investmentbriefing

May 2010

Spendthrifts, super-savers & currency cheats

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Fans of 'Doctor Who' will recall the time he made one of Macbeth's three witches vanish simply by naming her. The US Treasury has taken note and is preparing to name China a 'currency manipulator' in hope that this will encourage its current account surplus to vanish.

Rebounding markets and economies together with high unemployment rates have caused a shift from crisis cooperation to parochial politics. But there are many positives in the past year. Global growth is back close to pre-crisis levels and emerging Asia has been stellar.

After a sharp contraction in 2009, the major advanced economies are now growing again, albeit at an anaemic pace. This two-speed global economy reflects both the weak fundamentals of the spendthrift West which faces a prolonged (at least 5 year) belt tightening, and overly stimulative policy in the emerging currency-pegged world.

Advanced Economies

The medium-term outlook for the advanced economies is fragile and doubtful. The advanced world is in a liquidity trap. High levels of leverage have barely begun to decline - the 'great switch' has simply transferred the burden from private to public balance sheets. Policy levers are limited. Central banks normally determine interest rates on the basis of economic growth (versus trend) and inflation or deflationary pressure (versus target). Unfortunately the current calculation implies negative short rates for the US, UK, Euro zone and Japan.

Since it's not easy to have negative nominal short rates, policy is too tight. This is why the US will keep rates 'exceptionally low' for an 'extended period'. It's also why quantitative easing has been important, but that's now being wound back more or less simultaneously with uncertain consequences.

The US is clearly the best placed of the majors with the possibility of growth close to potential (3%) this year, but this rests on huge federal government support (borrowing will amount to around 10% of GDP according to The Economist).

One of many uncertainties is the impact of the end of honeymoon mortgage rates. In both the UK and US there's been a mortgage flipping bonanza that's now rolling off - this means a higher proportion of income allocated to mortgage repayments. It is risky though to underestimate the ability of the US economy to adapt. But even there the expansion looks unlikely to put much of a dent in the US unemployment rate. This will keep a lid on income growth and dampen already constrained demand.

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Importantly the US economy is rebalancing - the same cannot really be said of the Euro zone or Japan. The US current account deficit (CAD), a key indicator of the global imbalance, has halved (from -6% of GDP at its low in 2006 to -3% in 2009). While the US CAD has improved, its twin – the public sector deficit – has more than trebled (from -3% of GDP in 2008 to -10.4% in 2009). It's positive that savings are rising to repair damaged household balance sheets, but, this means persistent lower demand and slower growth, unless there's an offsetting boost from something.

Could business investment provide the offset? Corporate cashflow is improving and leverage (which was not excessive to start with) is falling, but excess capacity is high (according to the OECD it's as high as in the early 1980s) and credit constrained. There has been a dramatic decline in investment spending, but leading indicators are now improving and surprise from investment is certainly more likely than from consumption. However, expectations that a quick turnaround is unlikely mean that most are looking at exports to boost growth.

The Euro zone is a clear growth laggard, and with pressure spreading to aggressively tighten fiscal policy, it's unlikely that growth will be much more than 1% this year. Europe also has the unresolved internal strain of a fixed exchange rate across disparate (and desperate) peripheral economies which beat the UK for the title 'poor man of Europe'. All need the same thing - a boost from exports.

In Japan too, growth has slowed as re-stocking and the fiscal stimulus have faded. Of course it has never got properly back on track after the banking crisis of the 1990s - it still needs to cut excess capacity (it's estimated that a 30% cut in capacity and employment could actually raise profits[1]) and deregulate local industries (recent limits on the hiring of temporary workers in manufacturing run counter to this). Although growth is positive in Japan (around 1% looks in prospect this year) it is now more reliant on and highly sensitive to export demand.

Exports are the traditional route out of a financial crisis - those in crisis export to the non-crisis countries. The problem is this is a global crisis. Everyone wants export led growth but by definition not all can get it.

The UK is best placed given its currency weakness, a product of a flexible exchange rate. In contrast the "poor men of Europe" (Greece, Portugal, Spain, Italy and Ireland) do not have the currency flexibility and will struggle to export their way out of their debt crises.

In contrast, the US may be the most flexible and opportunistic (it probably has greatest potential for a productivity boost to help outgrow the debt drag). The focus on exports is increasing investors' concern about the surplus regions (which export more than they import) and in particular on the fairness or otherwise of China's currency strategy.

In summary, the West is at the start of a deleveraging cycle, and the world is awash with excess savings. Before the crisis the Anglo world was spending too much and Asia (and OPEC) spending too little. That gave rise to huge current account imbalances. Now the advanced countries are saving more but no one's spending more…except governments. Of course lower household spending is what the developed world needs to correct previous overspending, but the current excess of savings over investment comes at the cost of employment. And public sector spending must gradually be pulled back; that means slower growth unless something replaces it. Importantly, too many countries have their eyes on exports as the salvation.

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1 'How Japan could lead return to durable growth', Tadashi Nakamae, Financial Times, March 30 2010.

China

In this environment Chinese currency management presents an obvious target. Intervention to hold the Renminbi peg is at an extraordinary level. Chinese monetary policy targets the exchange rate not the economy; and reducing monetary stimulus without permitting currency appreciation is not simple. An artificially depressed Renmimbi results in an artificial current account surplus, which in turn depresses output and employment in advanced countries. We estimate (using IMF projections) that the Chinese surplus is over 1% of the combined GDP of the liquidity trap counties, hence the growing political sensitivities.

Ultimately China needs to address its unbalanced economy - too much reliance on exports and investment and not enough on consumption. The consumption share of GDP needs to rise but it can't happen quickly (the development of a social safety net is one important ingredient - it's on the agenda but will take time) and that means continuing pressure to let the currency appreciate. While the Chinese will likely resume the previous slow currency appreciation at some point this year, protectionism is a concern. The extent of global inter-dependence hopefully significantly reduces the risks.

Crisis related policy intervention in China has been on a scale never seen before. Ultrastimulative monetary and fiscal policies have maintained strong growth with positive flow-on effects for the region.

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China has been a fairy Godmother to Australia! It's not that China was the only source of growth last year – fortuitously the agricultural sector produced bumper crops – but it was an important source of stability. Chinese policy is now walking a tightrope between overheating and over-tightening (things would have been much worse if China had fallen in a heap).

Monetary tightening is a response to concerns that the stimulus may fuel asset bubbles and push up inflation. Whether they pull off this balancing act or not is critical for Australia.

Australia

Thanks to China, above trend growth and limited spare capacity puts Australia out of step with other advanced economies. But Australian households are every bit as indebted as those in the US and UK.

All these Anglo countries face a multi-year deleveraging process. Australia's strong growth is due to external stimulus driven commodity demand, which has offset lack lustre domestic demand. Clearly Australia is vulnerable to Chinese policy mistakes.

Domestically policy makers continue to raise interest rates; the April rise takes rates to 4.25% and an additional 1% looks in prospect over the next 12 months. A strong Australian dollar also helps limit inflationary pressure; some analysts expect a move towards parity with the US dollar. We agree this is a possibility, but if it occurs it would present highly asymmetric risks.

Market behaviour

Having anticipated considerable good news in 2009, markets have been more tentative in the first quarter. Sentiment is fluctuating with risk alternately being put on and taken off – often fairly uniformly across risk assets. Deteriorating public finances have been a common trigger.

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Of course, market outcomes depend both on what happens and what's already priced in. In many respects the easy gains have been made, and continuation of recent positive economic news is close to fully priced in. We've seen a strong rise in profits typical of the early expansion phase.

In January risk was taken off the table, but in March most of the usual risk trades did well – equities versus debt, emerging versus developed markets, growth versus value, high yield over high quality. The flow of data will continue to be uncertain and uneven, which means we should expect this on-again, off-again pattern to persist. Some synchronicity across risk trades will also likely persist, but it is no longer as pronounced as in 2009.

The Australian dollar was moving in lock step with equities; that has diminished for now but we would expect it to reappear if clearer persistence in market direction emerged.

The link between the US dollar and treasury yields has also weakened, in a reversal of recent correlations a spike in Treasury yields in March was accompanied by a stronger US dollar. Issuance concerns pushed yields higher, while inflows into the US (attracted by higher yields) tends to push the currency higher. An added contributor to USD strength was an expectation of an earlier tightening in US cash rates, an event that scares the "crowded" carry trade which depends on zero cost USD funding.

Following two momentous years for investment markets, 2010 may turn out to be rather dull. At least we should hope so. However, further negative surprises could well be in store for the market, and it's not clear that traditional safe havens will work. Nominal government bonds are the archetypal defensive asset – they performed admirably in 2008. Issuance is now bringing this safe haven status into question.

During the March quarter the pricing of US government bonds moved into uncharted waters with the 7 and 10 year bond yields trading higher than the equivalent swap yields (this is the first time - ever). It reflects relatively conservative management of corporate finances versus poor management of public finances, as well as the significant transfer of credit risk from the private sector (financials) to the public balance sheet. It is indicative that the market is being saturated with government paper. Will the next crisis be in sovereign bond markets? That's an unknown for now.

The Japanese experience at least suggests not – there issuance fears were offset by economic stagnation.

Of course, market outcomes depend both on what happens and what's already priced in. In many respects the easy gains have been made, and continuation of recent positive economic news is close to fully priced in. We've seen a strong rise in profits typical of the early expansion phase. US corporate profits were 30% higher year on year in the final quarter of 2009 – though 85% of this comes from the financial sector courtesy of bail-outs and the generosity of the Federal Reserve. The consensus expectation in the US is for 36% EPS growth, and 31% globally for 2010. Potential for cost cutting is now more limited, which increases the reliance on revenue growth. While this pace of change can't persist, earnings momentum remains positive. The short-term is as always highly unpredictable.

One possibility is that 2010 could be another stellar year for profit growth, if so this would likely support higher share prices.

Investment Strategy

We believe we have most insight into medium-term market return potential. Our main assessments are made of earnings relative to trend. We assess equity market valuations within this context, and return potential over a series of years. Equity market valuations are a poor guide to short-term market returns, but more reliable over the medium-term. Current valuations are not excessive but most are fully priced even assuming a return to 'normality'. Only the UK and Europe appear to be discounting the structurally impairments to the medium-term growth cycle. Consequently, our assessment is that medium-term equity return potential is below average.

Credible sustainable future scenarios all seem to involve (at best) modest GDP growth. While that constrains earnings potential, persistent low cash rates support global equities. On the other hand, the consensus is that bond markets are expensively priced in view of high levels of prospective issuance. The "anti-money" view suggests treasuries may be better supported than currently feared.

Deflation also remains a stronger force than inflation but there are increasing mutterings about an ultimate inflationary work-out. Inflation is not a problem today because there is plenty of surplus capacity in the developed world. In fact downward pressure on inflation outside the emerging markets is expected to intensify. There may be an ultimate inflationary work-out but that may require an undermining of confidence in currencies.

The investment environment continues to be difficult and fraught with uncertainty. Capital preservation should have a relatively high priority in an environment dominated by deflationary forces, but there is no simple answer to which assets and strategies will provide a safe haven. Australia may now be over-owned due to its safe haven status, and as already argued it is uncomfortably reliant on China. Cash domestically has become more of a safe haven, while sovereign bonds have lost some lustre.

In the near-term further Australian dollar strength may well be in prospect, taking the currency towards parity with the US dollar, but the potential for further appreciation is considerably smaller that the potential for depreciation.

Another feature of global debt markets has been yield chasing behaviour stemming from a rebound in risk appetite and super low interest rates. This worked in our favour during 2009 and will likely continue until capital losses scare off investors. This is reassessed as the risk-reward trade-off has shifts.

More generally, controlling risk in a multi-asset portfolio requires an understanding of the extent to which returns are or are not correlated. Our scenarios framework provides a depth of information about the circumstances in which certain assets reduce risk and in which they increase it.

One thing that stands out from the scenarios modelling, and has been very evident during the past few years, is the correlation of the Australian dollar with risk appetite (this is also consistent with longer-term trends which reflect the reliance of Australia on global economic fortunes). In spite of structural supports, the Australian dollar is likely well above sustainable fair value – upside potential is lower than downside risk.

In the near-term further Australian dollar strength may well be in prospect, taking the currency towards parity with the US dollar, but the potential for further appreciation is considerably smaller that the potential for depreciation. This presents an opportunity to reduce medium-term portfolio risk by raising the foreign currency exposure. Adjustments such as this help increase the robustness of multi-asset strategies. Asset exposures that hedge specific scenario risks are of similar importance. Inflation linked securities (ILS) are included in our diversified funds because inflation presents a distinctive risk and accordingly such assets need to be included well before markets perceive the risks.

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Investment strategy is of course not just about risk control; our focus is extracting as much return potential as possible while controlling risk exposure. This begs the question, looking forward, what are the most reliable sources of real returns. While, in aggregate equity market return potential is likely lower than average, equities may nevertheless offer the most reliable prospect for sustainable real returns.

Of course risks remain for equities. If the world is lacking in pricing power, profits overall will be constrained but still there will be some companies with pricing power. Alternatively, if inflation ultimately rises this would normally be associated with lower equity valuations, but in this case may not be so if this rise in inflation is associated with an exit from a deflationary trap. We know also that some companies provide great inflation protection – those with fixed costs (utilities) and fixed rate debt do best.

Last years risk tide raised all boats: the future will likely bring more differentiation. Extracting the return potential for investors is about stock selection and manager selection rather than asset allocation. But it is also about our tolerance for performing differently from the index. The tension between peer and index relative performance and absolute return outcomes is an important one and we should all continue to challenge ourselves as to where the appropriate balance lies.

Evolution of the Environment

In major advanced countries we have a stable but fragile disequilibrium based on super low interest rates. There are a number of things that could upset this balance. Low rates are supporting the servicing of the debt overhang.

A risk is that rising interest rates in the emerging world puts upward pressure on Western rates, or requires Western currencies to devalue (subject to the pegged currency conundrum) and allow some imported inflation in the developed world (the inflation risk is greatest in the UK). Both could upset the current scenario and interrupt the recovery. Policy mistakes represent another risk, particularly given short electoral cycles and the long politically unpopular period of austerity ahead. It is also possible that we're in the midst of a muddle through that will take a long time (years) but ultimately restores balance to the global economy; with plenty of volatility along the way but no further major shocks.

Within our medium-term scenarios analysis we are contemplating a variety of different typically modest but ultimately successful growth paths.

At the other end of the spectrum, it is difficult to deny the possibility of a second round credit crunch or of an escalation of sovereign risks. And it has to be said that conditions in the UK and Europe, less so the US, bear more than a passing resemblance to 1990s Japan.

Overall, while the medium term-scenarios are skewed towards sustainable growth outcomes, this has been anticipated in market pricing which means that return potential appears relatively modest across the board.