Investment Briefing

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Lights and tunnels

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Since early March, world share prices have risen by over 44%. Emerging markets have fared particularly well, with prices now around 71% off their lows. Locally, our market has tended to lag somewhat – share prices are 'only' up by 37% or so since their early March lows. While the recovery has been welcome, history has plenty of examples where markets, after major declines, enjoy substantial 'bear market rallies' before falling apart again.

Given the magnitude of the crisis we have been through, it is no surprise that there are plenty of voices – both credible and not-so-credible - in the world arguing that the rally in equity markets we are currently enjoying will inevitably fizzle out. The reason most often quoted for such a forecast is that the world is still a nasty place. The world economy is still mired in recession, and it is by no means clear that problems in the US and global banking system have been properly addressed. More credit losses and balance sheet problems are going to inevitably emerge as the recession progresses.

Yep, agree with all that. The major economies are still in recession, and likely to stay there for much of this year. The downturns in the UK and Japan in particular are as severe as any in living memory.

On the financial system, I don't believe we're out of the woods yet either. Not long ago, the results of the US Federal Reserve's 'stress tests on US bank balance sheets were released, which showed that the worst offenders 'only' need to raise around $75 billion or so to provide for the losses that are likely to emerge during a supposedly 'adverse' economic scenario. I agree totally with sceptics who believe that those tests were nowhere near stressful enough, and that the losses will end up being much larger than officials are prepared to recognise.

What about here in Australia? If we really believe that some better than expected retail and housing numbers, and the fact that we avoided two negative quarters of GDP growth in a row means that we'll be just fine, then quite frankly we are kidding ourselves. The private sector has been shedding jobs for over a year, and business surveys tell us that more job losses are to come. We've only started to see investment intentions being wound back, and our exports haven't yet responded to the collapse in our major trading partners' economic growth.

All this sounds awful I know. So, the recovery in equity and credit markets we have seen this year is obviously unsustainable: a bear market rally, a false dawn, right?

Not quite. There will certainly be setbacks – times when markets take one or two steps back after three or four steps forward, even though in the market recovery so far, steps backward have been few and far between. However, here are some reasons why the recovery might be sustainable.

After the failure of Lehman Brothers, the world financial markets and indeed the world economy really were teetering on the edge of an abyss. The financial system is the central nervous system of the world economy, and that system had effectively shut down. In that environment, equity markets truly nosedived for what looks to me like the last time for this crisis, and seem to have factored in an

outlook for corporate earnings that was more than sufficiently dire. Since those desperate times in the final quarter of 2008, conditions in world money and credit markets have improved significantly, and the world took not just one, but many steps back from that abyss. *In short, the probability of a 1930s scenario unfolding has plummeted.*

The recovery in equity and credit markets has been followed by a clear turn in a range of global leading economic indicators: in other words, those numbers that tell us where we might be heading as opposed to where we've been. The recovery in these indicators now looks well established. They are certainly not telling us that global growth is going to race away – far from it. Nevertheless, they look significantly better than they did towards the end of 2008.

While bank share prices have rebounded strongly since the March lows in world share markets, it still seems to me that in the US and elsewhere, banks will need to raise significantly more capital than either they or monetary officials are willing to acknowledge. However, better equity market conditions have made capital raisings considerably easier for both financial and non-financial companies. Moreover, even if these conditions were to take a turn for the worse, we now know what the authorities' instruction manual now looks like. *If a large US or UK or European institution needs to raise more capital and cannot raise that capital from private sources, public capital will be injected.*

A recent broker report noted that recoveries never look likely, yet they happen all the time. One of the most respected fixed income analysts in the world, Jonathan Wilmot from Credit Suisse, wrote in a July research report that "It is precisely when so many of the most experienced and serious people are most deeply troubled that risk assets are most likely to be seriously cheap." That said, I think I feel a 'however' coming on.

However, I don't believe it's credible to argue that we can endure a crisis of this magnitude, where so many investors, businesses and financial institutions have been so badly burned, and have memories fade so quickly. The economic and investment environment we are going into is going to be entirely different to that which prevailed over the past decade or so. The economic recovery when it clearly emerges is likely to be an incredibly subdued affair, particularly in the English speaking economies. The private sector's appetite for risk and credit is likely to remain very anaemic for years to come. The regulatory pendulum, which arguably swung too far in the direction of deregulation in the past decade or two, seems like to swing back some way.

At MLC, we spend a good deal of time focusing on the medium to long-term outlook for the economy, financial markets, and investment returns. While we would caution against extrapolating the recent stellar run for world equity markets too far into the future (setbacks are inevitable), the longer term outlook for equity market returns is still quite reasonable.

It would be a great tragedy if one of the lasting effects of crisis was to scare a generation of superannuation fund investors away from equities. If we are in the business of building long-term wealth for retirement, we are going to have to have at least some exposure to share markets. In a free market economy, businesses build the wealth.

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