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Australian equities – what happened to the exalted optimism?

by Andrew Fleming, Senior Portfolio Manager - Australian Equities

The first week of January saw the exalted optimism that had propelled the market through the last 9 months of 2009 continue unabated. China announced an effective tightening of monetary policy in the second week of January, prompting a "Toto, I've a feeling we aren't in Kansas anymore" moment. The following week, another, more dangerous form of tightening emerged as Barack Obama announced a proposal to inhibit deposit taking banks from participating in risky behaviour, such as principal trading and investment in private equity. We say dangerous only because its implementation contains material uncertainty, and not because we disagree with the policy approach. No one can accuse Schroders in Australia of championing increased self regulation by financial institutions and financial agents such as private equity, given the results of the past decade.

Uncertainty is a distasteful medicine for markets, albeit in our view an ultimately helpful one in this case if it is merely a precursor to much needed regulation of many global financial institutions and agents such as private equity firms. In any event, after the unabashed orgy of fiscal and monetary stimulus through late 2008 and 2009, this move by each of the giants of global commerce from an accommodative policy to a tightening bias, in a broad form, resulted in January's ASX200 market performance being the worst month since November 2008.

Uncertainty around proposed banking reforms

2009 was an amazing year for financial markets. Australian consumer and corporate confidence hit record levels and market performance was strong, and hence confidence was restored from the March 2009 depths, but alas little fundamental change occurred in the fundamental imbalances that precipitated the GFC. In that context, we found the rapid strengthening of asset prices at first confounding, but increasingly disturbing. The risk was the imperative for change had been lost – a good crisis had been wasted, as we mused in our national roadshow last October.

The financial system regulatory proposals announced recently by Basle, and Obama in January, whilst unpopular with markets and commonly blamed (along with the risk of Greek sovereign default) for the market fall, appear to us sensible and much needed. This is especially so given the increasingly smug commentary coming from the greatest beneficiaries of global aid through the GFC.

To wit, the response to the proposed banking reforms has been as audacious as self interested. Which of the following comments from Davos World Economic Forum participants is true?

- a) Barclays Bank President Bob Diamond saying he has "seen no evidence that suggests that shrinking banks is the answer" to preventing a future meltdown;
- b) Bob Diamond again, opining "If you step back and say large is bad, and we move to narrow banking, the impact of that on banks and on global trade, the global economy, would be very negative";
- c) Standard Chartered CEO Peter Sands warning there was a growing risk that fragmented regulatory initiatives would "create enormous amounts of complexity."; or
- d) central bankers such as China's deputy central bank chief Zhu Min saying there was no reason for the finance industry to chase overly high returns on equity.

Sadly, the answer is (e), all of the above.

Indeed, an objective observer might conclude that the above four mentioned factors were actually contributors to the GFC and resulting global recession, ie:

1. a system where banks exploited their 'too big to fail' status,
2. that the result of this was a financial system crisis which decimated global trade in hard goods,
3. that most of the financial ills besetting banks was related to the structuring, sale and holding of complex financial securities, where the true risk and returns were unknown; and
4. where China invested in fixed assets with a zest which led to asset price bubbles and questions about their required returns on investment.



Increasingly, it appears that vested interests are galvanising to ensure that a good crisis has, indeed, been wasted. Hence, whilst markets may recoil in horror at the uncertainty created by the reforms proposed by Obama and global financial regulators in the face of these vested interests, ultimately we believe the proposed reforms will potentially lead to more sustainable financial systems and hence a better environment for investment returns. It is hard to argue in the face of the past 5 years that regulation per se is bad for markets. The test will be whether the regulation is effective (such as we believe increasing liquidity requirements and decreasing risk positions for deposit taking banks would be), or not. Obama outlined his broad policy agenda in his late January State of the Union address "We can't afford another so-called economic "expansion" like the one from the last decade -- what some call the "lost decade" -- where jobs grew more slowly than during any prior expansion; where the income of the average American household declined while the cost of health care and tuition reached record highs; where prosperity was built on a housing bubble and financial speculation". These are sentiments we largely agree with and we hence suspect the policy settings, for the first time in a long time, are pointing in the right direction, which is why we welcome accompanying regulatory change.

In the meantime, until it is clear what the execution of this policy is likely to resemble, we expect both equity and credit markets to be volatile. Just as the political and policy mishaps along the restoration of confidence to the banking system 12 months ago brought to mind that great scene from *Back to the Future*, as in the past Marty McFly observes his father George's incompetence and mutters "George, it was a wonder I was even born", we suspect the withdrawal of stimulus will also be a painful process for markets to digest. Policymakers, and even more so politicians, given this is an election year in the US, UK and Australia, are treading virgin paths. Hence we are likely to see a re-run of the confusion that reigned through the refinancing of the global financial system 12 months ago, which is a hostile market backdrop.

Outlook

In recent months we had moved portfolios towards a more defensive tilt, as prices of assets had increased without appropriate regard for risk. Our view remains that not addressing the underlying imbalances that caused the GFC and resulting global recession will most likely see the same problems recur. The definition of insanity is doing the same thing and expecting a different result. Hence we'll continue to underweight Resources, and we've progressively underweighted banks over recent months reflecting both outperformance through 2009 and the potential for regulatory change to increasingly pressure financial sector returns. We continue to maintain that listed property is expensive, and hence our portfolios are largely dominated by a diversified mix of Industrial stocks, many of which tend to have a large proportion of foreign earnings. We suspect 2010 will continue to feature regulatory uncertainty, feeding market turbulence, and a likely significant dispersion of returns, which aided our performance through 2008 and 2009.

Important information

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