

Investment Briefing

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Debt Deflation

Growth is faltering, inflation is up, and equity markets have plunged. And that's not all, commodity prices and the Australian dollar are now faltering too. What does it mean, and what should investors do? Before the credit crisis investors were highly optimistic that robust global growth and stable inflation could persist indefinitely but, as we then repeatedly warned, risks were building. In brief, the Fed's aggressive interest rate cuts in response to the bursting of the tech bubble provided the initial fuel for a new bubble. Strong US consumer demand sucking in imports should have been offset by US dollar weakness (making imports more expensive), but dollar pegging by the export dependent Asian economies inhibited this.

Global capital flows required for this currency management provided a surge of liquidity which spilled across markets – particularly residential property, riskier debt assets, and then commodities. Growing indebtedness fuelled inflation, not in consumer prices but in asset prices. This was always unsustainable, and the longer it persisted the more painful the eventual adjustment had to be.

The good news is that these risks are progressively unwinding. We are on what economists call a dynamic adjustment path. While debt continued to build, the global economy was moving into a more unsustainable position. Now it is on transition back towards sustainability. It is already clear that this adjustment process is a very painful one, but how much more pain is to come, how much more bad news remains to be revealed, how long it will take to be dealt with and how severe and prolonged the impact on the real economy will be are all uncertain.

Economic theorists have long hypothesised that economies tend towards an equilibrium or steady state. Equilibrium economics sees an economy as being in a steady state until something changes to push it into a disequilibrium position, from where it follows an adjustment path towards a new equilibrium. The reality is that it takes a very long time for economies to approach a steady state; in fact they rarely if ever get there because things are always changing. But what happens along the adjustment paths and what sort of equilibrium an economy is heading towards matters. The most commonly described equilibrium or steady state for an economy involves stable inflation and steady economic growth – a pretty benign environment for financial markets. But economies may get pushed so far off course that they diverge towards a less pleasant scenario. Debt deflation environments run this risk.

The process of reducing debt involves the sale of assets which pushes asset prices down; these price declines may in turn force more selling. In this way debt deflation risks a vicious spiral of asset sales and price declines. The experience of Japan in the 1990s shows us what this can lead to. Debt levels need to fall, but if everyone tries to reduce debt together, aggregate demand may shrink (we have a recession) and savings fall. Falling demand reduces inflationary pressure which sounds like good news, but inflation can provide an incentive to spend (if prices are expected to be higher tomorrow, it can be better to buy today than wait). If consumer prices are steady or (worse) fall, already nervous consumers tend not to spend. Where consumers remain reluctant to spend even with interest rate



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cuts we have what's called a liquidity trap. This is what Japan experienced, and once in a liquidity trap it's hard to escape. The problem is that nominal interest rates can't go below zero and this might not be low enough to encourage spending. This means that there has to be a massive amount of fiscal support for the financial system when a severe credit crisis occurs.

Importantly now, not only are bad debts being progressively dealt with, policy makers were very prompt and forceful in dealing with the initial crisis and are very aware of the need for aggressive interest rate cuts and fiscal stimulus to avoid the possibility of a liquidity trap. In contrast, the Japanese authorities allowed the bad debts to fester. They preferred to hide the problem hoping it would somehow go away – it didn't. While this won't happen in the current crisis, there's still the potential for policy mistakes. This time though, the crisis is so severe that there's little risk of inflating yet another bubble.

Looking forward we know that the adjustment will take time. The economy can't simply jump to a new steady state because many economic variables need time to change. Those variables that are flexible adjust first. Many prices - particularly asset prices - are very flexible and they take the brunt of initial adjustment. That's what we're seeing now. With major financial institutions on the brink of collapse, equity markets are naturally priced down. As each problem is dealt with (for example the Fed's engineered bail out of Bear Sterns and the US Treasury's efforts with Freddie and Fannie) there is some respite for markets. At the time of writing, Lehmans have surrendered themselves to bankruptcy protection. This is unlikely to be the last shoe to drop. There are likely many more failures among banks, broker-dealers, insurance companies, and hedge funds. We may still be relatively early in dealing with the most severe banking crisis since the 1930s. According to Professor of economics at New York university, Nouriel Roubini, the ultimate cost to the US economy may be 10% of GDP. About 50% of the global economy is now thought to be contracting, not only the US is in recession but now also Eurozone, UK, and Japan. If the developing economies also slow appreciably then we will have a global recession.

It is clear that the credit problems will take considerable time to work through; it may be two to three years before the financial system is fully sorted out. The impact on the real economy is also far from over. Looking forward, what this means for equity markets depends on what's already priced in. Over the past year there has been a dramatic shift in investor expectations and asset price declines reflect this. But it takes time for expectations to adjust fully, and also for all the bad news to be fully revealed. Just as in a boom, the market does not stop rising until the last pessimists have been converted; in a bust it takes time for investors to understand that the good times are not coming back quickly. In both cases asset prices tend to overshoot fair value. While much bad news has rightly been factored into prices, as the bear market proceeds more and more assets start to offer good longer term value. Just when investors are at their most pessimistic, prospective returns can be at their most attractive. To exploit this emerging potential you need active stock selection. The market does not adjust evenly. Sectors, regions and markets tend to adjust sequentially with the most obvious asset prices (in this case developed market financials) in the front line of initial adjustment, but as the flow-on effects are revealed the pattern changes. Previously robust sectors can suddenly become vulnerable.

This produces a rolling adjustment process both for economies and markets. The US (and UK) was the initial epicentre, with direct flow on effects to other major developed economies, and second round effects on emerging markets dependent on US exports. Some respite for the US has come from exports as slowdowns elsewhere lagged, this is now likely fading. Commodity prices and resource stocks also did well initially. But the Chinese consumer, while on the rise, is not fully ready to take on the global growth mantle. The Chinese economy is slowing, it remains unclear how far but it has been enough to take the pressure off commodity prices and reveal the vulnerability of the Australian dollar to a global slowdown.



Over the past decade perceptions of Australia have swung from boring backwater during the tech bubble to leading light with the China boom. Australia is starting to lose its lustre again as the resources boom begins to fade. Australia is not a safe haven for investors' retirement assets – far from it. While global growth and inflation were well behaved getting an adequate return to build a retirement nest egg was fairly straightforward. It is when the risks of a more difficult scenario emerge that the vulnerabilities of too concentrated and inadequately diversified strategies are revealed. Diversification, particularly outside Australia, is more important than ever. The adjustment process is not going to be easy or quick. Being clear about your investment objectives and sticking to your carefully selected, well diversified strategy – avoiding being spooked by market declines, and not chasing past returns – are what will count.

Finally, we are starting to be asked why we didn't have a more defensive positioning in our diversified funds. If we go back a little over a year ago, MLC's portfolios were already relatively defensively positioned which meant that our diversified funds were lagging in the performance surveys. We were under considerable pressure to increase weightings to the hot investments of the time – property in particular. While our funds have benefited from the risk control insights of our scenarios analysis, this short term relative performance focus makes it impossible to protect portfolios more fully against the investment risks that have now materialised. This need to focus on peer relative performance led us to launch LTAR (the MLC Long-Term Absolute Return Portfolio). This strategy has no peers and is unconcerned with short term performance. While it has an aggressive neutral strategy, LTAR has benefited from very defensive positioning – this meant that performance lagged significantly prior to the credit crisis but it has subsequently reaped the rewards.

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