

QEII could turn into the Titanic



The US economy has been out of recession for over a year, but the US Federal Reserve is still discussing the adoption of a second round of quantitative easing to stimulate growth. Matthew Sherwood, Perpetual's Head of Investment Market Research examines this and concludes that this is likely to have little impact given the issues in the household and government sectors and that strong corporations are likely to experience a surge in merger and acquisition activity.

Key takeouts:

- There is no need for a second round of quantitative easing in the US
- High corporate free cashflow is likely to underpin a rise in merger and acquisition activity
- Dividend income offers a reliable source of return, with potential tax advantages as well
- Dividend income growth is much less volatile than share price growth

Introduction

You could half-fill the Melbourne Cricket Ground with market analysts who have written some time in their careers something like, *'the movement in US rates, sets the scene for a similar policy adjustment by the Reserve Bank of Australia (RBA)'*. Such a statement did not suggest that the US Federal Reserve (the Fed) sets Australian interest rates, but rather that the Australian and US economies have been highly correlated since the end of World War Two. However, with the industrialisation of Asia supporting Australian exports and negatively impacting the US's trade balance, this correlation has diminished over the past five years.

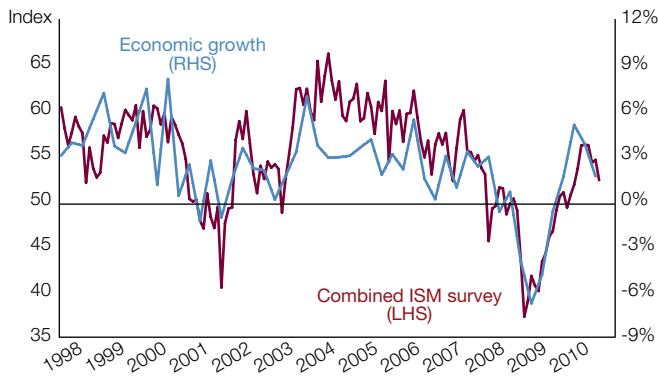
Central banks are moving in opposite directions

The RBA has increased official interest rates six times since the early-2009 economic trough, whereas US rates have been on hold at record lows as far as the eye can see. The Fed is considering another round of monetary stimulus to support the anaemic (but positive) US recovery. This is surprising as the US economy has been out of recession for 15 months and recent data has been notably better-than-expected. In particular, retail sales (up 0.4% in August) have confirmed that consumer spending is resilient (although not growing briskly), the Manufacturing ISM and non-manufacturing ISM surveys (at 56 and 52, respectively) continue to suggest the US economy's outlook is positive (but certainly not bullish – Chart 1).

US trend growth has declined to around 2¼%-2½%

Although recent data has been better than expected, structurally higher unemployment, waning consumer confidence and a weak housing market have prompted fears of a renewed US economic downturn. It is hard to determine what would drive this given that nearly all the cyclical parts of the US economy are already beaten down and population growth remains solid. Nevertheless, markets appear concerned about the deteriorating momentum in the recovery despite unprecedented policy stimulus (interest rates cut to historic lows and Budgets balances at non-war highs). However, US officials need to realise that US growth is unlikely to return to 4% for a prolonged period, given the debt levels of the household and government sectors (which contribute around 80% of US activity) both of which need to achieve lower spending growth going forward. Accordingly, trend growth in the US economy is well down from its 3.5% average between 1950 and 2007 and appears closer to around 2¼%-2½%.

Chart 1: the US outlook is for modest, but positive growth
Combined ISM Survey and Annualised US Economic Growth



Source: US Institute of Supply Managers as at 31 August 2010.

The Fed thinks it needs to provide more stimulus

With US unemployment well above the level that the Fed likes to see and inflation at the low end of the unofficial target range (of 1.5% to 2%) some officials believe the Fed should act now to spur the recovery. However, it might be a case that growth won't improve a lot from here. Nonetheless, the Fed is considering another quantitative easing (dubbed QEII by the markets) where it will buy bonds and force bond yields down to stimulate investment (either business or housing or both). This would most likely prove futile as:

- US investment bottomed in December 2009 and has already recovered 5%.
- US corporates have no trouble raising capital to fund investment with August corporate bond issuance robust relative to the past couple of years.
- Firms already have excess capacity in their business models and can increase output to meet any rise in demand.
- There is a structural overhang in the US housing market.
- Housing investment is low due to negative equity and high unemployment and is not reflective of the price of credit.

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This suggests that there is no structural impediment to investment increasing further and supporting US growth, other than households and corporations have no desire to do it. As such any quantitative easing is likely to have only a slightly modest growth impact in the best case scenario. However, one would have to question the merit in such a decision, given it is unlikely to lift growth much and a higher money supply (which is what happens when the central bank purchases bonds) could facilitate rising inflation. If this eventuated, it could be the worst of all worlds – rising inflation prompting higher interest rates at a time when the US recovery remains fragile. Consequently, it will be very hard for the US to make a meaningful dent in its unemployment rate, which market analysts in the Wall Street Journal predict would have only declined to 9% by the end of 2011.

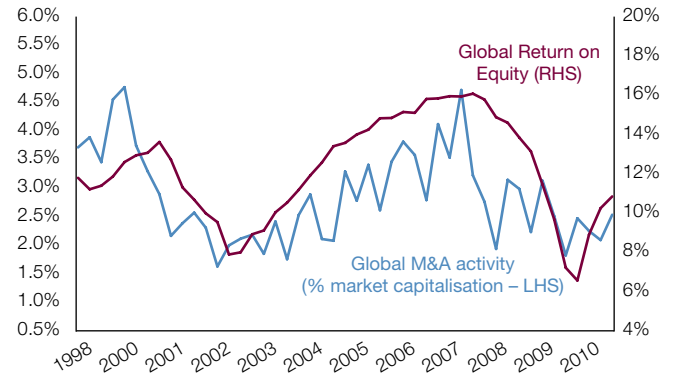
What can firms do with their surplus cashflow?

US corporate earnings have been very positive over the past year (considering the subdued economic environment), underpinned more by rising productivity, rather than top-line revenue growth, but what can corporations do with these funds? Basically, they have three alternatives; pay the earnings out as dividends to all investors, pay the earnings out to cash-hungry investors via a share buy-back (with other shareholders benefitting from higher future earnings per share and higher share prices) or use the money to fund merger & acquisition activity (M&A). Conditions for the latter seem quite ripe considering:

- Market share will be harder to grow organically in subdued economic conditions.
- Corporate earnings growth and returns have been strong and this has a strong correlation with M&A activity (see Chart 2).
- Firms are not using these funds to internally fund projects (investment seems to be replacing depreciated assets only).
- Funding is widely available (in both debt and equity markets).
- Valuations are cheap relative to the past 20 years.

Chart 2: Corporate activity is linked to profitability

Global M&A Activity and Earnings (%)



Source: UBS Australia Limited as at 25 September 2010.

Investors are likely to be rewarded for investing in income growing companies

Although increased M&A activity should support some company share prices, reduced spending growth in the household and government sectors is likely to place a ceiling on economic growth, and by association, earnings growth and investment returns. This is likely to create an environment where investors are not rewarded for taking big risks, but are rewarded for investing in companies that are more resilient to these trends and can deliver earnings and dividend growth. Capital gains in take-over targets are attractive, but income growth from sustainable business models is more reliable and more visible in companies that have strong balance sheets and are shareholder focused. These stocks will be key for investors going forward.

The Australian economy – back to and beyond trend

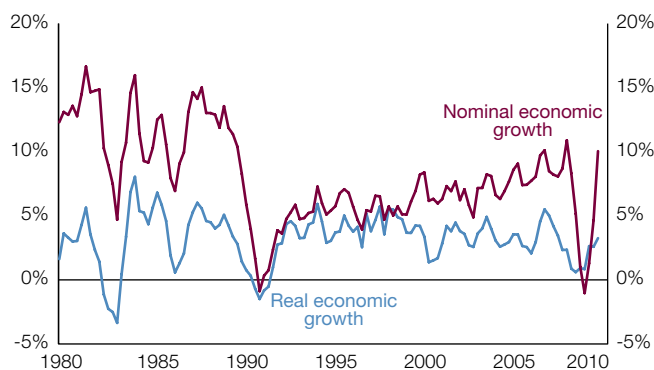
In contrast to an anaemic US economy, the outlook for the Australian economy is very strong. In fact, the Australian economy is already growing at its 30-year average of 3.2%, even though the big driver of growth in the next five years (namely, investment) is still detracting from growth. Australia is one of the highest investment-countries in the developed world, with the stock of physical capital having risen rapidly in recent years. Some analysts have stated that if China experiences a slowdown then investment could weaken. However, most of the resource investment going forward is in the energy sector, where firms invest for a decade-long cycle and are unlikely to be impacted by cyclical short-term trends which any China slowdown is likely to be.

Although real Australian economic growth is already back to trend, nominal economic growth (which has the largest impact on listed corporate earnings growth as both are nominal concepts) is already growing well above its 30-year average (10.0% as at 30 June 2010 relative to an 8.0% average since 1980 – see Chart 3) and shows no sign of slowing at present. Nominal GDP is growing near a 20-year high driven by increased commodity prices, whereas the higher nominal growth in the 1980s, was driven by increased inflation.

A strong consumer – is this surprising?

If past experience is any guide, resources sector growth will have positive effects on other industries and rising real incomes will increase demand in the non-resource sector as was the case in 2006/07. One of the notable contributors to recent domestic growth has been the strength of the consumer and this has surprised many analysts. However, it is hard to understand why this is the case considering that since the labour market trough in June 2009, 367,000 jobs have been created (a rise of 3.4% – most of which have been full-time), average hours worked have risen 3.7% and average weekly earnings have risen by 3.8%, all of which have supported consumer spending. These growth rates reflected the spare capacity in the labour market, a lot of which has now been utilised.

Chart 3: The nominal Australian economy is at a 20-year high
Annual Australian Economic Growth (%)



Source: RBA Bulletin Table G11 as at 24th September 2010.

Australia cannot withstand a strong consumer and corporate sector – rates to rise

Given that there is little spare capacity in the Australian labour market, the risk of upward pressure on inflation would be amplified if both investment and consumption were to be both growing at an above-trend pace. Indeed with the investment boom and expected rise in export earnings, the household sector will need to soften to make way for these booming sectors. This means that the RBA will be required to raise interest rates significantly in the next year to offset the income gains that are likely considering the very tight labour market, solid corporate earnings growth, below-inflation wages growth for many workers and the labour share of economic activity being low. At present interest rate settings, the RBA is still stimulating the economy at a time it does not need to and the Bank probably needs to raise rates by another 100 basis points to constrain consumer spending.

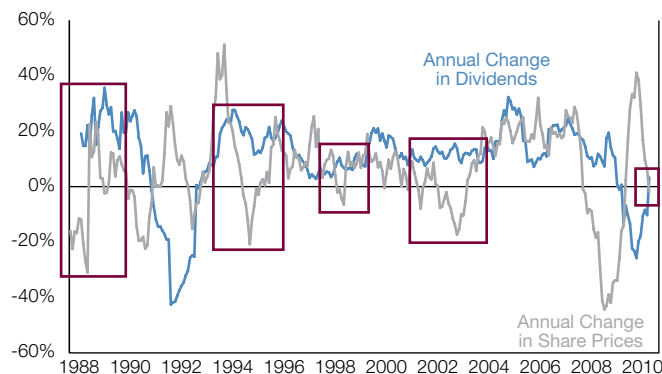
Income is more reliable than capital gains.

Even though Australia's economic outlook is very robust, Australian investors will not be immune to what is happening globally in relation to increased contribution from income and will have to invest accordingly. Dividends contributed a much lower portion

to total return since financial market deregulation in 1983 (32% of total return) relative to the 100 years before that (56% of total return) even though the overall return was almost the same (at 12%-13% per annum). However, in the new environment income growth will not only be very important from a return perspective, but also from a risk perspective. Indeed, looking at trends over the past 25 years, there has been seven occasions when annual share price growth in Australia has been negative. However, on five of these occasions (in 1987/88, 1994/95, 1998, 2002/03 and August 2010), listed companies increased their dividend income and partially (or entirely in some cases) offset the capital losses (see Chart 4). This is why income is very important to domestic investors.

Chart 4: Share price growth is much more volatile than dividend growth

Annual Change in Dividend Payments and Share Prices (%)



Sources: UBS Australia Limited and DataStream as at 31 August 2010.

Implications for investors

The outlook for the Australian and US economies are very different, given the positive impact of the emerging economies' industrialisation and the severity of government debt in the latter's case. Although US prospects are subdued relative to Australia at present there is little need for QEII as growth is positive and the price of credit is already low. As US growth appears set to be structurally lower, income is likely to become a significant contributor to total returns as was the case for the best part of 100 years. Although the emerging M&A boom is likely to underpin some large returns in a selective group of companies, income growth from sustainable business models is much easier to identify in companies with strong balance sheets that are shareholder focused. Australia's economic outlook is considerably brighter than the US's, but domestic investors are unlikely to avoid the global trends. This is not the new paradigm, but the old (pre-1983) paradigm and individuals need to invest accordingly.

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