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World recovery at risk where contradictory forces collide

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The twin conditioners of macro regimes - growth and liquidity - are hard to predict, now more than ever. Differences in underlying fundamentals mean no two cycles are the same. The world is faced with two massive and contradictory forces: the Great Deleveraging of consumer and financial system balance sheets; and the Great Reflation effort of the monetary and fiscal authorities. Where these tectonic plates collide we expect much higher volatility of inflation, akin to the pre-Bretton Woods era, but with much greater amplitude. Given the wider range of possible inflation outcomes today, growth expectations, liquidity and therefore equity markets tend to be conditioned principally by inflation expectations, perhaps more so now than over the past few decades.

With the above in mind, we believe there are three possible scenarios for the next 12 months.

The first is that GDP growth in the US - the consensus forecast for 2010 is 2.6 per cent - surprises on the upside.

There are three possible catalysts. One, the inventory contribution to growth could be significantly higher than expected, following the biggest inventory deletion in 50 years. While inventories could continue falling for another two quarters, the pace of the decline may well slow, boosting growth. More importantly, once inventories arrest their decline, the rebuild could be faster than predicted.

Two, capital spending could surprise positively. US business investment plunged 24 per cent peak to trough in this recession. Financial markets accordingly believe the output gap has become very wide, and that more capacity will not be forthcoming until companies return to trend production. We think that's wrong, primarily because it underestimates the rate at which capacity can be permanently removed from the system. Moreover, the level of capacity utilisation does not drive capex: the change in the level of utilisation does. And utilisation is rising.

Three, consumer spending could surprise on the upside. US unemployment is forecast to peak at 10.5 per cent or 11 per cent by Q2. It is assumed consumers will continue to curb spending in accordance with this lack of job (and therefore income) growth. But are cupboards that bare? Asset price gains boosted the net financial wealth of US consumers by $2,000bn in the last quarter. If asset prices continue to rise, the wealth effect will turn positive. And the labour market could also turn into a plus: profit growth is strong and labour productivity growth cannot continue at near double-digit rates. Companies will have to start hiring sooner rather than later.

Should most of the above occur in 2010, GDP growth should be stronger than expected - perhaps as high as 4 per cent. This will be supportive of asset prices over the next three to six months, or at least until the US Federal Reserve removes the stimulus. That would trigger a fairly minor correction and a rotation into defensives, similar to 1994 and 2004.

The second, and gloomiest, scenario presupposes US economic growth disappoints because Keynes' mysterious "animal spirits" never recover. Consumers, alarmed by ballooning government deficits, do nothing but save in the belief that the state will not or cannot look after them. Fiscal stimulus in this scenario is counterproductive.

On a corporate level it would mean inventories are only modestly rebuilt and capex gains are negligible. Global trade might climb slightly, as now, but US economic growth could easily weaken with central banks, unable to cut rates and lacking fiscal firepower, left impotent.

A general loss of confidence could follow causing interbank lending to evaporate as Libor spreads blow out. The S&P 500 could conceivably collapse to its March 2009 low or lower. Equities would be a disastrous investment, but government and corporate debt would be almost as unattractive and deflating commodities no more appealing. Gold and some currencies would be the only hiding places.

The third scenario is a "normal" recovery. If consumers start spending, and inventories rebuild sooner than expected, cash-heavy investors would jettison money market funds and pile into risk assets. Demand for credit would, bizarrely, rise. Equities and commodities could surge 30 per cent or more. From a macro perspective the labour market would improve as companies resume hiring. China would not decelerate, and central banks, anxious not to choke off the recovery, would leave rates at their historic lows. The global economy would spark into life, and in some style.

Which scenario is most likely? The first is the most probable, with a likelihood of about 50 per cent. The second I'd put at 20 per cent; the third at 30 per cent. The key is the US employment market. If that does not start to recover, the general recovery is almost certainly doomed.

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