Dynamic Investment Solutions

Red Paper – Fiscal packages with a confidence shock on the side

Implications for investors

May 2009

Snapshot

- The US and Australian governments have recently announced large fiscal packages totalling 5.5% and 3.8% of Gross Domestic Product (GDP) respectively.
- We have used a macroeconomic model of the global economy to examine the short-term and longer-term impacts of the packages, as well as the impact a positive confidence shock may have on outcomes.
- Both packages will boost growth and employment in the short term, but future growth will reduce as the impact of the stimulus fades and as governments tighten their fiscal policies.
- The expected short-term boost to the US economy should have positive flow-on effects for the global economy.
- The stimulus is unlikely to significantly impact bond markets due to the increased tax inflows and additional savings it will generate.
- If a positive confidence shock reversed the fall in confidence experienced in late 2008, the impact of the US fiscal package on GDP growth would be twice as large.
- A positive confidence shock could occur very quickly, and the opportunity cost to investors who take a 'wait and see' approach may be significant.

Fiscal packages with a confidence shock on the side

Background

The sudden decline in global growth since September 2008 is forcing policy-makers to take a more aggressive approach to fiscal policy, and many governments have recently announced large fiscal initiatives aimed at jump-starting their economies. In the US, a package of US$787 billion (approximately 5.5% of GDP) has been announced, and Australia recently enacted an A$42 billion package worth around 3.8% of GDP. The size of these packages should mean they have a significant impact on the US and Australian economies. At QIC, we have used a large-scale macroeconometric model of the global economy to examine the short-term and longer-term impacts of the US and Australian packages on their respective economies, as well as the potential impact on bond markets.

We have also looked at the impact a positive confidence shock (often seen following extreme market downturns or negative shocks) might have on economic outcomes in the US. The slowdown in global growth that occurred in late 2008 was compounded by a dramatic slump in household, business and investor confidence that was triggered by the collapse of Lehman Brothers in September. More recently, investors have had some reason to be less pessimistic about the future. A raft of policy initiatives has been announced and economic data released in April show evidence that the pace of economic decline is abating. As a consequence, investor confidence has improved and equity markets have rallied by more than 20% from their lows at the start of March. This quarter, the US government will commence the implementation of the fiscal stimulus package that was passed by Congress in February. The prospect of tax cuts, government infrastructure spending and the distribution of other benefits presents further reason for an improvement in confidence. Of course, it is very difficult to predict the timing and strength of changes in confidence; however, to help our investment professionals understand the impacts of a significant positive shock we have used our macroeconomic model to examine the expected economic outcomes both with and without a significant boost to confidence.

What impact will the packages have on growth and employment?

While the US package will be implemented over a number of years, the bulk of the package (US$584 billion or 74%) is planned for the next two years. Our models suggest that the implementation of the US package will boost US GDP growth by 0.7% in 2009 and by 1.3% in 2010. This should also result in an improvement in labour market conditions, with the unemployment rate expected to be nearly 1 percentage point lower (peaking at 9.9% in the first quarter of 2010, compared to 10.8% in the second quarter of 2010 in the absence of the package). Although the fiscal package will help limit the downturn in the US economy, growth over the medium-term will be lower as the government is forced to tighten fiscal policy in order to reign in the budget deficit.

In Australia, the A$42 billion National Building and Jobs Plan should have a significant impact on Australia's short-term growth prospects, with our models suggesting a positive impact of 0.3% in 2008/09 and 1.4% in 2009/10, which is broadly similar to the Commonwealth Treasury's estimates of 0.5% and 0.75-1% respectively. Our modelling assumes only around 20% of the $12 billion bonus payments issued in March and April will be spent in the first three months, consistent with evidence from the $8.7 billion stimulus payments issued in early December, with a further 30% to be spent in the following year. In terms of employment, we expect that the implementation of the package will limit the rise in Australia's unemployment rate to around 8% by the end of 2010, compared to almost 9% in the absence of the package. However, the stimulus package modestly lowers Australia's medium-term growth outlook due to the requirement for tighter fiscal policy once the economy recovers.

Impact of Nation Building & Jobs Plan	Increase in real GDP growth (% annual average)	
	QIC	Australian Treasury
Calendar year		
2009	1.1	-
2010	0.6	-
Fiscal year		
2008/09	0.3	0.5
2009/10	1.4	0.75-1.0

Source: QIC: Updated Economic and Fiscal Outlook, Australian Treasury, February 2009.

What impact will the packages have on bond markets?

A major concern for investors is the impact large-scale fiscal expansion will have on bond markets, as the issuance of additional supply to fund government expenditure drives bond prices down and bond yields up. For investors, this means that value of an existing portfolio of bonds may fall.

However, we don't expect this (higher yields and falling bond prices) will occur for three key reasons:

1. The fiscal stimulus package will generate higher inflation and tax revenue, and this higher tax inflow will reduce the amount the government has to borrow (via the issue of bonds).
2. The stimulus package will also result in additional savings by households and businesses, and some of these savings will be used to purchase the additional supply of bonds on issue.
3. Central banks are expected to maintain low official cash rates, which should help lift demand and further limit any rise in bond yields.

What impact would a confidence shock have on the economy?

One of the criticisms of fiscal policy is that it boosts growth in the short term at the expense of future growth, because governments are required to tighten fiscal policy in the future to stabilise public finances. While this is true, there are other potential benefits that need to be considered.

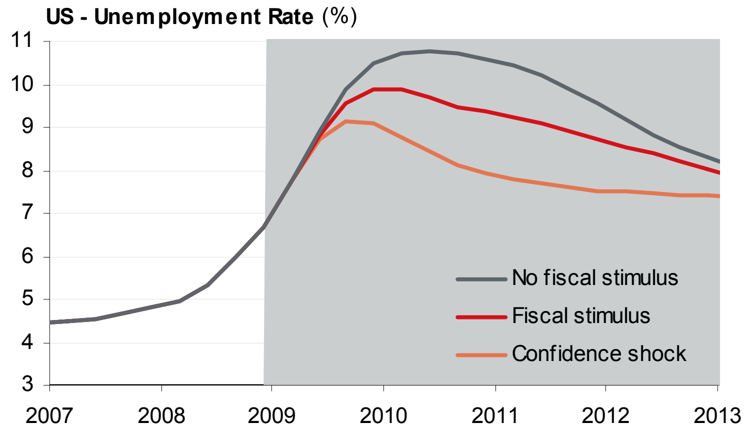
For example, the expected short-term boost to the US economy should have positive flow-on effects to the global economy. If the US package results in the predicted boost to short-term growth, we expect rest-of-world growth to be 0.1% higher than it otherwise would be in 2009 and 0.2% higher in 2010.

One of the biggest potential benefits of the stimulus packages is the effect they may have on confidence levels. The slowdown in global growth that occurred in late 2008 was compounded by a dramatic slump in household, business and investor confidence. Our modelling suggests that if the shock to confidence (proxied by corporate credit spreads, mortgage and consumer credit spreads, equity prices and savings rates) that occurred in late 2008 was to reverse during mid 2009, the impact of the US fiscal package on GDP growth would be twice as large.

That is, if the spike in credit spreads, equity risk premia (i.e. the extra return required to reward investors for taking the risk of investing in equities) and the savings rate that occurred in the last quarter of 2008 were to reverse in mid 2009, US growth would improve by a further 0.8% in 2009 and 2010. This would push the US growth rate above trend in 2010 and allow it to maintain trend growth in 2011. Rest-of-world growth would also increase by a further 0.1% in 2009 and 0.7% in 2010, as stronger US equity prices lift sharemarkets globally.

Real GDP growth forecasts % annual average		2009	2010	2011	2012
US	**No fiscal stimulus**	-3.2	0.7	2.7	3.5
	Fiscal stimulus	-2.5	2.0	2.5	2.8
	Confidence shock	-1.7	3.4	2.7	2.3
World ex US	**No fiscal stimulus**	-0.1	3.1	4.5	5.8
	Fiscal stimulus	0.0	3.3	4.5	5.7
	Confidence shock	0.1	4.0	4.9	5.7

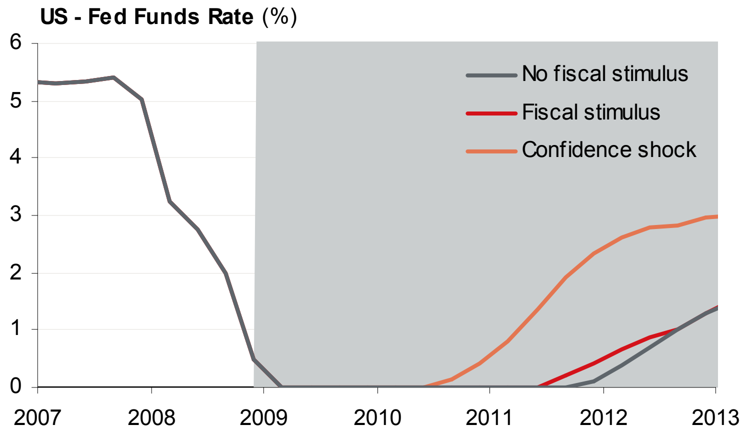
Such a confidence shock would also reduce the unemployment rate in the US by a further 0.9 percentage points and lead to a faster recovery in inflation levels.



In the scenario where the fiscal package is implemented but there is no boost to confidence, we expect that higher growth and a stronger labour market will cause the US economy's level of excess capacity and rate of deflation to decrease, but not disappear. Deflation is expected to persist throughout the second half of 2009 and into 2010, with inflation remaining below 1% in 2011. Consequently, we expect the US Federal Reserve (Fed) will maintain its 0% interest rate policy for the next two years.

However, in the scenario where there is a dramatic improvement in confidence, we expect that:

- inflation will return to around 2% in 2011
- the Fed will begin to raise interest rates in the second half of 2010 – nine months earlier than in the case of the fiscal package alone, and 15 months earlier than in the base case (i.e. no fiscal package or improvement in confidence)
- ten-year US Treasury yields will increase by around 80 to 100 basis points in 2009 as investor expectations of tighter monetary policy are factored into bond valuations.



Predicting confidence shocks

History tells us that positive confidence shocks can occur, particularly after periods of negative investor sentiment. While it would be unrealistic to attempt to predict the exact timing and strength of a confidence shock, it is prudent to understand that such shocks are a realistic possibility, and as such they should be incorporated into investment decisions.

QIC's analysis clearly shows the significant impact that an improvement in confidence could have on economic outcomes, and, as they typically occur very quickly, the opportunity cost to investors who take a 'wait and see' approach may be significant.

By utilising our comprehensive economic model, our investment professionals have good insight into the possible economic scenarios that their portfolios may experience, and this will assist them to test and build more robust portfolio positions.