



This Time It's Different

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Personally, I don't like the ring of the words in the title of this month's newsletter. I feel that it's a precursor for history repeating itself. It almost dares Murphy's Law to intervene, so I am throwing it out there with some degree of caution. For once however, I am convinced that the noise behind recent share market volatility does have some significant differences to the market crash from the GFC in 2008/09, regardless of the many commentators suggesting it is phase two of the same GFC.

The GFC

To simplify the GFC into a single event that caused markets to crash in September 2008 through to March 2009, it could be explained as the freezing of credit markets in the private sector. During the prior years, the private sector enjoyed an era of cheap and easy credit. Because borrowing was so easy and cheap, it encouraged the private sector to leverage themselves (both individuals and corporates) to higher levels than had ever been witnessed in history. For companies, this meant refinancing their debt usually each year or two at the prevailing rate. Important to note is that the lenders were not obliged to renew their lending agreements.

When the supply of easy credit dried up, companies were in a position where they had significant amounts of debt and for many, very limited sources of refinancing this debt, and at a rate much higher than they could afford to pay. This led to an en masse selling of assets in an order to de-leverage (i.e. reduce their debt and avoid default). When the number of sellers in the market far outstrips demand, asset prices will naturally fall, and we saw companies being forced to sell assets at far below their long-term value. The after-effect of this de-leveraging was a fall in the value of assets and (thus share prices) that was often compared to the most famous crashes in history.

2011

I do not have a three-letter acronym for the current global economic condition. What I do know is that we, as investors, have a short memory. With the spectre of the GFC still lurking, our perception of what lies ahead is in part formed by our emotion; well, mainly fear. Fear and greed are an investors worst enemies, and the past month in share markets has been a culmination of both reaching a crescendo.

Interestingly, there are a number of very significant differences in our current climate that sets it apart from the GFC. Firstly, the debt has shifted from the private sector to the public sector. This is a very important observation. During the GFC, we saw companies de-leveraging by selling assets and cutting costs (e.g. culling staff, etc).

In the US today, we see many companies hoarding cash on their books. The current profit reporting has seen around 70% of companies exceeding their profit estimates. The devalued US dollar has boosted their exports and helped drive these positive results. The US needs these same companies to commence deploying this capital by investing in their businesses and hiring staff. Without this, the next phase of recovery remains just out of reach. What we have seen instead is a flurry of companies using their cash reserves to participate in mergers and acquisitions and in some cases paying a 60% – 70% premium to the target companies' share prices. Firstly, this signals that companies are cashed up; secondly, that they view share prices as offering good value at the present time; and thirdly, they are prepared to deploy this extra capital to stave off counter bids.

Although this consolidation is a positive and could be interpreted as companies planning for the recovery, it perhaps is not likely to provide the immediate increase in employment that investors are seeking to reassure themselves that now is the time to increase their investments in risky assets. This means that we are likely to observe share markets continue to hobble along for a while yet.

In Australia we are seeing the opposite, particularly in our resources sector. Companies have been accumulating so much cash on the back of the China Boom (and a number of unsuccessful takeover bids) that they are using their cash to buy back shares, to tidy up their books, and to pay extraordinary dividends to shareholders. There has also been massive investment in boosting production while commodities prices are strong.

A major factor holding the Australian share market back from a more complete recovery is our inflated currency. The chart below (sourced from UBS Asset Management) illustrates that currency is a key part of the story.

If we look at the Australian and US share markets in US dollar terms, Australia marginally outperformed in the year to the end of July 2011. The Australian share market has been weighed down by a tightening in monetary conditions. Reserve Bank interest rate hikes over the past 18 months, tightening bank lending standards and a rising Australian dollar have all impacted earnings. Despite the relative strength of the economy, Australian earnings per share is still well below its pre-GFC peak.



Source: UBS Global Asset Management Adviser Monthly Newsletter

The blue line shows the ratio of the S&P/ASX 200 (Australian share market) to the S&P 500 (US share market). A fall in this line indicates underperformance by the Australian market. The brown line is the inverted Australian dollar / US dollar exchange rate. Basically, this means that the chart is turned upside down. When this line falls, it indicates that the Australian dollar has risen compared to the US dollar.

The swings in relative market performance between our share market and that of the US have moved closely with, and at times been led by, the Australian dollar. This correlation has been particularly tight since the Australian dollar moved above the US dollar 90 cents level, a time corresponding with a sharp underperformance by the Australian equity market. The recent outperformance of the Australian market has occurred at the same time as a fall in the Australian dollar.

It might be worth considering that a substantial contribution of the Australian share market's underperformance has been driven by the decisions made by the Reserve Bank (RBA). The RBA has been nervous that our mining boom would cause inflation to spiral out of control and as such, and contrary to the rest of the developed world, they raised interest rates early and quickly post-GFC. To their credit, inflation does appear to be under control. But the cost to investors and companies not exposed to resources and mining has been high. Perhaps their reputation for moving too slowly in the past has contributed to jumping the gun on this occasion.

Rising commodity prices and the associated boom in mining capital expenditure have kept the RBA on edge over the inflation outlook. During commodities booms, mining companies spend large amounts of money developing mines and infrastructure so that they can extract from the ground, sell and export as much as possible to take advantage of higher prices. Official interest rates have been set at a level to 'make room' for the surge in mining investment, by squeezing down other parts of the economy such as retailing and housing construction. So while the current settings of macro policy (i.e. interest rates currently set at 4.75%), 2.0% fiscal consolidation in 2011/12 (fiscal consolidation is government debt reduction) and an above-parity Australian dollar, have to date worked against the equity market. In a weaker and more uncertain world it may just be the opposite.

Australia has macro policy flexibility, unlike the rest of the developed economies. If economic conditions in the major developed economies deteriorate, the current path of fiscal and monetary policy can be reversed. Along with a weaker Australian dollar, the economy would get a chance to re-balance somewhat from its current 'two-speed' path.

When a country such as the US needs to stimulate its economy, one part of the solution is to devalue their own currency, which has the effect of making their export industry more competitive. So far, for the US, this seems to be working; their export industry is showing some signs of improvement.

Unfortunately for Australia, a rising Australian dollar has the effect of making our share market less attractive to foreign investors, and with the Australian dollar reaching \$1.10 this year it is no wonder our share markets have not enjoyed the same upside as experienced in the US. As investors, the rising Australian dollar has also eroded the returns we have received from investing in the US share market. There could be more pain for the Australian dollar ahead as the US, Japan, Switzerland, and other nations battle to devalue their currencies and boost and/or protect their export industries and foreign investment.

Financial advice

For any further information or to discuss your financial situation, please don't hesitate to contact me on **0413 244 733** or email **simon.whiteley@eqtsuper.com**. I look forward to hearing from you.

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