

### Risks and recessions – finding the ‘value gaps’



Financial markets were more erratic in the first half of August than they have been at any time since the global financial crisis as concerns about government debt and global economic growth sparked large losses in global sharemarkets. Matt Sherwood, Perpetual's Head of Investment Market Research examines this volatility and finds that US, European and Japanese growth could remain below their historic average for an extended period and that the key for investors is avoiding the 'value traps' and extracting the 'value gaps'.

#### Key takeouts:

- Investors have bought gold and Swiss Francs as safe havens, but these appear to be very crowded positions.
- The primary macro risk is that the combined output growth from the US, Europe and Japan (which represents 58% of global output) could remain low for several years.
- Australia needs to either take significant action to lift productivity or be willing to accept a lower rate of economic and earnings growth and investment returns.
- Despite the market decline, wise investors can find reasonable value in strong business models that are surplus cash flow generators.

#### Introduction

Investors have experienced a roller coaster ride over the past four weeks. The market downturn was initially sparked by US growth revisions, which showed the downturn during the GFC (-5.1%) was larger than initially estimated and that the recovery has been weaker with US (and European) output now equivalent to what was produced in September 2007. After this, global data came in weaker than expected, with some investors fearing that the global economy was heading into a double-dip recession and that the global financial system might require large-scale surgery by the European and US authorities. The latter concerns were sparked by Italy's and Spain's government debt and expectations that they would need to be bailed out by the European Central Bank and the International Monetary Fund – even though the current European Financial Stability Facility (EFSF) rescue package could not materially support either of these countries, let alone both of them.

#### Ratings downgrades will be part of the investment landscape in the next few years

Italy and Spain were 'too big to fail' but 'too big to bail'. When the ECB began to purchase Italian and Spanish debt and forced yields down to reduce government borrowing pressures, market concerns about debt centred on France and the US (after its government debt was officially downgraded for the first time, with risks of a further downgrade in the next two years). Unfortunately, ratings downgrades from AAA levels (and indeed other levels) may very well be part of the investment landscape in the next few years as France's and the UK's net government debt to GDP ratio is forecast to be around the same level as the US in 2015 (80% of GDP).

#### How safe are the safe-havens?

Although foreign exchange and bond markets were reasonably stable during the recent volatility, investors have not bought bonds as they traditionally would. Investors have been seeking safe-haven alternatives, either because bonds are very expensive (yields are historically low) or investors believe governments don't have the capacity to fix their balance sheet stress, at least, in the short-term. The latter seems more likely as the assets investors have bought as safe havens (namely, gold and Swiss Francs) now are very crowded trades and appear (at least) to be fully valued relative to their fundamentals (the gold price is near an all-time high in both real and nominal terms). Importantly, there is a risk that when the global situation stabilises these prices could decline and investors will need to time their exits well.

## Investment risks are centred on economic growth and costs

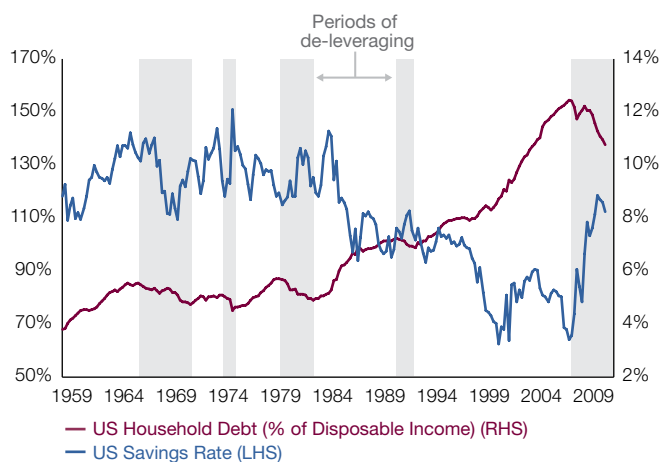
Investors have to ponder their sharemarket exposure in an environment where share prices are much lower, but macro risks are materially higher. The primary macro risk is that advanced economy growth will be significantly below trend due to the unwinding of a 25-year leverage and asset price boom. This leverage rise was primarily used to purchase existing assets (housing and shares) and prompted higher asset prices, which supported economic growth more so than drove it. However, households are now in the process of lowering their consumption growth and increasing their savings to unwind this multi-generational debt build up.

## Advanced economy growth will remain anaemic for an extended period

Higher savings will negatively impact economic growth as consumer spending is 50%-70% of an advanced economy's activity. The duration of previous household deleveraging cycles has been, on average, half of the length of the build-up (see Chart 1). This means that, if history is any guide, the build up between 1992 and 2008 could take just under nine years to unwind. During those previous deleveraging episodes, economic growth averaged just 1.5% (with slowdowns in household, business and government spending). Given this trend is evident in nearly every advanced economy, combined growth in the US, Europe and Japan (which represent 58% of global output) could remain low for a while and make reducing government debt somewhat harder.

### Chart 1: The US deleveraging process could go on for another five years

US Household Debt and Savings Rate



Source: UBS Australia Limited and DataStream as at 16 August 2011.

## ... and this leaves these economies highly exposed to shocks

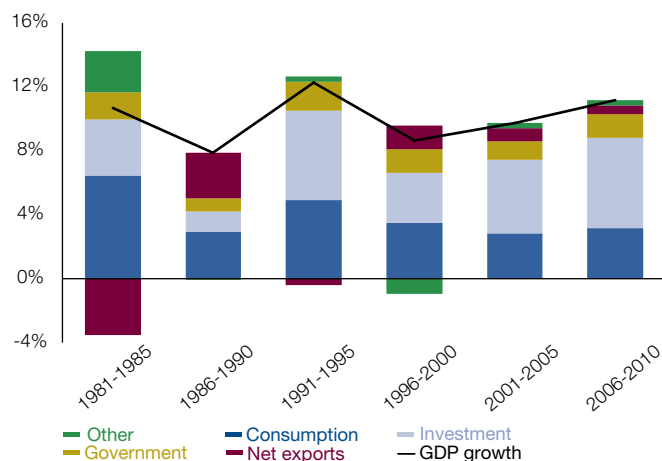
The risk of low growth turning into a recession may be higher than normal due to three factors that have not been seen for over half a century:

- As the debt problem is so wide-spread, it is not possible to achieve broad based currency realignments to stimulate export growth.
- Deleveraging sparks a 'liquidity trap' where household or business spending does not respond to changes in interest rates. This does not mean interest rates are irrelevant as the price of credit needs to be kept very low so households can make larger principal reductions and reduce the duration of the deleveraging cycle.
- Concerns about government balance sheets have forced a period of fiscal tightening at a time when the growth outlook is anaemic, and would normally require more stimuli, not less.

Fiscal restraint is required on a medium-term view, but front-loading budget cuts risk tipping the developed world back into recession. These pressures could be amplified for countries that are net commodity consumers given the negative impact that rising food and energy prices has on consumer spending. However, the outlook for the Chinese economy still remains intact, as China's major trading partners are Asia (48% of total exports), relative to Europe (22%) and the US (18%), and net exports have been a minor contributor to Chinese economic growth over the past 30 years (see Chart 2).

### Chart 2: Net exports from China are a small contributor to its economic growth

Contributions to Chinese GDP Growth (5-year %pa)



Source: Macquarie Equities as at 18 August 2011.

## The RBA cutting rates may not be as certain as people think

Consequently, China's demand for raw materials will increase and countries like Australia and Canada are fortunate to have low government debt and being net producers of energy. The recent market turmoil and soft domestic economic data has sparked calls for domestic interest rates to be cut, despite inflation continuing to rise. The current nature of the market downturn, however, suggests that the RBA would not be concerned about declining share prices per se. The Bank is likely to need to see evidence that either wealth destruction has prompted a large decline in household and business confidence and spending, or lower corporate earnings have underpinned a reduction in investment and employment growth, before it reduces interest rates. With inflation continuing to rise, it would need to see this weakening for an extended period to force a rate cut. Indeed, unemployment would need to rise towards 6% for the RBA to consider reversing hikes made less than a year ago considering inflation is rising strongly and growth is likely to accelerate over the remainder of the year in response to Queensland reconstruction spending, higher coal exports and the start of the mining investment boom.

## Australia needs productivity improvements like never before

In Australia, cost pressures from higher prices for inputs and labour continue to rise. When this trend is combined with subdued top line revenue growth (in line with a soft domestic economy outside mining), what the Australian (and global) economy and sharemarket needs is a major rise in productivity to lift profits, economic growth without pushing up inflation.

## Lower productivity means that 3.5% wages growth can be inflationary

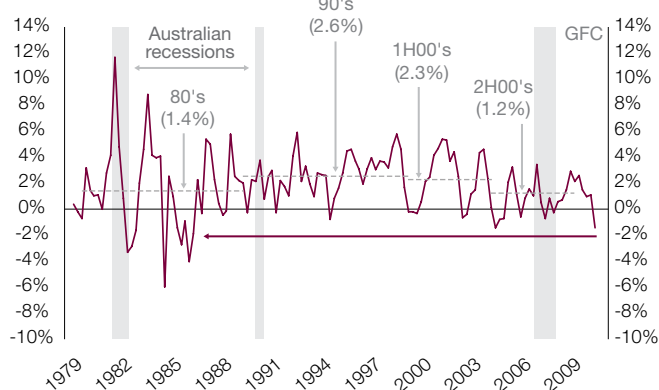
While it is normal to see productivity decline at the late stage of the global business cycle, what has been alarming is that Australia's productivity growth has worsened since the GFC.

At the end of 2010, it was worse than every other major developed and developing economy and is now (at -1.5% in March 2011) down to a 25-year low (see Chart 3). This reflects, among other things, the fading effects of reforms by the Hawke, Keating and Howard Governments and a lack of any new productivity-enhancing reforms since 2005. If productivity growth remains around 0%, then the wages growth that has been consistent with the RBA's inflation objective will decrease. The old rule was that 2.5% inflation plus 2% productivity growth enabled wages growth of up to 4.5%, however, if productivity remains around 0%, this could drop below 3%. This would mean that the current wages growth of 3.8% could place increased cost pressures on listed and unlisted companies. Consequently, Australia needs to take significant action to lift productivity or be willing to accept a lower rate of economic and earnings growth.

### Until then, income and yield are key

The absence of productivity improvements 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 in a difficult climate. Dividends have been a smaller contributor to total returns since 1983 (32% of total returns in Australia and an average of 34% in global markets) than they were in the 100 years prior to that (57%, 59%), even though overall returns were almost the same (around 12% per annum).

**Chart 3: Australia's productivity growth is at a 25 year low**  
Australian Productivity Growth (%)



Source: UBS Australia Limited as at 31 March 2011.

### Implications for investors

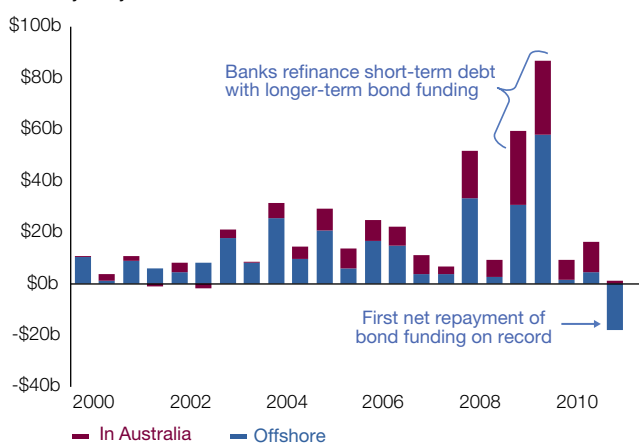
In the new environment income will not only be more important from a return perspective, but also from a risk perspective. Capital gains from large take-over targets can be more appealing to speculators, but income growth from sustainable business models is more reliable and more visible in companies that have strong balance sheets and are shareholder focused. These sort of stocks may very well be the key for investors going forward. Despite much of the Australian economy struggling outside of

mining, Telstra, Tabcorp, CSR and the banks are examples of high income stocks that should support investors in a low-return environment.

Telstra has been experiencing strong growth in its mobile business and, with good cost controls, it has produced strong free cash flow. The banks' results were on the whole solid, considering we are in almost the weakest credit growth environment in 60 years. Indeed, the first half of 2011 was the first time Aussie banks made net repayments of wholesale funding, with the bulk being for AUD18 billion of offshore issued bonds (see Chart 4). AUD9 billion of short-term funding was also repaid. This highlights how the banks have modest top line revenue growth, but can rejig their business operations and diversify their funding risks by using more deposits and longer-term bond funding, which helps them manage their net interest margins.

**Chart 4: Australian banks have returned bond funds for the first time ever**

Aussie Banks' Net Borrowing in Bond Markets (AUD bil)  
– Half yearly



Source: Merrill Lynch Australia and Reserve bank of Australia as at 15 August 2011.

Listed companies with consistency in cash flow generation, reliable dividend income growth and good management are likely to find favour with investors and should outperform in a more challenging trading environment. The key in previous cycles has been avoiding 'value traps' and taking advantage of 'value gaps'. This may require wisdom and patience, but these characteristics have always rewarded investors well in the long-run.

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For further information speak with your  
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