

investmentbriefing

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Too much too soon?



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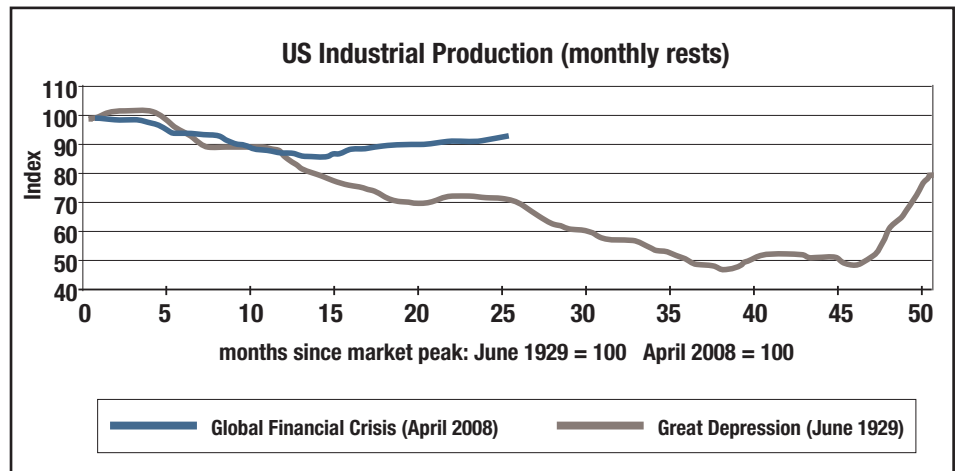
The financial crisis has gone through several stages from terror to relief and now to renewed unease as a new phase of the crisis focused on sovereign risk unfolds.

The policy response to the crisis was decisive and for the US at least (as the chart below illustrates) successful. This chart compares the paths of US industrial production in the financial crisis versus post the 1929 market crash and 1930s slump. The experience thus far is dramatically better than the 1930s. This has encouraged a belief that we're now on the path to normalisation.

Unfortunately, the world is still in serious economic trouble. In the first quarter we said that the environment was stable but fragile.

That fragility has been more apparent in the second quarter. Considerable market volatility was seen during May as concerns about Europe's debt problems intensified. Escalating risk aversion led share markets, commodities and the Australian dollar sharply lower.

Looking forward the path remains highly uncertain. Policymakers in much of the advanced world face a difficult problem. As Martin Wolf recently put it, they need to walk and chew gum at the same time. While their fragile economies need more fiscal stimulus, they must build confidence in medium-term fiscal prudence. This is difficult with every large developed nation running an unprecedented fiscal deficit. If they are prudent too soon there's risk of a Japan style stagnation; too late and they risk the wrath of the bond vigilantes



Source: St Louis Fed MLC IM. Calculated by MLC Investment Management by taking St Louis Fed US Industrial Production Index data (100 = 2007 seasonally adjusted) and rebasing to 100 in June 1929 and in April 2008.

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(look at what happened to Greece). There's a tightrope to be walked while they try to grow their way out of the current problems.

Our unease is growing in light of a new focus on tightening the macroeconomic stance. We are of course concerned about the growing public debt burden and the risks of default, and about the possibility of loose policy eventually feeding into sharply higher inflation. However it is a case of which is the lesser evil. We worry that this policy shift is too much too soon.

The OECD is projecting global growth of around 4¾% this year and next.¹ It apparently has sufficient confidence in the recovery to call for fiscal consolidation. But it's not only confidence in the recovery that's driving this policy shift, the main issue is fear of the bond vigilantes. They've turned on Greece and may lose their nerve – not only elsewhere in Europe, but also in the UK and ultimately in the US. Markets need to remain convinced about the ability and willingness to eventually repay debt.

Governments are acting on these fears. The new coalition government in the UK has taken a brave (or foolhardy) step in announcing what looks like (some of the details are missing) dramatic fiscal tightening. Germany, France, Italy, Spain and Japan have also announced seriously unpalatable cuts and some tax hikes.

Ironically the fastest growing developed nation, the US, has been asking whether these moves are premature. Despite this, the US went along with other G20 members in late June in committing to at least halve its fiscal deficits by 2013 and at least stabilise its government debt-to-GDP ratios by 2016.

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Tighter policy is right if we're on a sufficiently robust path towards economic normality. The global economy has stabilised but growth in large advanced countries has been due largely to policy support.

In the US, growth momentum has continued into 2010, but it's still uncertain the recovery is strong enough to be self-sustaining. Consumer resilience seems to have been driven more by the boost to net wealth from equity market strength; and while income growth has picked up nicely, it has lagged (private wages growth has been healthy, but public sector income support will decline in the second half).

In the Eurozone currency weakness is helping exports. This boosts the manufacturing sector, which is where most of the good news has come from, but this accounts for less than 20% of the economic activity. Domestic demand is the most important driver for services and the outlook there is subdued with retail sales still declining.

Despite a boost from Asia, Japan's recovery is limited by a capacity overhang, a shrinking labour force, and a social security system struggling to cope with retiring baby boomers. On the positive side unemployment is falling (but this is mostly because people are retiring) and fiscal policy is supporting consumption. However, as elsewhere, the effect of these measures will start to fade later in the year.

We are far from normality and the OECD's policy prescription is contrary to much of counter-cyclical (Keynesian) economics. It's contrary to the lessons of the 1930s and contrary to the lessons of 1990s Japan. In both cases policy was tightened too early with devastating consequences.

Fiscal tightening is a problem because it undermines growth. The private sector is rebuilding balance sheets and so has a huge excess of income over spending. As the public sector winds back spending, the risk is that the private sector does not take up the slack. Economists call this 'crowding in'. The theory is that public spending is pushing out private expenditure.

¹ 'G20 : Global economic conditions and short-term prospects for recovery' http://www.oecd.org/document/15/0,3343,en_21571361_44315115_45541135_1_1_1_1,00.html



After the biggest financial shock in 80 years and decades of over-spending this is wishful thinking. All this raises the risks of a failed recovery. The key economic variable to watch is unemployment; it has not begun to decline convincingly even in the US.

Despite some currency volatility, **Australia** has escaped the worst of the crisis. The banking system was not as exposed to the excesses; the agriculture sector provided a timely boost and China's robustness have all assisted. Australia is not invulnerable. A weaker than expected global economy (and in particular policy mistakes in China) are risks. Furthermore the susceptibility of the economy is increased by what looks like a seriously overvalued residential property market.

Thus far the Chinese have looked very shrewd, both economically and politically. The much anticipated announcement of increased currency flexibility is more about the latter, but may only delay a protectionist row with the US.

Of more immediate concern is the continued tightening to control a speculative Chinese property market. . . fallout from this may not be positive for Australia.

In summary, the easy money has been made. Sovereign debt risks are not going away any time soon; pressure for spending cuts are only just beginning; policy makers have an impossibly difficult task and we are no where close to returning to a 'normal' growth cycle. We're not expecting a tide that keeps lifting all boats – we're expecting that the strong will prosper and the weak will fail.

The good news is that a lot of quality companies are cashed up and the winners will be those with the ability to use that cash most effectively. All this implies significant potential to out-perform market indices as restructuring and industry consolidation proceeds, which is key to getting the medium-term outcomes that investors need because we may be in for a period of lack-lustre market returns. This is the new normal!

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