CREDIT SUISSE

Market Focus

Global Strategy

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The Harder They Fall...

Global industrial production has resumed growth following an 11% plunge that began last summer and that was most intense in the four months after Lehman Brothers failed. The exhibit below ranks the peak-to-trough decline by major country. By sector, the sharpest contractions were in G3+ auto production (down 50%-60%), non-energy materials and intermediate goods. After falling sharply from May through October of last year, US consumer spending has been roughly flat since last October despite rising real disposable income. Consumer cutbacks have been overwhelmingly concentrated in autos, housing-related spending and other discretionary areas. Global trade appears to have contracted about 17% during the same period.

The speed and synchronisation of these production cutbacks reflect an extreme and virtually global spike in liquidity preference on the part of both firms and households during the period when the safety of the global banking system was most in doubt. This “dash to preserve cash” was unlike most post-war recessions, and in our view has led many creditworthy households and firms to over-cut spending, production and inventories. The plunge in inventories appears particularly extreme in areas such as steel and materials production (ex-China) and least convincing in US autos (GM in particular). This pattern is, however, more characteristic of nineteenth and early twentieth century financial panics.

Financial and credit market indicators, as well as consumer confidence data suggest to us that some of the extreme spike in liquidity preference is reversing itself, and this should translate directly into higher output.

The hard data already tells us that Asian production and exports are turning sharply higher: Korean production is already up 15% in just three months, with a similar rise expected for Japan in May and June. Our model of US durable purchases suggests that growth could resume here too in May and June.

We assume that GM production will be largely shut down two to three months as it moves into bankruptcy, but elsewhere we see the potential for a further and sharp production rebound in those sectors most affected by the slashing of inventory. At the same time we expect at least a partial rebound in many areas of final demand, including even auto sales.

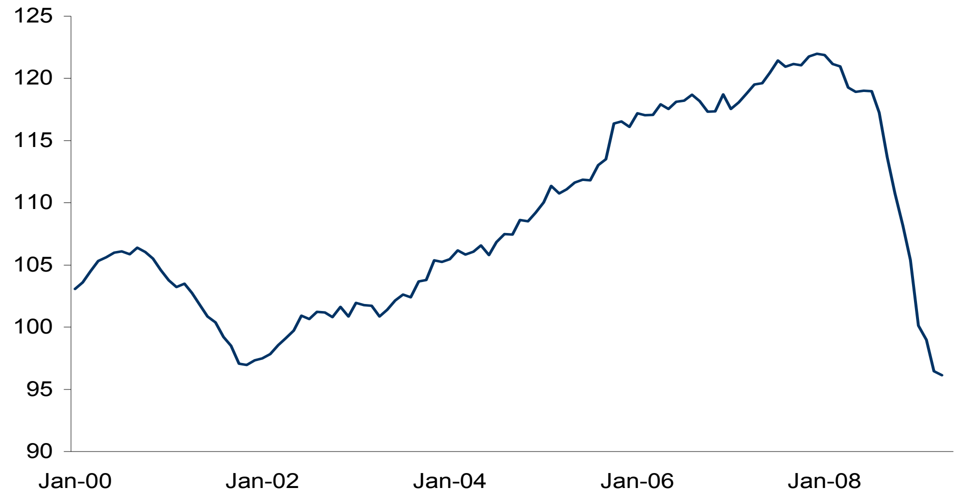
This note explores in a little more detail where we can expect output to recover most quickly, and how the current episode might compare with other severe contractions in the past.

Exhibit 1: Peak-to-Trough Declines in Industrial Production

	Japan	Taiwan	Korea	CE4	Brazil	Euro Area	Russia	US	UK	India
Peak-to-Trough Decline	-37%	-34%	-22%	-21%	-20%	-18%	-16%	-14%	-13%	-4%
Average Annual Growth ‘03-‘07	3.2%	7.4%	7.9%	8.2%	4.7%	2.6%	6.3%	2.1%	0.4%	8.5%

Source: Credit Suisse

Exhibit 2: US Durable Manufacturing Production Level (38% of IP)



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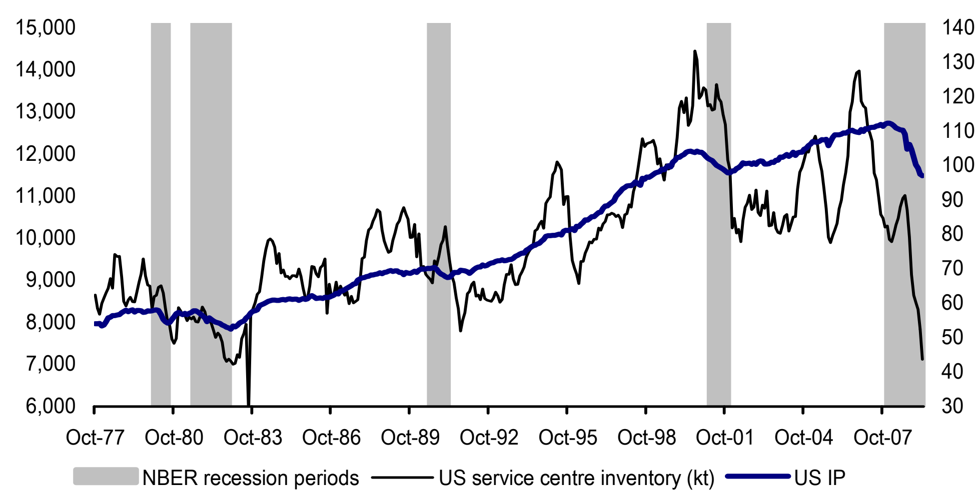
Recent wobbles in some data releases should not obscure a critical fact: production in many countries is just beginning a significant rebound.

Micro data, cyclical history, price action, and logic support our view, and the key risk to the market in the short run may be that our (more optimistic than consensus) recovery forecast is not strong enough.

The durable manufacturing goods component of US IP in April was 21% off the January 2008 peak and appears to be bottoming (see Exhibit 2 above). In the first eight months of recovery from the trough in the 2001 recession, about one-third of the decline was reversed – a typical pattern. If the level of durables production reverses a third of its fall by October, it would rise 7%. Because this component is 44% of total IP, the boost it gives to the overall level would be considerable. And this is not the only example: a number of other components seem to have massively overshot on the down side, in our view, and are therefore due for a significant rebound.

Exhibit 3: US Steel Inventories vs. Industrial Production



Source: Credit Suisse Equity Research

Industry level data confirm this in some cases. US steel inventories have been pared to 25-year lows (see Exhibit 3). We have heard anecdotal reports of purchasing managers who wanted to increase orders being told by executives they cannot because cash must be conserved. With LIBOR rapidly falling and market normalization partly underway, we expect this feedback from market conditions to orders to dissipate rapidly.

One key observation about this cycle is that demand in the US, in terms of real retail sales or real personal consumption expenditures, has been roughly stable or slightly down since last October. The sharp fall in consumption occurred in Q2 and Q3 of last year and was over before global risk appetite troughed in November. The trade finance difficulties in Q4 associated with huge LIBOR-OIS spreads caused inventories to rise even when desired inventories were very low. The result was an inventory liquidation the magnitude of which we have not seen in decades. Reversing such a move without considerable cyclical violence is unlikely, in our view.

Exhibit 4: US Real Retail Sales, Disposable Income and Global IP

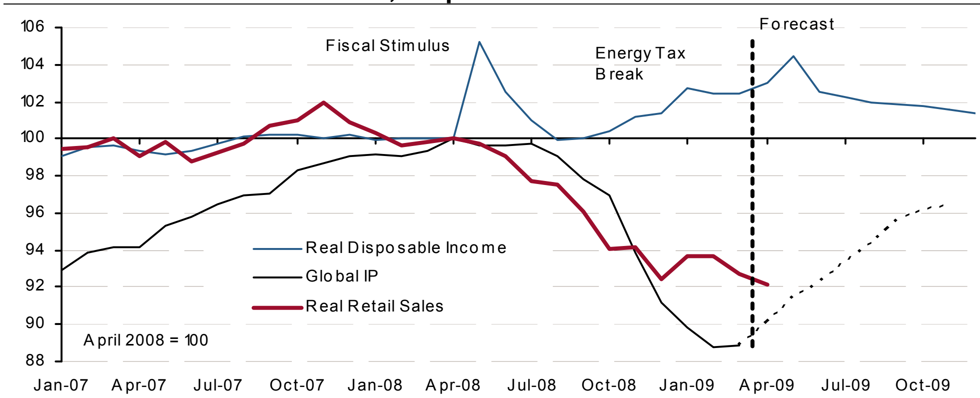


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Exhibit 5 below shows the level of global IP indexed to 100 as of last summer and compared with some of the worst contractions in US history. Clearly, as late as this March, the cycle was tracking the severe recessions and even the Great Depression. But now that depression risk has been diminished considerably by policy changes, stabilizing household income expectations, and a substantial improvement in risk appetite, we must look at cyclical recoveries in order to get a sense of the rebound's magnitude.

Exhibit 6 shows the same cycles with their recoveries but excludes the 1930s. Here a clear pattern emerges. Production typical gets back to peak levels after about 2.0-2.5 years, and even faster than that in the 1957 IP cycle when the collapse was due to a strike. Since global IP peaked in Q2 of 2008, that would suggest summer or spring of 2010 for this cycle. That would also suggest 12% IP growth in the next year – more than double the long-term trend.

The dotted line in Exhibits 5 and 6 show our expected path of recovery. Exhibit 7 shows possible paths for momentum (3m/3m annualized growth rate), which is of course closely correlated with PMI surveys and with global risk appetite. Momentum troughed at -24% in February and has recovered sharply since. We estimate it will have already reached 10% in June, and will reach a high plateau near 15% from July to September. As strong as these numbers appear, they are consistent with country level data.

Output across Asia – not just in China - has rebounded sharply. Korean IP has surged 15% in three months and following a 22% fall. Taiwanese output is up 19% after a 33% decline. Japanese IP is up 7% after an almost 40% decline. Even in Eastern Europe, IP has started to post monthly increases again following large double-digit declines since last autumn.

Our baseline forecast for IP momentum has that summer plateau dropping off in Q4, but only trending down with continued positive growth in early 2010. This would deliver the return to the peak level by next summer. In Exhibit 6 we show two alternative scenarios. The first currently would appear to be more likely, and it is based on an overshoot in shortterm momentum all the way to 25% late in the summer. Such a sharp increase would be reminiscent of nineteenth century cycles or the 1892 and 1907 cycles shown in the exhibit. Obviously such a sharp improvement would be likely followed by a significant cutback, barring a very large improvement in demand.

The second alternative scenario is for more severe weakness. In this case momentum would still peak near 15% in the summer but then gradually more toward negative territory by the end of the year. In this case there would be no return to peak in 2010. Note that even this weak scenario is a far cry from a depression: the 1930 second leg down in momentum began while output was already negative. Based on numerous global data releases, the recovery has already passed that point.

Exhibit 5: Global IP Contraction versus Major US Slumps

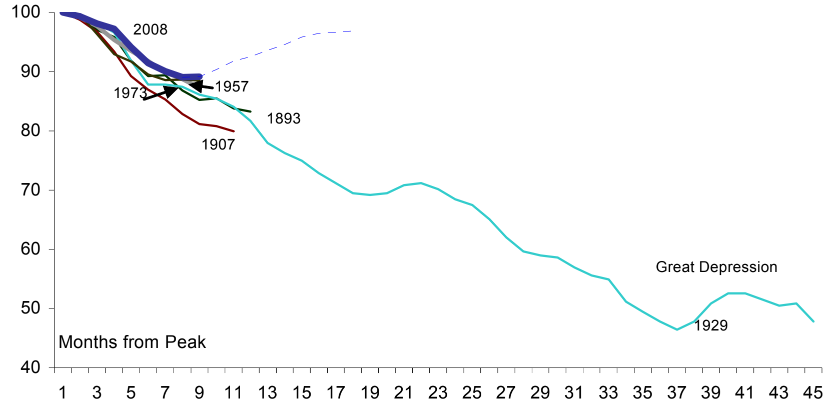


Exhibit 6: Global IP Contraction versus Major US Slumps

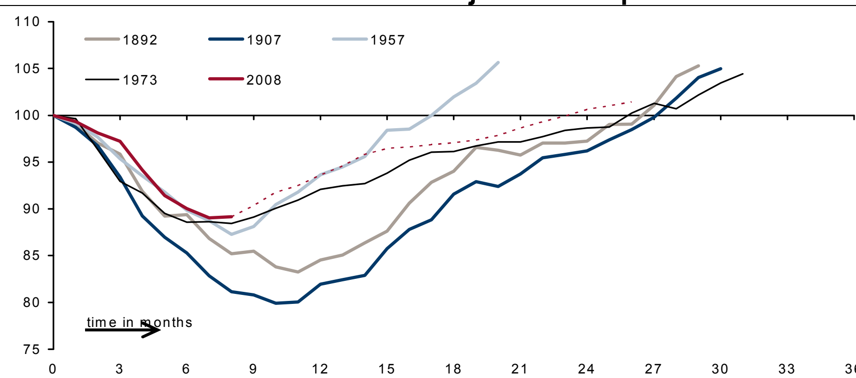
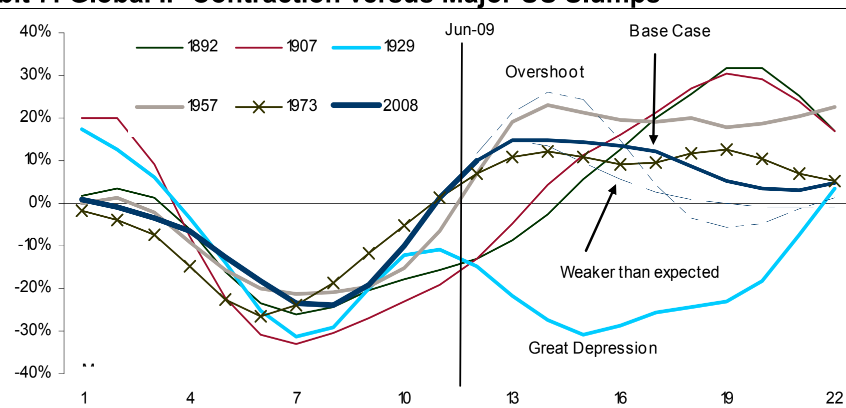


Exhibit 7: Global IP Contraction versus Major US Slumps



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Thus far we have barely mentioned demand. One reason is that the inventory cycle has a big component largely autonomous of demand – as long as animal spirits are not so disturbed that an inventory rebuild is for some reason impossible. Of course, for a recovery in production to be sustained demand must improve, and the "merely flat" recent performance of US retail demand must get better.

US demand faces a notable headwind in that real disposable income growth in the second half is unlikely to benefit further from the fiscal stimulus, transfer payments, and lower oil prices that have helped since last October. Unless non-farm payrolls resume growth by the end of the summer it is likely that income will be falling in the second half of the year, limiting the upside for spending. Still, with many household durable purchases put off during the recession, and consumer confidence now rising, pent-up demand is likely to be strong, in our view, so that a better cyclical environment is likely to bring forth some additional spending and a reduction in savings even if income is down. Car sales clearly matter, and it would only take 11-12 million SAAR late this year to cause a substantial improvement in discretionary spending on durable consumer goods. See Exhibit 9 below, which comes from our US economists.

Exhibit 8: G3+ Consumer Confidence

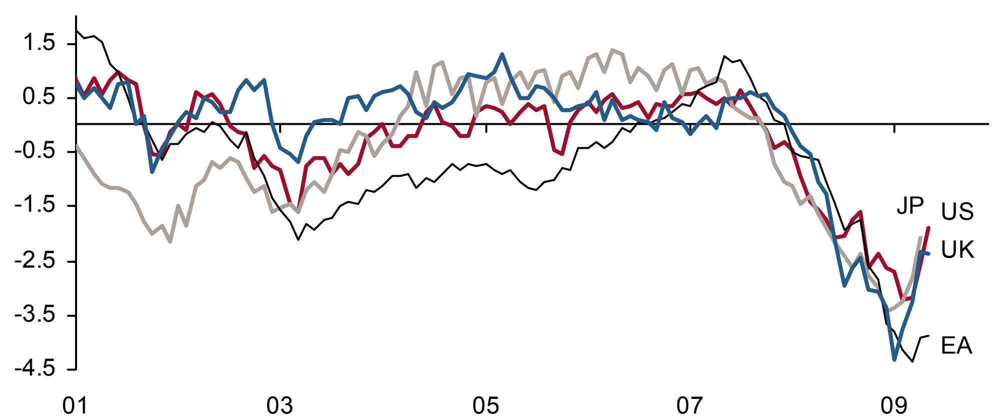
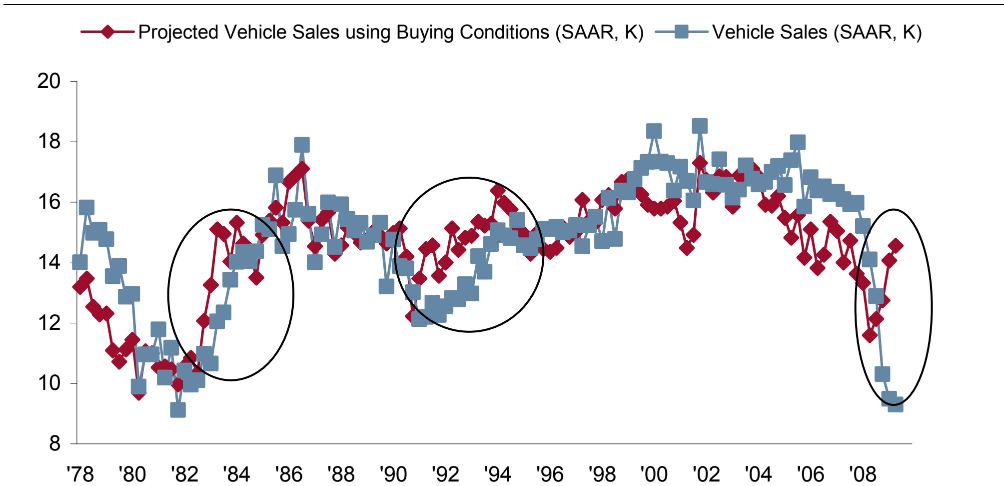


Exhibit 9: US Vehicle Sales



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Financial markets are now faced with judging the importance of a production improvement when longer-term profit dynamics still look severely strained. Simply put, even if IP reaches its January 2008 peak level in the summer of 2010, there will still be a large global output gap, a very high level of unemployment in most countries, and a lower level of aggregate profits associated with any output level, due to a decline in margins in many industries and an inability of most firms to generate pricing power in an era where core CPI inflation is very subdued even if PPIs are rising.

The output gap in global manufacturing will likely take years to close: assuming capacity grew only 3% in the past year – well below average – then the global output gap opened by nearly 14%. If capacity grows at that 3% going forward, it would take nearly five years to close the gap with 6% annual IP growth. 12% production growth in the next year would cut the gap by more than half but with the longer-term outlook so clouded, a possible second recession could still delay a complete recovery substantially.

Still, markets usually reward those who increase their risk appetite at the first sign of a growth momentum recovery, but then are nimble enough to reduce their exposure once recovery is fully priced in. While forward-looking indicators have already improved sharply, true confirmation from GDP and production growth is still to come.

Normalization has come rapidly to some markets. Baltic freight, often a good indicator of Chinese growth, has more than doubled since early April. Two-year US swap rates five years forward have mean reverted with great force: from a trough of 2.60% in December, the rate rose to over 4% on May 13 and in two weeks has risen a further 100bps to 5.15%. The S&P is over 30% above its March low and has shown great resilience recently despite a large number of still-bearish investors. And finally, global risk appetite is up to 1.5, not just out of panic but above its long-term average, and equity-only risk appetite has risen by so much that it is close to euphoria!

Sometimes it's best to listen to the markets, and right now price action is confirming what seems logical: a spring rebound in the markets suggested a summer of economic recovery is likely ahead.

Exhibit 10: Global IP Momentum and ISM New Orders

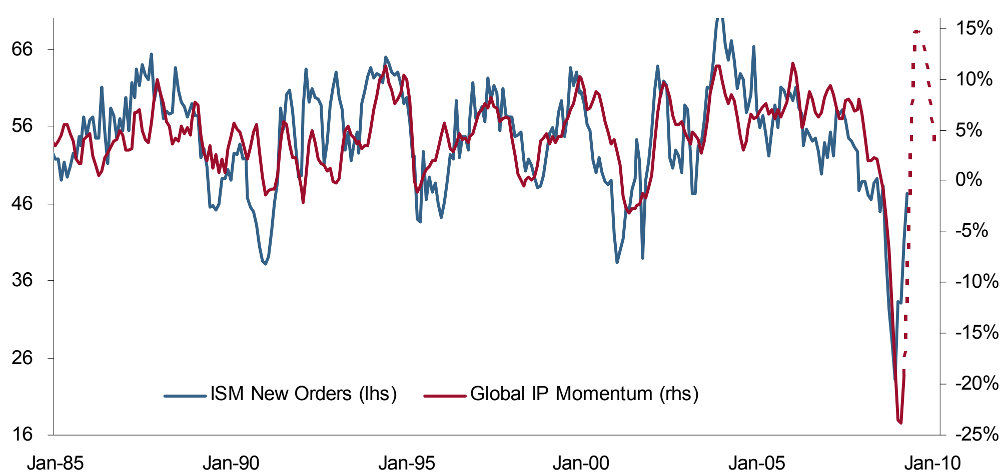

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Exhibit 11: Baltic Dry Freight Index (log scale)

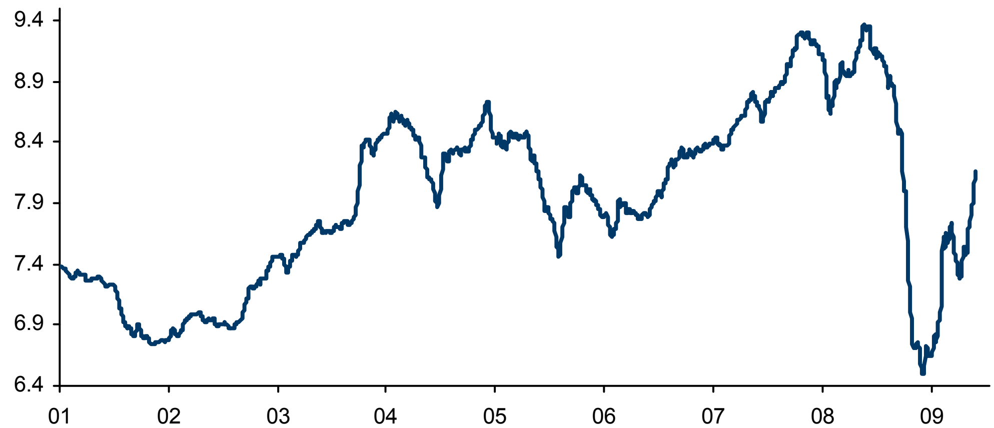

Exhibit 12: US 2-year Swap Rate 5-Years Forward

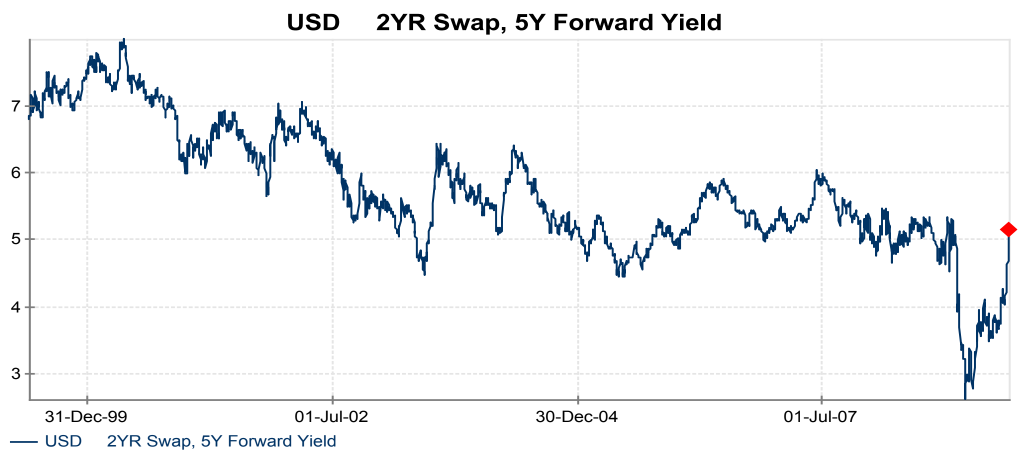

Exhibit 13: US 5y5y Forward Breakevens

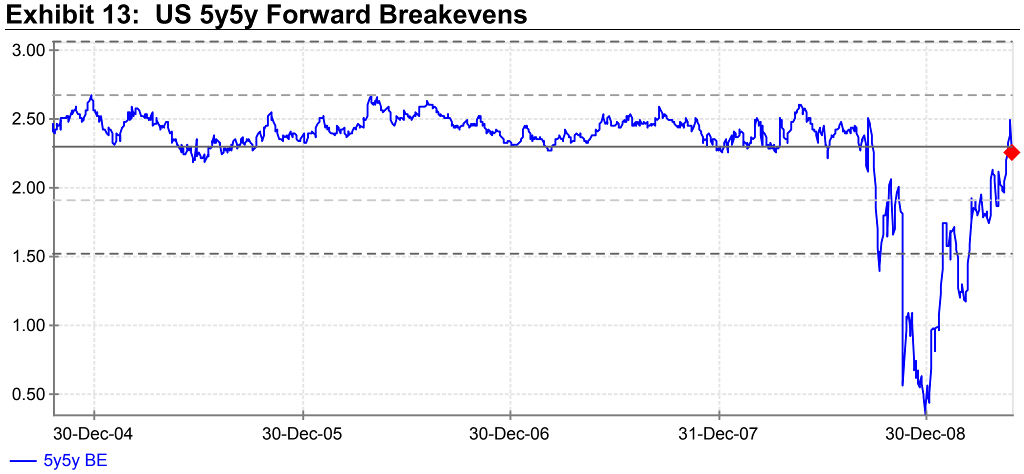

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Exhibit 14: Global IP Momentum and Global Risk Appetite

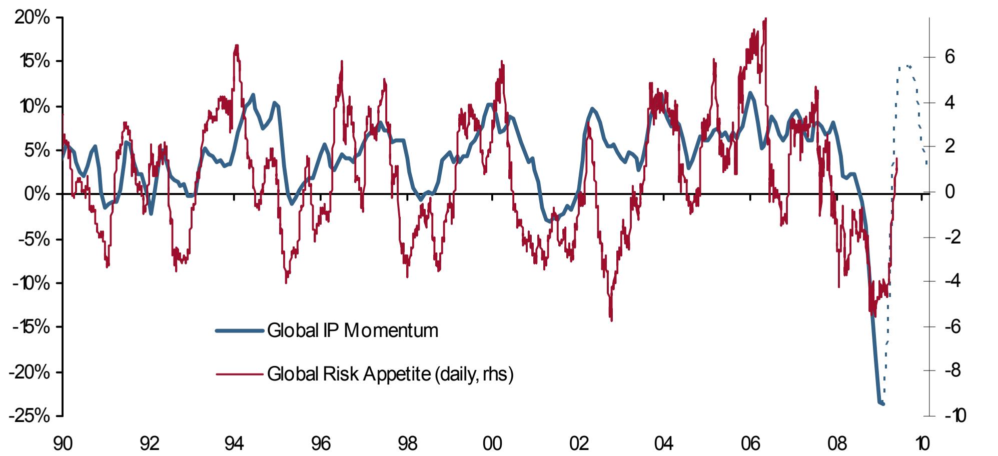


Exhibit 15: Global Risk Appetite and Equity-Only Risk Appetite

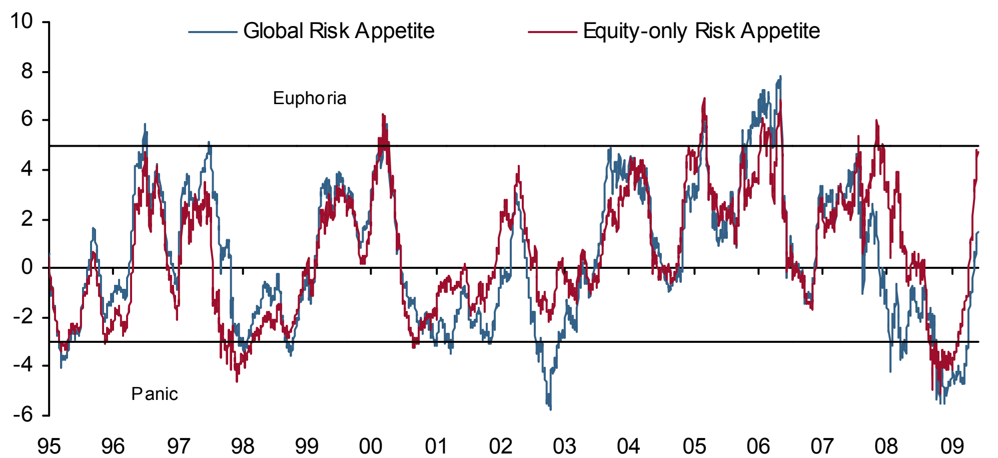
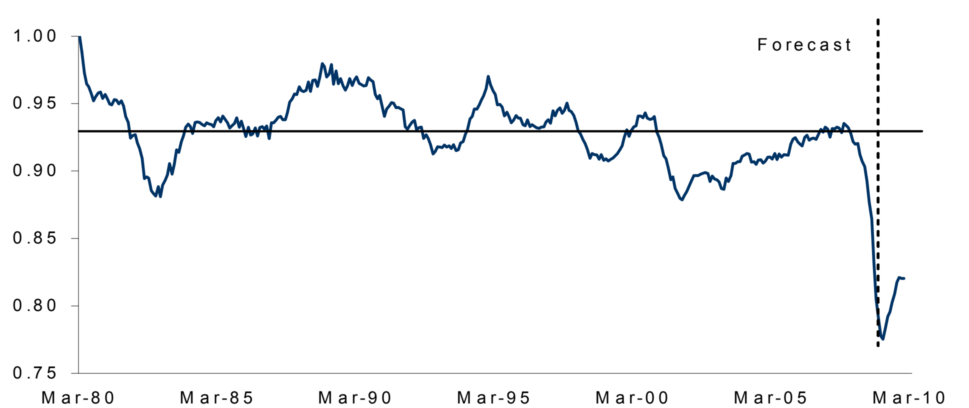


Exhibit 16: Global Output Gap



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