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World events and the big picture for 2010

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The year 2009 was littered with milestones, trials and triumphs. The US inaugurated its first African American President, who subsequently went on to win a Nobel Peace Prize in his first year in office. Two coups were recorded in Madagascar and Fiji and a similar attempt was quashed in Iran following accusations of electoral fraud.

The world travel market was hit hard by the outbreak of swine flu, which was formally recognised as a pandemic by the World Health Organisation. Australia was devastated by the most deadly bushfires yet with 173 deaths brought about by the hottest recorded temperature in an Australian capital – Melbourne, 46°C. Despite such tribulations, the past year saw Australia compound its reputation as the “lucky country” by narrowly avoiding a technical recession during the March quarter (+0.4 per cent growth following a -0.8 per cent decline from the December quarter) – the only developed country globally to achieve this feat following the onslaught of the Global Financial Crisis. With an unemployment rate still under 6 per cent and room to move on interest rates, Glen Stevens remains the envy of central bankers around the world.

In November the US Federal Reserve reiterated plans to keep interest rates at an unprecedented low of 0-0.25 per cent for “an extended period”. The Bank of England base rate was 2 per cent at the start of 2009, but three successive cuts from January to March took it to a record low of 0.5 per cent, where it has remained ever since. The cuts saw rates on many traditional savings accounts fall to zero, forcing savers to look for better deals. Thus, the carry trade has been on in earnest. Borrow cheap in the US or Europe, short the dollar and long risk assets has been the consensus trade globally over the past twelve months. The result has produced a strong Aussie dollar and surging commodity prices - the proliferation of exchange traded commodity funds has exacerbated this emerging bubble.

There were some spectacular falls from grace this year. In 2008 Iceland had ousted Norway from the head of the UN's league table of 177 countries that compared per-capita income, education, health care and life expectancy. Iceland had also presided over the fastest expansion of a banking system anywhere in the world. Little did anyone know that the expansion once so admired would go on to saddle the country with liabilities in excess of US\$100 billion – liabilities that now dwarf its gross domestic product of US\$14 billion. And then there is Dubai – who thought that building the world's largest fish tank, indoor ski slope and residential tower in the middle of the desert could possibly end in tears? The individual award goes to Bernie Maddoff, who in March 09 pleaded guilty to 11 felonies and turning his wealth management business into a giant Ponzi scheme - “To every con artist, he is the Godfather, the Don,” suggested by a fellow inmate at the Butner Federal Correctional Complex. And why not? In the scheme of the Con world, defrauding clients to the tune of US\$65bn is impressive stuff indeed! US institutions again covered themselves in glory with a mad dash to repay TARP money in hopes of being able to distribute egregious year-end bonuses to their top 25 employees. Ten of the big banks were allowed to repay US\$68bn in taxpayer money during the year. While taxpayers actually came out ahead (to the tune of US\$1.8bn in interest payments), the structural banking reform required to reign in excessive risk taking is now immeasurably more difficult to execute as Government control of the industry has now been given up.

The outlook for 2010

The outlook for the domestic and global economies remains highly uncertain. The aggressive and necessary action by world bankers appears to have averted the possibility of a sustained depression and credit markets are beginning to operate with some semblance of normality.

The US Government continues to print money which is leading many commentators to argue that inflationary pressure over the medium term may increase. It is worth noting however that TARP funds were largely used to repair bank balance sheets rather than to lend, and with those funds being repaid over the year, the M1 money

multiplier effect isn't kicking in. Excess capacity in most parts of the US economy (and globally) is also causing short term price deflation across most sectors. It is conceivable in the longer term, however, that the US may be happy enough to inflate its way out of debt (largely held by China in the form of Treasuries), devaluing the dollar more persistently over time (notwithstanding a major economic shock, for which a flight to safety in US Treasuries / dollars prevails). As John Connally, then US Treasury secretary, identified as China's quandary almost 40 years ago "It may be our currency, but it's your problem".

Speaking of interdependency problems, much of Australia's economic resilience over the past twelve months can be attributed to its close trading links to China. This dependency is a double edged sword as some of the cracks in the Chinese "miracle" story begin to widen. There are a number of points that continue to be overlooked by bullish market commentators and China bulls in general. Chinese bank debt is largely understated (to the tune of US\$1.7tn – circa the size as its foreign reserves) as debt has been shifted off balance sheet to "Asset Management Companies" controlled by the State. The targeted GDP growth rate above 8% is now dependent on consumer spending growing at unprecedented levels to fill the export void (the compound growth rates required in consumer spending have never been achieved by any nation over any time period in the past). Government funded capital spending has been allocated to boost output in industries which are oversupplied and into infrastructure projects that appear to have little strategic value. Social issues are also worrying. There are 60 million Chinese with household incomes over US\$20k per year, the global standard for the middle class. Out of 1.3 billion Chinese, the "surging" Chinese middle class is 60 million, which by itself looks impressive (circa the same population as France). Looking at the whole country however, China is extraordinarily poor. Six hundred million Chinese live in households whose income is below US\$1,000 per year and another 440 million live in households that earn below US\$2,000 per year...that's a combined 80% of the population.

Perhaps the Chinese Government is in a tight spot? It is conceivable that if the economy was to enter into recession then the country may plunge into economic chaos with social disquiet ensuing. The State therefore finds itself obliged to pump more capital into uneconomic projects such as industrial estates and surplus infrastructure to keep the economy moving, despite the growing debt burden ...not sustainable long term. Other than these issues, China is in great shape. It is worth keeping in mind that China is Australia's largest export market and the vast majority of export dollars are in commodity products. Around 23 per cent of Australia's exports were shipped to China in the most recent quarter, up from 4 per cent 10 years ago. China takes 80 per cent of Australia's iron ore exports and 20 per cent of coal exports. While betting against commodity momentum may be unrewarding in the short term, it is becoming increasingly difficult to mount a bottom-up argument that supports a demand led price surge from here.

More generally, excess global liquidity may well lead to further asset price bubbles – especially within those countries (such as Australia and Asia) where capital is currently being allocated at record levels. The Reserve Bank of Australia appears keen to prick any signs of excess asset price growth or general inflation early, as evidenced by rate hikes during the month. Australian household indebtedness remains at historically high levels (increasing 6 fold over the last 18 years) and sensitivity to the above mentioned interest rate moves may have a meaningful impact on benign retail trading conditions for housing and retail related stocks. Rate hikes coupled with the cessation of government stimulus may reveal some tough conditions for Australian retailers and housing dependant businesses during FY10.

With capital markets stumping up A\$100bn during 2009 the pace of capital raisings may be set to decline this year. However, our merchant banking friends should not fear. With the market at 15 month highs, we can expect further IPO's to come to market. The private equity sector is pregnant with deals past their intended holding period and its likely our banking friends will enjoy another year of extracting significant fees while taking on zero risk.

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