

Investment Briefing

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Thinking the unthinkable

After the stock market crash in October 1929 it took more than three years for US policy makers to launch a series of dramatic measures to end the depression. By this time the US had already seen the worst economic collapse in history – including the failure of thousands of banks, GDP dropped by almost one third, unemployment rose to 25% and a destructive deflation took hold. The first of today's financial storms struck in August 2007. Policy makers began to respond early in 2008 and in just two dramatic weeks in September this year the Federal Reserve and the US Treasury put in place the most radical series of measures seen since the 1930s. But have policy makers done enough to avert a prolonged slump?



Dr Susan Gosling
Capital Markets Research
MLC Investment Management

There is a dramatic difference between now and the 1930s when US policy makers were to be stunningly incompetent. We are experiencing nothing resembling that today. This is not to say that policy makers have not already made mistakes or that there won't be any more. Had Lehman's not been allowed to fail and had the policy measures now in place been taken six months earlier, the meltdown in markets would probably not have occurred. We should also admit that we are now likely in for the deepest and most protracted recession in at least 25 years. But if there's a historical comparison, the closer one is the Japanese stagnation rather than the depression era.

We are experiencing a credit contraction that will undermine demand and profits until it turns into a credit expansion. Borrowing is collapsing, and this means lower demand. The speed of deceleration in the global economy is unprecedented in the last 25 years. Declining demand forces companies to cut costs and layoff labour, which reduces household income further, and spending drops again...and so on. The unthinkable is that this spiral remains unchecked for long enough for the global economy to get stuck in a deflationary trap.

In modern economic history Japan's decade and a half stagnation represents a unique experience. But Japan was not alone in having an asset bubble burst and subsequent banking crisis. The US savings and loans debacle occurred in the late 80s; Sweden had a banking crisis with similarities to Japan in the early 1990s; and much of emerging Asia experienced financial storm late in the decade. Japan's was the only economy that did not deal with its problems fairly promptly and subsequently resume a normal growth path. Elsewhere prompt policy responses helped clean up bad debts and restored banking system strength. In Japan the authorities colluded with the banks which hid rather than dealt with bad loans. This acted as a brake on new lending, resulting in economic weakness which made the problem worse. Misguidedly the authorities relied on mainly (badly directed) government spending which could not result in sustainable growth while the banking sector remained crippled.

This is just not going to happen today - a good example that it won't is the speed with which policy makers worked out they had to nationalise mortgage lenders Fannie Mae and Freddie Mac. While the US and European bank regulatory systems are not without fault – there was little reaction to the



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shifting of risky securitised assets off balance sheets –compared to the Japanese, they are accountable, transparent and disciplined.

Part of the problem was that the deflationary slump took Japan's policy makers completely by surprise. Again, this stands in stark contrast to today. The Federal Reserve in particular is ready to provide all the liquidity the economy requires. This will not just involve cutting interest rates (the effective official rate is anyway already close to zero), but a range of unconventional measures to get credit in the hands of those that need it. This might include targeting not just cash rates but long bond yields too – buying long dated paper to get mortgage rates down.

Regardless of the policy response the worst recession since at least the 1970s is likely unavoidable. This creates a tension between apparently cheap valuations and rapidly deteriorating fundamentals. The US debt market seems to be discounting a default rate consistent with economic stagnation. Equity markets have certainly priced in a lot of bad news, but there are two forces driving earnings down. Compounding the effects of the slowdown is a shrinking profit share of income or GDP. However, even taking into account further substantial earnings adjustments some companies are certainly attractive right now even if the global economy has a period of stagnation. Winners will include companies with strong management and low or no debt; those with income and price inelastic demand (producing staples not luxuries; or with strong franchises) that can weather tough economic times; and those that will benefit as weaker players get squeezed out. Being in the right companies is now more critical than any of us can remember! In difficult economic times some companies will fail. This is not a time for index strategies.

In considering nearer term returns there is an additional factor to consider. Many investors, particularly leveraged players but also those with a lot of very illiquid assets, have been forced sellers of whatever can be sold at any price. We cannot be sure yet that this indiscriminate forced selling has finished. On the positive side this creates great opportunities for active stock selectors, but it does mean that the short term path of returns remains highly unpredictable.

At MLC we've been skeptical about lots of things from hedge funds to high allocations to illiquid investments. But being skeptical doesn't always mean being pessimistic. In fact if all are negative about the future, then a skeptic has to be optimistic! This certainly does not mean we can assume that markets will not move lower, but it does mean trying to time markets is a dangerous game. Markets typically will rally before the fundamentals improve and before you get your confidence back. The best investment opportunities are had when investors are at their most nervous, but don't bank on a rising tide that keeps lifting all boats.

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