

Greek relief for now, but what about the US?

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Key points

- > The Greek election has averted a messy Greek default and euro exit for now, but European problems remain intense with hopefully the June 28-29 EU leaders' summit providing some lasting solutions.
- > The US economy has also been slowing lately and faces a "fiscal cliff" from the start of next year. Odds are though that the US will ultimately do whatever it takes to keep its recovery going.
- > Investors remain caught between near term uncertainty and risks, but good value in shares and the prospect of more policy stimulus. We still see shares higher by year end.

Introduction

The Greek election has provided some relief for global investors. With the "pro-bailout" New Democracy prevailing over radical left wing Syriza and likely to form a coalition government, the prospect of an imminent Greek default and disorderly exit from the euro spreading contagion across Europe has substantially reduced, at least for now. Of course, Greece is likely to continue to be a source of volatility – its way behind in terms of its bailout agreement which will have to be renegotiated anyway and its population is badly divided. More broadly, Europe's problems go well beyond Greece, encompassing Spain, Italy and maybe France. The June 28-29 European Union leaders' summit will be looked to for clear signs that Europe is heading down a more sustainable path – involving less austerity, some sharing of risks (maybe via a redemption fund that gradually replaces national debt above 60% of GDP with Euro-zone wide debt) as a trade off for a banking and fiscal union along with economic reforms and more support from the ECB.

However, while the focus recently has been on Europe, the US economy shouldn't be ignored. After all, it's worth noting that the 15% share market correction of 2010 and the 20% correction of 2011 both had their origins in Europe and Greece but they morphed into concerns about the US. And at the same time America's budget deficit and overall level of public debt is higher than that in Europe. Whatever happened to America's sovereign credit rating down grade and the worries around that?

There are two key issues concerning the US – the recent flow of economic data has been softer and it faces a "fiscal cliff" from year end as various stimulus measures and budget savings kick in on January 1 next year resulting in a big contraction in America's budget deficit and hit to growth.

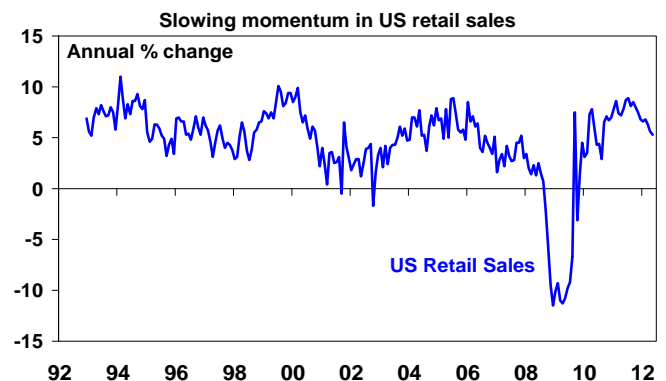
The US economic cycle

Reflecting post financial crisis caution, particularly on the part of the US corporate sector, the US economic recovery since 2009 has been anaemic and fragile, subject to periodic setbacks and fears of a "double dip" back into recession.

These soft patches were evident in both mid 2010 and mid 2011. And it looks to be going through another one this year.

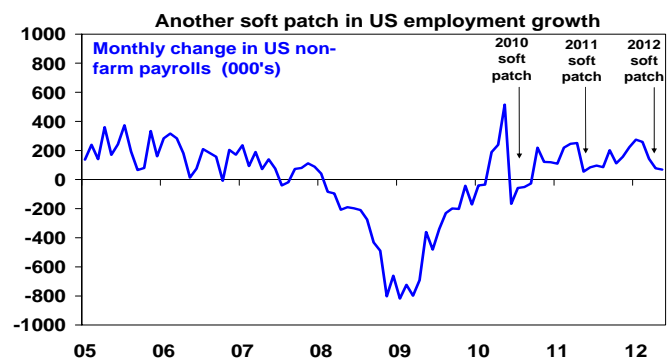
From the December quarter last year until about two months ago US economic data was surprising on the upside, but recently it has started to surprise on the down side again.

- Retail sales have been soft for the last few months;



Source: Bloomberg, AMP Capital

- Consumer sentiment has been adversely affected by bad news out of Europe and share market falls;
- Labour market indicators, including non-farm payrolls, have shown a slowing in the rate of growth (although in the chart below it looks kind of normal even compared to pre-GFC patterns – but investors are more twitchy now!!);



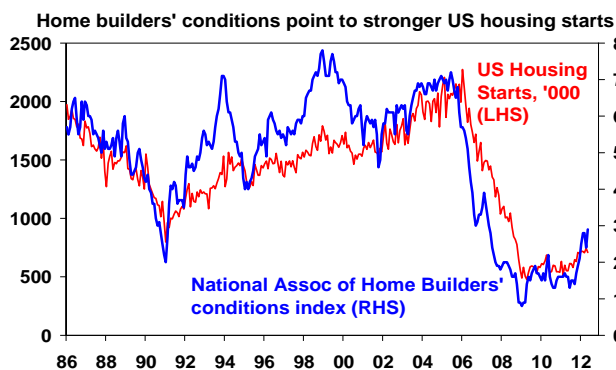
Source: Bloomberg, AMP Capital

- While the national ISM manufacturing conditions indicator has held up reasonably well, regional surveys have softened and these sometimes lead the national survey.

To be sure the current soft patch may have further to run, causing consternation for investors. However, there are several reasons to believe that the slow grinding fragile US recovery of the last few years will continue.

First, the Fed is likely to respond with more monetary easing and already appears to be heading in this direction.

Second, while recent data has been a bit soft there are three key positives for the US: housing seems to be gradually on the mend (see the next chart) which is good for economic activity and household wealth; the manufacturing sector is benefitting from a structural turnaround as companies are relocating production back to the US; and the shale oil phenomenon is driving employment in the mid west and flooding the US with oil and gas.

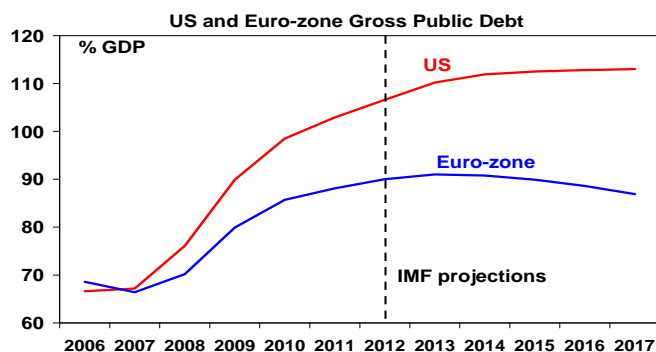


Source: Bloomberg, AMP Capital

Third, the US normally needs some sort of shock to go into recession. So far there is no sign of this, but beyond Europe, the biggest threat is the fiscal cliff.

Fiscal cliff approaching

It's well known that America has a bigger public debt problem than the Euro-zone in aggregate, but can get away with it as it is a strong fiscal union with plenty of credibility that it won't default unlike peripheral Euro-zone countries, there is strong demand for US dollars and hence US bonds from countries like China and the US Federal Reserve has been a strong buyer of US bonds (now holding about 15% of them).



Source: IMF, AMP Capital

While ratings agency Standard and Poors, which cut America's AAA rating to AA+ last August, has retained that rating it has warned America risks another downgrade in 2014 if it doesn't bring its debt under better control. Other ratings agencies have the US on a negative outlook.

Basically what the US needs is a long term plan to reduce its budget deficit, by slowing growth in health and social security entitlements and reducing tax breaks. The trouble is that under current law the fiscal cutback in 2013 will occur too quickly and threaten the economy.

The main measures that will result in the fiscal cliff from January are the expiration of the Bush era tax cuts on income, dividends and capital gains, the payroll tax cuts and extended unemployment benefits that were part of President Obama's stimulus measures and cuts to Medicare and defence that flowed from last year's debt ceiling agreement.

The US Fiscal Cliff - Fiscal Drag in 2013

| Budget item | \$bn saving 2013 | % GDP in 2013 |
|-----------------------------|------------------|---------------|
| Bush era tax cuts | 221 | 1.4 |
| Payroll tax cut | 95 | 0.6 |
| Unemployment benefits | 26 | 0.2 |
| Budget Control Act 2011 | 65 | 0.4 |
| Payment rate for physicians | 11 | 0.1 |
| Other items | 188 | 1.2 |
| Total | 606 | 3.9 |

Source: Congressional Budget Office

Taken together, these plus other measures will result in a fiscal drag equal to 3.9% of GDP in 2013. Of course the actual economic impact may be less than this (depending on so-called output multipliers), but with GDP growth running at an anaemic 2% per annum it may be enough to plunge the US economy into recession next year.

America needs a plan to reduce its budget deficit over the long term, but this would see it come down very quickly – from around 7.5% of GDP for the Federal budget deficit in 2012 to around 4% of GDP in 2013.¹

The other problem is that America's debt ceiling will also be reached again late this year, although it's likely the US Government will be able to survive into early next year. So any negotiation regarding reducing the fiscal cliff will likely also have to cover the debt ceiling and of course memories are still fresh from the dysfunctional negotiations that occurred last year in terms of the debt ceiling, which dragged on till the last minute and ultimately saw America lose its AAA sovereign rating from Standard and Poors.

However, there are several points worth noting. Firstly, neither side of politics seems keen to do anything about the problem prior to the November elections.

Second, both sides understand that if they allow the economy to plunge into recession the backlash from voters could be significant, so ultimately a deal is likely to be done, albeit at the eleventh hour.

Thirdly, the fiscal drag is ultimately likely to be much less as some form of compromise is reached. Most scenarios see the drag being reduced to around 2% of GDP with the Bush era tax cuts likely to be extended along with some other measures. The smallest drag, of around 1.3% of GDP, is likely to occur if the Republicans gain the presidency and both houses of Congress. However, given a Republican president won't gain office till January, America may initially fall off the fiscal cliff for a few days or weeks before current laws can be reversed.

Either way, there could be a period of uncertainty for the US into year end. That said, investors are likely to take a view on the likely outcome in the run up to the elections and once the results are known and past experience suggests some form of deal will be reached and the debt ceiling will be extended.

It's also worth noting that the US Federal Reserve is more than aware of the fiscal cliff concerns so it may play a role in bringing on more monetary easing over the next six months if the Fed comes to the view that the fiscal cliff or uncertainty around it will threaten the US economy.

So what does this mean for investors?

Our assessment remains that while the current soft patch in the US and fiscal cliff concerns may result in ongoing bouts of volatility, ultimately the gradual US economic recovery will continue. Worries around Europe and the US mean investors remain caught between near term uncertainty and risks, but good value in shares and the prospect of more policy stimulus which should result in higher levels for shares by year end. For long term investors the current environment provides great opportunities. For those who can't take a long term perspective our view remains that strategies around outcome based approaches to investing or a focus on investment yield beyond the diminishing returns from bank deposits are worth considering.

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¹ Allowing for other levels of government adds around 1% of GDP.