



Investment Briefing

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What a difference a year makes...but is it really over?

The despair and dramatic global economic contraction of the start of 2009 have gone. They have, uncomfortably quickly, been replaced with renewed optimism and expectations for a sustained recovery. Unprecedented policy action has averted disaster and fostered a nascent economic recovery. But is the crisis really over?

We've had the most severe banking crisis since the 1930s. The difference in the policy response is stark. 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 2008 the Federal Reserve and the US Treasury put in place the most radical series of measures seen since the 1930s.

Banking systems have been saved from the precipice, but the IMF estimates that so far banks have recognised only half of their expected losses. Also the strength and stability of the recovery remains uncertain. The US consumer, who has been hit by a huge labour market shock, is facing a multi-year reversal of prolonged over-spending (the consumption share of GDP at 71.2% is more than 5% above the pre-bubble average). Perhaps of most concern is that imbalances in the global economy which we have worried about for more than five years are not yet resolved. Chinese growth is relying on massive expansion in fixed investment funded by state-directed spending – this is unlikely to either be sustainable or to represent an efficient allocation of resources. All this suggests a lacklustre recovery at best – and a weak recovery is vulnerable to shocks.

As we have seen before, policy makers have restored optimism but is this a temporary or permanent fix? Investing on the basis of economic fundamentals has been a frustrating task over the past 20 odd years. Former Fed Chairman Alan Greenspan carries a lot of the responsibility for this frustration. Of course annoying asset allocators is far from being a crime against humanity...but the ultimate dire implications for main street are now clear in the double digit US unemployment.

From the late 80s each time the economy looked to be at risk the Fed loosened monetary policy. The term 'Greenspan put' refers to consistent pump priming in response to financial market turmoil, in order to avoid a recession, only to increase the risk of a far worse recession later. The put has been used numerous times: after the 1987 crash, the Gulf War, the Mexican and Asian crises, Y2K (ahem!), the TMT bubble, and after the 9/11 attacks. Each time policy makers were successful in putting a floor under asset prices. In combination this policy action created the dangerous perception of a downshift in risk. If the Fed steps in when things go wrong, then why not take more risk. The response to the TMT bust provided the fuel for a new bubble, on top of an existing bubble that was not fully resolved. In averting a painful recession, the Fed sowed the seeds of a depression. Having now averted a depression, what has it now sowed the seeds of?

Is it only a matter of time before there's a new crisis? The jury is out on this. If the excesses are not cleansed from the system but instead continue to build, there will be a new even worse crisis. The



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warning signs will be growing optimism and soaring risk asset prices. Excess liquidity is the driver of this outcome, returns could remain stellar in this scenario for a time but it would end very badly indeed. Surely policy makers will not let than happen again!

A return to stability requires that the excesses be dealt with. There has been a massive transfer of private sector debt into Government borrowing. This puts confidence in currencies at risk – and that can be a source of inflation. One of our managers, Jonathan Ruffer, argues that ‘there is a cure unfolding on us’ which involves inflation that will be sudden, high and almost everywhere. This is a risk scenario that we are well aware of. In this scenario, inflation rates would rise above cash rates - policy makers back growth at the expense of inflation – the lesser of two evils. Savers are penalised and debtors bailed out. This too is a highly unpleasant scenario with major risks for investors. The relative fiscal rectitude of the Australian public sector should provide some protection but the private sector is exposed. Australia’s dependence on the rest of the world for capital and export demand as a growth driver makes it vulnerable.

Is there a more benign alternative? Yes. A more preferable and more mainstream scenario involves pretty modest economic growth and returns. For this to occur not only does there need to be low growth in the West, but also Chinese growth must rebalance and move to more sustainable levels. Again there are risks for the Australian economy and currency here relative to current market expectations.

The challenge we face in positioning investors’ portfolios is a familiar one. In the near term markets may continue to perform strongly, but there are serious risks to real retirement outcomes. This is a highly complex environment which will take an unknown amount of time to play out. For the Horizon funds we have to balance missing out on short term gains versus protecting against the risks. Recently we have started to increase diversified fund foreign currency exposures as a means to reducing overall risk – with so much good news factored in, the Australian dollar is vulnerable to medium term risks. We will not be surprised to see the Australian dollar move higher (perhaps to parity with the US dollar) in the near term, and if it does expect that we will raise foreign currency exposures further. For LTAR whose focus is purely on long term real return outcomes, recent strategy changes are aimed at increasing risk control while retaining return potential.

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