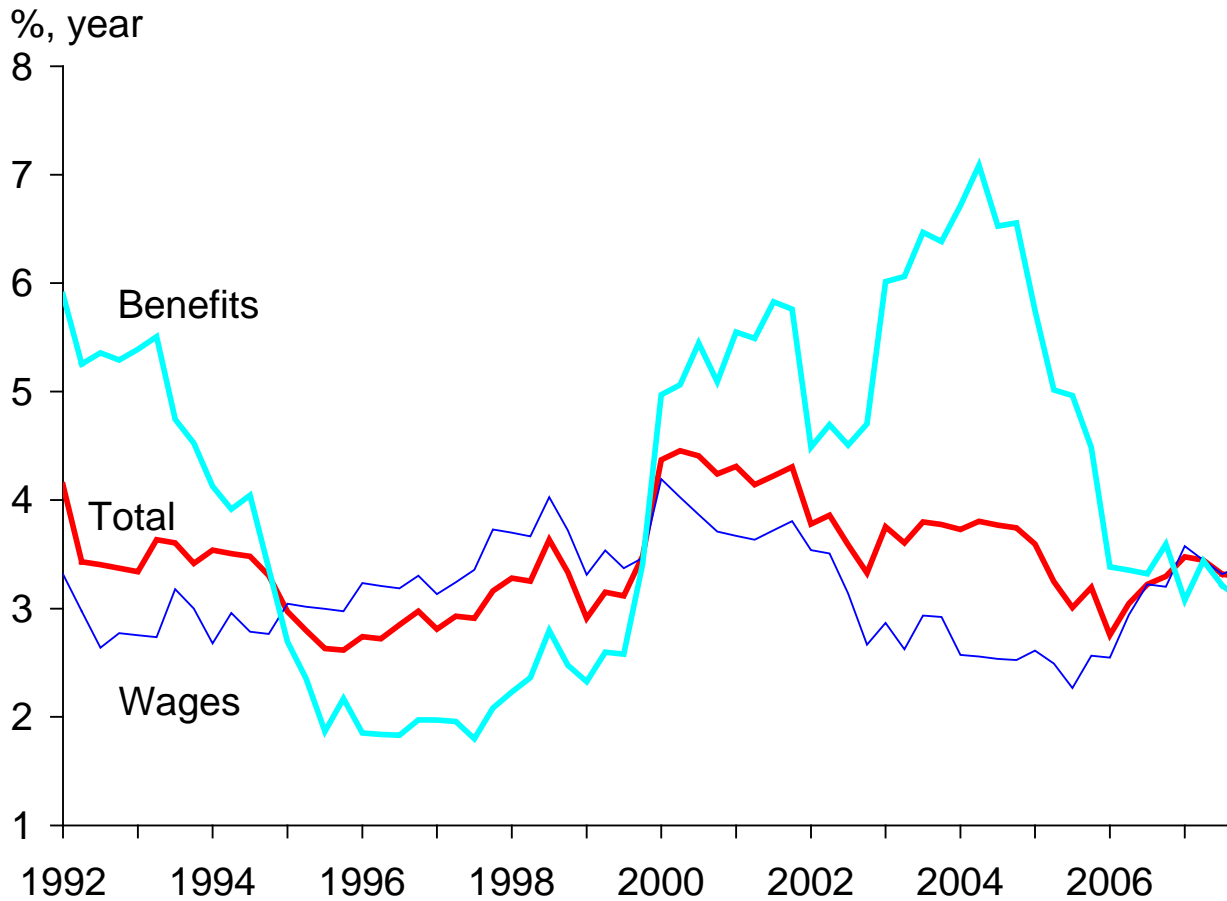
US : Consumer prices



Source: BLS

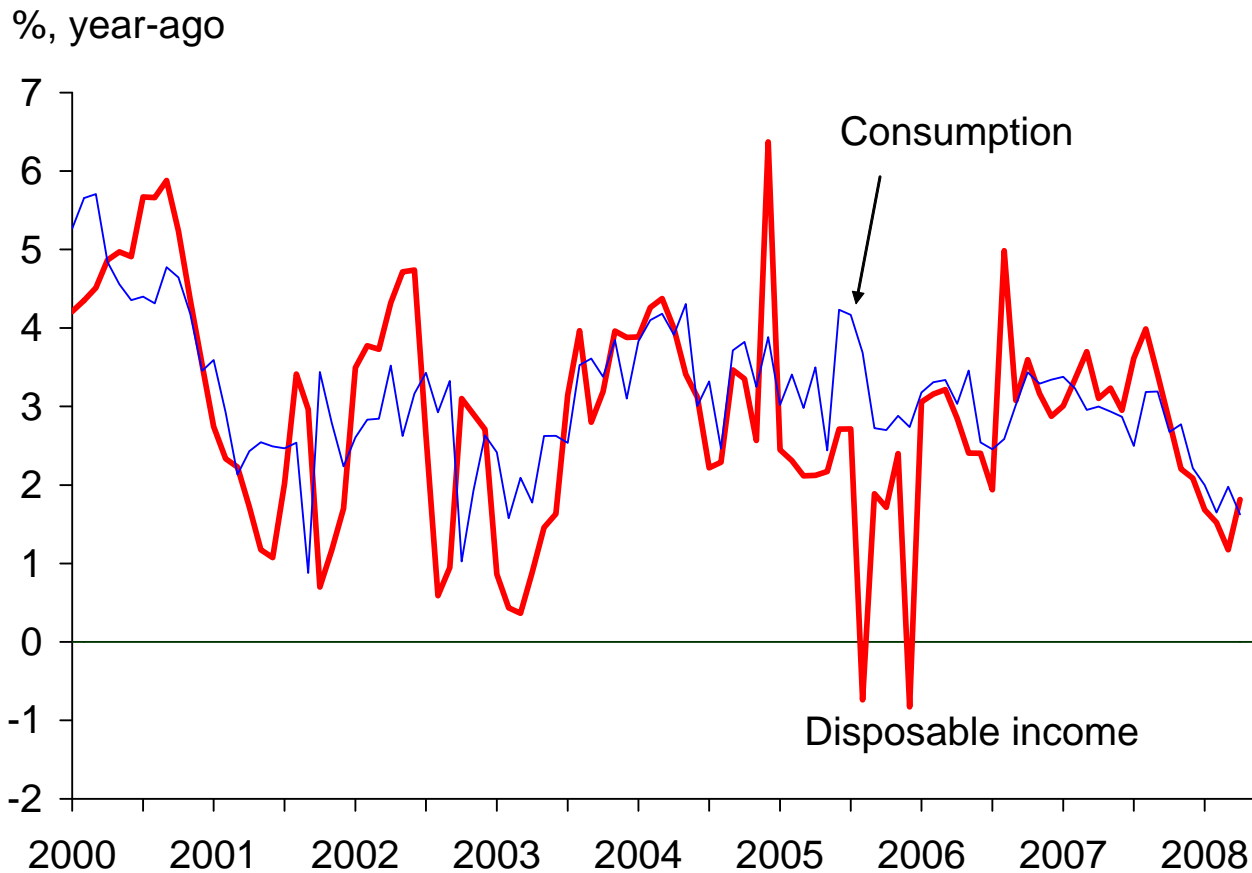
ECI remains moderate

US: Employment cost index



Source: Haver Analytics

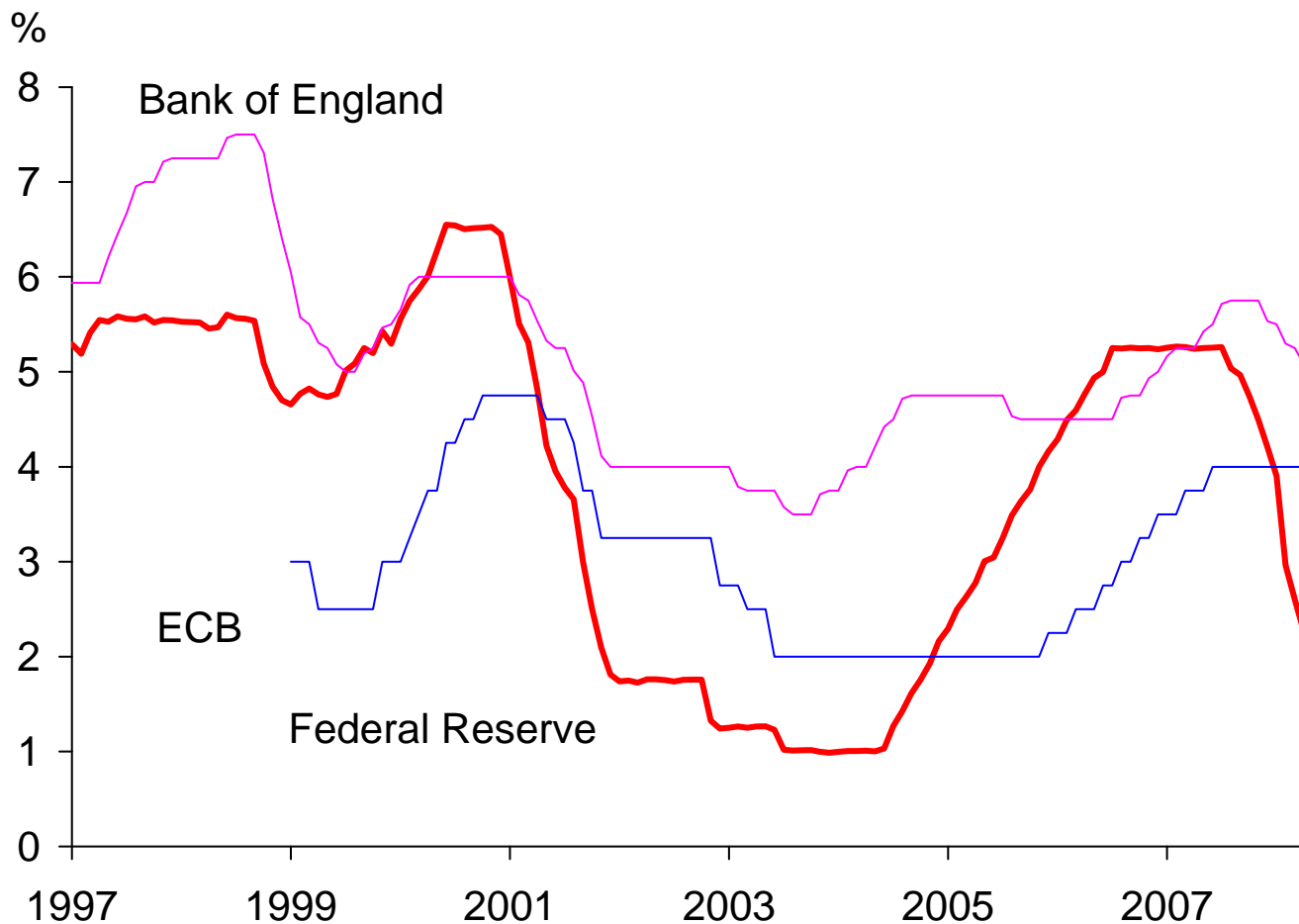
US: Real disposable income and consumption



Source: BEA/Haver Analytics

Policymakers respond...

Fed, BoE and ECB rates



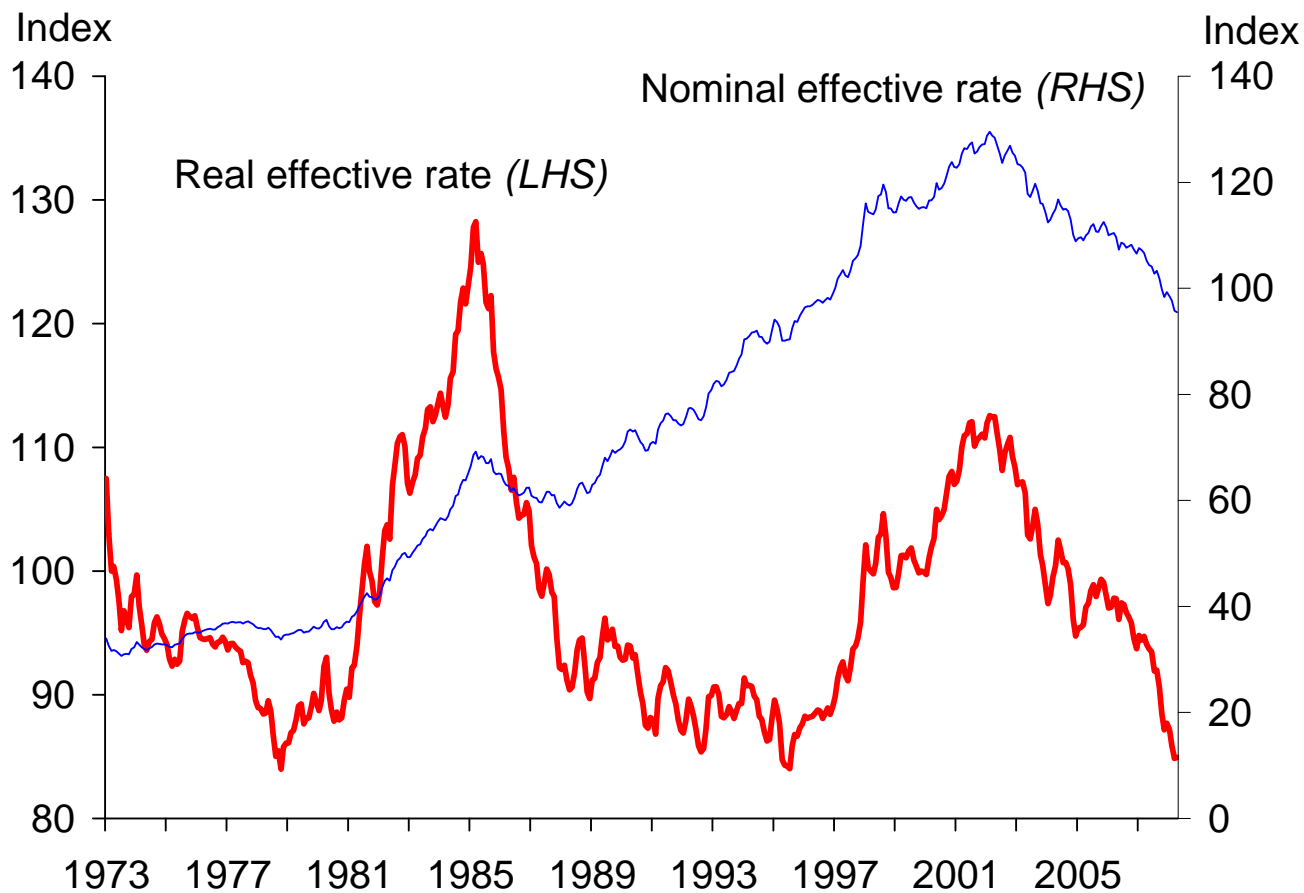
Source : Haver Analytics

Fiscal stimulus added...

- Total size US\$150bn or 1.2% of GDP
- Includes tax rebates of up to US\$1800 for a couple with two children
- Also includes investment incentives via relief of up to US\$50bn in business taxes
- Risks – cash slow to get to those who need it, and uncertain propensity to spend. Some polls suggest much of rebate could be saved or used to pay down debt

...and dollar weakens sharply...

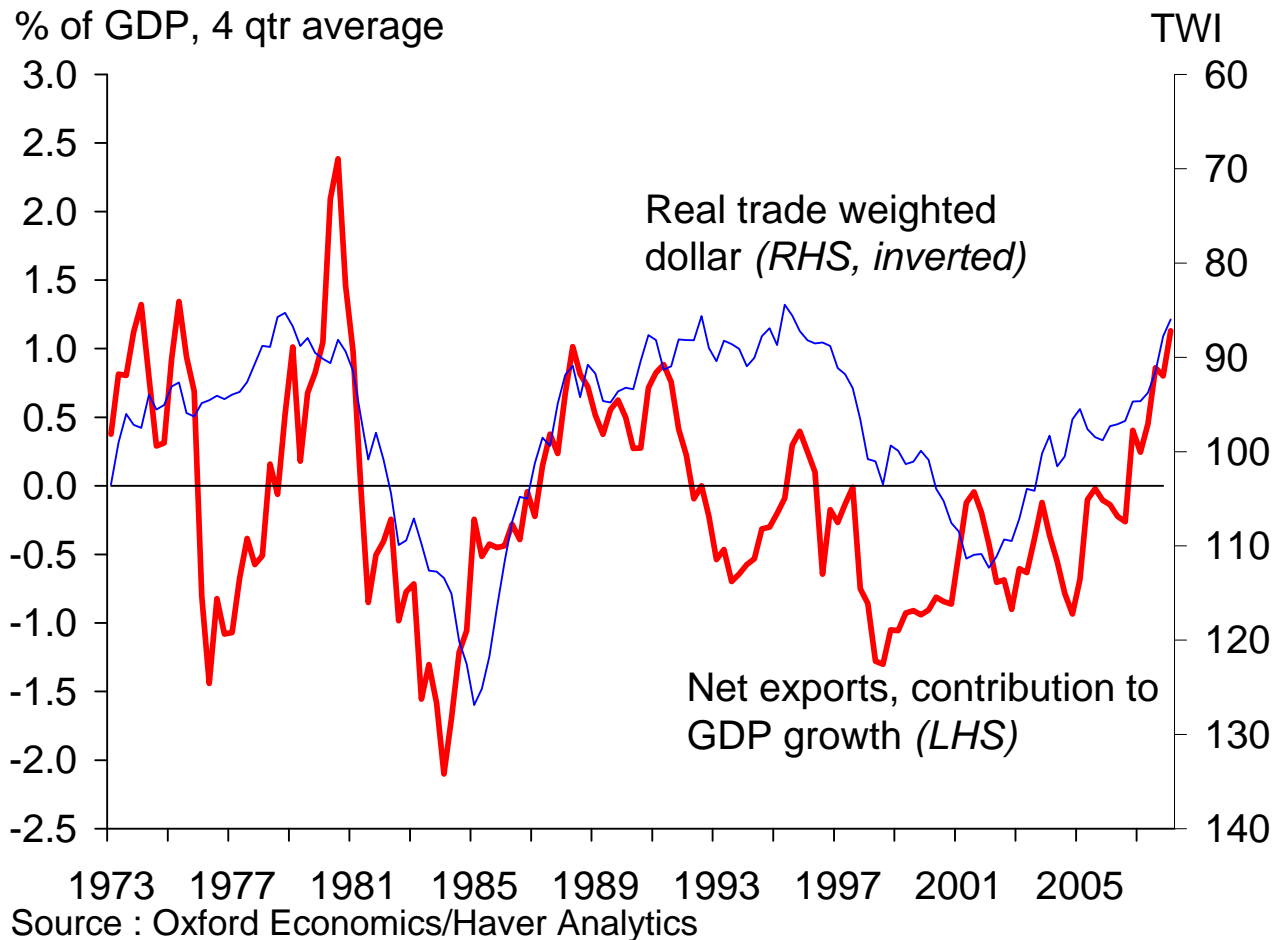
US: Real and nominal effective exchange rates



Source : Oxford Economics/Haver Analytics

...boosting exports

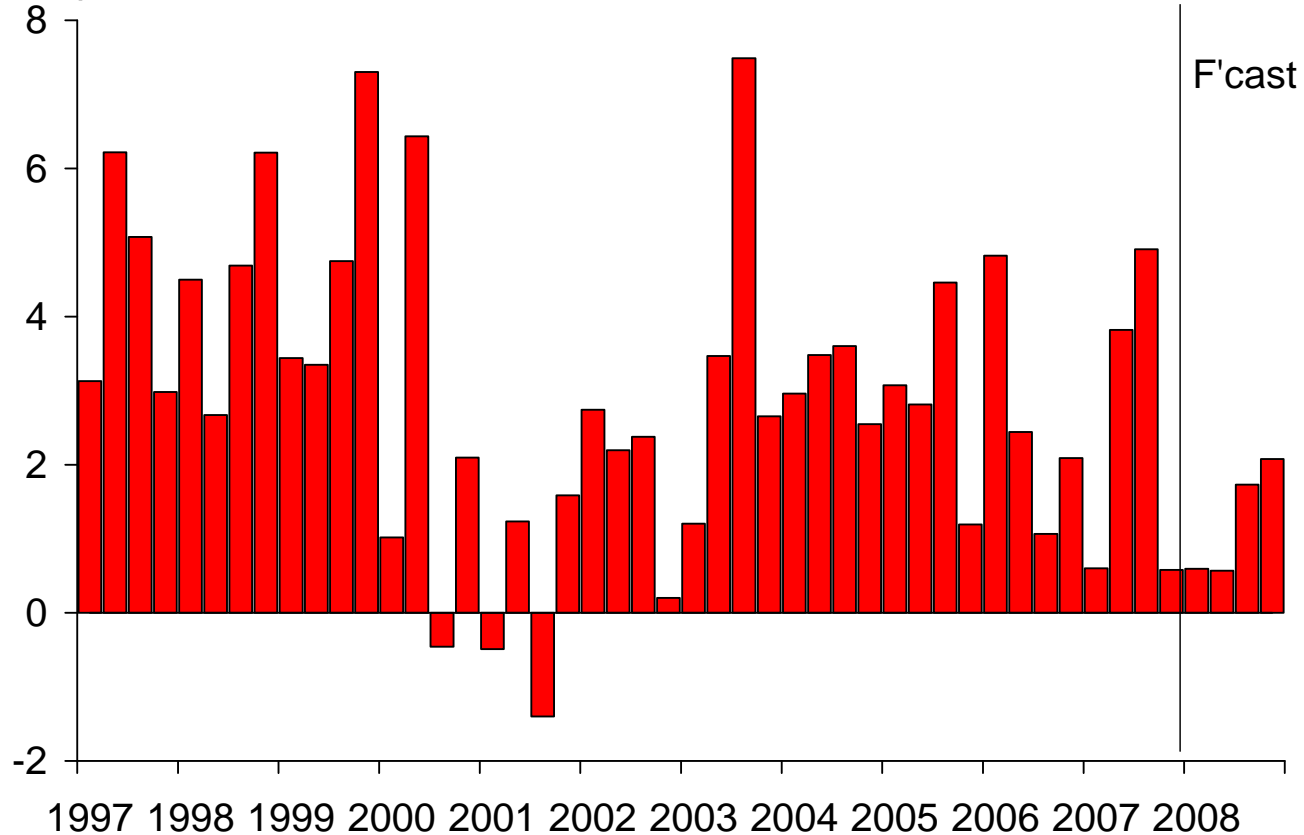
US: Trade weighted dollar and net exports



so sharp slowdown then modest recovery

US: GDP growth

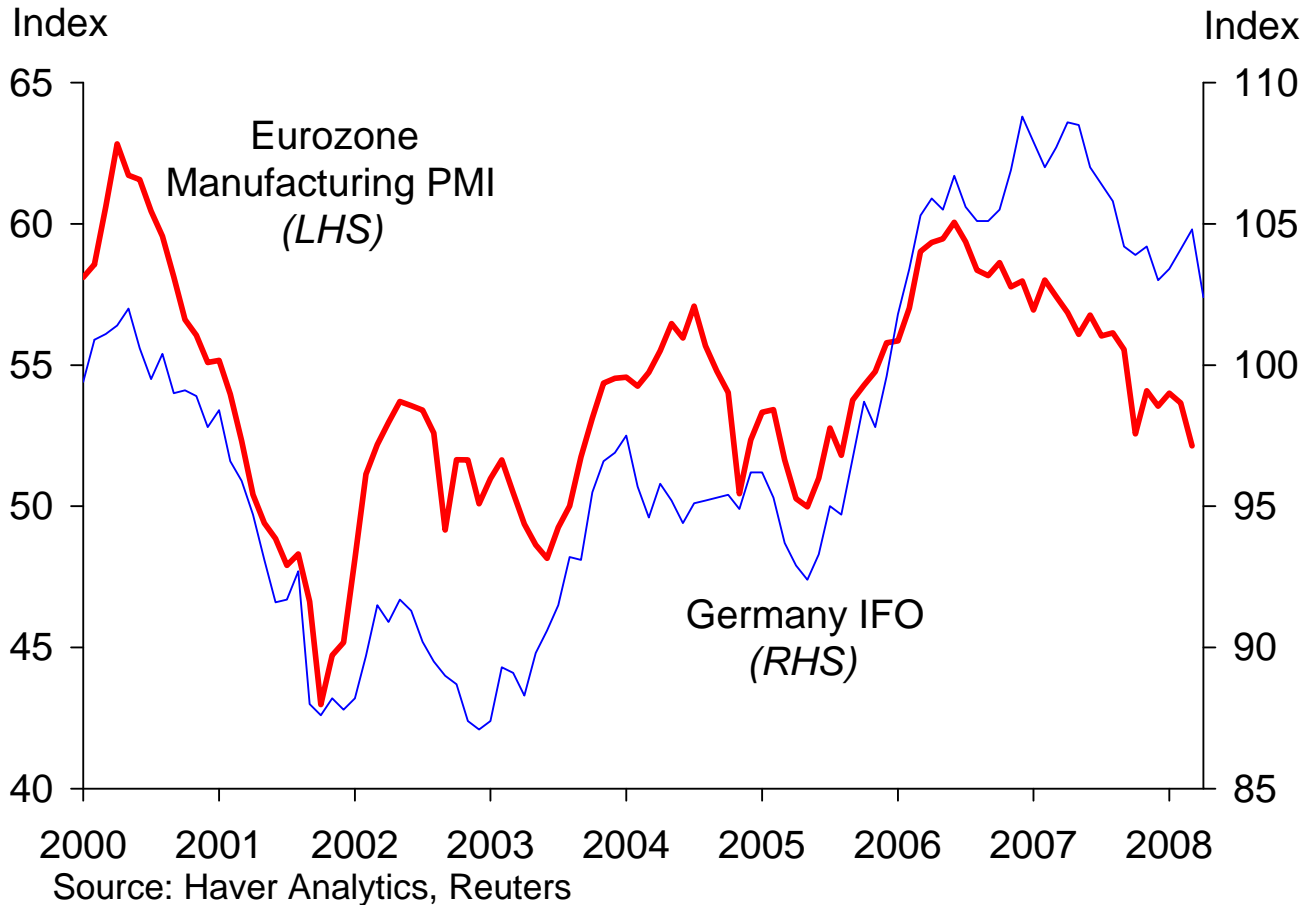
% quarter annualised



Source: Oxford Economics

Europe seems to be slowing

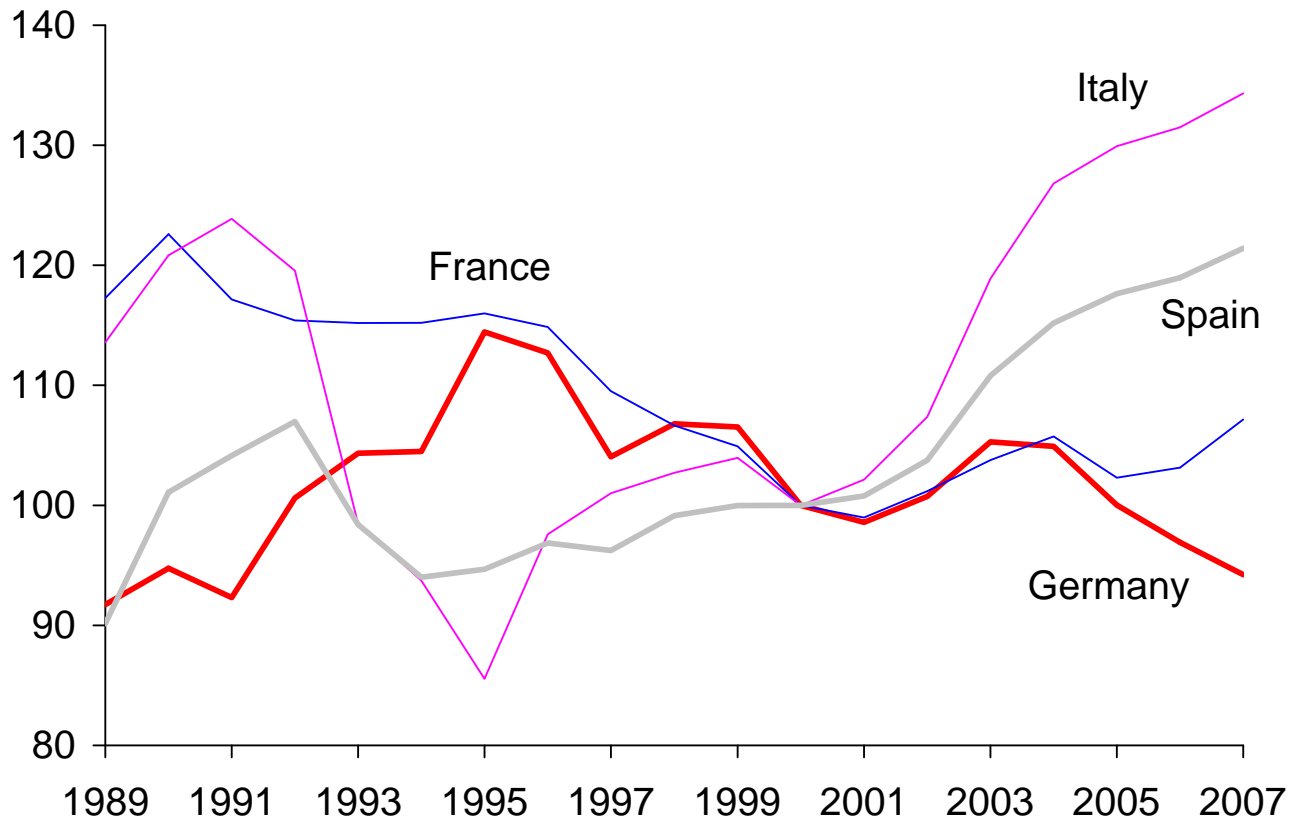
Eurozone: Leading indicators



And competitiveness a worry for some

Eurozone: divergent competitiveness

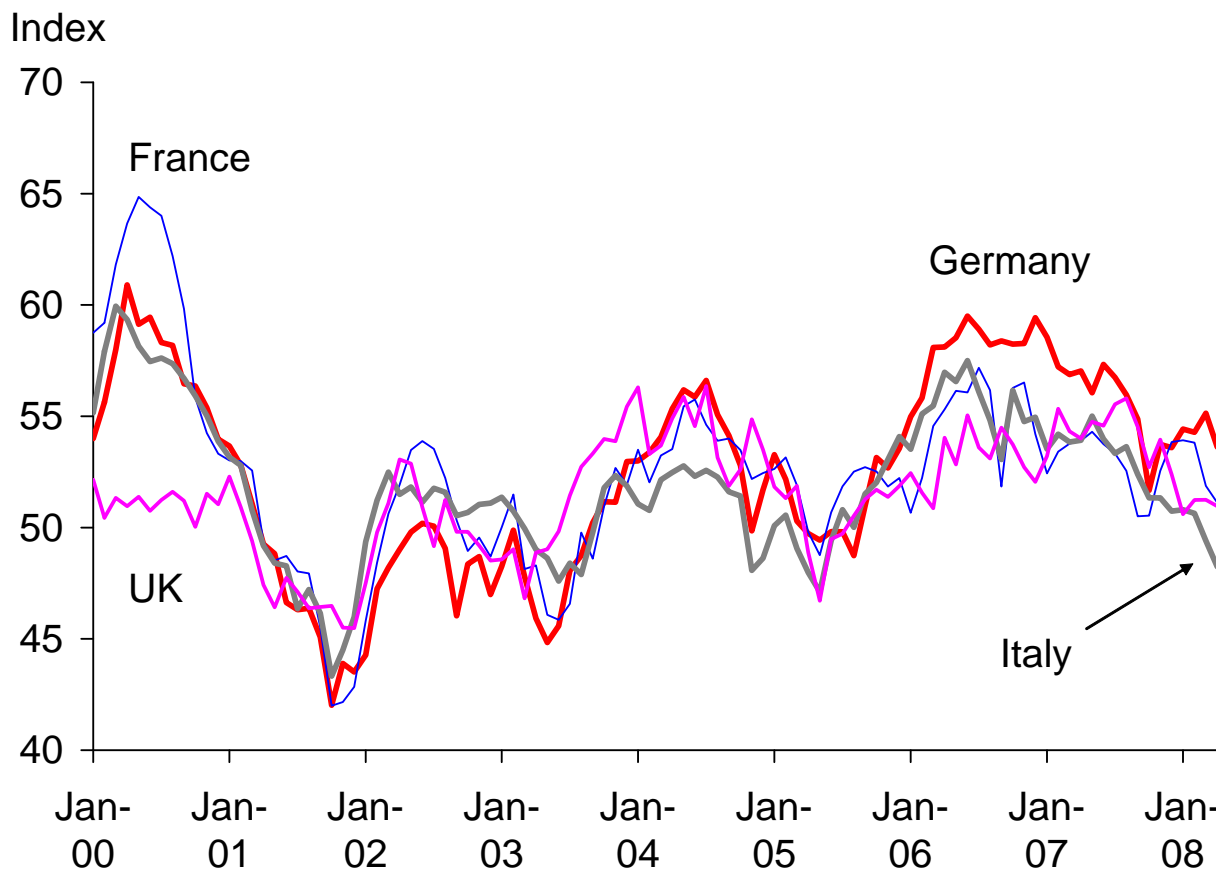
Relative unit labour costs, 2000=100



Source : Oxford Economics/Haver Analytics

So extent of the slowdown varies

Manufacturing PMI



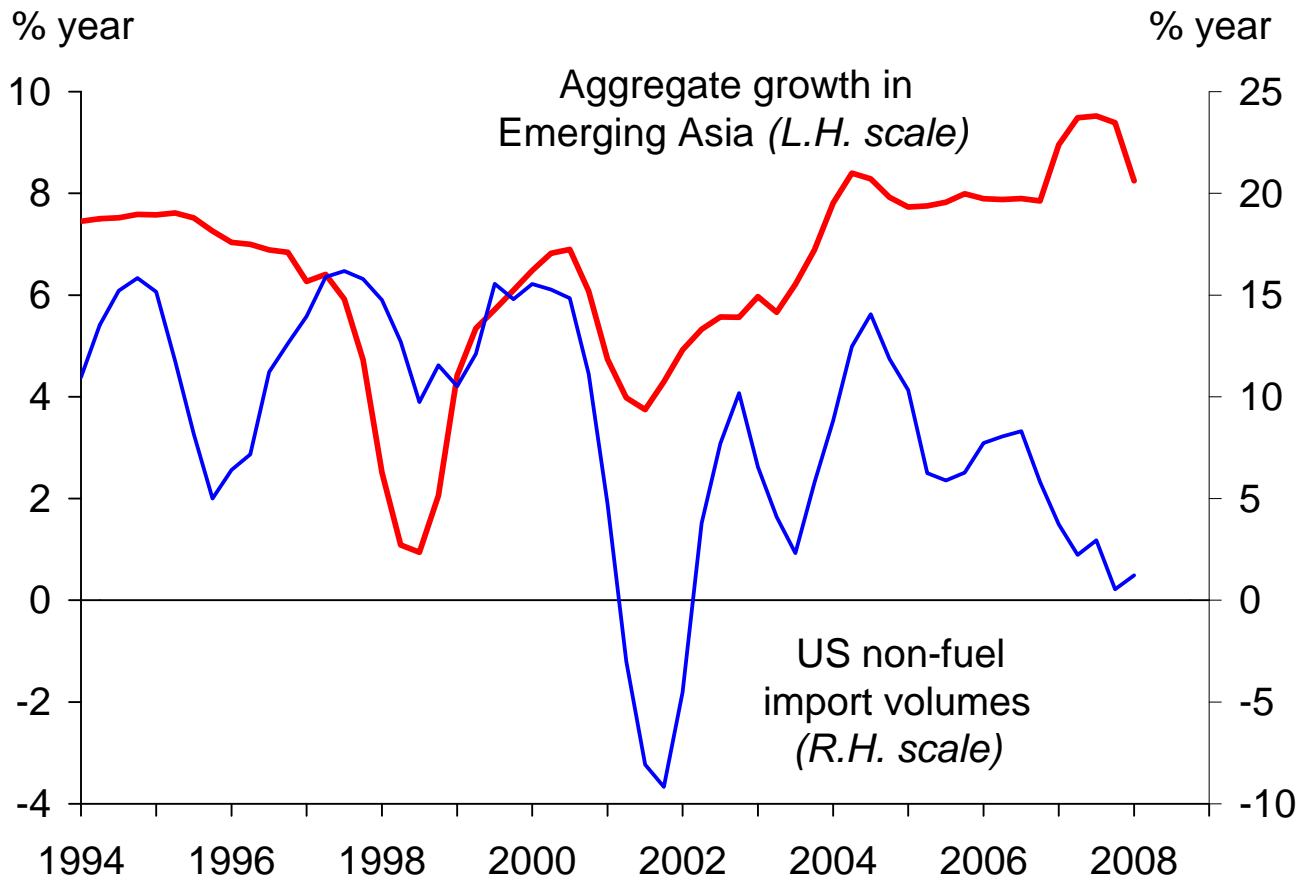
Source : Oxford Economics/Reuters

Emerging markets – strong growth but inflation worries

- Strong domestic demand growth in the leading emergers continues. The picture elsewhere is more patchy however. Most countries' banking sectors have been little affected by the credit crunch. Indeed, increased access to credit is an important source of growth in many economies.
- Export growth of the emergers has held up well in the face of a weak US economy; Asian exporters have compensated by expanding sales to new markets, other emerging markets and oil producers.
- BUT risks of a sharper slowdown in the emergers have intensified given the sustained burst of inflationary pressure stemming from surging food and oil prices – and the danger this poses to economic stability.

..Asia appears less dependent on the US...

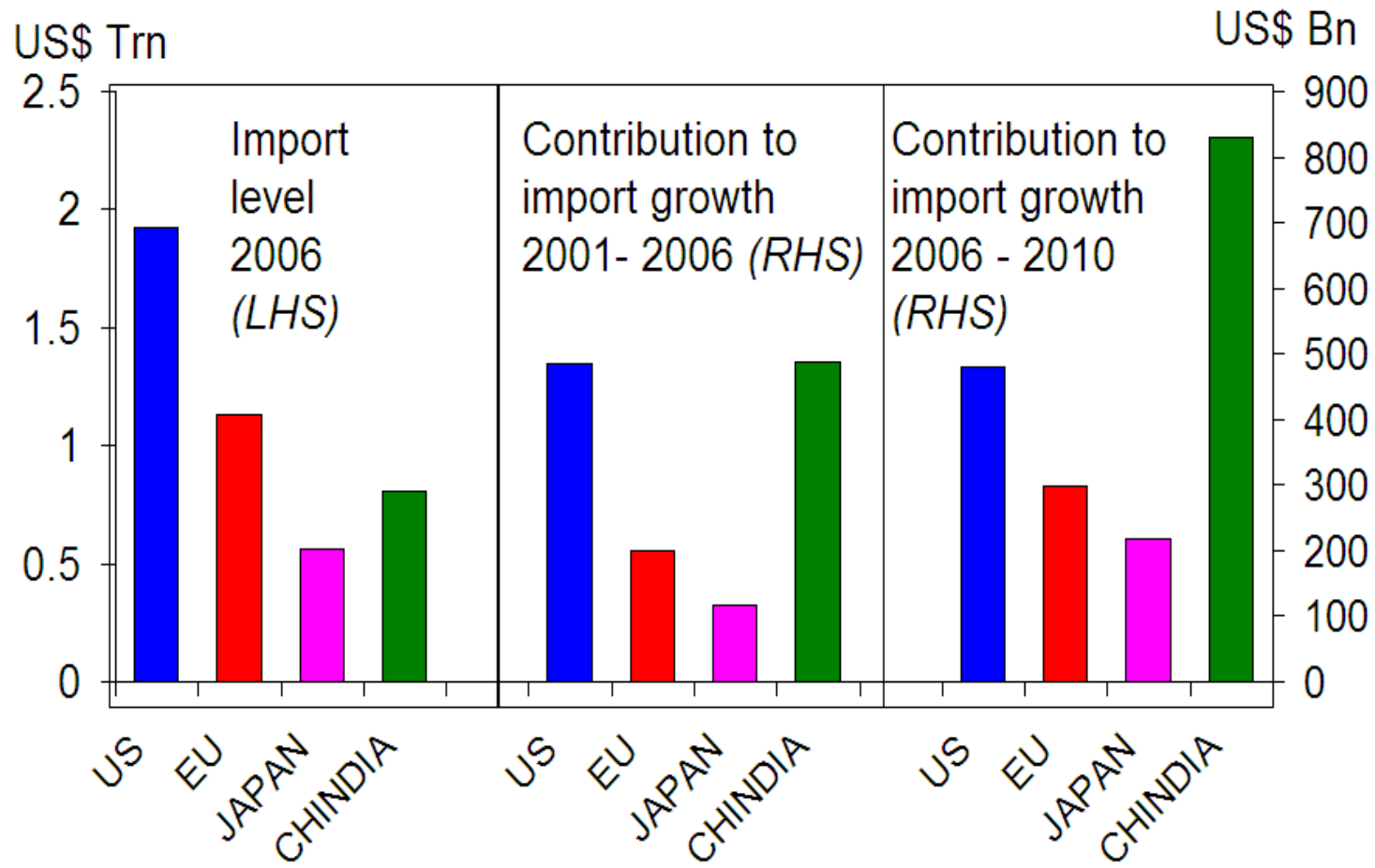
US imports & real GDP in Emerging Asia



Source: Oxford Economics

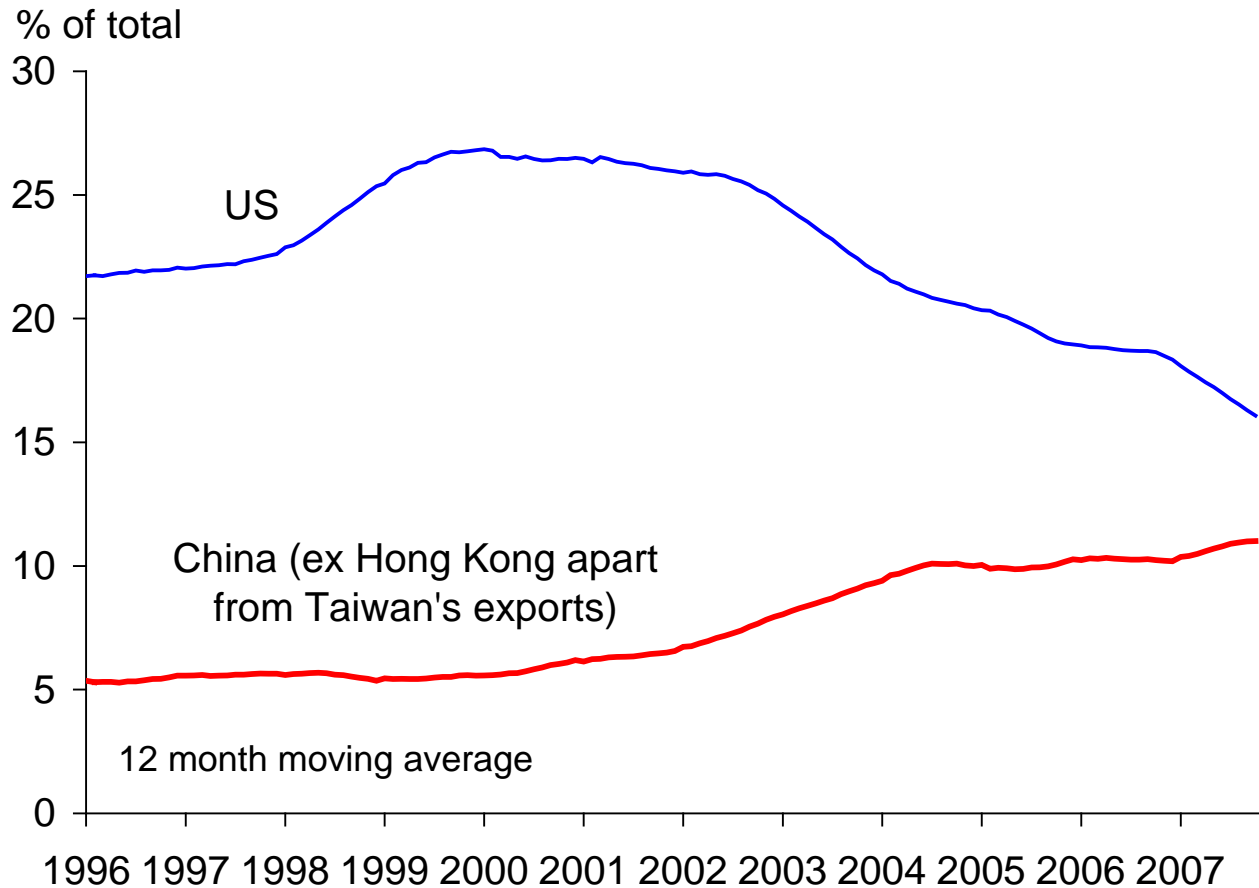
...because of China and India...

Contributions to import growth



Source : Oxford Economics

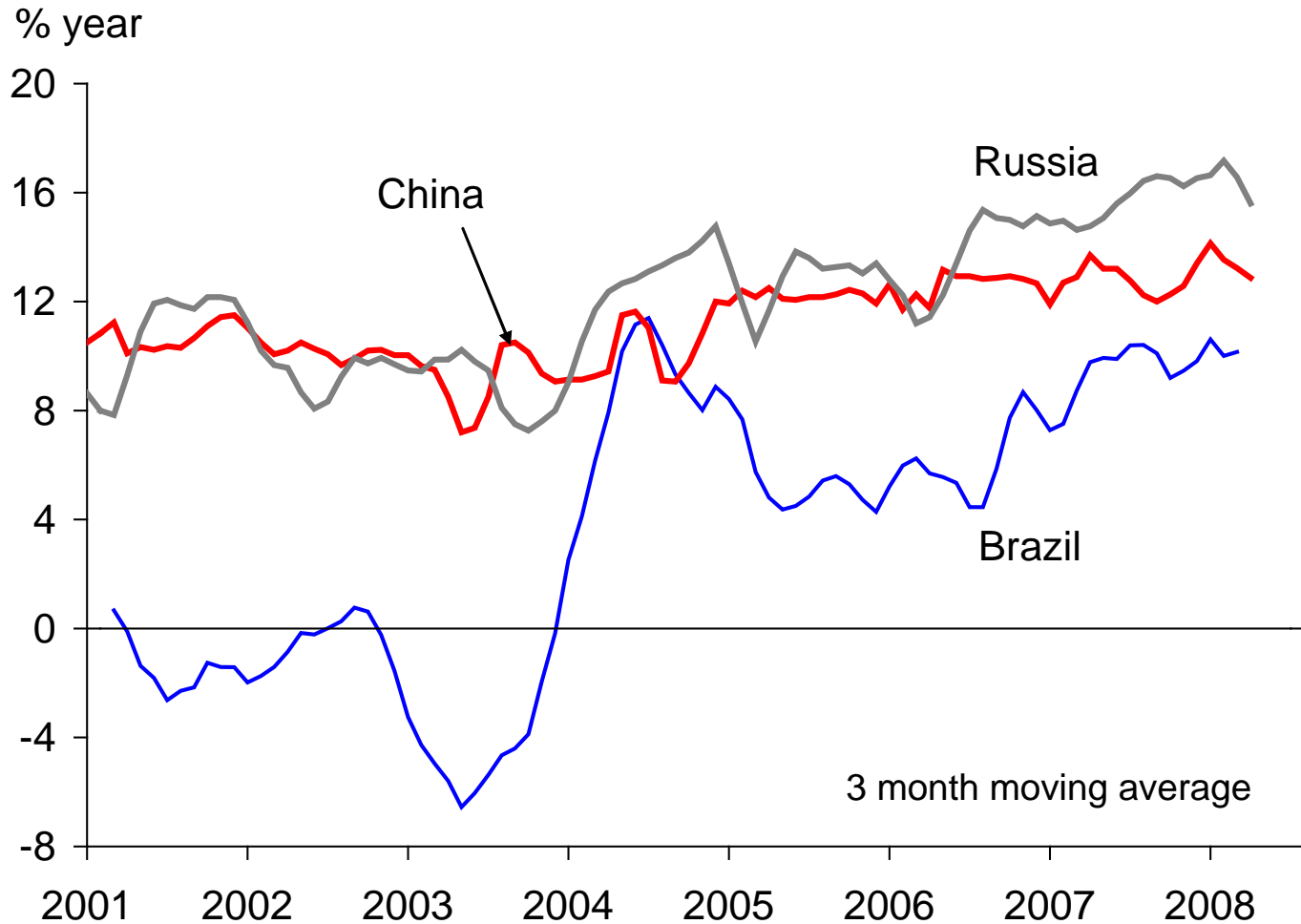
Emergers: Destination of exports



Source: Haver Analytics / IMF DOTS

Strong demand growth in the BRICs

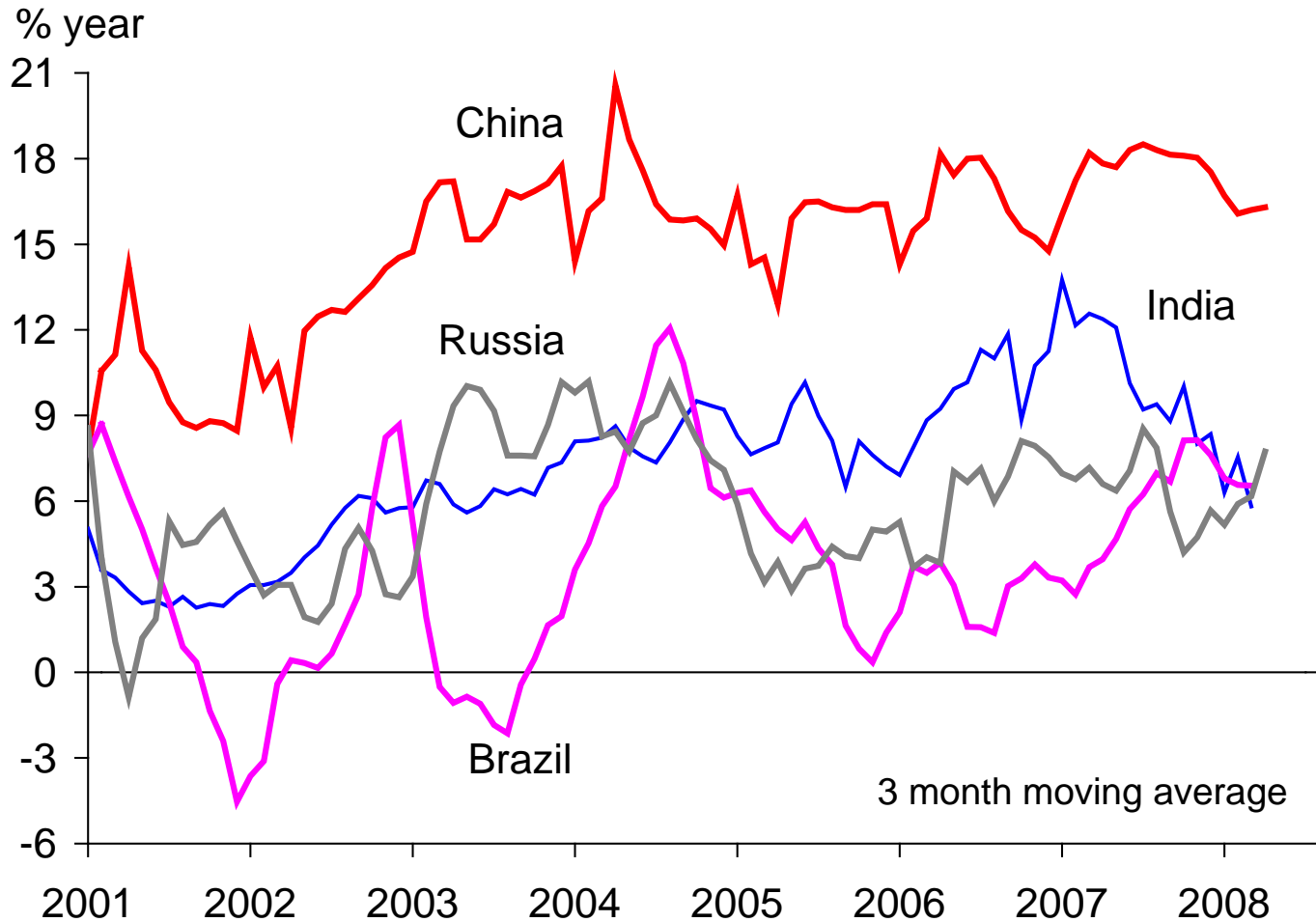
Brazil, Russia & China: Retail sales volumes



Source: Haver Analytics

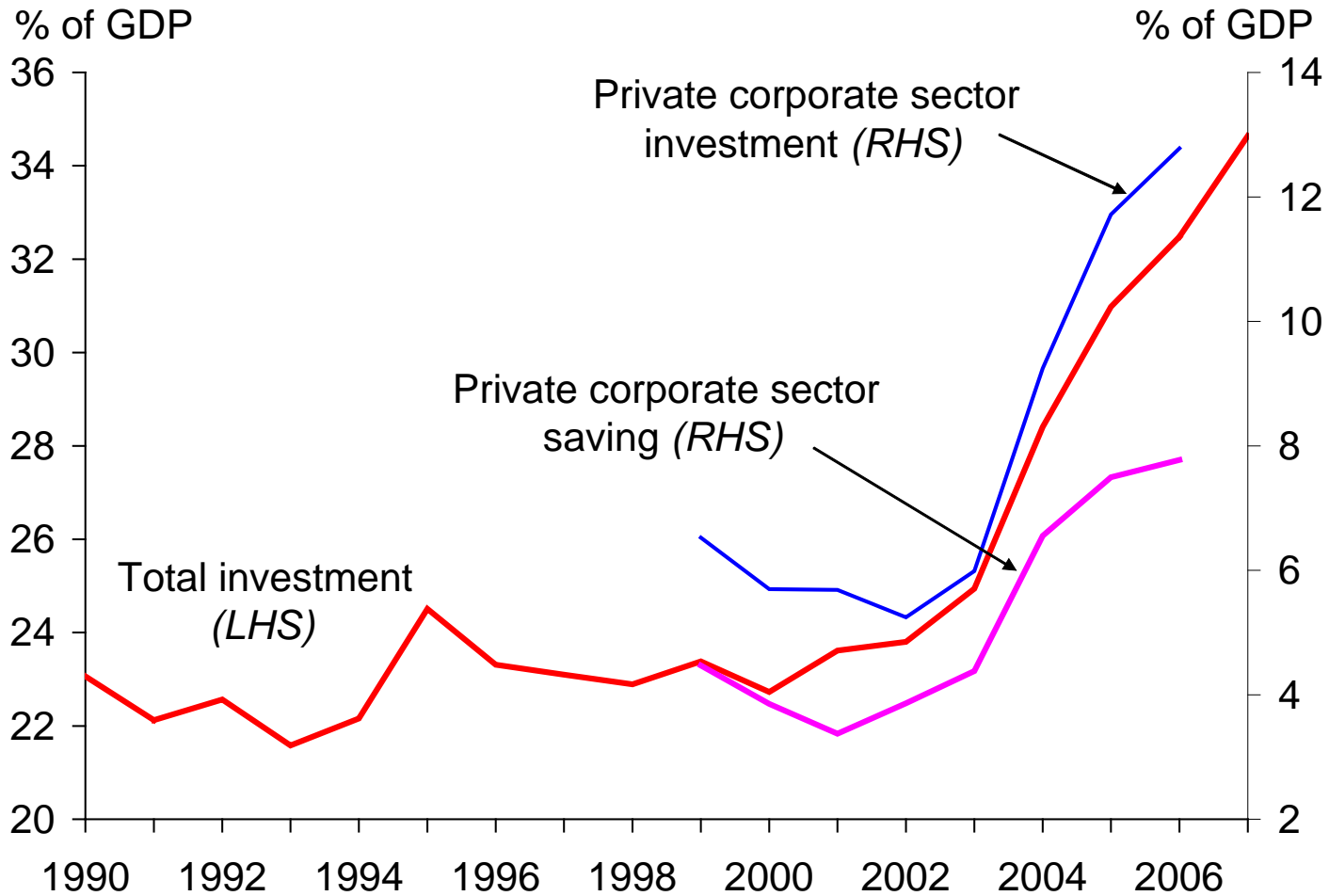
BRICs – solid output growth, except in India?

BRICs: Industrial output



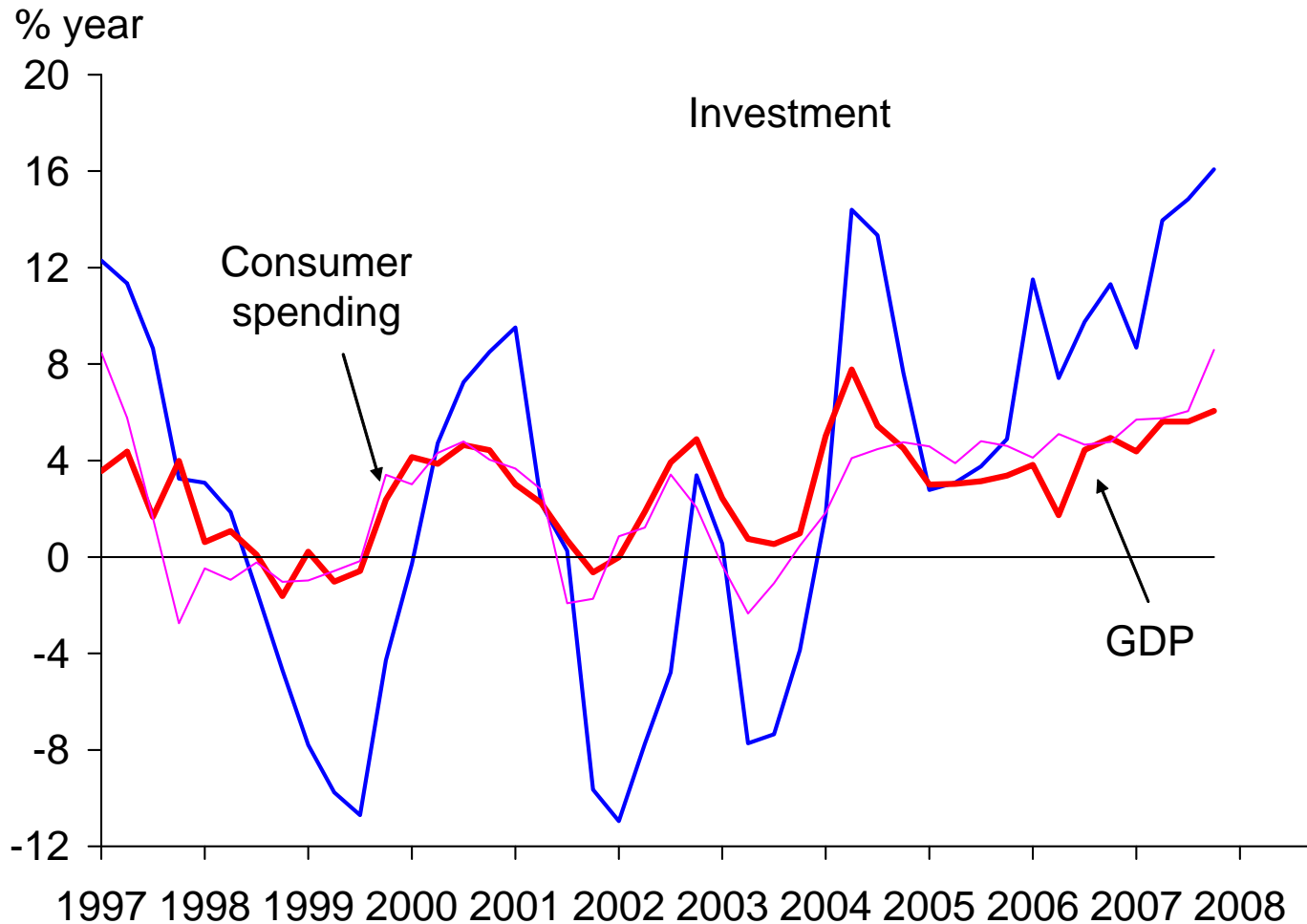
Source: Haver Analytics

India: Investment as % of GDP (fiscal years)



Source: Haver Analytics

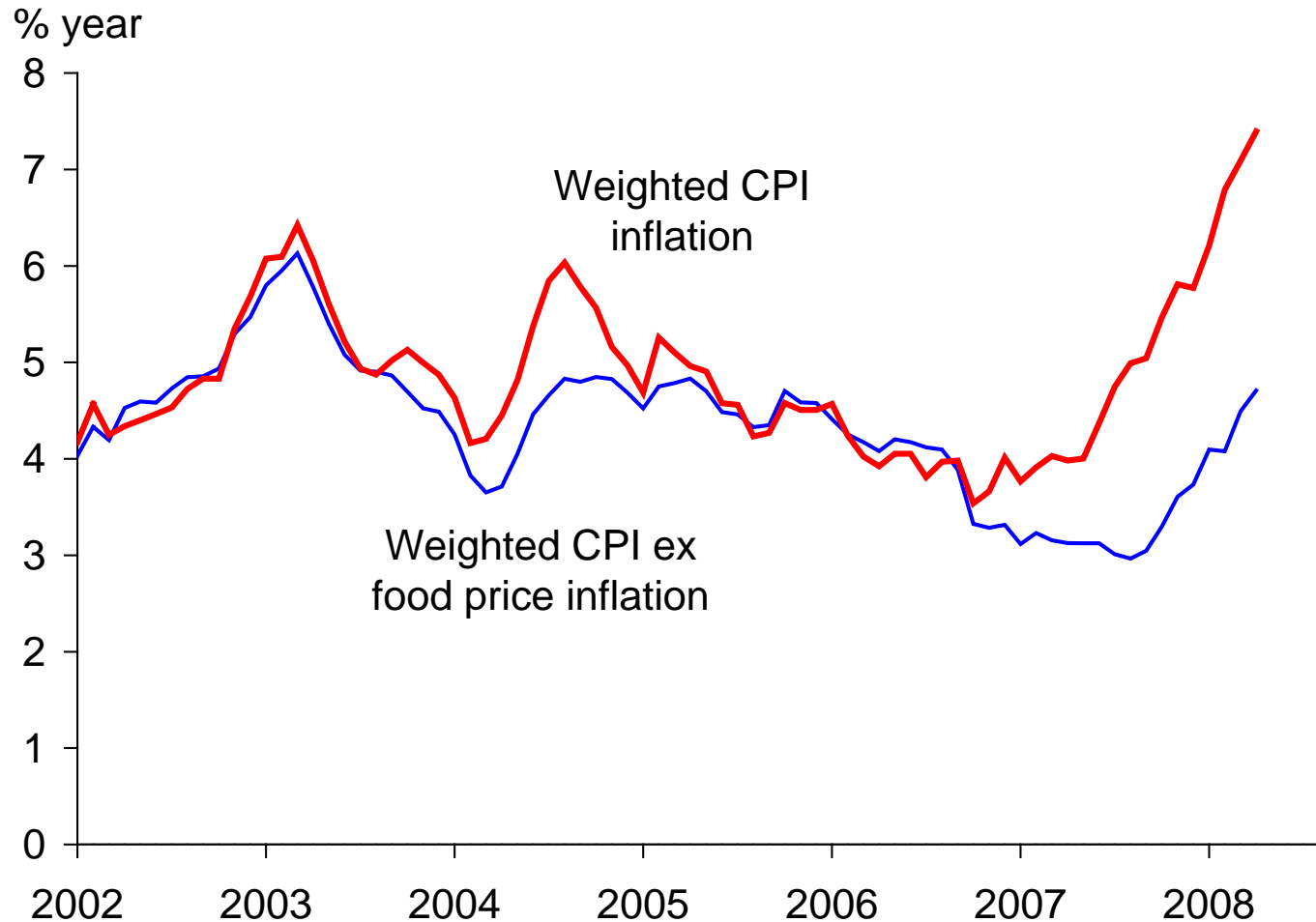
Brazil: GDP, consumer spending & investment



Source: Haver Analytics

Inflation under serious pressure from food prices

Emerging markets: Consumer prices

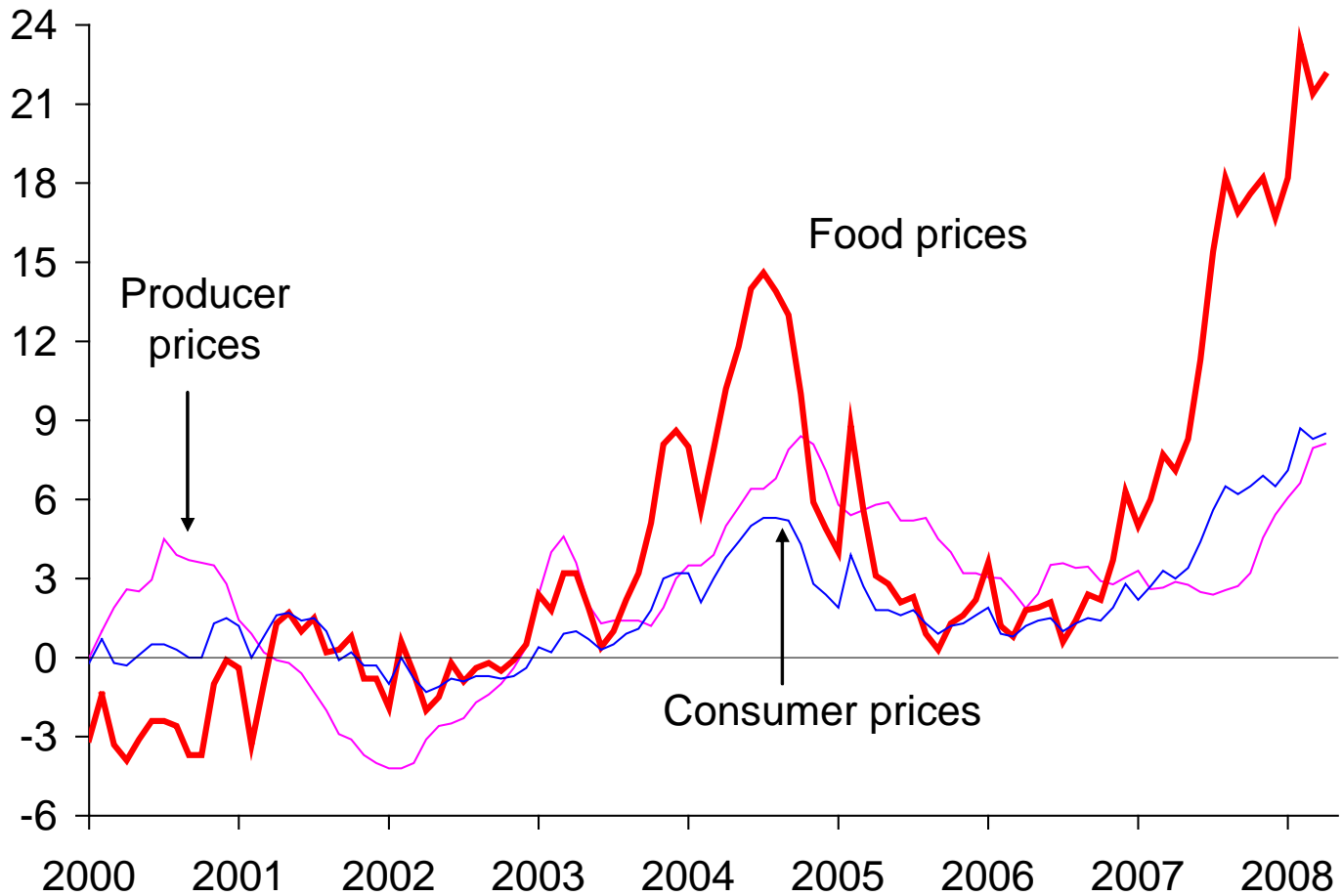


Source: Haver Analytics / Oxford Economics

China: Food prices main worry but...

China: Inflation

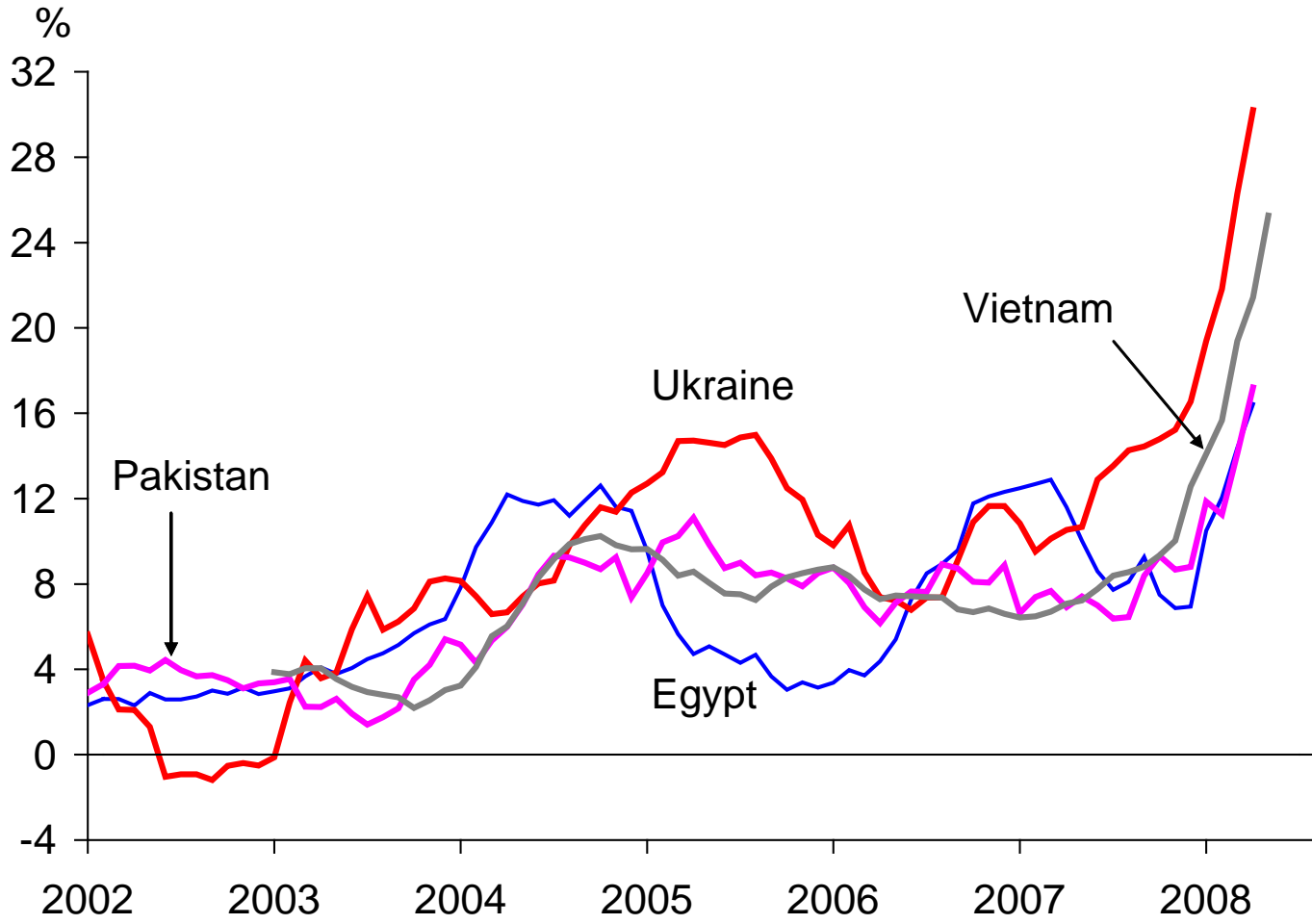
% year



Source: Haver Analytics

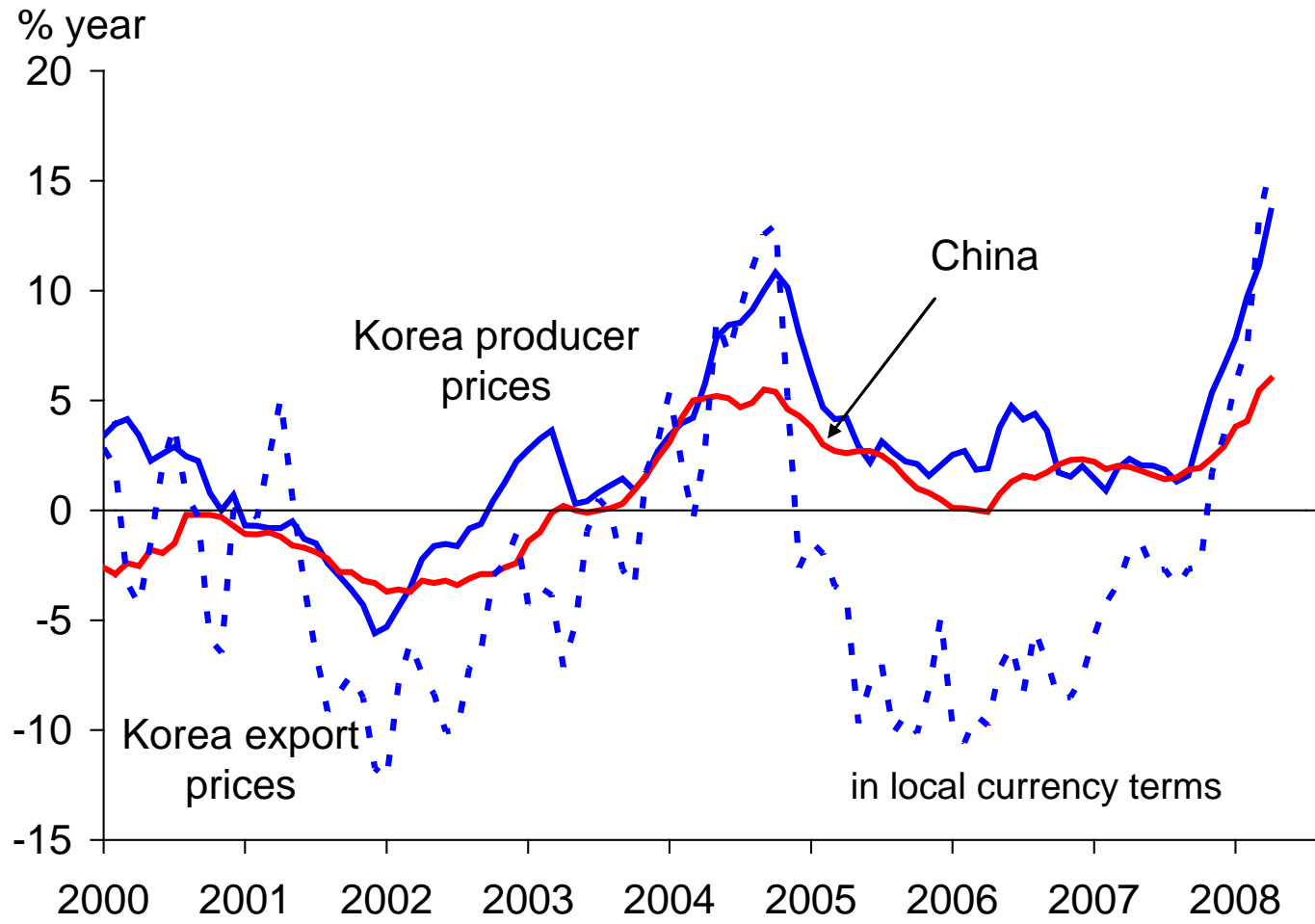
Inflation has soared in several emergers

Emergers: CPI inflation



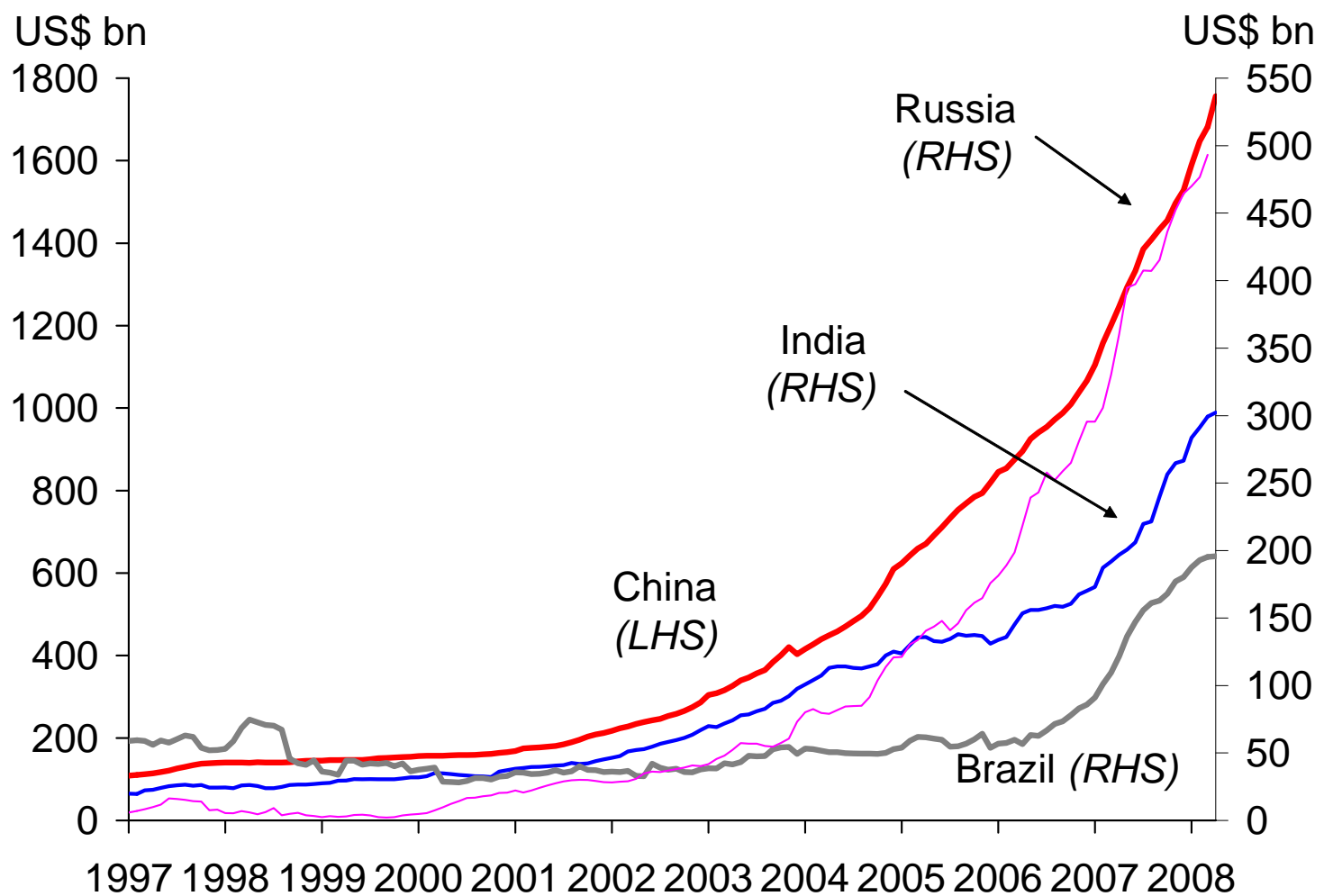
Source: Haver Analytics

China & Korea: Manufacturing producer prices



Source: Haver Analytics

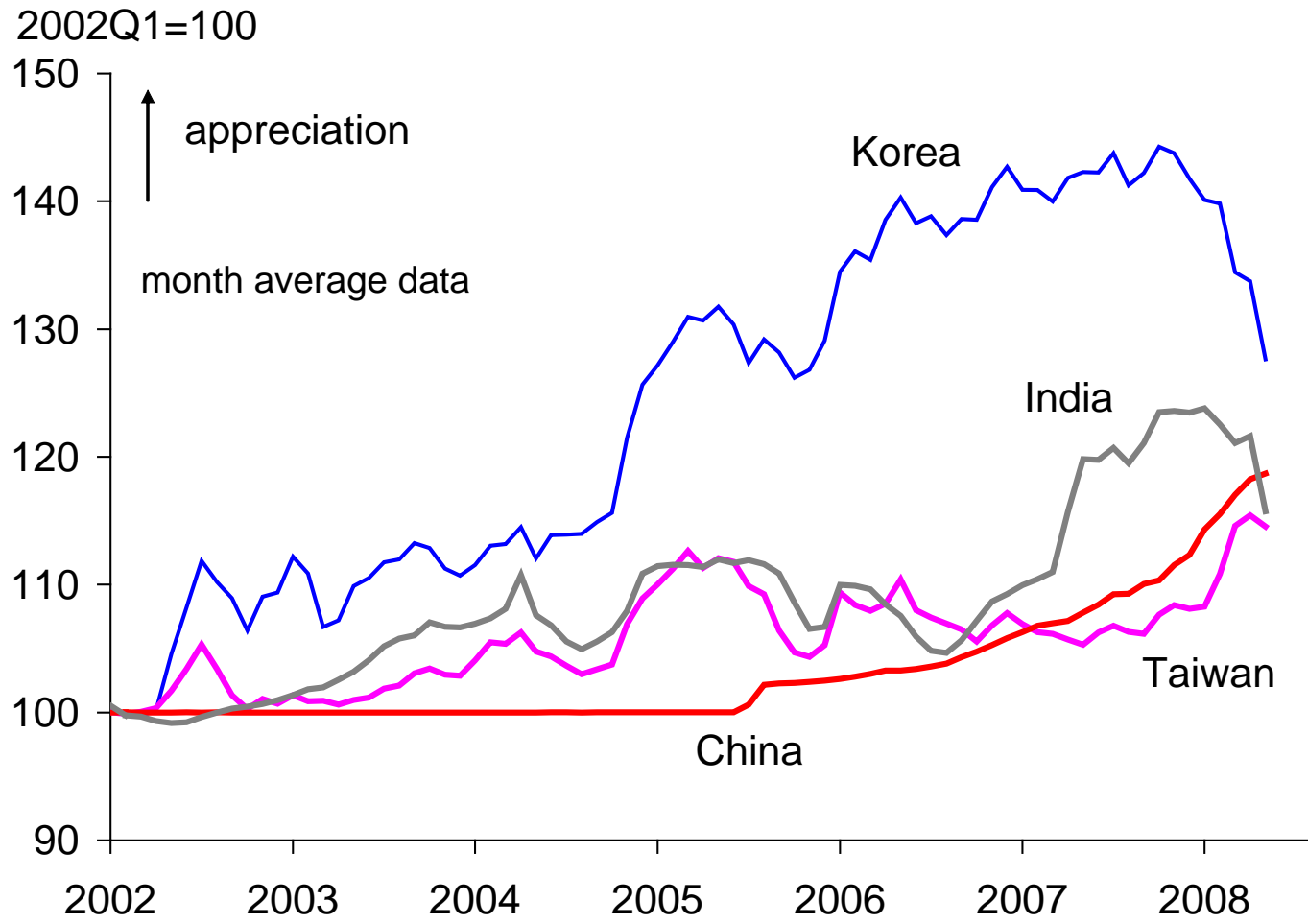
Emerging Markets: Foreign exchange reserves



Source: Haver Analytics

Diverging exchange rate trends...in Asia (1)

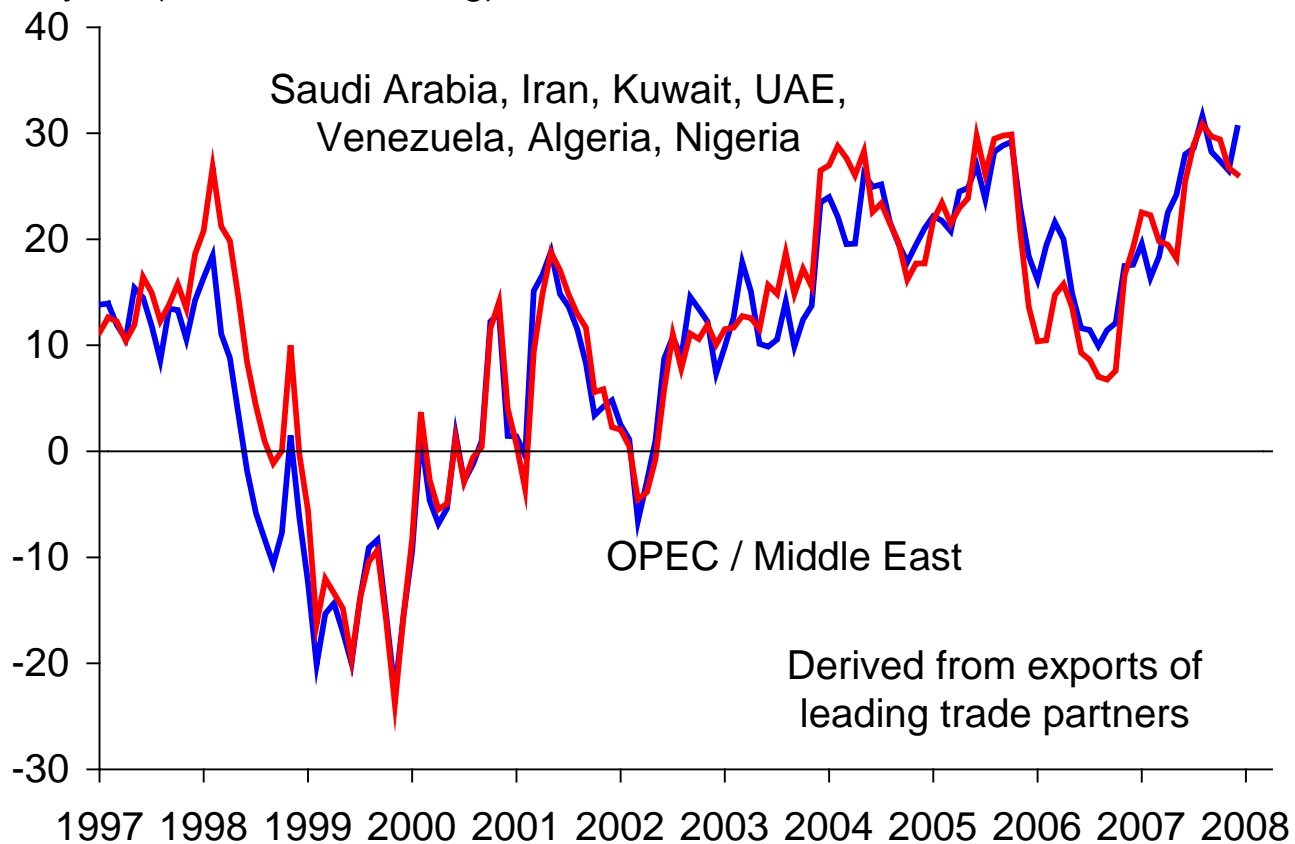
Emerging Asia: Exchange rates v US\$



Source: Haver Analytics

OPEC: Proxy for import growth

% year (US\$, 3 month avg)



Source: Haver Analytics

Food main cause of inflation even in 2007

Contribution to headline %	Food	Fuel
Advanced Economies	19.5	12.1
Developing Asia	67.5	3.4
CEE	34.9	11.8
Middle East	42.3	24.4

Reasons other than demand for high food prices

- Bio-fuel production – directly for corn and rapeseed oil
- Drought in Australia and poor crops in EU and Ukraine
- Fall in the dollar and lower interest rates (inflation and currency hedging etc) also energy and fertiliser costs raise production costs by 15%
- Favourable investor sentiment (portfolio diversification etc)
- Credit Crunch also limiting ability of commodity producers and others to trade against the trend?

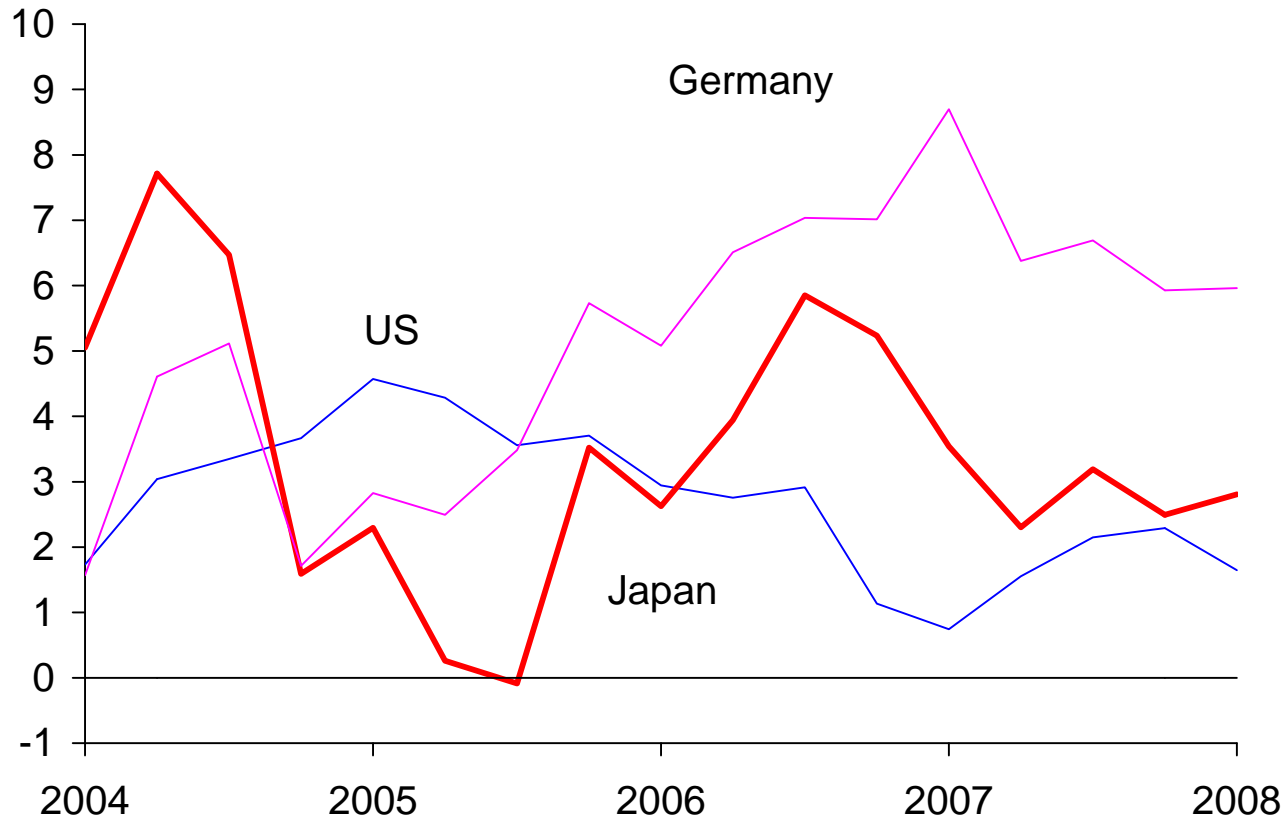
Summary so far

- Credit crunch and housing causing problems in US. But squeeze on real incomes from higher commodity prices perhaps even bigger problem.
- Risk of US recession but aggressive policy reaction, lower dollar and emerging market resilience more likely to lead to modest recovery in 2008H2.
- Asia and Mid-East still booming and South America solid but EU hit by weak dollar.
- But if high oil and food prices persist then risk of inflation becoming more entrenched especially in emerging markets and policy tightening plus a squeeze on real incomes could have severe impact on growth in 2009.

Industry: divergence amongst big 3 continues

Manufacturing Output

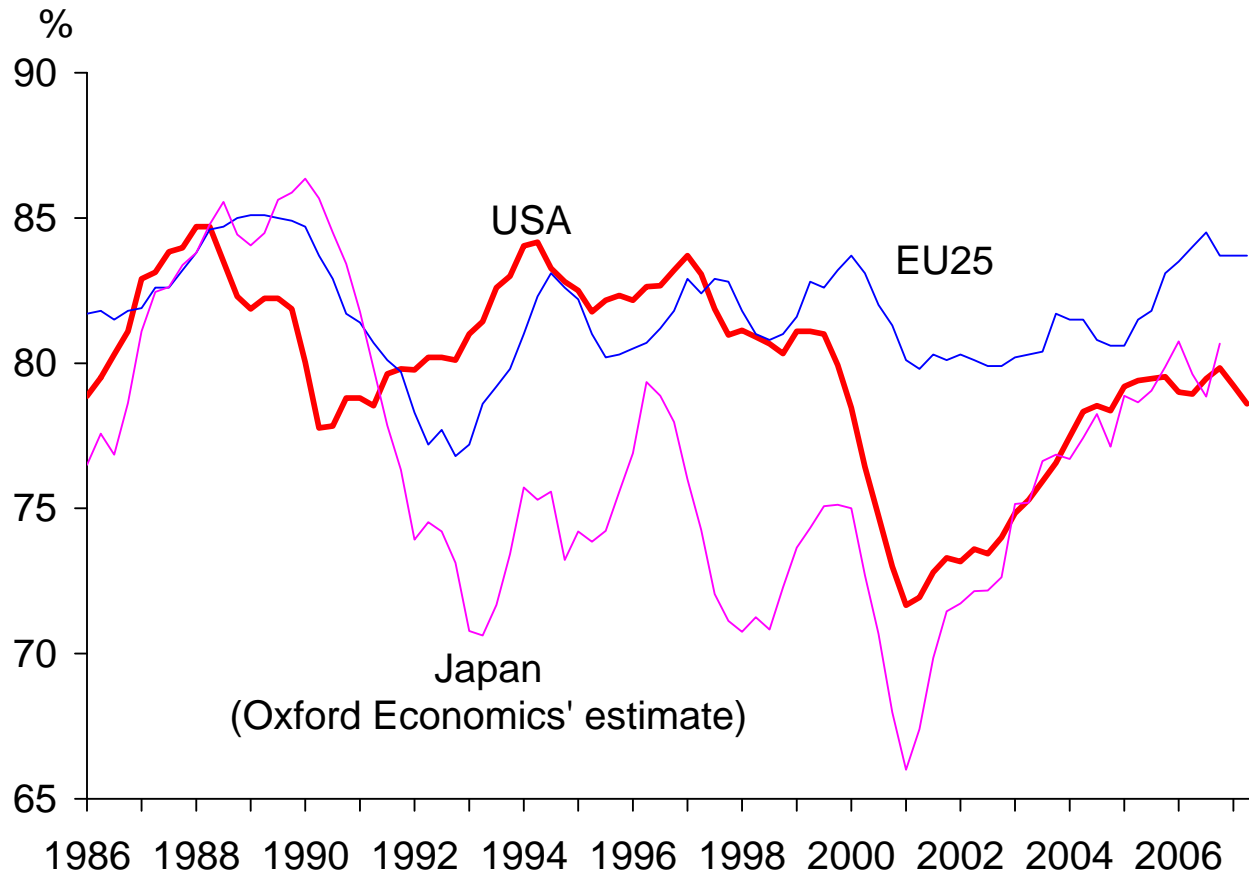
% change



Source: Oxford Economics

Capacity utilisation to drive industrial investment

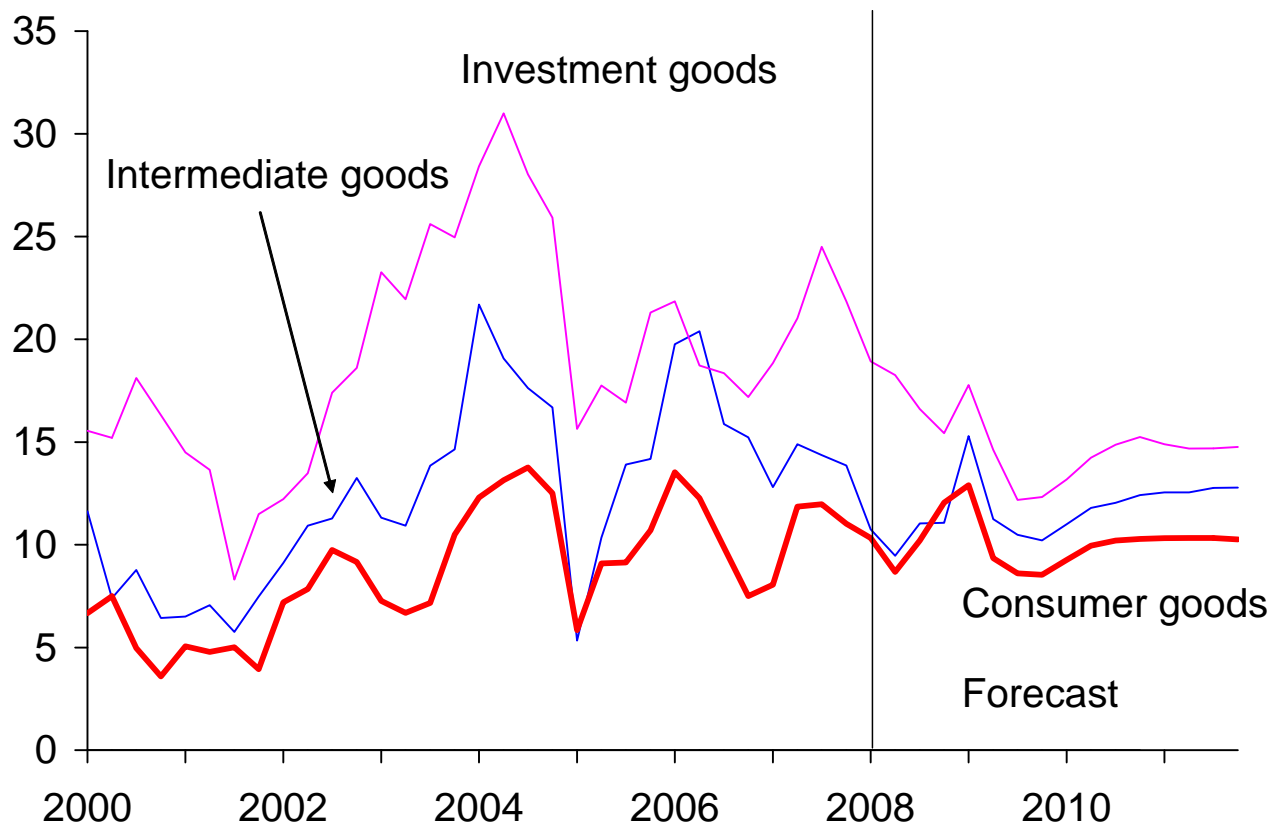
Manufacturing capacity utilisation



Source: Haver / Oxford Economics

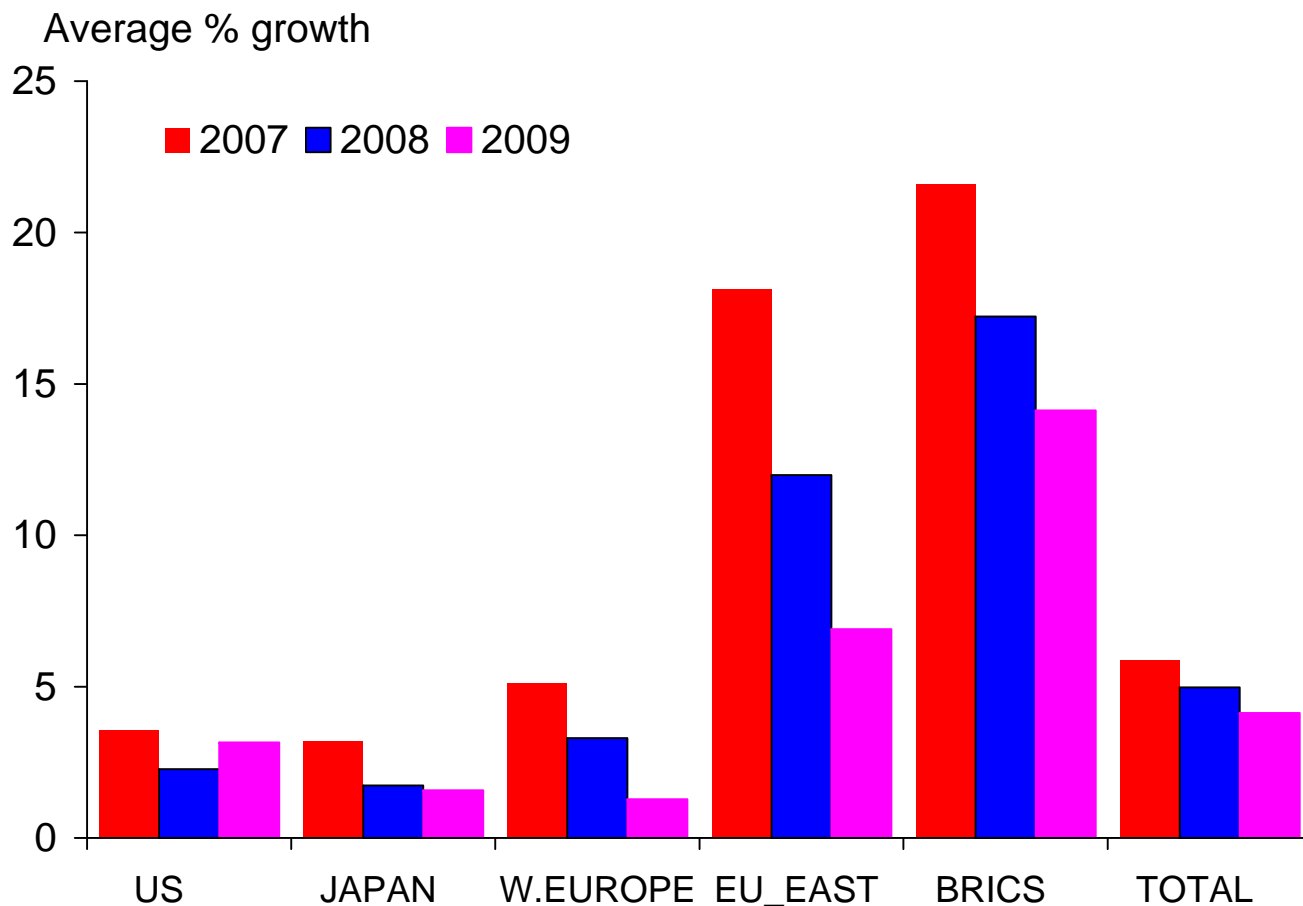
BRICS

% change



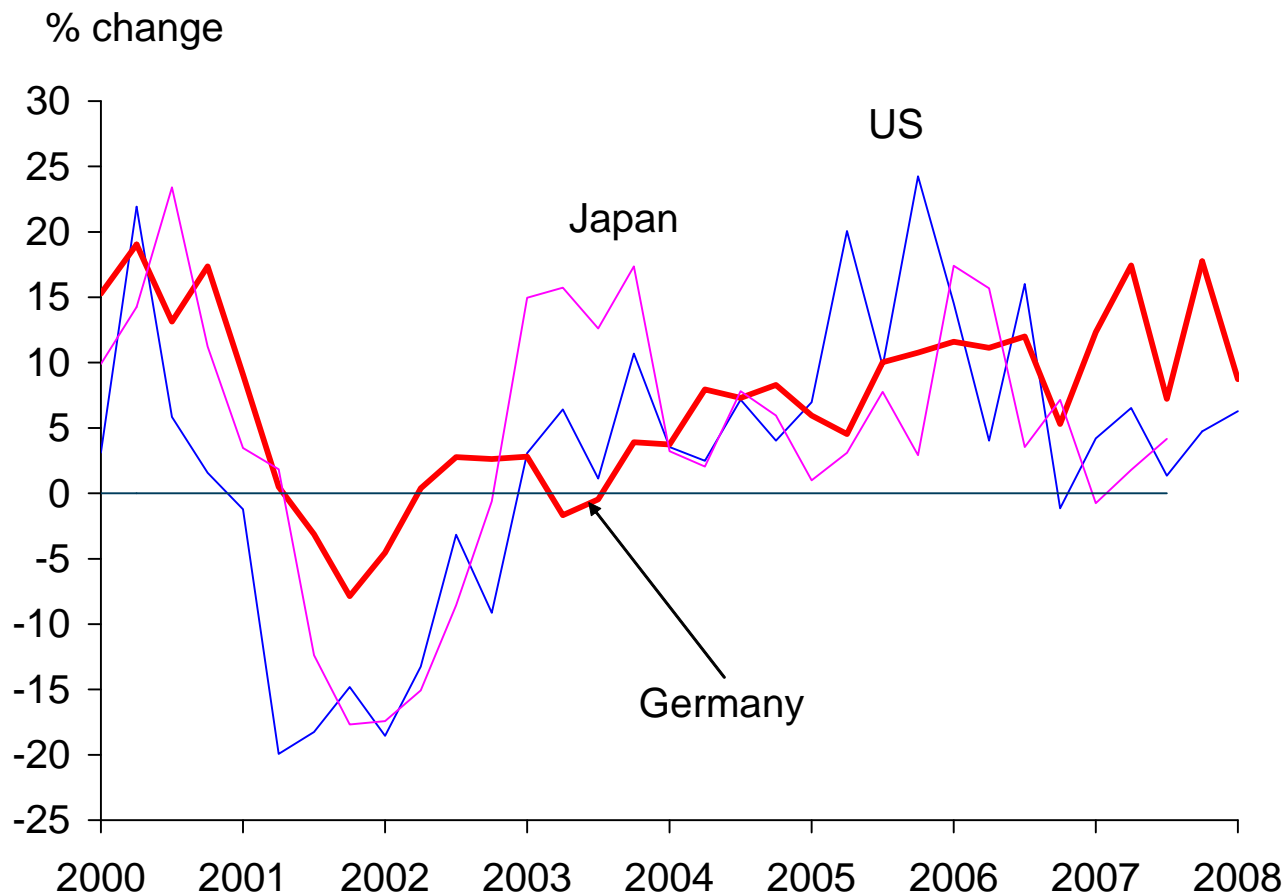
Source: Oxford Economics

Outlook for Investment goods



Source: Oxford Economics

Capital goods orders

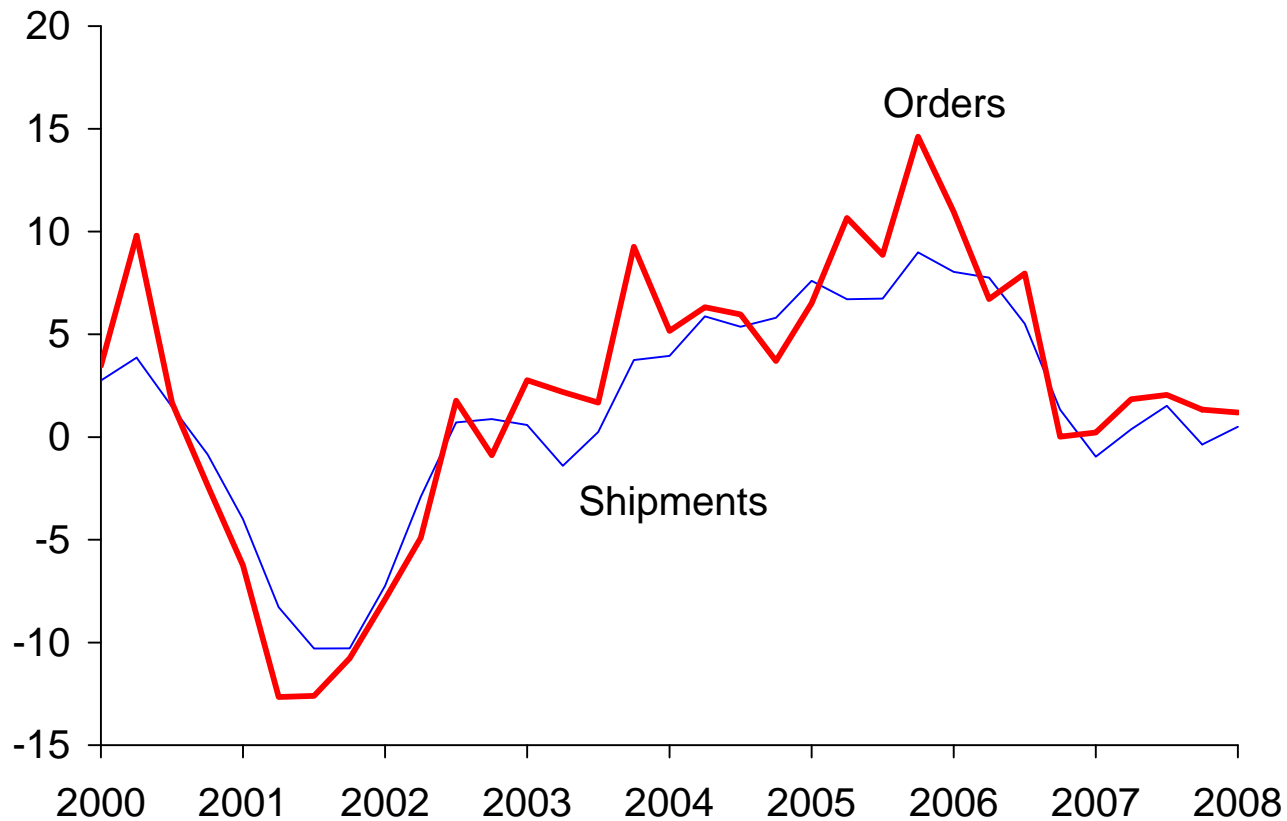


Source: Haver Analytics

Some signs that the US has flattened out

US durable goods

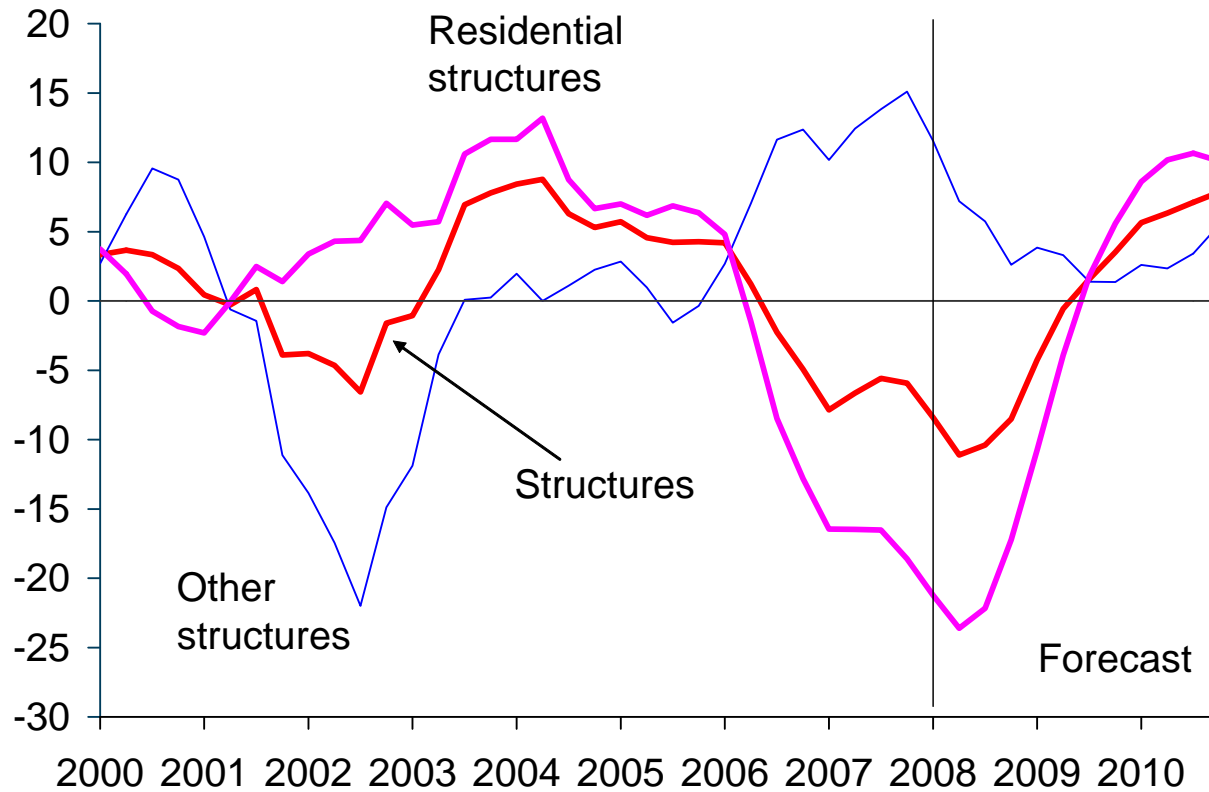
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Source: Haver Analytics

US Construction: Output growth

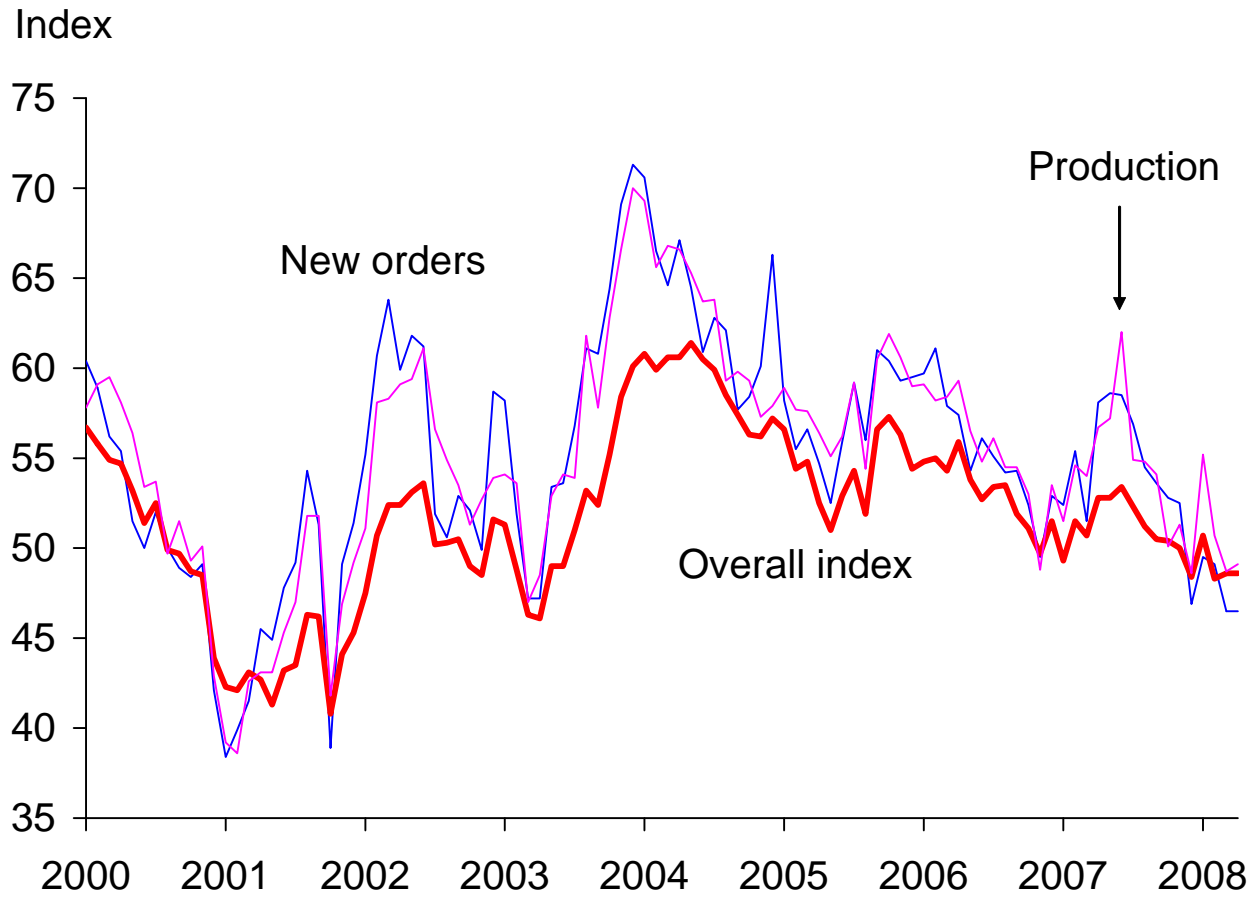
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Source : Oxford Economics

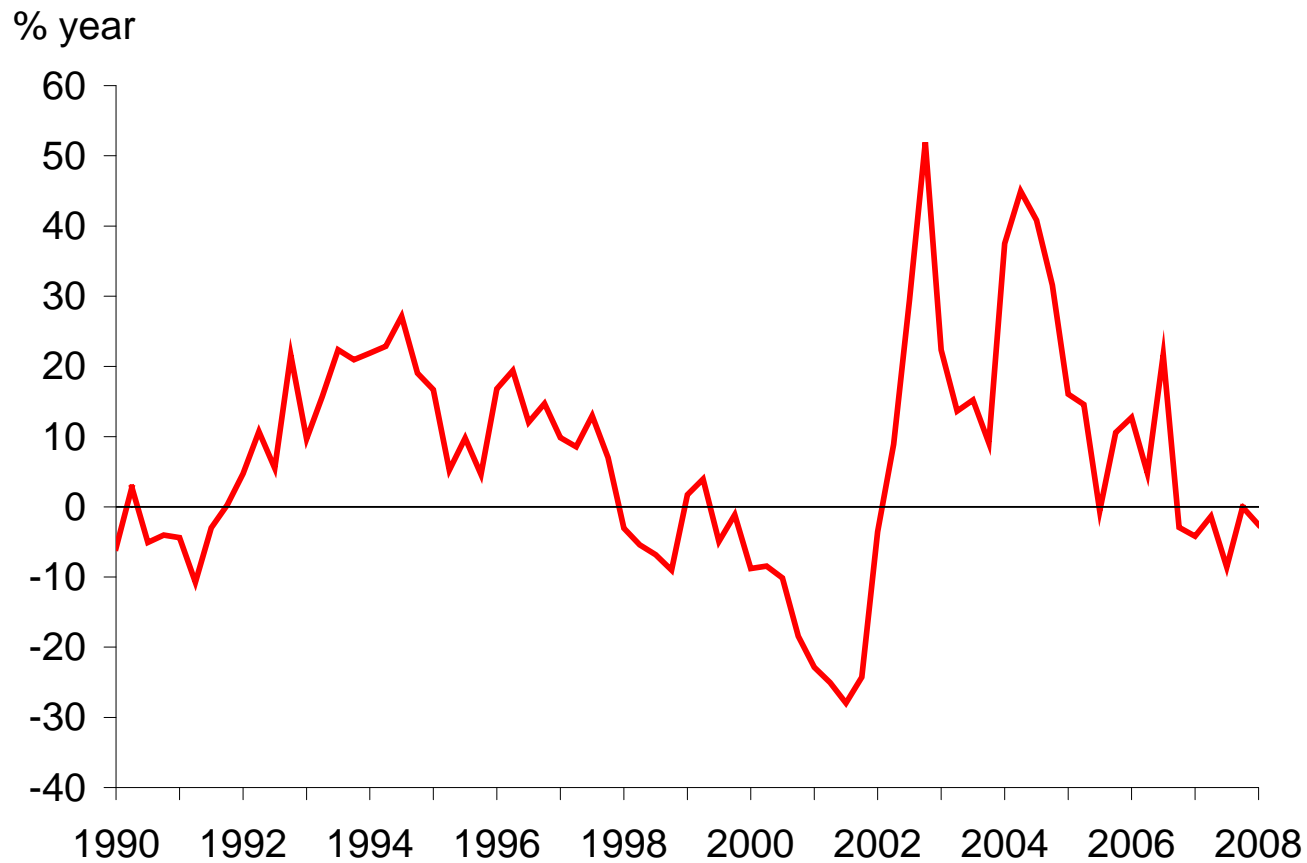
But not out of the woods yet

US purchasing managers survey



Source: Haver Analytics

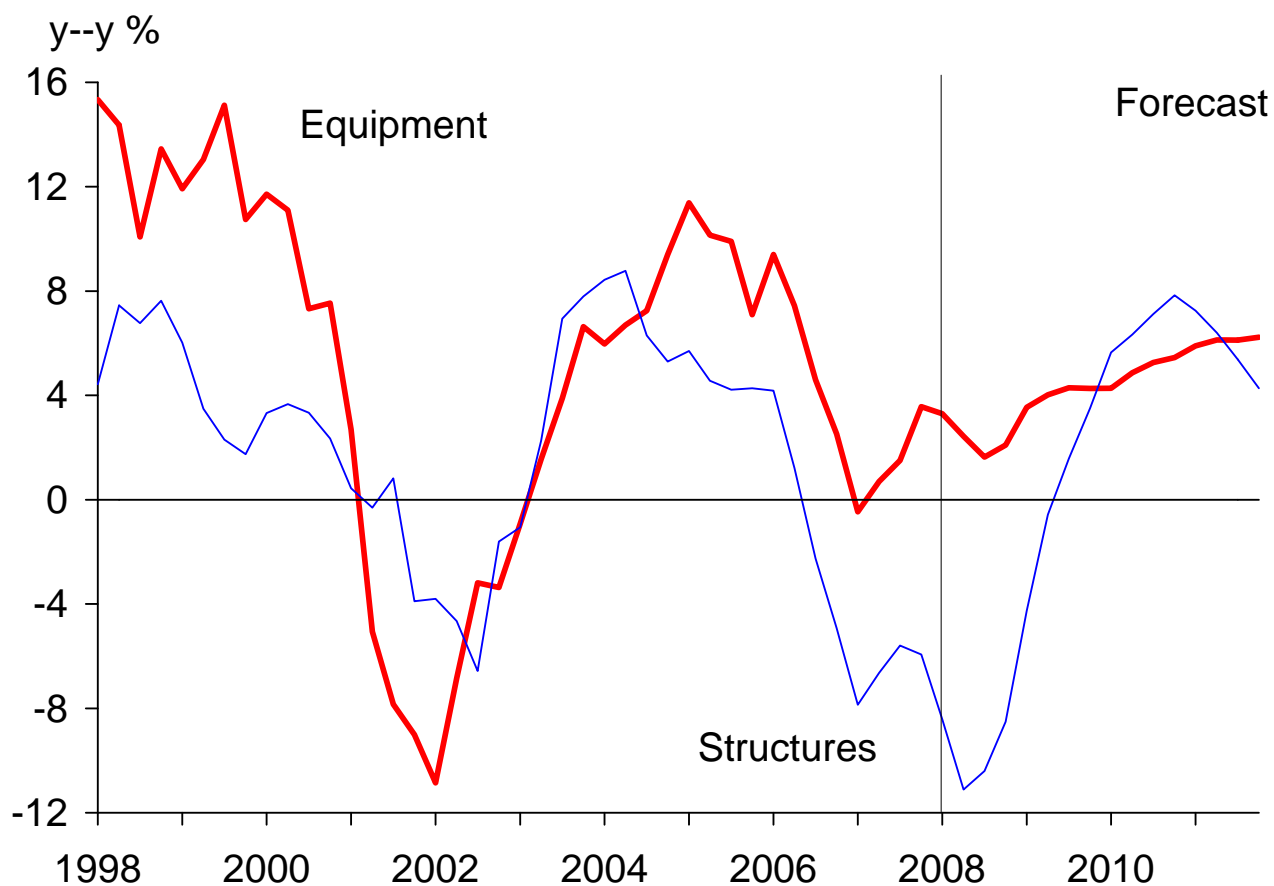
US: Non-financial profits



Source: Oxford Economics/ Haver Analytics

So investment remains a support to industry

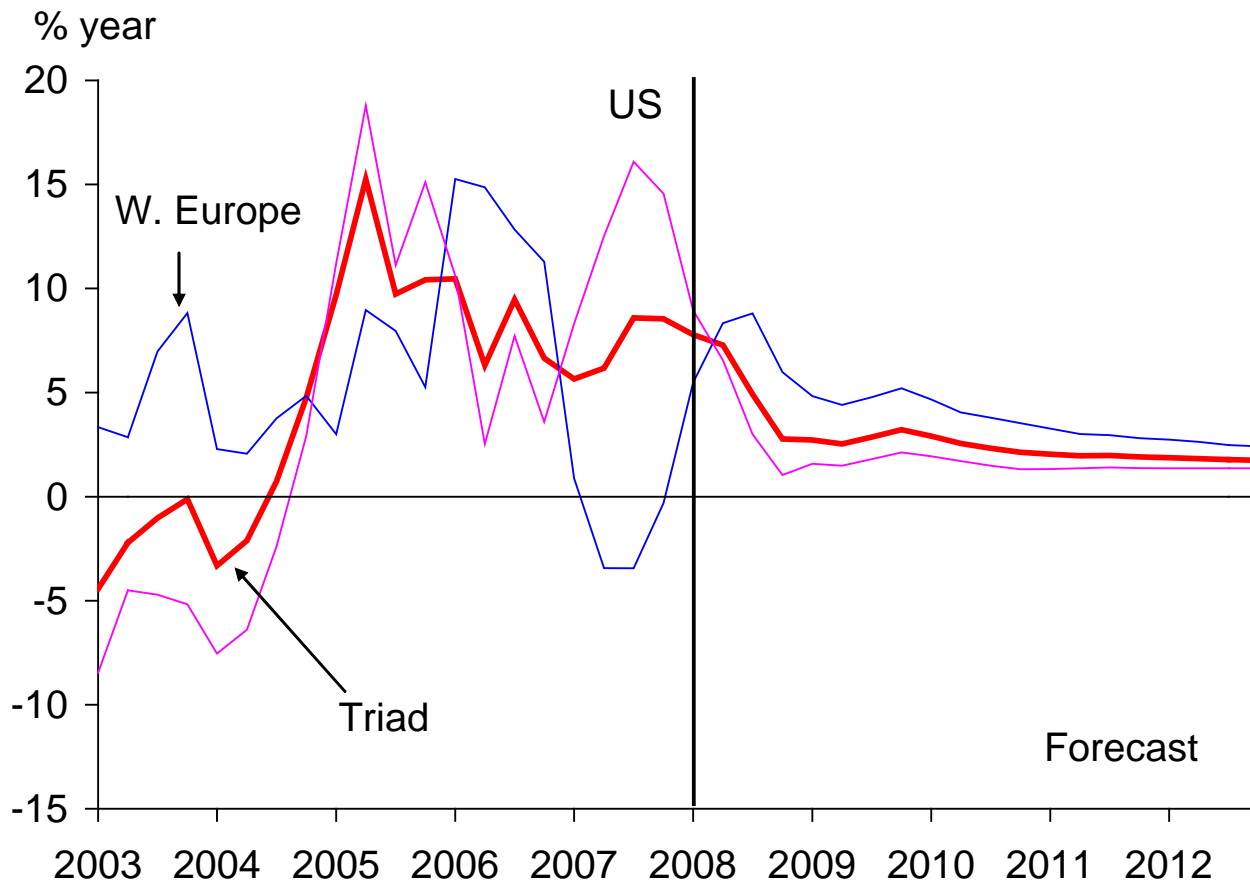
US: Investment by asset type



Source: Oxford Economics

Aerospace output to continue to rise

Triad aerospace: Output growth

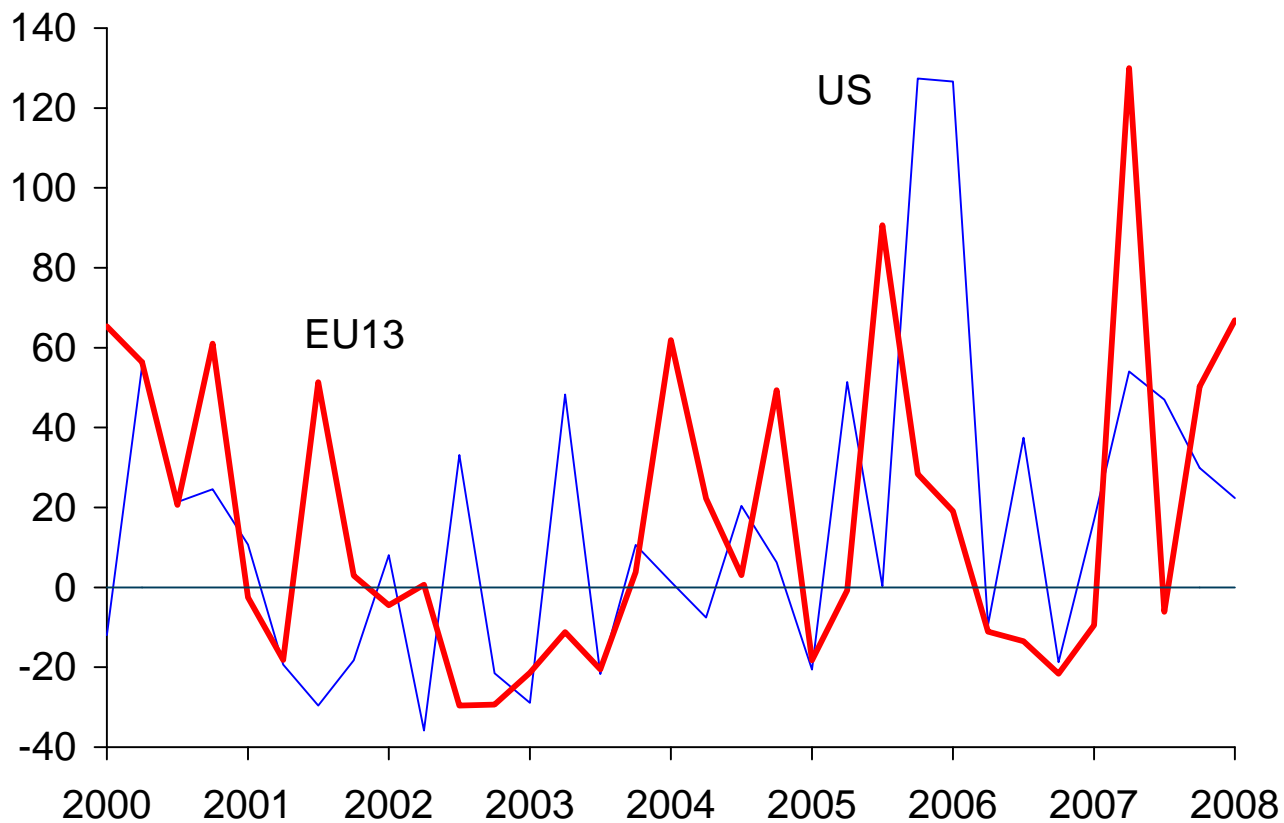


Source: Oxford Economics

Orders still look good

New orders

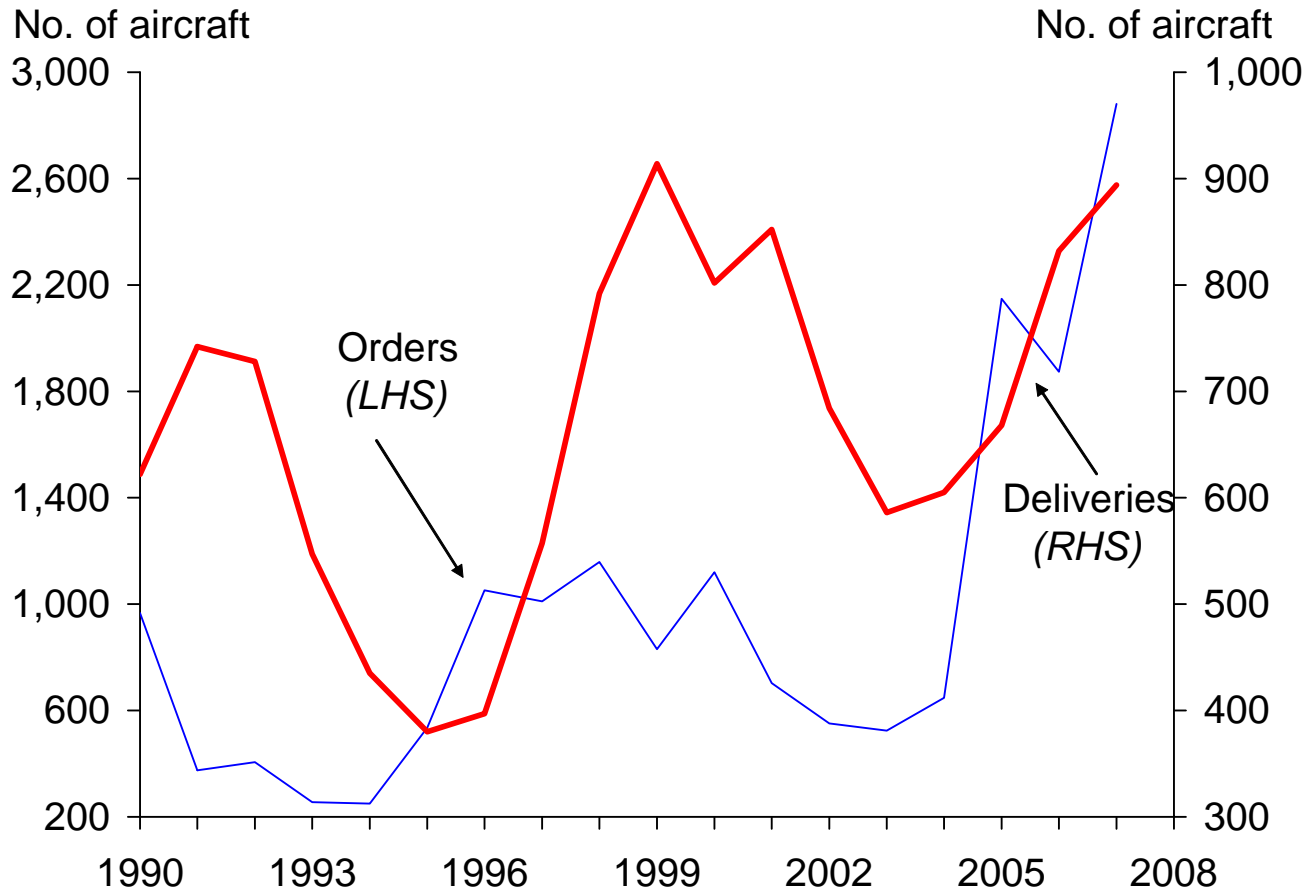
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Source: Haver Analytics

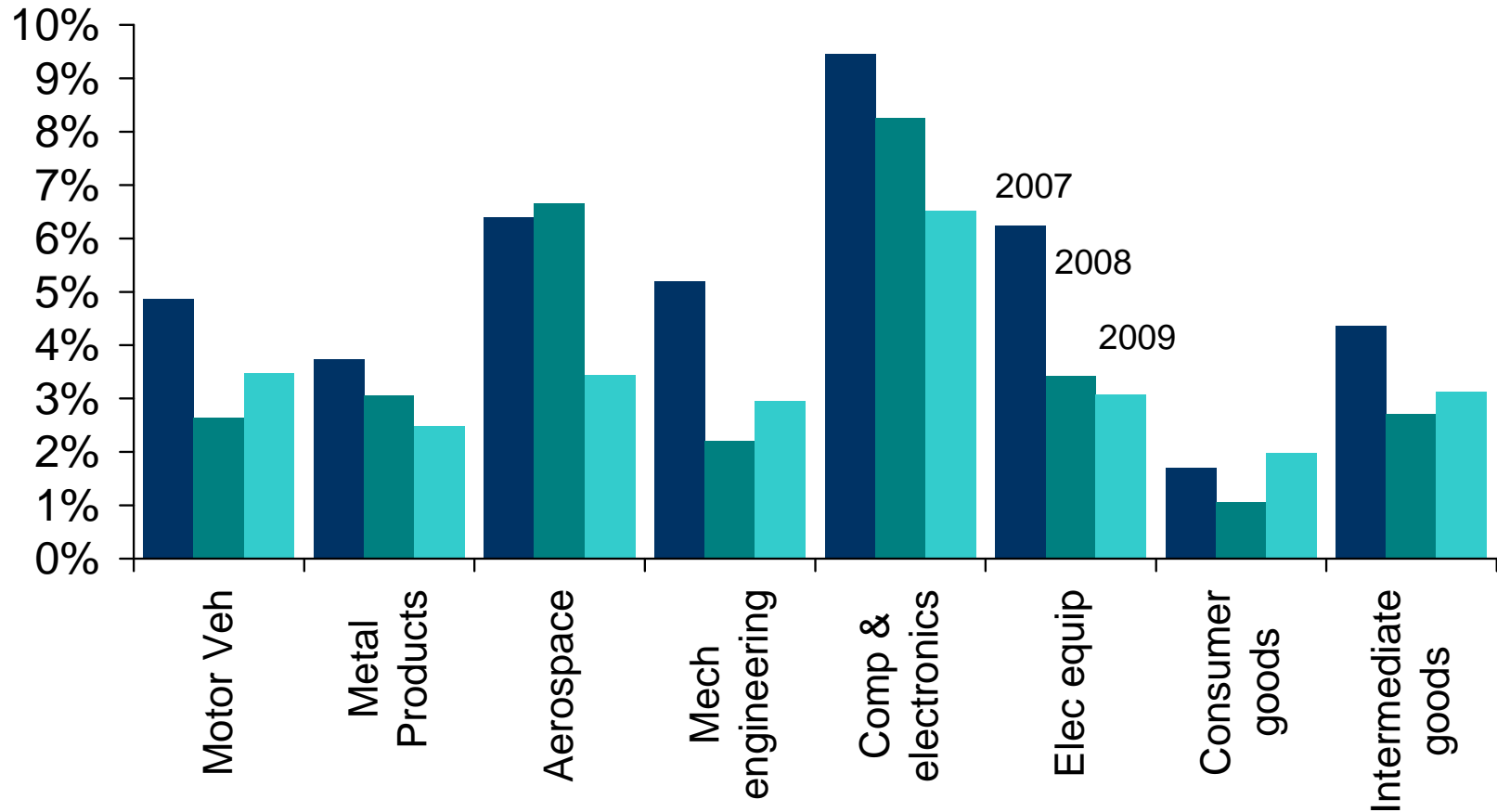
And are still outpacing deliveries

Airbus & Boeing: Orders & deliveries



Source: Company reports

Global growth in industrial production of machine tools customer sectors



Source: Oxford Economics

Conclusions

- If the US goes into recession it will be caused by the consumer. Higher food and energy prices, weak housing and the credit crunch are all offsetting the stimulus from lower income taxes.
- Investment is holding up reasonably well helped by the stimulus package, strong exports and generally growing profitability.
- But this generally positive outlook hides wide divergence between a number of sectors. Substantial weakness in autos, residential construction and financials is offset by a boom in mining, agriculture and aerospace.