



David Bowers
INSIGHT

It's businesses, not consumers, that need to lead recovery

It might be heresy but what if the credit crunch turns out to be more of a supply shock than a demand shock? While markets appear to be focusing on the prospect of multi-year consumer deleveraging and weak consumption growth, it strikes us that investors risk forgetting that it is corporates, rather than consumers, that have been on the frontline of the 2009 recession.

The conventional wisdom is that this recession was in essence a housing bubble followed by a bust. But that is too narrow a view. Analyse this year's gross domestic product falls in the US, eurozone and Japan and you will discover that the dominant contributing factor has been the collapse of corporate, rather than consumer, spending. Capital spending has been cut back brutally and inventory levels run down. So it might be that corporates rather than consumers now hold the key to the shape and duration of the recovery. We believe corporates were significant beneficiaries from the plentiful supply and

mispricing of credit during the boom years. Multinational companies profited from an extremely low cost of capital as banks rushed to offer them Swiss franc- and Japanese yen-denominated credit to help fund the long, thin, supply chains that seemed such a winning formula during the Great Moderation. Moreover, this "portable cost of capital" supported a plethora of vendor-financing deals whereby producers extended credit to their customers to purchase their products, making revenue lines appear more predictable than was really the case.

This business model came crashing down

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with Lehman's collapse. Companies' cost of capital went through the roof (assuming you could get any) and the vendor financing deals evaporated as the credit ratings of customers were called into question. This happened so rapidly that companies found themselves with excess inventory at a time when they had no recourse to bank credit. In a desperate attempt to preserve cash they cut dividends, jobs and capital expenditure and when that failed they temporarily ceased production to liquidate inventories. Thus, Lehman's failure triggered a contraction in global supply all the way down the supply chain as inventories were liquidated and capex projects abandoned.

Economic recovery, however, may pose an even greater challenge to these fragile supply chains. As any accountant will tell you, one cast-iron way of ceasing to be a going concern is to have nothing to sell. When inventory falls to critically low levels, companies will reorder only to find that their suppliers have no inventory either – a pattern echoed all the way through the supply chain. In the ensuing scramble for resources, we fear a rise in "frictional" inflation – particularly among the industrial sector. Already our proprietary news flow indicators are showing much more concern about inflation than we would normally expect

given the depth of the recession. Did the credit crunch force companies to cut back capacity excessively? If so, then the amount of spare capacity in the economy might not be as great as first thought, meaning deflationary pressures will be weaker than the bond bulls had been expecting. It would come as a big surprise if what they saw as a

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negative demand shock turned out instead to be a negative supply shock. One of the greatest risks of this is that we see a sudden "bear flattening" of the yield curve where short-term bond yields rise faster than long-term yields.

So next year could see the start of some fundamental challenges to the business models of global non-financial companies. For a start, companies will have to start thinking how to reinstate that supply. With employers having maxed out productivity gains from their current workforce, there could be a rush to re-employ workers. It is quite conceivable that US unemployment might fall in 2010, which would call into question the consensus view of a "jobless recovery".

The second challenge will be to rebuild and resecure their supply chains. But that will depend on what funding is available. Following the credit crunch, the supply of private sector cross-border finance will be much reduced, especially the farther away companies stray from their home market. Faced with these and other challenges, companies might look to relocate their supply chains nearer to home - "nearshoring" rather than "offshoring" could be a buzzword to watch out for in 2010.

Finally, companies will find that they face a very different regulatory agenda as scientists persuade the politicians of the need to reduce carbon emissions. Not only will companies have to reinstate their supply and relocate it closer to home, but they will also have to re-engineer their capital stock to be more climate-friendly. Maybe it is time that we stopped worrying about the consumer, and focused more on how the corporate sector is going to have to rebuild its capital stock and how that rebuilding is going to be funded.

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