

WHY IS OUR SHAREMARKET FALLING?

It's a surprise that the stockmarket is falling even though economic data here and abroad are largely positive. We recommend a defensive stance for investors this year, with an emphasis on yield and risk management. It's been said for 18 months that stockmarket volatility will remain high as economies recover from the GFC, so this year's sharemarket falls shouldn't really be a surprise at all. It's also surprising to see one of the other reasons for the market nervousness - the shameless bonuses that fat cat investment bankers paid to themselves last year has accelerated the Obama administration's demand for repayment of TARP funds, triggering not only a reduction in cash feeding global stockmarket growth, but also spooking parts of the market still concerned about a second wave of economic downturn. In turn this market fall has rippled into the wider pool of investors and advisers from whose awareness the central purpose of government stimulus – now being withdrawn with direct repercussions to the global markets – has probably not been clearly understood.

Although most “ordinary” investors would think that the Governmental economic stimulus packages were targeted as a general restorative of the broader economy, in fact their main aim and target was designed to prevent collapse of the financial system, ie the banks. So to understand the reason for last month's sharemarket falls, which occurred despite strong signs of economic growth both here and abroad, we need to look at the strength and threats to the global and Australian banking systems. This is the key issue for Australian investors and advisers in 2010 and 2011 – misunderstanding or mis-reacting to this issue, either by being too bullish or too bearish, may well be the greatest wealth destroyer in our lifetime.

Our view is that there is a compelling case for cautious optimism in relation to the Australian sharemarket over the next few years – but this doesn't automatically translate to simply buying stocks now and hoping for the best. Protection and risk management will become far more important over the next few years than ever before.

What is the problem with the banking system?

We have noted here before how the real start of the GFC was the run on the investment banks which was precipitated by the failure of Lehman Brothers. Since all banks are permanently technically insolvent, they function primarily on the perception of their credit worthiness, rather than on the basis of liquid funds available to meet at call debts. That is, if banks had to pay all their debts tomorrow, many whose assets include long term loans like home mortgages or term commercial loans, would be unable to pay. The only real time that a bank has the need to pay all its debts in one day is when depositors start a run on the bank – so it's the role of the central banks to stand behind banks, in order to prevent depositors from starting a run on them. In the case of investment banks a run may not be seen as a panicked withdrawal of deposits by investors (investment banks don't usually have deposits), instead it will manifest as a

redemption out of investment products, a closing out of money market positions, and a refusal by other banks to do business with them.

The onset of market panic after Lehman's collapsed meant that a range of measures were needed to stem the panic and run on the banks. In the US the TARP program, after a false start when Congress failed to pass it, was rapidly ushered into place and provided Government funding for troubled bank assets. When that didn't stem the tide, the UK introduced bank privatization, which did the job. The US and many other countries around the world followed suit.

There is now an estimated \$300bn of TARP and TARP like money that has been injected into the banking system, and which has found its way into global stock markets – and it's the threat of the withdrawal of this money that, in part, has spooked the markets. As we show below, the balance of the problem is the perception that credit markets may start to harden against countries like the US that may need more funds if their economies worsen.

The trigger for repayment of TARP money has been accelerated by the Obama administration, apparently in response to the payment of massive bonuses to investment bank executives. The bank's excuse for these bonuses by the way seems implausible – claims of being forced to pay bonuses to retain staff that would be poached by other banks could surely be overcome by global measures to curb bonuses during the TARP period.

What is the downside risk?

At last September's Portfolio Construction Forum we were treated to an in person presentation by the notorious Marc Faber aka Dr Doom of the "Doom, Gloom and Boom" Report. Faber was part of a panel that included Bill Gross of PIMCO and Dr Phillipa Malgrem (a member of the Bush Council of Economic Advisers). Faber represents the "crisis" view of the world economy and predicts a firestorm of financial catastrophe including the total collapse of the US economy. His view in summary is that inflation is massively understated in the US official figures, and that inevitably rising US interest rates will push its economy to collapse (rates must rise on his view in order to attract buyers to the huge supply of bonds that the US will issue in coming years to fund its TARP and general deficit). As part of this thesis, it's posited that China will not be able to continue to come to the aid of the US (nor will other countries), in part because China's economy will be in collapse itself, and in part because the US will become such a basket case that others won't want to bail it out.

Bill Gross and Pippa Malgrem represented the more moderate view; namely that the situation is dire, but that stimulus will help economies return to positive GDP growth and over time economic health will return to the system. They both acknowledged that the US would need to reduce its budget deficit but also noted the critical importance of the US economy to that of China (ie as a major trading partner).

The recent market weakness coincides with strong US and global GDP growth – so how come the market fell whilst economies grew? Could the most recent Harry Dent missive be correct?

For those that don't follow him, Harry Dent is a US based demographer and over many years, his work has predicted a demise of the US economy and a sharp fall in the US market, as a result of the ageing population and growing budget deficit. Dent is also a chartist and in his current missive he lays it on the line. Interestingly, his comments come precisely at the time where the US stock market fell, even though GDP and other key data showed massive improvements:

- US housing prices are not recovering despite strong GDP growth – reflecting the rising number of defaults and foreclosures that are lagging the first wave of the GFC;
- As US interest rates rise this year and next this will flow directly into more expensive US mortgages and will lead to a peak in defaults and foreclosures in 2011 and 2012;
- US commercial real estate values are “falling like a rock” and since they are more leveraged than home loans, even though commercial mortgages are only 1/3 the value of home loans, rising defaults will have as big an impact as home mortgage defaults;
- Euro zone sovereign risk is rising with Iceland already in default, and concerns around Ireland, Greece, Portugal and Spain;
- Dent comments that “This is not just a U.S. subprime crisis. It is a mainstream mortgage and debt crisis and a global debt crisis that will come back in spades in the next two years or so;”
- Dent again: “China has been the strongest growth engine in 2009, but it has grossly over-stimulated its economy and will fall hard when the global boom fails in the second half of 2010. Its excess capacity in manufacturing will contribute to deflation as well as the debt deleveraging around the world;”

Clearly, if that view of the world takes shape as reality, then we are in for a big fall in our stock market, perhaps back to GFC crisis levels. But what do the moderates say?

What is the prospect that we don't have a second wave economic crisis?

Writing in The Age on 29 December 2009, the doyen of Australian economists, Saul Eslake commented on the prospect of sovereign debt default:

“Despite its rapidly deteriorating public finances, the United States is probably the least likely of any major Western government to default on its debt (no matter what the probability implied by market pricing of ‘credit default swaps’ on US government debt: surely the financial crisis has taught us that financial markets are not very good at pricing default risks). US Treasury securities are widely held within the US itself and across the world; they were the instrument of choice in which panicked investors sought refuge during the financial crisis. And all of the US Government's debt is denominated in US dollars. Among other things this means that, if it really wanted to, the US government could procure as many US dollars as it needed to repay its debts from the US Federal

Reserve. That's an option which isn't available to members of the euro zone whose governments may run into difficulty refinancing or repaying their debts, such as Greece."

What about China? Certainly the news from there is not as simple and clear as it has been for the last few years. Fears of an asset bubble forming after massive Governmental stimulus have prompted the PRC authorities to tighten monetary policy – in fact, China was the first country in the world to raise interest rates after the GFC. But it's safe to say that, for now, China is not the main focus of concern in the global markets: countries like Greece and Portugal occupy that position.

What about the credit markets?

Concerns about sovereign default are showing in the credit default swap market, which allows investors to buy protection against bonds defaulting (this is the same CDS market that people loved to hate after the GFC, where the tidal wave of sub prime bonds defaulting rippled out into the packaged CDS market known as CDO's). After reporting a large rise in its budget deficit which now stands at 12.7% of GDP. Credit spreads are widening as the market returns to worries about defaults – and forcing countries like Greece to undertake to reduce its deficit to 2.8% by 2012 – a massive reduction but one which it has pledged to report progress on a quarterly basis to the European Commission. Rising spreads have impacted on the cost of funds for Australian companies and banks, too, with the cost of Australian Government debt nearly doubling to 56bp over, versus 30bp over for much of last year. Australian banks funding costs have risen as well, to 90bps over, but this is well below the 190bps over that was prevailing in March last year.

Even though sovereign defaults from any of these countries would be a major concern, it's important to note that markets have a strong history of recovering from defaults, recall the Russian default in the late 1990's – a shocker at the time, but one which was absorbed by the markets.

What about Australia?

It's hard to fathom all of this, when we look at the strength of the Australian economy. It does make it clear that we can't afford an ETS at this time of the cycle (we'll leave that one to Barnaby Joyce and Tony Abbott to handle)! Australia has one of the highest GDP growth rates in the world, and as Bill Keenan at Lonsec notes, we have now had 19 consecutive years of economic growth. Writing in Lonsec's current "Investment Insights" Keenan notes that:

"The Australian economy avoided recession in 2009, experiencing only a mild slowdown. Lonsec expects growth to pick up to between 3.0-3.5% in 2010. This would be the 19th consecutive year of growth for Australia cementing it as the best performing economy in the OECD and the third best performing globally, after China and India."

This is the reason why, even if the global economy does falter, Australia will remain relatively unscathed. As Keenan notes:

"Australia's strong fundamentals relative to most OECD countries include:

- The economy is in its 19th consecutive year of growth;
- The financial system is in good health;

- The Government is in a relatively strong fiscal position;
- The unemployment rate remains relatively low at 5.7%;
- The housing market has proven resilient;
- Asia, Australia's major export partner, has been less affected by the GFC than Europe and the US; and
- Prices for Australia's key commodity exports are rising once again.

The combination of Australia's relative economic strength and a weakening USD has led to the AUD strengthening to US\$0.93, at the date of this report. While a rising currency hurts our export competitiveness, it isn't all bad news as Australia still runs a current account deficit. Put simply, Australia imports more than it exports and it also borrows a large amount of capital offshore (about \$680bn in foreign debt). A rising currency lowers the cost of imports and reduces our interest costs in AUD terms. It is probably a net positive in the short term but will tend to lead to long-term problems if our current account deficit continues to expand."

What to look out for this year

It won't be possible to make big returns simply by buying Australian stocks this year. For long term holders, Australian shares remain a good investment, and buyers will find value in further market weakness. We do suggest adopting a defensive stance with investment this year. To better assess the likelihood of the markets descending into the chaos that Dent etc predict, you should keep your eyes on the following indicators:

- Credit spreads (if they rise it becomes harder and more expensive to borrow, feeding further economic problems);
- Commodity prices (if they fall, countries like Australia and Brazil will suffer)
- US interest rates (if they rise this will hurt US borrowers and the banks will suffer as defaults rise)
- US housing data, eg foreclosures etc (ditto)
- Australian interest rates (rising means the RBA thinks we are still growing, falling means we are starting into a period of deflation).

The sharemarket is a leading indicator of economic health – and as you can see, in this market, we have to contend with understanding the pressures on the stockmarket, even though current economic data is largely positive. Stay calm, be defensive, and make sure your investments are the best value and soundest that you can find.

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