



# Investment Update

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## Navigating uncharted waters

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The investment environment is continuing to present significant challenges. On the positive side, excesses that had been building for many years are now being corrected; on the downside the worst case adjustment scenario has occurred and there may not be a quick or simple path back to normality.

The prices paid for financial assets must ultimately reflect their underlying fundamentals. Fundamentals include things like the level of earnings a company can sustainably generate, or the true risk of default on a corporate bond. One of the difficulties investors face is that asset prices can stay well away from these fundamentals for a long time. What we've seen a lot of over the past twenty years is asset prices way over their true value – remember the tech bubble when earnings no longer seemed to be important, and more recently spreads on higher risk bonds dropped dramatically as risk everywhere was assumed to be lower than it used to be. All that has now reversed but we're still seeing a lot of asset prices out of line with their fundamentals...only this time some of them the other way.

Liquid assets have been sold off indiscriminately. The process of unwinding excessive leverage has seen forced selling of anything that can be sold and at any price. Markets have been disorderly and normal conditions have not fully returned. Not only have the imprudent been punished, so too have prudent investors who have seen their portfolios shrink. And it's not only investors; some previously sound companies have faced considerable difficulty in getting the credit they require. Some of the good guys won't come out of this unscathed. This is not a simple cycle in which we just drift off track for a while, but a more significant shift in fundamentals which changes the game. And those strategies that relied on leveraging up portfolios multiple times have very clearly been revealed as not only having excessive levels of fees, but also (absurdly) as being reliant on nothing going all that wrong.

One of the difficulties now in terms of setting investors' expectations is that while many assets (treasuries are a notable exception) undoubtedly offer excellent value, the fundamentals are still deteriorating and we can't be sure there won't be more forced selling. Calendar 2009 looks set to be a volatile year as expectations shift with the flow of news. While we're now seeing a clear synchronised contraction in advanced economies, we do know that economic growth will resume in time - though likely not much before 2010, and the recovery may be more muted than is typical.

In past banking crises, economies typically stop shrinking within a couple of years but the unemployment rate can remain stubbornly high. Asset market adjustment is uneven too. Liquid equity markets adjust far faster than housing markets. It would not be a good idea to shift from beaten up equity markets and into yet to be beaten up residential property (don't assume that Australian house prices will survive unscathed).

Looking forward, the principal uncertainty is the extent to which this environment is genuinely 'abnormal'. There have been dramatic changes in the expectations of market participants over the last few months, and these are still adjusting. It is clear



that the developed world is contracting more rapidly than anything seen since at least the 80s. A key issue is whether this is a 'normal' recession that is almost inevitably followed by recovery, or whether we're facing our worst nightmare of a prolonged stagnation or depression.

These two scenarios are almost diametrically opposed in terms of their implications for investment returns. For example, a prolonged slump means that government debt could rally further still, while a recovery suggests treasuries are overvalued with significant rises in yields in prospect - particularly if there's an inflation surprise. Right now the focus is on deflation and inflation is a very out of consensus call, but it is right to be worried about it. The developed world is pumping in massive amounts of liquidity, particularly the US and UK. At some stage this could feed through somewhere into rising consumer prices and/or rising asset prices. Make no mistake central bankers have a strong preference for inflation over deflation. So despite being in a deflationary slump including inflation linked securities in a diversified strategy now may prove to be very valuable.

There are certain to be both rallies and reversals as the outlook is reassessed through the year. But will equity markets move higher overall? A sustainable rally in risk assets remains unlikely until there is normalisation in credit markets, because this is what's required to stabilise the real economy. Resumption of the credit creation process is the single most important foundation on which the recovery will be built – and this will be the most important positive signal for risk assets. Normalisation in credit markets (which means that credit flows resume for households and businesses) will not immediately end the downturn, but it will mean that this is a 'normal' (though severe) cycle and not a prolonged stagnation. Some steps have been taken toward normalisation but this still needs to go further. Importantly, the latest round of bank assistance in the UK is contingent on the banks increasing lending.

Meanwhile equity markets have not priced in as adverse a scenario as debt markets and there could be further declines - further earnings adjustment should be expected. But some companies are certainly attractively priced right now, and looking through the next few years our assessment is that the longer term prospective return from equities is stronger than it has been for quite some time. Those companies best positioned for the next year may have 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. In difficult economic times some companies will fail. Being in the right companies is now more critical than any of us can remember!

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