

# investmentbriefing

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## What the future holds



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**A marked change of sentiment occurred during the third quarter. Initially optimism about the recovery waned following weak economic data, raising fears of a double dip. However, the Fed wasted no time in responding by signalling a second round of quantitative easing – so called QE2.**

This reversed sentiment about the economy and sparked one of the sharpest and synchronised monthly rallies on record. This is no normal environment – the prospect of QE2 supported not only equity but also gold and debt markets. Both debt and equities are rallying on weak economic news because this increases the likelihood of QE2. For equities this is the best of all possible worlds – both weak and strong data are positive for shares prices. Clearly both debt and equities are at risk if QE disappoints – but this is not what we expect.

The most important consideration is what lasting effects QE2 will have – policy makers themselves are unsure and will adapt the policy to evolving conditions. The market view is that it reduces tail risk. Whilst I agree that it reduces immediate risks, QE obviously does not offer a simple cure. . . particularly in the face of some strong fiscal headwinds.

There are two things that should concern us about the future: where we're heading and the path we take to get there. The dynamics of this environment are fascinating. While our

medium-term asset allocation process (strategic overlay) is primarily concerned with where we're going, today the path is more important than usual.

What is the path to 'normality'? By normality I mean simply any environment in which the principal sources of instability or disequilibrium have been resolved – these are the debt overhang and the imbalance in the global economy (some saving too much and spending too little, and others doing the reverse).

The conventional solution to too much debt is more savings and hence less growth. If the spendthrifts cut back their spending and the savers spend more, that could rebalance the world in a relatively benign manner...we have seen some significant rebalancing coming from strong growth in Asia but there is still a long way to go. Without enough additional spending from the surplus countries, which is in doubt (memories of the Asia crisis are still strong), the debt overhang of the spenders may not be easily resolved.

The difficulty today is that developed world fiscal tightening could make the problem worse, because it pushes us towards deflation which may make us poorer at the same time it raises the real value of debt. Such deflationary traps can be very prolonged – witness the 1930s depression and 1990s Japan.



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This is why policy makers are resorting to extraordinary policy measures such as QE. But how can QE solve the debt problem? To understand this it is necessary to think about the sequence of events. We need to understand the path to appreciate that QE can take us back to normality...eventually.

During September we saw the impact of a prospective new round of QE in the US. The QE boosts asset prices, but (deliberately) undermines confidence in the US dollar. This is a managed competitive devaluation. Share prices rise as bond yields fall but it's debateable that QE boosts economic growth. It encourages banks to lend more, but the experience so far doesn't give us confidence that they will. It is to be hoped that lower real yields will result in higher fixed capital expenditure, but the extent of this is uncertain.

The more immediate boost to growth from QE is from the US dollar's decline, and this is undoubtedly what policy makers are after. Creating more US dollars undermines the currency, which boosts US competitiveness and increases the US share of global demand. It's robbing Peter to pay Paul – somewhere else growth is lower.

Don't expect other countries to do nothing; expect a series of competitive devaluations as others play catch up. The Japanese have already been intervening in currency markets to protect their competitive position, but their \$20 billion dollars had only a short-lived effect. Their only real option is to play the QE game – the Bank of Japan and Bank of England

understand this while the ECB remains in denial. If others do so convincingly expect that their currencies will be much weaker.

What's clear is that the US is calling the tune here: other countries may not want to play this game but the US has the power to inflict so much pain that they are forced to respond. As Financial Times columnist Martin Wolf recently commented "The US must win, since it has infinite ammunition: there is no limit to the amount of dollars the Federal Reserve can create".<sup>1</sup>

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The US is trying to force global rebalancing; meanwhile the Chinese (and consequently other emerging countries) are stubbornly resisting currency appreciation by continuing direct currency intervention. There is a risk of trade wars which will shrink the size of the global economy and increase risks of a prolonged stagnation, if the strategy fails. There are no winners in this scenario.

If the world continues down the competitive devaluation path, expect that initially there will be further appreciation of the Australia dollar. An appreciating currency acts like a tightening in monetary policy. The Australian dollar is of course most vulnerable if it becomes clear that the world is not rebalancing.

The future seems to hold a squabble about how the global economic cake is sliced up. But what does that solve? If the solution can't be more growth to increase the size of the global economic cake, then at best it must be a re-slicing of the cake.

The importance of a global squabble over market share is that it may provide the means to a redistribution that could ultimately resolve the debt overhang. This is not about whether the US can grow at the expense of the rest of the world. The debt problem can be solved by giving debtors a bigger share of the cake, which means someone has to have a smaller share. Unfortunately, those in line for a smaller share are those that least deserve it – savers.

Of course savers are not simply going to hand over cash to the spendthrift debtors. The process will be insidious and at first hardly noticed. It is a process that has already commenced in the UK.

<sup>1</sup> "Why America is going to win the global currency battle", October 12 2010



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The mechanism is quite simple. Higher inflation can reduce the real value of debt and shrink the purchasing power of savings. All you need for this to work is an inflation rate above the cash rate (as in the UK). Of course it doesn't work if debtors have to pay an inflation plus return – which is why the UK has quietly withdrawn its inflation-linked national savings bond. It works best if borrowers can take advantage of near zero short rates and savers suffer from money illusion (they are duped).

This begs the question as to how inflation can possibly emerge when deflationary forces are so strong. The stronger the deflationary forces (and hence the policy response) the more concerned we should be about an inflation shock. The source is a global tidal wave of liquidity. I can't describe all of the ways in which this will find its way into higher prices.

Rising inflation expectations is an explicit target of the Fed and could precede an actual rise in input costs. If it occurs, I expect that the process will start slowly but rapidly gather momentum, particularly as confidence falters in the ability to maintain the real value of savings. The incentive to spend then becomes strong.

At MLC we don't so much predict the future as try to describe what could happen. I've described a very important scenario. It is by no means a certainty but it is credible and has some important implications for positioning portfolios. We would all prefer that somehow the world could grow out of its problems, but currently that path looks to be slow and difficult and we must consider the alternatives. Only by considering what could happen well in advance of it happening will we be equipped to protect investors from the risks that the future still holds.

If this scenario plays out what are the implications for markets?

- Currencies will be volatile – expect wide swings.
- Nominal bonds will deliver unpalatable negative real returns.
- Cash will not be a safe haven... perhaps even in Australia.
- The risks are not yet priced in Australian inflation-linked debt – this asset class is most attractive relative to nominal bonds.
- Rising inflation and bond yields are not bullish for equities, but some companies will do well while others will not – being in the right stocks will be the most effective means of generating attractive real returns. Higher yielding value stocks could do relatively well. More generally, favour companies with pricing power and foresight – among these are the winners from global restructuring.

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