

M&CO Newsletter

Getting the big picture right: Dr. Frank Gelber examines why recent equity market falls represent a golden opportunity to now fund for your retirement

Should we regard the extraordinary falls in share prices as a reason to seek the security of fixed interest or as an opportunity to invest to take an equity position at a price unimaginable a short time ago?

The US, the UK and parts of Europe are going into recession and will take other countries with them. In those countries, falls in assets prices will cause banks to write off bad debts hence substantial parts of their assets, leaving them vulnerable and inhibiting their funding of sound parts of their economies. To get through, they will need to separate the "good" and "bad" parts of their banking systems and to refinance their capital base. These issues the rescue package and interest rate deductions in the US, the UK and elsewhere are designed to address.

The genesis of the problem lay in a long period of low interest rates, encouraging financial investment in real assets with no shortage of "masters of the universe" to transform that into asset prices and new investment, with the consequent over supply of assets leading to sharp falls in both asset prices and investments. Hence the need to write off bad debts associated with aggressive lending in asset markets. Hence also the negative impact on economic activity resulting from the downturn in real investment as well as the negative impact of constraints imposed on economic behaviour, both consumer and business, by the financial crisis.

In these countries, the oversupply and excess capacity in assets markets has pulled the rug out from under the asset values that underpinned loans and hence the asset base of the financial system. The problem began in the US where, after a 17 year boom, the downturn in housing markets destroyed the sub-prime market and residential mortgage-backed securities. Given oversupply, that flowed on to non residential markets. The impact in other countries would have been limited had it not been that their markets were oversupplied and vulnerable.

On the financial side, a necessary but not sufficient condition for recovery is to refinance "good bank" activities, allowing banks to underwrite sound economic activity, while the "bad bank" slowly trades out of its bad debts.

That, by itself, won't initiate economic recovery from recession. While financial constraints can inhibit real economic activity, the availability of finance can only accommodate, rather than boost, the initial phases of recovery. It's like pushing on a piece of string. Low interest rates can boost activity in the boom. But they will only trigger a recovery when the preconditions, normally a shortage of capacity, exist. They will do little for an oversupplied market. Accordingly, my fear is that it will be a slow rebuild, inhibited by weak

investment during the period required to absorb the excess capacity created during the preceding investment boom.

I am steeling myself for a protracted period of weak developed world growth.

Will the contagion spread to Asia, in particular to China? And how will it pan out in Australia?

China is a creditor, not a debtor, nation and hence not as vulnerable to a credit squeeze. It will feel the impact of the developed world recession on exports, but the impact on growth will be relatively minor.

China's growth is being driven primarily by investment, financed internally, which will continue to underpin growth and demand for minerals.

Australia, too will be sheltered from the worst effects of the financial crisis and the Western world recession. Australia's asset markets are not oversupplied and hence, while they have been hit by the financial crisis, real assets prices will not collapse.

However, Australia has been hit by the edge of the cyclone, reeling from twin shocks, firstly in the share market and then through the credit squeeze, coupled with tightening bank credit criteria. The financial sector switched from greed to fear. They hit the brakes, making first equity and then debt finance difficult, if not impossible for some and expensive to obtain. Pressure to reduce gearing and sell assets to finance activity has hit prices in investment markets.

The share market collapsed, with world markets following the US lead, now entrenched in a deep bear phase. The financial engineers, who had prospered in the greed phase, collapsed as markets sought lower gearing and security. The classic overreaction was in real estate investment trusts (REITs), with share prices substantially below asset values and zero valuation on attached businesses. Hence the pressure to reduce gearing, with lower share market valuations threatening to trigger loan covenants, and the quantum of assets for sale affecting property prices.

Moreover, Australia is vulnerable to the world credit squeeze. Our current account deficit means an annual overseas borrowing requirement.

Interestingly, the credit squeeze was reasonably mild in the first part of 2008, only reasonable mild in the first part of 2008, only escalating in the last three to four months, with the crisis coming to a head as overseas financial markets started to understand the magnitude of bad debts and the impact on the bank balance sheets.

But, despite current pessimism the Australia economy remains sound.

Certainly, confidence has collapsed in the face first of interest rate rises and then of uncertainty relating to the world financial crisis. The resultant precautionary saving by consumers and delaying of non-essential expenditure by business is having a negative impact on growth. But solid investment, increasing exports and partial recovery from drought will cushion the softening of growth. With a non-inflationary speed limit on growth of 3-3.5%, growth needed to slow from last years 4.4%. That was the point of the RBA's tightening of interest rates earlier this year. Now, however, the RBA has aggressively reduced interest rates, revealing its concern about the financial developments.

We are optimistic about the outcome – Australia won't have a recession: at least not in the next two years. We don't expect extreme pressure in the Australian banking system to constrain activity. In fact, our forecast is for growth to sustain between 2.5 and 3%.

Australian property markets are not oversupplied. Perhaps we should thank the RBA for bursting the housing bubble in 2003. Since that time, construction has fallen below underlying demand, leading to an escalating deficiency residential stock. The housing market is marking time at the bottom of the cycle, with the next stage an upswing. Meanwhile, commercial property markets haven't had time to oversupply, with tight vacancies underpinning rents. Indeed, capacity utilisation is tight industry-wide.

The solidity of the Australian economy will underpin corporate profits, property rents and hence asset prices. Indeed, we expect a rebound in asset prices as the impact of the world financial crisis recedes. Longer term, the health of the world economy will impact on the sustainability of minerals investment – but current projects have locked in strong investment for another two years at least.

Some in the banking sector think that this is like 1989, with the 1980s boom followed by the 1990s bust, the banking crisis and recession. While true for many overseas markets, particularly in the US and the UK, it is not true for Australia. With only minor impacts from bad debts and having lost most of their competition,

Australian banks will come through this stronger than ever. The Australian banking sector will be insulted from the cataclysm affecting bank overseas.

Meanwhile, given the inability to raise equity funds at sensible prices, the credit squeeze, tightening bank risk criteria and higher funding costs are inhibiting Australian companies ability to fund investment and, in some cases, ongoing activity. Constrained by, and uncertain of, future financial conditions, the first

responsibility of Australian companies to survive. My rule of thumb is that Australian assets are okay, overseas assets are in question and "excessive" gearing is dangerous. The opportunity is to take advantage of current anomalies to underwrite future prosperity. Expect significant merger and acquisition (M & A) activity.

The listed property trusts (LPTs), for example, are under extreme pressure from banks to reduce gearing, with little opportunity to sell assets at sensible prices, so that tight and expensive funding is constraining their ability to conduct the businesses attached to their REIT component. For those with primarily Australian assets, access to debt or equity financial now can remove the shackles of financial constraint and underwrite a strong future. Australian equity markets have been hit hard by the financial crisis – an overreaction in my opinion – creating extraordinary investment opportunities. If we're brave enough to take them.

Acknowledgements: Dr Frank Gelber is director and chief economist of BIS Shrapnel

In a period like this the way you make money coming out of it is to own the things were the fundamentals have not been impaired," Professor Jim Rogers

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