As Revival Dawns, Clouds Gather On Horizon

Global industrial growth has just begun to recover, but is likely to start slowing again by next summer.

Whipsawed The past three years have seen sharp swings in global growth, each of which was a surprise to the consensus. In 2008 a related surge in commodity prices greatly heightened policymakers' inflation fears to such an extent that the European Central Bank (ECB) actually boosted interest rates in July 2008, several months after the major Eurozone economies had entered recession. Meanwhile, by mid-2008 – six months into the U.S. recession – hawkish talk from the Fed, which thought a recession had been averted, induced financial markets to factor in a one-percentage-point rate hike by year-end.

It is a truism that recession always kills inflation. However, central bankers were largely unaware of the steepening slide into recession as it happened. Yet, by August 2008, before the Lehman Brothers failure, there were unmistakable signs that we were "on the cusp of the worst global recession in nearly three decades" (↗*International Cyclical Outlook, Vol. XIII, No. 8*). Of course, the Lehman collapse dramatically worsened the downturn.

In the West – and especially in the U.S. – policymakers threw everything they could at their economies in desperate bids to head off economic Armageddon. While the U.S. Long Leading Index growth rate bottomed in 2008, worries about the risk of depression remained widespread, and constituted the main topic of discussion at the April 2009 G20 meeting in London. That same month, ECRI was able to correctly predict an end to the U.S. recession by that summer (↗*U.S. Cyclical Outlook, Vol. XIV, No. 4*).

Our view was almost universally derided, though, and the U.S. government implemented a huge fiscal stimulus plan to complement the Fed's massive quantitative easing program. Europe was hardly immune to the gloom. But the biggest stimulus, relative to the economy's size, had come from China, where an enormous fiscal stimulus package was accompanied by rapid monetary easing. Fear of contagion also spurred rate cuts by the Reserve Bank of India.

It was not until early 2010 that the reality of the ongoing economic recovery in general, and the snap-back in global industrial growth in particular, began to dawn on most observers. Thus, few were prepared for the global industrial slowdown that began shortly thereafter, even though ECRI began warning of it as far back as July 2009 (↗*International Cyclical Outlook, Vol. XIV, No. 7*). So confused were most pundits by that downturn, and especially the mid-2010 slowdown in U.S. economic growth, that it is still being blamed – even in hindsight – on a laundry list of unforeseeable shocks: "a European financial crisis

Divergent Outlooks

	Current Growth	Consensus Growth Outlook	ECRI Growth Outlook
↗U.S.	Slow	Average	Average
↗Canada	Average	Average	Slow/Average
↗Mexico	Slow/Average	Average	Slow/Average
↗Germany	Average	Average	Average
↗France	Average	Average	Slow/Average
↗U.K.	Slow/Average	Slow/Average	Slow/Average
↗Italy	Slow	Slow/Average	Slow
↗Spain	Recessionary/Slow	Slow	Recessionary/Slow
↗Switzerland	Slow/Average	Average	Slow/Average
↗Sweden	Average/Strong	Average	Average
↗Austria	Average	Average	Average
↗Japan	Recessionary/Slow	Recessionary/Slow	Recessionary
↗China	Average	Average	Average
↗India	Average	Average	Average
↗Korea	Slow/Average	Average	Recessionary/Slow
↗Australia	Average	Average	Slow/Average
↗Taiwan	Average	Average	Average
↗New Zealand	Recessionary	Recessionary/Slow	Recessionary
↗South Africa	Slow/Average	Slow/Average	Slow/Average

FOCUS: No Different This Time

triggered by Greece, the gulf oil spill, conflict over Gaza and the concurrent gyrations in the stock market" *(pages 5 to 9)*.

By last summer, this had so exacerbated deflation fears that the Fed decided to pay a $600 billion insurance premium, in the form of the second round of quantitative easing (QE2), to guard against that possibility. By year-end, Congress and the Administration had agreed on an additional $858 billion fiscal stimulus package. It is only in recent weeks that a renewed revival in global industrial growth – which we predicted last July in this publication *(Vol. XV, No. 7)* – has become evident to most.

Yet, the mid-2010 slowdown in overall U.S. economic growth, which created such panic, was hardly a departure from the norm. As we discuss in detail later *(pages 5 to 9)*, economic growth in the major developed economies typically begins to throttle back about a year after the end of recession. In the U.S., the slowdown arrived precisely at the time it normally does after a recession.

The median duration of post-recession slowdowns in the large advanced economies is just over a year in the case of soft landings, and twice as long in the case of slowdowns that culminate in recessions. Because most of these economies are set to experience soft landings, their slowdowns should end later this year, though the likely timing is best inferred from the respective long leading indexes.

As we shall see, a revival in global industrial growth has just begun, in line with our earlier forecast *(International Cyclical Outlook, Vol. XV, No. 7, July 2010)*. Having been whipsawed by violent cyclical swings in recent years, it may therefore come as an unwelcome surprise to some that ECRI now expects a renewed downturn in global industrial growth starting as early as this summer. Again, this would be very much in line with standard cyclical patterns.

Cyclical Patterns in Global Industrial Growth

Cycles in global industrial growth, which are not country-specific, have been quite volatile in the wake of the Great Recession. A sharp recovery in 2009 was followed by a 2010 downturn, but we are now on the cusp of another upturn, which does not look like it will last long. In fact, the obvious implication of our latest downturn forecast is that the current upswing in global industrial growth could last less than a year. How unusual are such brief upturns?

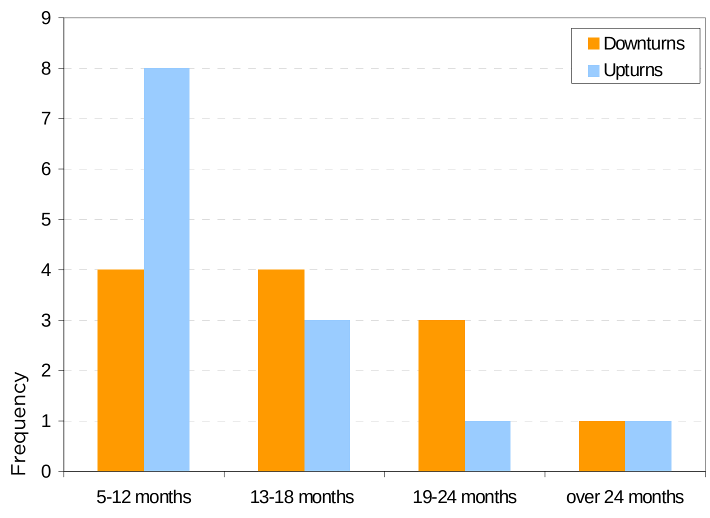
The median duration of upturns in global industrial growth is exactly one year, and over 60% of them have ended in a year or less. In contrast, the median duration of downturns in global industrial growth is 16.5 months, and more than 60% of them have exceeded a year in length (Chart 1a). In other words, the timing of a fresh global industrial slowdown starting by this summer would be quite consistent with historical patterns.

Our actual forecast is based on the Global Industrial Growth Long Leading Index (GIGLLI), shown in Chart 1b (top line). The GIGLLI is a long leading indicator of global industrial growth, as measured by the growth rate of the Global Industrial Production Index (GIPI, bottom line). The GIGLLI has a median lead of almost a year over GIPI growth.

The middle line depicts the growth rate of the International Leading Manufacturing Index (INTLMI), which has a median lead of three months over GIPI growth. Thus, the GIGLLI, INTLMI growth and GIPI growth typically turn in sequence – as they appear to have done once again in 2010. Specifically, following the upturn in the GIGLLI in early 2010 and the upturn in INTLMI growth in the late summer, GIPI growth is now in a nascent cyclical upswing.

However, the GIGLLI turned down in August 2010 and has declined for four straight months from 0.68 to 0.36. This is almost certainly a cyclical downturn, which is likely to be followed in due course by a renewed downturn in global industrial growth. Given the median lead of almost a year, that downturn is likely to arrive by the summer of 2011. If so, short leading

Chart 1a: Duration of Cyclical Upturns and Downturns in Global Industrial Growth



indicators like industrial commodity price inflation could very well begin to weaken by late this spring.

The downturn in the GIGLLI is rooted in a fairly widespread worsening in its components. What lies at the root of these developments?

Payback Time There has been wide acclaim for the perspicacity and policy skills displayed by the Indians, and especially the Chinese, in the immediate aftermath of the financial crisis. But, as we discussed in this publication last month *(↗Vol. XV, No. 12, December 2010)*, those Asian giants are now having to deal with the lagged inflationary effects of superfluous stimulus.

Back then, we questioned the latest, soothing assurances from Chinese leaders to the effect that the main problem was inflationary psychology, and warned that the "Christmas Day rate hike will surely not be the last one in this cycle. The real risk is that ...Chinese policymakers ... [will] have to stomp hard on the brakes, with the attendant lagged impact on economic growth." In the days that followed, our concern was amply vindicated, with a flurry of anti-inflation measures being taken by the Chinese authorities. The Indian central bank has also had to tighten policy further.

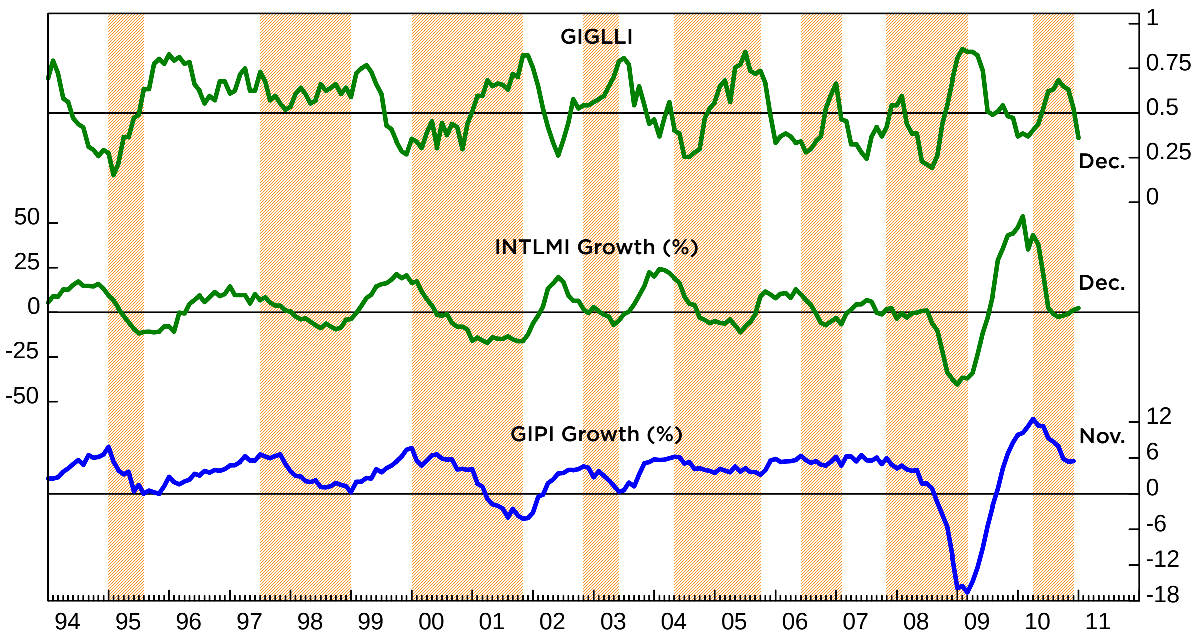
Exporters to these economies, like Korea and Australia, have also had to raise rates in recent months. And in Germany, which has enjoyed robust economic growth driven by soaring exports, especially to Asia, payback time may be approaching sooner than many think.

Normal cyclical patterns in evidence. New global industrial slowdown in sight.

Early this month, even as reports showed Eurozone inflation rising above the ECB's target for the first time in more than two years and ECRI reported a rise in its Eurozone Future Inflation Gauge (EZFIG) to a 25-month high, ECB President Jean-Claude Trichet dismissed inflation concerns, declaring that all indicators pointed to price stability "for the foreseeable future too." In less than a week, he had reversed course, admitting "short-term upward pressure on overall inflation" and declaring that "very close monitoring of price developments is warranted."

The EZFIG was pushed up primarily by a sustained upswing in the German Future Inflation Gauge *(↗Chart 10, page 17)*, and secondarily by a pop in the French Future Inflation Gauge *(↗Chart 12, page 19)*. So, even with the economies of Southern Europe in

Chart 1b: Indicators of Global Industrial Growth



Shaded areas represent cyclical downturns in global industrial growth.

precarious positions, Eurozone inflation pressures are clearly mounting *(↗page 16)*, presenting a tough dilemma for the ECB.

It is in this context that we are witnessing a decline in the GIGLLI. The eventual upshot, as discussed, is likely to be a renewed slowdown in global industrial growth that is apt to blindside most observers – who are only beginning to recognize the current global industrial upturn.

Inflation pressures mount in most economies.

At this time, many economies are in the early stages of a revival in industrial growth. This includes Canada *(↗page 10)*, as well as the Asia-Pacific region as a whole, where "the upturn in regional industrial growth is now underway." As in most other economies, though, "the current cyclical revival is likely to be short-lived" in that region *(↗page 30)*.

When the industrial slowdown arrives, it will not spare the U.S. economy, which is likely to succumb sooner or later. Even so, over the next few months, policymakers in Washington, in particular, will be able to take credit for a revival in U.S. economic growth without a surge in inflation. They may want to enjoy any accolades while they can. ■

