

M&CO Newsflash

A brief update on 3 major economies that are of capital importance to Australia in this Worst Economic Downturn since "The Great Depression" of 1929-32, # 80 years ago !

George Soros, in his Financial Times article of 22 January 2008 pointed out that we have come to the end of a 60 years credit boom and that "the ability of the (US) financial authorities to stimulate the economy is constrained by the willingness of the rest of the world to accumulate additional dollar reserves".

The US Fed had dropped interest rates to virtually zero by mid-December 08, already beginning to help the refinancing of mortgages at lower rates and has begun to improve the level of activity in the corporate debt markets. The level of outstanding interest bearing obligations in the US now exceeds 350% of GDP. The consumer accounts for nearly 40% of this figure and servicing it absorbs 14% of disposable income. This compares with a total figure of 155% in the early 1980s when consumer debt accounted for about one third. Some have expressed concern about the printing of money but our view is that the sheer magnitude of debt in many developed economies will militate against it, hence the risk of inflation is some way off.

Equities, while not perhaps ideal, will be a lot more interesting than cash or bonds. We see an overlapping bear market. The first phase was the seizure of the credit markets. This is now well on the way to being resolved. The second phase is the collapse of profitability led by commodity producers and manufacturers of durable consumer goods but also service sector such as retailers, media etc. Some will be largely immune such as power, water and communication utilities.

We are quite upbeat. The new administration in the US is bound to spend liberally to try to avert a deep recession. Governments worldwide can be expected to deficit spend with emphasis on capital works. At the same time the effect of a lower oil price is highly beneficial to consumer incomes and consumer confidence.

We still favour Asia over the West. Not that Asian will escape a reduction in foreign direct investment, nor deteriorating trade surpluses but their state finances are in good shape, their banks' solvency ratios are barely affected by the credit crunch/write-offs and of course, bank funding tends to be from domestic sources. India may face a weaker Rupee to offset its less favourable fiscal position, but on the other hand, it has far less exposure to external trade than say China. The Asian markets fell 48% for the year. Exceptions were the Hong Kong H Shares, the defensive sectors of telecommunications and health care. Residential property development has slowed dramatically in China and India as markets have suffered from oversupply. In China, interest rates have now been cut and restrictions on bank lending eased. Government spending on infrastructure projects has been dramatically increased and various tax cuts announced. The government balance sheet is in good shape, as are those of households. So expect the domestic Chinese economy to respond well to these initiatives. India has also seen interest rates fall and fiscal initiatives announced.

European markets fell 45% and its real estate 77% in 2008. Bank funding for a car loan in Germany is not much easier than in the English-speaking markets, yet the conservative behaviour of German consumers this past 15 years is evident in today's steadiness. There's been no housing, consumer loan or credit card bubble in Germany. The household sector is a net saver, exports have boomed for years, and employment is strong.

- ✍ Company valuation measures are back to levels last seen in 1985 – almost quarter of a century ago!
- ✍ A survey of investor sentiment by Merrill Lynch reveals that most professional investors already expect corporate profits to "deteriorate strongly" and hence this is priced into most companies valuations.
- ✍ Portfolio cash levels are also high by historic comparison with figures out of the US suggesting they are equivalent to 75% of the US equity capitalization.
- ✍ In the short-term, commodities do look extremely oversold and ready for a rebound hence for a trading rally in the A\$. We are optimistic because we think, in the short-term; the market has discounted the worst.

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