Taking Stock

"Blow, winds and crack your cheeks"

by Martin Conlon, Head of Australian Equities

Complacency, an affliction impacting us all at times, exacts its revenge when we least expect it. Furthermore, the longer it has pervaded, the more severe the likely impact. In our minds, the current complacency has arisen in large part, due to unwarranted faith in the ability of policymakers to control economies. Early signs of this revenge were evident on a number of fronts during the June quarter and we are now left to ponder the potential severity. Complacency is usually synonymous with unpreparedness, and we remain concerned that many corporates are, as King Lear put it, unprepared for these forces to "blow, winds and crack your cheeks". They are hoping for a zephyr. The extent to which markets and economic variables have the potential to correct, depends on your view as to how grossly they have become distorted. Our suspicion is that winds may have some time to blow.

The first sign of change was the announcement by Ben Bernanke that securities purchases by the Federal Reserve may be tapered towards the end of the year. Given the program was experimental and tangible benefits difficult to discern, one would suggest that this announcement would not be in the 'bombshell' category, and in any case, was conditional on a quantum of economic recovery which does not yet exist. However, for trigger happy financial market participants, the comments were sufficient to see a severe reaction. Bond markets sold off aggressively and stocks offered no correlation benefit whatsoever. Whether the sell-off is a harbinger of improving US growth to come, or, as is more likely in our view, a tacit admission that the detrimental impact of QE may be as significant as its claimed benefits is a moot point. We remain adamant that the distortion of market pricing and asset prices through QE was a damaging attempt to remedy previous policy errors. Its removal can therefore only be positive. In no way do we believe that it is certain that bonds will continue to retreat, as we have been open in our views that deflation is a far more likely outcome than its opposing force, however, it is only when intervention is abandoned for a sustainable period, that we may determine where free market pricing lies. Further, the apparent calm which ensued when most major economies were pursuing similar policies concurrently may be disturbed when one even questions the efficacy of indefinite continuation on the path. What seems likely is that the apparent calm of recent times will give way to greater volatility.

Closer to home, although perhaps not unrelated, the winds of change began to impact on some important domestic factors. The first was the currency. Having forged a career using a range of random variables to justify forecasts which hover around spot and drawing lines on charts which represent 'support levels', the witchdoctors otherwise known as currency strategists were thrown a curve ball during the quarter. Their 'support levels' were breached and they had to draw new lines further down the page. We claim no short term expertise whatsoever and our long term expertise is only marginally superior, but our view remains that purchasing power parity will remain a better long term indicator of currency levels, and on that basis the lines will continue to move down the page. There is little doubt that the reversion of the currency to more normal levels (if it eventuates) will be a positive, as the currency has proven a most useful shock absorber over time, however, our dominant concern remains that the shock it will need to absorb will come in the form of the domestic economy. Twenty two years without a recession have ensured that the above-mentioned complacency is firmly entrenched in the government, consumer and corporate mindset. Sadly, esteemed commentators such as our erstwhile Treasurer, are not learned in the laws of probability. All those long years of uninterrupted economic growth, massive credit expansion and exploding government spending have done little to improve the odds of never again experiencing recession. To the contrary, they have allowed our wages, work practices, house prices and almost every other variable to grow ominously disparate from our global peers. Judgement day is nigh, and Paul Keating's famous words, "the recession we had to have", are likely to resurface sooner rather than later.

For those willing to observe, the signs are clear. Commodity prices, with the exception of iron ore and copper, have relinquished boom levels. Capital that followed the usual pro-cyclical path in boom times has exited and miners have been busy battening down the hatches for some time. The rise in capital expenditure that accompanied the boom was staggering, more than quadrupling as a percentage of GDP. The amelioration in this spend (which still has a long way to run to reach pre boom levels) has already caught mining services companies napping, driving collapsing equipment utilisation and significant staff layoffs. Many are close to financial distress, left hoping for the rebound that won't come. Manufacturing has all but ceased to exist in Australia, and even with a weakening currency, cannot hope to support a bloated and inefficient services sector, whose extremely high incomes by global standards, support even more outrageous asset prices.

As is usually the case, investors are well and truly on the path to assimilating the obvious. Miners and mining services, for the most part, have been savaged. We are not sure that many present great opportunity, as ill thought out financing structures and weak business models remain rife, and the ability to raise sufficient new equity may have passed for many. The more pernicious impact is where complacency remains high. Our greatest concern is for businesses dominantly exposed to asset prices and those accustomed to using aggressive leverage in an attempt to enhance returns. The range of businesses in this category is broad, from banks, probably the most obvious leveraged bet on asset prices, to property development, insurance and others. Few will be totally immune. The best inoculation against tougher times is capital structure. Businesses with pure equity financing will always weather a downturn more successfully, as it is perpetual in nature. At present, few are prepared, as denial normally precedes acceptance. Banks think they are supremely well capitalised despite having virtually no more equity capital as a percentage of their loan assets than 20 years ago. Industrial businesses are waiting for recovery even as unemployment just edges off its lows.

Our message is simple. 20+ years of benign experience influences human behaviour sharply. Companies are used to rising revenues, profits and asset prices. When the deleveraging forces which central bankers are attempting to assuage become overwhelming, those that have recognised the new environment will fare best. Reality sometimes isn't pretty, but dealing with it is better than trying to hide from it.

On the stock front, performance was polarised. In the case of mining services and gold stocks, market capitalisation continues to vaporise. Newcrest Mining, Kingsgate and Medusa Mining typified the carnage in gold, whilst Ausdrill, Transfield Services and Boart Longyear received the same treatment in mining services. Profit warnings remain the order of the day. They were bettered only by Billabong in the underperformance stakes, as potential suitors headed for the exits and banks sold down debt positions at a haircut. It would appear the drive for global surf wear domination will not end well for equity holders. The positive side of the ledger saw offshore earners treated well, with currency falls aiding stocks such as News Corp, Brambles, QBE Insurance and Aristocrat Leisure. Property, banks and anything yield based continued to perform strongly as investors continue to happily swap earnings risk for valuation risk.

Outlook

You may have noted that we don't expect the future to be a bed of roses. Profits have benefited from an extended artificial tailwind borne of excessive credit. Credit brings forward demand. Slowing credit and deleveraging mean slowing demand. Twenty years of booming credit will not be unwound in one or two years when debt levels merely stabilise. Deteriorating demographics will exacerbate problems as unsustainable promises to the ageing create increasing burdens on an already indebted younger generation. We may prove to be overly cynical, but we take little solace from regulators and policymakers who assure us things are fine. Their lack of understanding as to why increasingly loose monetary policy creates hugely disproportionate speculative activity and asset price increases versus real activity suggests a lack of awareness of the imbalances and instability which historic policies have engendered. This goes for Australia too. Few countries have built a sustainable future on high property prices.

We do not pretend to have all the answers, but in the quest to protect capital it seems clear to us that the path forward is unlikely to mirror history. As Einstein quipped, “we cannot solve our problems with the same thinking we used when we created them”. Sensibly priced businesses focused on generating sustainable long term profits will always be able to provide decent investment returns. We would suggest that those with apparently low levels of financial leverage will fare much better in a tougher environment. Importantly, these are also far more likely to provide returns which are uncorrelated to debt markets, as business with lots of debt will always get into distress when lenders get twitchy. The ups and downs of profitability will remain part and parcel of running a business and we are fairly sure that those searching for businesses that have cashflows which never go down (and paying an exorbitant price for the privilege), will be found wanting. We feel it will be far more lucrative to find businesses that are accepting of the ups and downs, management that run them as well as possible regardless of the conditions and finance them in a manner which will not see shareholders become hostage to banks in the downs.