Perpetual

Perspective

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'Houston, do we have a problem?'

After reaching 18 month highs in mid-April, global sharemarkets have hit several major headwinds which have driven all international sharemarkets lower. Matthew Sherwood, Perpetual's Head of Investment Market Research examines these issues and concludes that markets will have to factor in a slowing in Chinese growth and sustained elevated sovereign debt stress in the Northern Hemisphere into their market outlook.

Introduction

Apollo 13 is one of the more memorable films of the past 15 years. The movie was made in 1995 and dramatizes the unsuccessful lunar mission of the same name in April 1970. This film earned critical acclaim for its accurate portrayal of the events of NASA's third lunar mission and was nominated for nine Oscars. In the movie the line *'Houston, we have a problem'* gained much notoriety and ten years later it was ranked the 50th most memorable movie quote in history by the American Film Institute. The statement was originally used by the astronauts to report a life-threatening fault to Mission Control, but nowadays is humorously used to highlight any kind of problem. Over the past month, the global financial markets have had many problems and also much good news, but investors have focused on the former and dragged down market sentiment and share prices.

The good news

The global economy is recovering strongly - global industrial production is currently running at 12% per annum. With consumer spending improving, firms are using the opportunity to rebuild inventories from depleted levels. The rise in consumer spending in the US has boosted the recovery in the manufacturing sector which has subsequently spread to the broader US economy. Meanwhile, households appear to be deleveraging, which creates room for future spending growth when their balance sheet issues eventually stabilise. Elsewhere, businesses remain in a position to lift spending following large capital raisings and high profits over the past 12 months (driven by higher productivity), which have significantly boosted internal cashflow.

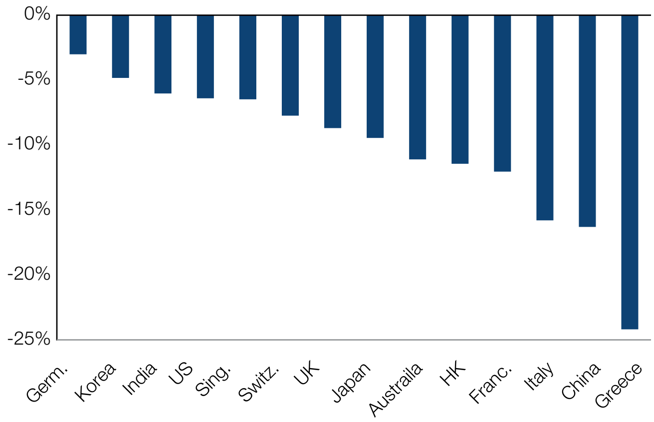
… but investors are focused on the headwinds

Investor sentiment has deteriorated over the past month. Events including European debt concerns, a potential slowing in China, rising geopolitical risk in Thailand and debate over the resources rent tax have driven shares down. However, markets have been discerning, with the pace of decline led by European markets where sovereign stress is the most significant (see Chart 1).

1. European debt crisis

Over the past month, markets have been focused on the economic and financial market consequences of Greece's sovereign debt problems and the possibility of contagion into other highly indebted members of the European Union (including Portugal, Spain, Ireland and Italy). Contagion did appear to be taking hold particularly when countries like Spain (who has a much lower government deficit and debt than Greece) entered market considerations. Contagion in financial markets is a state of mind and is not necessarily a rational thing.

Chart 1: Asian and highly indebted markets have led the decline
Sharemarket decline From April 2010 (%)



Source: IRESS as at 18 May 2010.

Could this crisis be Lehman Mark II?

There are two parts to the European Crisis, liquidity and default. The European Central Bank and International Monetary Fund have conjured a €750 billion stabilisation package designed to address both of these issues by providing accessible facilities for the next three years for the highly indebted economies should the rollover of debt maturities become troublesome in markets. Hence this is unlikely to turn into another global financial crisis as the global economy (outside Europe) is expanding, interest rates are at record lows and the debt involved in the Club Med economies is actually modest relative to the US housing market.

Investors are yet to be convinced that enough has been done in the European crisis. Europe is a liquidity crisis whereas Lehman's was a solvency crisis during which around 30 major global financial institutions were nationalised in the space of 40 days and it took another 140 days before the US Government came up with a solution which calmed market sentiment. The European authorities appear to be getting ahead of the problem much earlier than the US did.

The rescue package is baling water, but not getting the boat to shore

While the stabilisation package addresses the rollover risk of highly indebted economies until 2013, it does not solve the lack of competitiveness of the Greek economy, where costs of production are 50% higher than in Germany. This is why Greece's government debt is forecast to rise to 150% of economic activity in 2013 (Source International Monetary Fund). This suggests that the Greeks would need to receive Japan-type funding costs (around 1%) to stave off eventual default.

Austerity measures have led to social unrest

The Greek Government has faced major resistance to policy changes such as cuts to public servant benefits (who represent 40% of the workforce) and lifting the retirement age to 61 (from the current 57). It also recently announced that even illegal construction activity will be taxed (sounds a bit like jailing Al Capone for tax evasion in the 1930s). Despite these measures, the Greek economy will require perpetual assistance. Australia had an uncompetitive economy in the late 1970s and 1980s and benefited from a large currency depreciation in the mid-1980s, which lowered the price of our exports in foreign currency terms and enabled economic reforms to be undertaken without destroying growth or employment. Greece's and its Club Med peers inability to depreciate their currency or enact an independent monetary policy (or both) at a time of national crisis has exposed the flaws in the European Union.

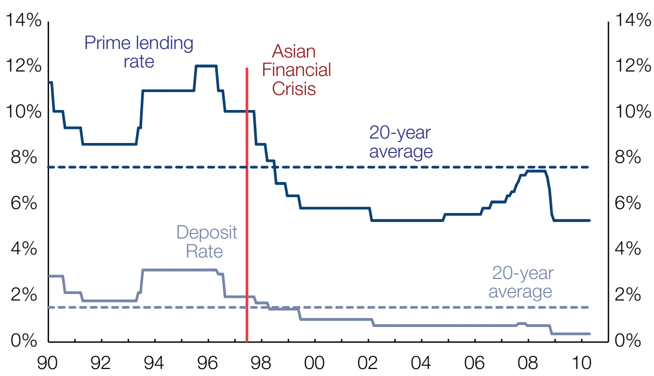
Regional governments have found that implementing austerity measures is difficult politically. Nonetheless, the damage of the European debt crisis has been contained to Europe and as such the current crisis is looking more like the Asian Crisis of 1997 (where some sharemarkets is South East Asia declined by around 50%-60%) than Lehman's Mark II. The debt crisis has raised doubts about Europe's strength and has softened the Euro. However, this has also raised the prospects for several exporting countries in the region. Is it any wonder that the leader of the world's largest exporter (German Chancellor Angela Merkel) is talking down the Euro with statements like, "... the Euro is in danger". Nonetheless, European growth will remain subdued for many years and there is little doubt that high western leverage will not end pleasantly.

2. China

China has been artificially inflated since 1997

Europe and the US are not the only economies which are likely to experience softer growth. China is in the same boat, but for different reasons. China has grown its economy at 10% per annum for the past 10, 20 and 30 years. While this is very impressive, its economy has been artificially inflated since the 1997 Asian financial crisis by interest rates been kept extremely and deliberately low (see Chart 2). This cannot continue as these low rates have led to sharp spikes in property prices and inflation and an unsustainable surge in investment.

Chart 2: Chinese interest rates – less than their 20-year average for more than a decade
Chinese Interest Rates (%)



Source: Datastream as at 30 April 2010.

Inflation and property prices have spiked

The Chinese Government risks rising social unrest unless it reduces the growth pressures on its economy as ordinary workers in the big cities are struggling to keep up with the soaring cost of living and are demanding higher wages. Meanwhile, Chinese property prices have surged over the past six years and the Chinese government is trying to boost supply to ease price pressures. But if growth suddenly turns negative it could cripple the fragile Chinese financial system given the USD 1 trillion worth of bank loans to the financing arms of local government authorities. These vehicles need rising property prices to contain solvency issues and it is an extremely delicate balancing act to take the heat out of the Chinese property market without causing enormous turmoil in the Chinese financial system.

... and investment growth needs to slow down

Elsewhere, Chinese investment is simply growing too fast and the Chinese Government has acknowledged this needs to moderate. Investment is around half of Chinese economic growth relative to 18% in Australia and 8% in the US. If the Chinese economy is to reduce investment's contribution to growth, it could slow iron ore consumption and hurt mining exporters including Australia and

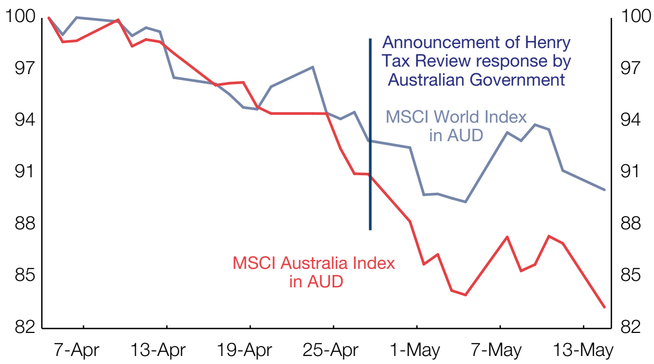
Brazil. Australia is not a play on Chinese growth, but is a play on Chinese investment given its high steel intensity and this is likely to slow in the period ahead. Clearly, such a slowdown is not in Australia's interest.

3. Resources rent tax

The primary focus of the government response to the Henry Tax Review has been the super-profits tax on the mining sector, which market analysts have estimated would reduce the value of the mining sector by around 8%-15% (including the impact of a lower corporate tax rate) if fully implemented. Lower profits would naturally lead to lower investment (as much of mining's investment is funded out of retained earnings) and reduced dividend income for investors. This is most likely why Australian metals and mining stocks have experienced a larger decline than their global peers, since the policy announcement (see Chart 3). Rarely has a government announcement had such a detrimental impact on shareholder wealth.

Chart 3: Australian metals and mining stocks have recently underperformed

Metals and Mining Sectors in Australian Dollar Terms
(Indices rebased, April 7 = 100)



Source: UBS Australia Limited as at 20 May 2010.

The proposed arrangements would place the total tax paid by Australian mining companies at around 57% (see worked example in Table 1), which is well in excess of the total taxes paid in other mining-based economies including Canada (23%), Chile (26%), China (30%), Peru (32%), South Africa (33%), Brazil (38%) and the US (40%). This will make it more attractive for all mining companies to invest (in capital and labour) overseas and is likely to reduce investment in Australian-based projects.

Meanwhile, with the Australian Government agreeing to provide tax credits to loss making mining investment, all Australian tax payers are acting as guarantors for global and domestic mining companies. This will lead to increased speculative investments at the higher-risk end of the mining industry. Consequently, if China experienced a major economic shock, Australian fiscal policy would experience wider volatility in its Budget balance in that revenue would be lower (as per normal) but expenses would be higher (than would currently be the case) as the government would have to make large cash payments to loss-making mining investments.

Table 1: The new system will increase the tax burden on resource companies

	Current system	Proposed system
Revenue	$100	$100
Expenses	$50	$50
Royalties	$5	NA
EBITDA	$45	$50
Depreciation	$3 (6% of EBITDA)	$3 (6% of EBITDA)
Resource super profit	NA	$47
RSPT	NA	$18.8 ($47 x 40%)
EBIT	$42	$28.2
Tax	$12.6 (30% x EBIT)	$7.90 (28% x EBIT)
NPAT	$29.4	$20.4
Tax rate	42%	57%

Source: ANZ as at 19 May 2010. EBITDA is earnings before interest, tax, depreciation and amortisation, RSPT is Resource Super Profit Tax, EBIT is earnings before interest and tax, NPAT is net profit after tax.

Implications for investors

Tom Hanks could say *'Investors, we have some problems'* as growth in Europe, the US and China is likely to moderate. While analysts tend to label every major global headwind as 'unprecedented', it has been this way for many decades. Despite things appearing dire during events like the two oil shocks in the 1970s, the global recessions of 1980, 1991 and 2001, the 1997 Asian financial crisis and the GFC in 2008, all the crises ended, growth resumed and sharemarkets recovered. The Northern Hemisphere debt crisis is an issue that will plague markets for years to come and is likely to restrict growth in Europe, the US and Japan. Meanwhile, a moderation in Chinese growth is likely to have investors nervous for a time and needs to be factored into market expectations. Nevertheless, the long-term rationale for remaining in shares is intact at present; global economic growth is solid, earnings growth is recovering, interest rates are low and valuations appear to be attractive.

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