

investmentbriefing

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The great experiment



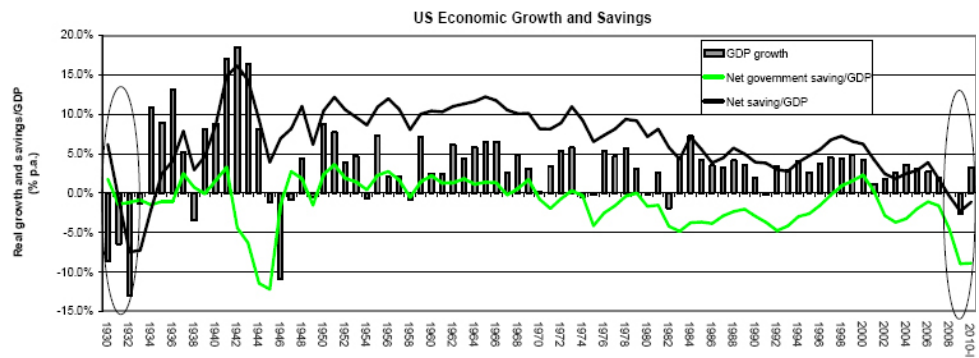
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The world is still working through the aftermath of the credit crisis. While improving economic data and more fiscal stimulus in the US support a positive consensus for 2011, other advanced economies are out of step and are tightening fiscal policy.

Neither commentators nor policy makers agree as to the best course of action. The outcome of these policy experiments will be of great interest to academics, and of great significance for the global economy.

Many investors are cautiously bullish about the coming year, particularly following confirmation of the Bush tax cuts extension and the surprise 2% cut in payroll tax. This is expected to boost US growth by 1% plus, which may take it to above potential levels and start to lower unemployment.

The chart below highlights the stark difference in the performance between the 1930s and current financial crises – these two episodes are circled on the left and right hand sides of the chart respectively. While US growth was flat in 2008 and dipped into negative territory (-2.6%) in 2009, last year saw a significant rebound (the 2010 figures in the chart are for periods to end September 2010). This is in stark contrast to the 1930s experience when growth averaged -9.4% during 1930-32. The other interesting difference lies in what happened to savings behaviour. In both cases total net savings (relative to GDP) declined but the extent of public sector dis-saving is today on a scale not seen in the 30s. It is this fiscal stimulus, together with the dramatic monetary policy response, which allowed the economy to expand last year.



Source: NIPA Tables 1.1.5 and 5.1. Bureau of Economic Analysis



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The public sector stepped in to take up the slack as households increased savings, thus avoiding the paradox of thrift (in which more savings reduces demand and hence incomes which ends up increasing debt). The difficulty with this strategy is, of course, spiralling public sector debt. For a time policy makers have to promise fiscal austerity while carrying on spending until the recovery becomes self sustaining... which hopefully occurs before bond holders lose confidence and grow wary of lending governments more money. Even if bond holders keep their nerve, policy makers know that as debt levels rise the risk is that GDP will slow down as the debt service burden grows. The US public sector debt is now US\$14 trillion(!) and above the 90% of GDP threshold believed significant for growth rates.¹

US policy makers know they are in for a multi-year consumer de-leveraging process, that will constrain growth unless there is an offset... hence they are chancing further fiscal stimulus, hoping that it will keep things going until the recovery is self sustaining. However, it's not clear that the fiscal stimulus is being targeted in the right way. To fix a structural employment problem they likely need public sector infrastructure programs aimed at

job creation (i.e. investment as opposed to short-term boosts to consumption). All fiscal stimulus of course increases debt, the reverse of what eventually must happen. It is a difficult trade-off – is more shorter-term growth worth more than longer term austerity? It is if there is sufficient risk of a Japanese style liquidity trap. While the US has plenty of problems, at least the growth outlook for 2011 is encouraging. Elsewhere policy makers have opted for fiscal austerity. Consequently, growth potential in the UK, Euroland and Japan is likely to be sub 2% in 2011.

The Eurozone, a coalition of ill-suited and (some) dysfunctional partners, is scrambling to avert a new crisis. Economic conditions are not uniform. The core countries are doing okay, partly because they benefit from a lower exchange rate due to the influence of the risky Euro periphery. In contrast the periphery suffers from too high an exchange rate, increasing pain for the real economy. This increases the need for more fiscal stimulus, except that this is difficult since it's already clear that many Euro periphery bond holders will suffer a hair cut on outstanding sovereign bonds and would be reluctant to invest more. Hence the stronger core is left to finance the weaker periphery.

The problems here look like going on and on. It is unclear how Spanish problems will be resolved, it is both too big to fail and too expensive to save. Policy responses to date have been reactive, and aimed at muddling through rather than finding a final solution. The German voters are impatient and its policy makers have been accused of dithering and acting at the last minute when forced to avert a new crisis. However, the German economy is doing well and there is some acceptance of the need to change behaviour and support weaker members. This suggests that despite all the problems the Euro may survive.

While the US has plenty of problems, at least the growth outlook for 2011 is encouraging. Elsewhere policy makers have opted for fiscal austerity. Consequently, growth potential in the UK, Euroland and Japan is likely to be sub 2% in 2011.

¹ Carmen Reinhart and Kenneth Rogoff have written a number of papers on this topic.

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Clearly policy makers face a range of highly unpleasant risks. Identifying the best policy stance is extremely difficult. The path forward is still very uncertain and policy makers will continue to be forced to react to emerging conditions. An added danger is the fracturing of the post crisis policy coordination, and increased focus on beggar-thy-neighbour policies. Protectionism will result in a poor outcome for all.

It is clear that in the near term the global economy is highly dependent on the US and the emerging world, particularly China. Unfortunately China also has issues. It is struggling with the flow on effects of an inflexible exchange rate, in particular spill-over from the loose US monetary policy. This increases excess liquidity, boosts short term growth but also creates instabilities. . . in particular what may be a bubble in the (vast) property market. The challenge for policy makers is to reduce the bubble risks without derailing economic growth.

Stellar Chinese growth is also creating labour shortages and wages are rising rapidly (over 20% in 2010). Commodity prices too have risen strongly following the most extraordinarily massive Chinese fiscal stimulus. Oil is around \$90 a barrel and many soft commodities are up by around 25% over the past six months. (Note that China is no longer a source of disinflation for the rest of the world. . . this is not an issue now, but will be later.) With inflation picking up (particularly food prices, which can have implications for social stability) there is concern that policy makers are acting too slowly. They may be overly worried about a property market decline, this is a planned economy and the impact on the real economy may be limited by strong infrastructure spending.

While China is trying to engineer a soft landing, more fundamentally it also needs to increase the consumption share of GDP and rebalance a highly skewed economy. However with China getting ready for a handover of power to a new generation of leaders, change is likely to be cautious.

It is worth mentioning China-specific positives. A large surplus reserve exists that can be used to offset economic downturns and this provides policy flexibility. Centralised policy making potentially allows the focus to be on longer-term solutions and the use of multiple tools/solutions (be it taxes, lending/trading restrictions, rate-setting, etc) that may not be available to other policy makers.

What are the implications for markets? This is a complex and confusing environment. There is the potential for a range of both positive and negative surprises. It is possible that the US manages to pull off a sustainable recovery, which is critical to the global economy. Also very much on the positive side, many US and other companies are cashed up and strong, and as confidence grows capex and (perhaps) labour hiring could both surprise. A wave of M&A activity is perhaps more likely in the near term, and that could bode well (at least selectively) for equity returns.



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Returns depend not only on what happens but also on what's priced in. At the moment there is a bit more optimism about the outlook which tends to push future returns down (because the good news is already in the price), but here is still an historically high-yield gap, or risk premium, between US forward equity earnings yields and the 10yr bond rate. That highlights how deeply unattractive US bonds are. In general, the combination of a highly uncertain environment and somewhat complacent market pricing would suggest a move into more defensive assets. However, today traditional defensive assets (nominal bonds) look very expensive and hence risky.

MLC became wary last year and we switched our global sovereign debt mandate to a cash benchmark. This reflects the risks of spiralling public sector debt, but also recognises that yields will rise as confidence grows in a self sustaining recovery (the December quarter 0.8% rise in the US 10 year Treasury yield was likely due mainly to higher confidence in the sustainability of the growth cycle).

Given typical time horizons and real return objectives, most investors need a significant allocation to equities. We think that a key to future returns is the quality of the stock selection – likely dispersion in individual stock performance implies high alpha potential. On the asset allocation side we are highlighting the need for a sufficient foreign currency exposure in portfolios. One of the biggest valuation anomalies is in the current level of the Australian dollar and, unusually, it may be vulnerable in both a return to risk aversion and more positive global growth scenarios.

The Australian dollar has benefited from what seems like unshakeable confidence, supported by stellar Chinese growth. But an improving US may reduce the focus on China. Furthermore Australia has an Achilles heel – extraordinarily high private sector debt which is very negative for growth potential. The high private sector debt burden that Australia carries is largely funded from offshore savers via our banking sector, which is highly reliant on offshore wholesale financing. This is a low probability tail risk but we all know what can happen when foreign lenders lose confidence and pull the plug: Iceland, Ireland, Greece, Portugal, Spain.

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