2010: Recovering from the near-depression experience

By Walter Kemmsies

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While robust growth is unlikely in 2010, the outlook is far better than this same time last year when the collapse of the world's financial system threatened to throw the global economy into a depression.

Hundreds of billions of dollars of support for financial institutions and fiscal stimulus in many countries stopped the world economy from circling the drain. The risk of antitrade policies diminished as the world economy found its bottom in the first half of 2009.

However, the world economy and international trade in particular has fallen into a deep hole and is unlikely to climb out of that very quickly. Lower consumer spending is the reason why governments in many regions have engaged in deficit spending programs.

U.S. consumer spending, which accounts for 17 percent of world gross domestic product, will continue to worry analysts and shipping industry professionals. The U.S. economy is not yet able to sustain growth without continued monetary and fiscal stimulus, as well as support from other economies that are financially healthier.

On a regional basis, intra-Asian trade, Asian trade with Latin America and Europe, as well as European trade with Latin America look set to stage a respectable recovery, while U.S. exports to these regions are likely to grow faster than its imports.

The International Monetary Fund projects global GDP will grow 2.2

percent in 2010, following a 2.3 percent decline in 2009. While 2010 looks a lot better than 2009, the growth forecast compares poorly with its 30-year average of 2.9 percent. Were it not for expectations for growth in emerging market countries to continue to be a multiple of that in mature industrialized economies, the global forecast would be a lot lower.

Underlying this below-trend growth are expectations for weak U.S. growth and that consumer and corporate spending around the world remain tight due to high unemployment and low capacity utilization that weakened pricing power across all industries. Poor pricing power results in low profits and therefore little if any investment in productive capacity.

It is very tempting to use GDP as the barometer for the shipping industry. However it is a very aggregate measure and what really matters is the detail underlying it. The main reasons for the substantial decline in U.S. GDP were the close to 40 percent decline in residential real estate investment since 2007 and reductions in inventories by businesses. These trends were in place and already negatively impacting volume growth even before the GDP measure of overall activity began to contract. Residential real estate investment has leveled off and the inventory burn seems to be over. But the aftermath is negatively impacting consumer spending and therefore the shipping industry.

The demographic segment that matters most for the shipping industry is comprised of 18 to 45 year olds, who account for most of the spending on goods. Older generations, such as the baby boomers, spend more of their income on services and are more likely to dispose of goods they no longer need.

Consumer spending has been negatively impacted by rising unemployment and credit rationing. The credit crunch has affected everyone. Baby boomers are poorer because of lower house prices and lower financial asset values. They are likely to postpone retirement and increase their savings. The younger generation tends to use credit to finance spending on goods. Since banks are not yet willing, or perhaps

able, to extend credit, younger consumers' spending is constrained. Unemployment has also disproportionately impacted younger people and constrained this segment's spending on goods.

Growth in unemployment insurance claims is an excellent indicator of labor market trends. New claims growth peaked in March and growth in continuing claims in July. On the surface business cycles have common features, but beneath the macroeconomic data it is evident that the industries that led the cycles varied. In the 1960s it was chemicals and plastics, commodities in the 1970s, aerospace and defense in the 1980s and information technology in the 1990s. At the end of a cycle, leading industries had too many participants and employees. As growth declined, those industries shed the most jobs.

In this cycle the financial and construction sectors led reductions in payrolls. Given that the next leading industries take time to begin hiring, unemployment lags overall economic activity. This cycle is no exception and we expect unemployment to peak in the second quarter of 2010 but remain high throughout the year.

Stabilization of the financial sector is the last barrier to a self-sustaining growth recovery. Unemployment and bankruptcies tend to lag economic recovery. Banks hold capital in the event of loan defaults, but it is not clear that they have enough to weather continued mortgage and commercial loan defaults. Banks are required to hold enough capital to survive these cyclical events, but given that they were very exposed to real estate and severity of this downturn, they appear more concerned about restructuring their balance sheets in order to survive than in extending loans. Investment in productive capacity usually requires financing. Importers still need access to lines of credit in order to build inventories and consumers rely on credit to finance purchases. Until banks are again able to extend credit to the economy, the growth outlook is constrained.

Between large stimulus programs and central banks injecting liquidity

into economies while setting interest rates to historically low levels, it is not surprising that a depression has been avoided. Once the economy is able to sustain growth on its own, the policy support will have to be withdrawn to avoid high inflation. Successful withdrawal of fiscal and monetary support is critical to the outlook. If the withdrawal is too quick, the economy could plunge into another recession.

The best outcome would involve low growth and low inflation in 2010 and 2011. That is the outcome we expect, but the risk of a policy error resulting in high growth and inflation, or another recession with deflation is substantial. We think that for now it is reasonable to expect policymakers to avoid either of those undesirable situations.

The difficulty in avoiding the undesirable outcomes originates in commodity prices and exchange rates. Oil prices are likely to remain in the $50 to $85-per-barrel range and metals prices are also like to remain in the range they have been in over the last year. A rise above these ranges could stoke inflation and provoke premature withdrawal of policy support.

One way to reduce that risk would be for the U.S. dollar to recover. Commodity prices are quoted in U.S. dollars. Therefore a weak dollar usually coincides with rising commodity prices. If the U.S. dollar were to begin recovering it would limit commodity price increases. If the dollar is to strengthen, U.S. interest rates need to rise, which cannot happen until the economy regains some strength. Given the views for the economy expressed above, commodity prices are likely to remain near the upper end of their range.

Faster growth in emerging market economies will support U.S. exports, particularly of agricultural products where it has advantages in resources, capital and technology. While the dollar remains weak, exports (particularly dry bulk) are likely to continue to grow faster in the near term. Over the medium term, I.e., two to seven years from now, imports should grow faster as the U.S. economy recovers and

outsourcing resumes.

These trends bode well for the shipping industry, but the data will become difficult to interpret. We expect U.S. maritime, surface and air freight volumes to grow in the high single digits in 2010. That is not as bullish as it may appear. In the fourth quarter many ports and railroads will report positive year-on-year growth, bolstered by the fact that those comparisons will be against the fourth quarter of 2008 when the steep descent began. Even if U.S. freight volumes grew 10 percent in 2010, they would still not reach 2007-2008 peak levels. That is more likely to occur in 2011.

The most significant surprise in 2010 might be stronger than expected growth in the second half of the year since a lot of the stimulus spending from the March 2009 American Recovery and Reinvestment Act is scheduled for 2010. It is not far-fetched to expect further fiscal stimulus to occur in advance of the mid-cycle elections in November, possibly in the form of job creation. It would be unwise for the shipping industry not to have contingency plans for a stronger than expected second half of 2010.

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