

Crouching Tiger, Hidden Dragon



Sentiment regarding the Chinese economy had softened in the past couple of months as rising inflation and potential asset bubbles prompt heightened investor concerns. Matthew Sherwood, Perpetual's Head of Investment Market Research examines these concerns and finds that the outlook for the Asian and Australian economies and sharemarket in 2010 is strong (albeit with higher risk) and although the US economic recovery is forecast to be one of the weakest in history, investors still expect a typical earnings recovery, which seems unlikely.

Introduction

Martial arts films hardly ever win critical acclaim and it is easy to see why, as Chuck Norris, Ralph Macchio and Pat Morita would barely make the top 1000 actors of all time. However, in 2000 a low-cost martial arts film had the traditional wine-and-cheese crowd cheering on kung fu fighters. *Crouching Tiger, Hidden Dragon* was a movie that was made on a USD15 million budget and won widespread critical acclaim winning four Oscars, two golden globes and about 35 other film awards. Among other things, the film centres on the theft of a sacred sword and how this leads to a prolonged quest, bitter betrayal and a larger-than-life face-off between good and evil in eighteenth century China. At its core, the film deals with the main character's (Jen) choice of future between being a court official's wife, the lover of a desert bandit, an outlaw or a martial artist. Just like Jen, global investors are currently in an important battle in terms of determining the path forward in what will be a different and more difficult global economic recovery.

Chinese interest rates have been artificially low for more than a decade

The Chinese economy has averaged 10% growth per annum over the past 10, 20 and 30 years (source: Citigroup). This has been underpinned by massive pent-up demand and, more recently, interest rates being kept artificially low (at around 60% of nominal economic growth). This has reduced the cost of capital (after rates were kept too high during the Asian Financial Crisis in 1997) and has had two important consequences:

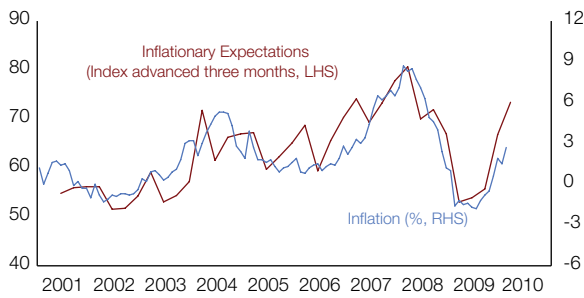
a. an asset bubble has developed

Artificially low rates has meant that deposit rates are also unusually low, which has encouraged investors to increase their exposure to higher-yielding assets. The associated surge in credit has positively impacted house prices (which have doubled over the past six years) and this suggests a major asset bubble has developed. At present, the Chinese government is dealing with this issue by increasing housing supply, reducing its loan growth target (to 18% in 2010 from 32% in 2009) and boosting banks' Reserves Requirement (RR, which limits the share of each bank's assets that they can lend). However, latest data indicates that banks already have 3% excess reserves above the RR, and this needs to rise by another two percentage points to begin reducing system liquidity.

b. rising inflation

The rapid rise in the credit and money supply has led to a build up of inflation and inflationary expectations. An index of inflationary expectations has risen in each of the past four quarters and is now well above the 10-year average (of 73 – see Chart 1), reflecting the impact of higher food prices, among other things. Expectations have been a good lead indicator of inflation and suggests that Chinese inflation could double in 2010 to a near-decade high. Rising inflation is the largest immediate threat to the Chinese economy as ordinary workers in the big cities are already finding it difficult to keep up with the cost of living and wage rates have risen, placing additional pressure on profit margins.

Chart 1: China's Inflation expectations have risen
Inflation and Inflationary Expectations: China (%)



Source: Citigroup as at 31 January 2010.

Chinese interest rates or the Yuan needs to rise

With inflation stalking like a tiger, the Chinese Government risks rising social unrest unless it reduces the growth pressures on its economy. To slow inflation, China has two possibilities; either increase official interest rates or let the currency appreciate, or both. However, the Chinese Premier recently said China would not give in to foreign pressure to raise the value of its currency. At present, it appears that global politics is the major driver of Chinese policy rather than economic management. Nonetheless, an appreciation of the Yuan is likely to occur in 2010, but any adjustment is likely to be seen in H2 2010. This leaves interest rates as the primary tool to curb inflation.

Financial markets won't respond positively

It is hard to envisage that global financial markets would view Chinese rate hikes positively. Indeed the reaction is likely to be quite negative given the fragility of global economic prospects and the recent reaction to an announced planned reduction in excessive liquidity and credit. Nonetheless, if Chinese rates are hiked to levels that will curb inflation and maintain growth, it would make the Chinese boom more sustainable over the long-term. Accordingly, any associated negative market sentiment is, all other things being equal, unlikely to persist over the medium-term unless structural issues arise.

Where is that crouching Chinese tiger?

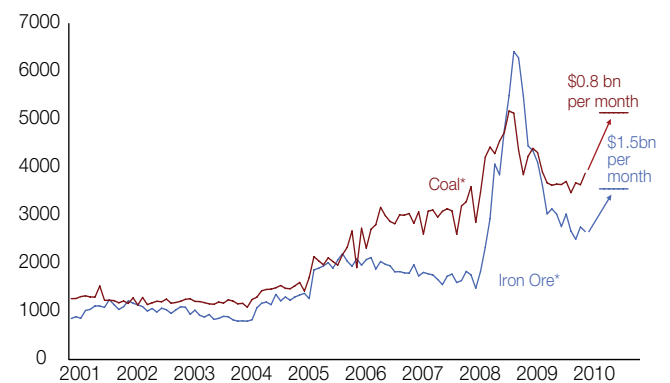
All rapidly expanding economies experience growing pains. These pains are already evident in China with higher inflation and inflated property prices. Asset prices have a large impact on booming economies, especially if bank lending around these over-valued assets is unsoundly based. Debt for the investment arms of local governments in China has been growing at a rapid pace over the past 18 months. Chinese banks have lent large amounts of funds to the financing platforms of these local governments (termed local government investment vehicles (LGIV)). These vehicles are highly leveraged with (overvalued) property as their main asset. Fortunately, these LGIV loans have only accrued over a short period and regulators have begun to mitigate the risks by securing payment sources to existing loans and reducing new loans. Financial markets seem to view these risks as being innocuous and strong industrial production growth has prompted market analysts to forecast large rises in commodity prices over the course of 2010 and 2011.

Rising commodity prices will massively boost national income

Market consensus for the upcoming annual contract negotiations is for a 40% rise in the price of iron ore and 32% for hard coking coal and 27% rise for steaming coal. This would be expected to add around AUD27 billion of national income (see Chart 2) to the Australian economy. In addition, spot prices suggest that the balance of risks to these forecasts is to the upside. This national income will be augmented by declining unemployment and have a massive positive impact on the Australian Commonwealth Budget

balance. The direct impact on economic growth will depend on whether export volumes also rise.

Chart 2: Australia has re-oriented its export base towards Asia.
Australian Exports of Coal and Iron Ore (AUD bil)



Source: Australian Bureau of Statistics and UBS Australia Limited as at 23 March 2010. Assumes no volume change from average level in past six months. Consensus estimates for negotiations for April 2010.

Australian interest rates also have to rise

China finished 2009 as Australia's largest export partner contributing 25% of our total exports and by mid-2010 Australia will export more goods to China and India (which contribute around 15% of global economic activity) than to the entire G7 countries (over 40%). While the trade and investment impact of Asia's industrialisation is very large and lucrative, the negative impact of this is higher domestic interest rates. In an environment of limited spare capacity in the economy, this growth surge is also likely to be associated with higher trade, investment, consumption and exchange rate and lower unemployment. This suggests that domestic interest rates will need to be considerably higher, especially as core inflation still remains above the Reserve Bank of Australia's 2%-3% target band. Above-trend economic growth will require above-trend interest rates to contain inflation.

Australia's hidden dragon

Australia's trade base is highly concentrated with exports of two products (coal and iron ore) to four countries (China, India, Japan and Korea) contributing around 50% of total exports. While this is a major positive in the short-term as Asian raw materials demand is growing strongly, it a significant medium-term vulnerability, especially when these economies inevitably experience growing pains. Massive investment in LNG projects will diversify the resource-base (to three), but not the dominance of the four Asian economies. Nevertheless, Australian prospects in 2010 look good as long as the economic outlook for the Southern Hemisphere economies, on average, remains strong.

A below-trend Northern Hemisphere recovery

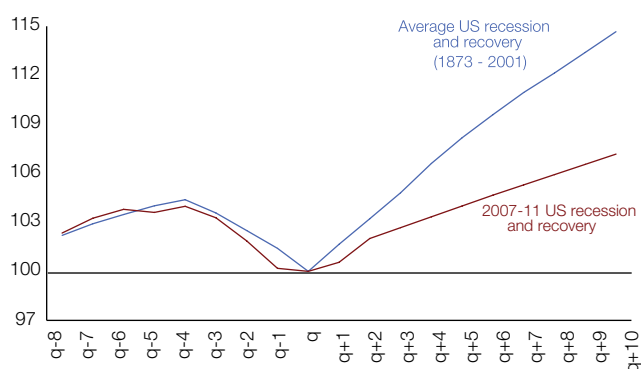
The outlook for the northern hemisphere is quite subdued due to the over-extension of balance sheets in the household and government sectors. Government debt is likely to continue holding back the US economy for a prolonged period and in mid-March Moody's stated the US and UK governments had moved 'substantially closer to losing their AAA credit rating' as the cost of servicing this debt continued to rise. Indeed in 2010 the US will spend more on interest as a percentage of revenue than any other country other than the UK. This is one reason why US bond yields have been rising and are now above some corporate yields. For example, corporate debt issued by Procter & Gamble Co., Johnson & Johnson and Warren Buffett's Berkshire Hathaway is now yielding less than US government debt with equivalent maturity. That is, the bond market believes that it is safer to lend to Warren Buffett than Barack Obama (despite his almost infinite ability to earn tax revenue).

A weak US recovery

Governments need to balance reducing their debt burden without having a detrimental impact on growth (like occurred in 1937 and produced a very nasty recession). More recently, the US economy has been strong with growth of 6% recorded in the December 2009 quarter. However, this pace is unlikely to be sustained as it was driven by temporary factors (fiscal spending and dynamics of the inventory cycle), the impact of which will fade reasonably quickly. Growth is likely to progressively return to a 2% pace by the end of 2010. Forecasts for the US economy out to 2011 by the International Monetary Fund indicate that the impending recovery is likely to be the 19th weakest out of the last 21 downturns (dating back to 1873). Accordingly, the pace of the recovery in the next two years is forecast to be around half the pace of the typical recovery (see Chart 3).

Chart 3: The third weakest US economic recovery since 1873

Economic Performance Around US Recessions
Recessions are rebased to 100 at their respective troughs



Source: US Bureau of Economic Analysis and International Monetary Fund as at 31 January 2010. The Great Depression is excluded from this analysis because of its extreme result impacting the overall average.

... but an above-trend earnings recovery?

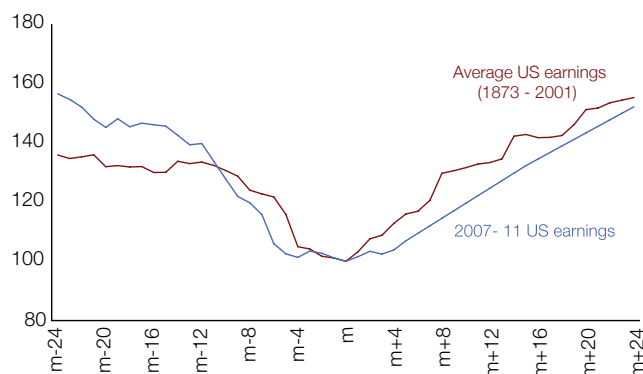
Despite the sub-trend US economic recovery, markets remain optimistic about the earnings outlook. At present market consensus expects a recovery (excluding the impact of asset writedowns) almost in line with the historical average (see Chart 4). This forecast recovery is the strongest since World War 2 and stronger than the aftermath of the recessions in 1949, 1954, 1958, 1960, 1969/70, 1973/75, 1980, 1982/83, 1990/91 and 2001, even though the current economic recovery is weaker relative to most of these periods. In fact, the 52% consensus rebound in corporate earnings out to 2011 is the sixth best rebound of the past 21 earnings recessions.

In the wake of a subdued economic climate, the anticipated growth in earnings only appears possible if there is a major rise in US productivity. However, this seems unlikely considering there are few efficiency gains left in the labour market (given the already

widespread corporate cost-cutting) and tighter lending standards are likely to limit growth in non-labour productivity. Consequently, if the economic recoveries in the advanced economies are subdued, it could frustrate investors who are expecting a stronger earnings rebound, particularly if higher bond yields negatively impact share prices. Accordingly, the typical listed company will need solid revenue growth to meet analyst forecasts and any disappointment would likely represent a drag on market sentiment. Market returns may be more modest going forward and a multi-year bull market is unlikely to develop.

Chart 4: The sixth best earnings recovery since 1873

Earnings Around US Recessions
Recessions are rebased to 100 at their respective troughs



Source: US Bureau of Economic Analysis and UBS Australia Limited as at 28 February 2010. The Great Depression is excluded from this analysis because of its extreme result impacting the overall average.

Implications for investors

Although there are growing risks, the outlook for the Southern Hemisphere economies remains stronger than that of its Northern peers. Like Jen in *Crouching Tiger, Hidden Dragon*, investors need to determine their strategy and where the risk and returns are accessible in the investment landscape. The outlook for the Asian and Australian economies remains relatively stronger and this could prompt another significant rise in domestic share prices, when the strength of the economy becomes more visible in H2 2010.

Importantly, the US sharemarket seems to be 'priced for perfection' even though its economic recovery is set to be one of the weakest since 1873. In this environment investors should consider realigning their portfolio risk and invest conservatively to receive full compensation for bearing risk in companies with sustainable business models, low earnings risk, reliable dividend income and a strong balance sheet. This would mean that investors would have access to any market upside, with downside protection should things temporarily take a turn for the worse.

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