MLC **Investments**

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No guts, no glory

I really do not want to get into the business of providing a running commentary on every piece of economic data, or every central bank policy action or comment. There are two key reasons for this reluctance: there are heaps of people already doing it and they do a much better job of keeping on top of these developments than I do; and focusing too much on the day to day news-flow can make you lose sight of the things that really matter – such as diversification, and patient long-term investing.

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Today's move by the Reserve Bank forces my hand however. The RBA have not cut interest rates by a full percentage point since May1992, and today's move surprised everyone. Over the past 15 years or so, the RBA have earned a considerable amount of credibility, both for their ability to manage the business cycle, and for their ability to achieve their inflation target. The fact that they could contemplate such an aggressive rate cut at a time when inflation is well above their target (in fact, this is their worst 'miss' since they started targeting inflation) might best be described as the 'no guts no glory' school of monetary policy in action. It's also a measure of the credibility reserves they have accumulated in the eyes of financial markets. In short, the RBA understands the risks the global economy is facing, and equally understands that however robust and well-regulated our banking system is, there is simply no way that Australia can be immune from the economic fall-out from what is a truly global financial crisis. In such an environment, the Bank can be very confident that inflation will fall back into the target range within a reasonable time frame. In the Governor's statement, he makes it abundantly clear that this is all about the real economy, not simply about taking some funding pressure off the banks.

"The recent deterioration in prospects for global growth, together with much more difficult market conditions even for creditworthy borrowers, now present the risk that demand and output could be significantly weaker than earlier expected. Should that occur, inflation would most likely fall faster than earlier forecast.

"Given that background, the Board judged that a material change to the balance of risks surrounding the outlook had occurred, requiring a significantly less restrictive stance of monetary policy. The Board also took careful note of movements in funding costs in wholesale markets. Having weighed these considerations, the Board decided that, on this occasion, an unusually large movement in the cash rate was appropriate in order to bring about a significant reduction in costs to borrowers."

The RBA have left the banks with virtually no excuse for not passing on at least part of the rate cut. They want consumers to get the benefit because they want the real economy to get the benefit.

The local sharemarket has responded very positively to the move – after opening sharply lower, a recovery was underway even before the rate cut, but at the time of writing, the ASX300 is up by 1.8% on the day. The Australian Dollar, which fell sharply overnight, initially fell a lot further, before regaining those losses, to actually be trading higher now than it was before the announcement!

Share markets are not out of the woods yet. The markets' thoroughly underwhelming response to the passage of the US Treasury's bail-out package is evidence of that. A number of things needed to happen, and still need to happen in order for markets to believe that the light at the end of the tunnel is not an oncoming train. We firstly needed to see a bail-out package put in place. Even the second or third best effort that eventually resulted is considerably better than no package at all. It is no panacea. It does not prevent a US and perhaps global recession, and hence further credit losses emerging over time, but it does help the banking system be better able to face those shocks if and when they come. We also need to see further monetary policy action. I expect that today's aggressive RBA move is part of a global, co-ordinated central bank response to the crisis. The RBA by itself obviously makes no difference to the world economy, but if followed (imminently) by the Federal Reserve, the Bank of England, the European Central Bank, and the Bank of Canada, then things start getting interesting. Today's statement by the Bank of Japan after their policy board meeting, hints at their willingness to be more flexible with policy – however, with overnight interest rates at the dizzy heights of 0.5%, there's a limit to what the BoJ can achieve.

Finally, a sustained recovery in financial markets – in equity and credit markets – probably needs to start from a point when valuations look genuinely cheap. In credit markets, where corporate debt spreads have blown out dramatically, value does seem to be on offer. In equity markets, value is emerging, but earnings expectations – both here in Australia and offshore – still look way too optimistic to me.