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Global economic review

Sharp swings in inventory levels have exaggerated changes in GDP

The global economy seems to have stabilized. Following sizable declines in gross domestic product (GDP) in the fourth quarter of 2008 and first quarter of 2009, most major economies look to have seen a smaller decline in this year's second quarter, with the possibility of positive GDP growth in third and fourth quarters of 2009. What is behind this reversal in growth prospects? And what does it mean for growth over the next few years?

The weakness in growth across the globe has been exacerbated by fluctuations in inventories. Given the extreme pessimism that existed late last year, companies cut inventories at a rapid pace and data will likely show that this trend continued in the second quarter. As a result of the inventory adjustment, companies began to produce at levels that were below final demand. Going forward, industrial production will tend to rise towards the level of final demand, and the decline in inventories will slow. As companies start to pare inventories at a less rapid pace, what was a big drag on GDP will disappear (and could become a boost to GDP). Thus inventories exaggerated the downswing in the global economy, and are likely to exaggerate the upswing as well.

Looking ahead, the recent downturn left some problems in the global economy, especially in the developed world. Granted, countries such as China have been able to stifle a slowdown in growth via a significant government spending program. Yet the importance of domestic demand in the developed world cannot be ignored. In countries such as the U.S., U.K. and parts of continental Europe, consumers are still suffering the effects of a drop in house prices and equities. This aspect of final demand seems to be well understood by many market observers.

Another aspect of final demand, corporate spending, could be impaired for the foreseeable future as well. A typical economic cycle sees production initially decline, as companies attempt to draw down inventories. At some point the level of production

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recovers and, as capacity utilization (or how much capacity is being used, in percentage terms) rises, corporations increase spending. The current cycle is unique in that production fell so much in some countries that many indicators are at levels which would take much longer to recover than in prior cycles. For example, assuming a recovery in production similar to what we have seen in prior recoveries, it would take Japan six to seven years for the level of production to rise to the peak that was seen prior to the downturn (with Germany and Sweden not far behind). Therefore, spending from corporations could be more tepid than normal. The significant declines in the level of production in various countries, and hence capacity utilization, points to weakness in corporate capital expenditures (for simplicity sake, buildings and equipment) going forward. However, any country that has a relatively high dependence on manufacturing and/or capital goods could be affected, including Japan, Germany and Sweden.

As mentioned earlier, such a decline in production levels has in many cases not been seen since the 1930s. Up to the time of the recession, companies geared their businesses to a much higher level of demand. This not only means that the amount of capacity in place is well in excess of current needs, but also that the amount of labor in place is more than what is needed. In many overseas countries, companies have been slower to dispose of workers in this cycle. Government statistics show that many foreign

companies have opted to cut the number of hours worked in addition to labor. Thus, the drop in employment in countries such as Japan and Germany has not kept up with the decline in output. Granted, there are some special circumstances where the government has put policies in place to limit the number of layoffs. Nevertheless, the point is that the level of current production and the expected time it will take for production to recover its previous levels means that new hiring could be subdued in several major economies as we go into the next upturn.

Outlook

To sum up, we believe the upcoming global recovery will likely be muted relative to historical recoveries. While the inventory swing will likely influence growth to the upside in the short-term, final demand may remain soft as consumer and capital spending remain sluggish. Therefore, we think economic growth could look better in the short-term, but growth prospects could be more challenging further out. Many companies boosted their profit margins in the second quarter of 2009 by managing inventories and cutting costs (employees, hours, etc.). In many cases this has led to bottom-line results that exceeded analysts' expectations. However, we feel such profit gains could be short-lived given the weak developed-market consumer demand environment. Without much top line growth, it raises the question of whether investors should be prepared for slower growth and earnings disappointments in 2010.



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