Perpetual

Perspective

October 2011

The Italian Job

Global sharemarkets have staged a partial recovery in response to resilient economic data and efforts by European authorities to address their debt issues. Matt Sherwood, Perpetual's Head of Investment Market Research, explains why the primary concern in Europe is Italy, not Greece, and with earnings growth key for markets, why industrial shares are paying out more of their earnings to bond and share investors, whereas resource companies are paying out less.

Key takeouts:

- With the European solution seemingly at hand, banks will need to find around 110 billion Euros to increase their Tier One capital back up to 9%. Some might reduce credit to reach this goal (rather than issue equity) and further weaken the fragile outlook.
- Italy is the primary concern as their government debt and economic output are around five times larger than that of Greece. The European authorities must ensure that Italy is completely funded as any market run on their debt will have a much larger market effect.
- Investors are increasingly turning to income, but term deposits are declining and are now yielding less than Australian corporate bonds and Australian shares.
- Since 2005, Australian operating profit has doubled. Non-resource share and bond holders are nowadays receiving a larger share of this total, whereas resource investors are receiving a smaller share as investment projects are increasingly internally funded.

Introduction

In 2003 a modern version of the 1969 movie *'The Italian Job'* was filmed and while it was not a total flop at the box office, it certainly did not capture the 'cult' following of its predecessor. The movie is about a plan to steal the payroll of the Turin-based automaker Fiat, and smuggle it out of Italy. The movie is famous for its ending, when the get-away bus (carrying a large amount of gold) veers off the road and ends up with its tail hanging off a cliff. The movie ends with Michael Caine saying one of best last lines in movies, *'lads I've got a plan'*, but the audience never finds out the plan and whether the robbers survive or go down with the gold as they've never made a sequel.

Crises everywhere – except the data…

Clearly movie making is not an exact science, and neither for that matter, is economics. In August, September and early October 2011 there was a plethora of view from experts that the global economic recovery was rapidly deteriorating. Crises were everywhere, and still are, according to some. Europe has a debt crisis. America has a jobless recovery crisis. Corporate profits could be in crises anytime soon. Indeed US Federal Reserve Chairman Ben Bernanke bluntly warned the US Congress in October 2011 that the US economic recovery *'is close to faltering'*.

Despite all the pessimism, all the weak sentiment and all the volatility, the only thing missing to support deteriorating sentiment about the economic outlook is the data to confirm it. Indeed economic data in the US, France and Germany has been much better than expected and is certainly not indicative of an economy (or economies) that are on the brink of recession. Importantly, the latest improvements in the economic data contrasts with the persistent pattern of bad news flow in 2008/09, as the global economy recorded its largest contraction in 65 years.

Are investors optimists or pessimists?

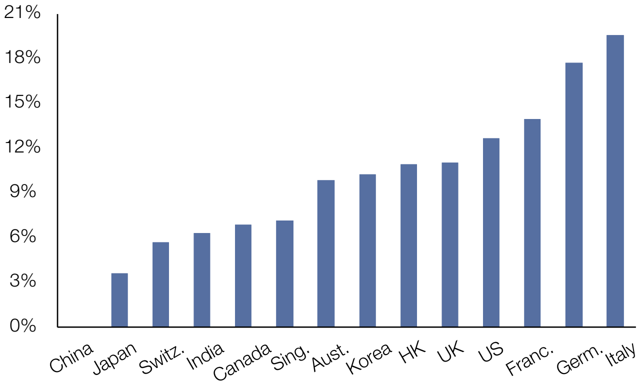
The better-than-expected data has been a springboard for global markets to recover in recent weeks, with the largest rises seen in the markets with the largest drop in August and September (see Chart 1). Some investors may view a recovery of 10%-15% since early October as evidence that the negative sentiment was overdone. Alternatively, some may view the recovery as a sign that optimism about Europe is overdone. The extent to who is right in the long-run is likely to be determined by whether the European 'rescue package' reduces government funding pressure and bank balance sheet pressure in a sustained way.

The European 'rescue package'

Three key themes have dominated the ongoing discussions among European authorities – Greece, bank recapitalisation and government bond market stabilisation. The plan to recapitalise Europe's banks seems to be completed. The details remain scant, but apparently, European banks will write 50% of their Greek government debt off their balance sheet. These write-offs are limited to the private sector and would reduce total Greek Government debt by about one-quarter. Consequently, the European banks will need to find around 110 billion Euros of new capital in the next nine months to increase their Tier One capital back up to 9%. Banks will first have to raise the money themselves in capital markets, if they can't, it then becomes the responsibility of the bank's national government to find the required funds and if this is not possible, then banks can turn to the European Fiscal Sustainability Fund (EFSF).

Chart 1: Global sharemarkets have partially recovered some of their losses

Investment Performance From October 2011 Trough (%)



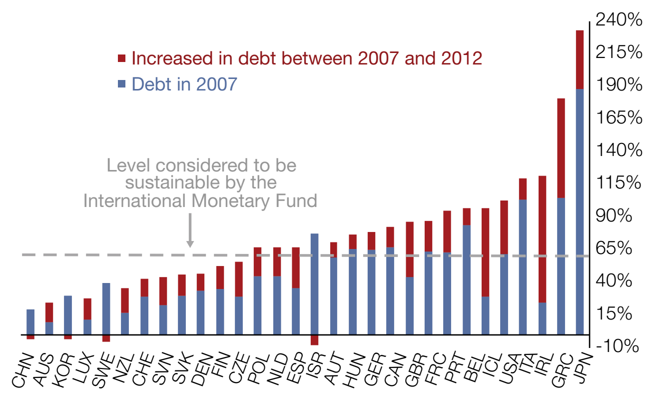
Source: IRESS as at 24 October 2011.

Greece may be the word, but is not the only problem

Recently it was revealed that Greece is well behind its reform process program and its Government's debt is expected to reach 181% of output in 2012 (before any debt write-off by banks). Accordingly, the rescue package sounds virtuous, but excess government debt is not a problem that is limited to Greece or Japan. Indeed of the 30 countries listed in Chart 2, 11 had government debt levels consider to be unsustainable by the International Monetary Fund at the end of 2007. By the end of 2012 the number of countries above this level will have risen to 18 and six of the seven recent additions are European.

Chart 2: Government debt has increased significantly since 2007

Gross Government Debt to Annual Economic Activity (%)



Source: International Monetary Fund as at 30 April 2011. Number for Greece for 2012 is latest forecast from the European Union as at 25 October 2011.

The Italian Job 2011 style

The surprising thing about the latest market rally is that the European package is solely focused on Greece. One word missing from this package is contagion. If Greece is somehow resolved, will markets forget about the debt issues of other countries such as Italy (forecast to be 120% of GDP at end-2012 and whose debt is five times larger than Greece), Belgium (109%), the USA (103%), Portugal (95%) and the UK and France (both 87%)? Although Greece is capturing all the headlines, its economy is small and the only risk from Greece is contagion.

Pressure is building in Italy

Greece is only a USD305 billion economy (as at end-2010) and total Chinese imports will increase by more than Greek GDP in 2011 and 2012. Given that annual Italian economic output (USD2.1 trillion as at end-2010) is six and a half times larger (than Greece's), it is far more important. Whatever they do now, the European authorities have to ensure that Italy is completely funded as its impact on any run on its debt on financial markets will be much larger. Indeed Italy is the third biggest European economy and the third largest bond market in the world (after the US and Japan) and with yields rising above 6%, pressure is building.

However, if the Italian government experiences funding pressures, the EFSF is not large enough to prevent any market run on Italy (or indeed Spain). Clearly the broader the solution, the better it will be for Europe and for markets.

Are there design flaws in the European package?

Although the bank recapitalisation (at around 110 billion Euros) is more than initial estimates, there appear to be two potential headwinds. Firstly, as banks have an extended time to restructure their balance sheet following the write-off and capital raisings are much more expensive when markets are depressed (in terms of their impact on earnings per share), it is likely that some banks may opt to reduce their lending, rather than issue more shares. This decision would further tighten credit conditions in an extremely fragile region and place more downward pressure on already anaemic growth prospects. Meanwhile, UBS recently highlighted that the European plan doesn't cover the capital needs of Spanish banks, who need a buffer of around 150 billion Euros against probable property-related credit losses. Consequently, the European bank recapitalisation plan may pose some headwinds for the recovery and may need more capital to help regional banks.

Will Europe drag the US down?

Although the US economy has been stronger than expected, investors are concerned that Europe will drag the US into recession. However, the US economy coped easily with Japan experiencing little growth over the past 20 years and there appears to be surprising strength in the US manufacturing and auto sectors reflecting currency trends and continued support from US authorities. In addition, corporate America is performing reasonably well and earnings results in the latest profit reporting season have been solid to date.

The earnings environment after 1983 was fuelled by leverage

Although markets have partially recovered, the earnings environment has completely changed. Over 25 years to 2008, above average earnings growth was driven by the largest leverage boom in history, where credit growth was averaging 15% (driving bank profits structurally higher), asset prices were rising, incomes were strong, regulation was declining. These factors were evident in North America, Europe and Asia. While rising leverage was the foundation for all these trends, each factors existence reinforced the others.

Despite the recovery, don't get carried away with the outlook

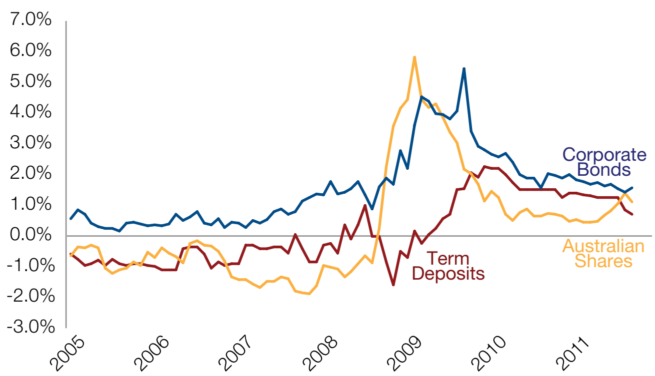
The keystone to this trend was rising leverage and asset prices. Eventually though, as is the case of all asset bubbles in history, the quality of bank lending began to deteriorate and over the past three years some of the leverage has unwound and earnings growth has slowed. Periods of deleveraging are characterised by lower economic growth, lower earnings growth, lower share price growth and increased contribution to investment returns from income.

Productive enterprise is yielding more than term deposits

Over the past two years, investors have been increasingly attracted to income as a way to reduce risk and boost returns. At the end of 2010, deposit rates (around 6.3%) were well above their five year and ten year averages (around 5.5%). This above-average result was driven by concerns from Ratings Agencies that bank funding was too dependent on global wholesale funding markets which can dry up quickly as seen during the GFC in 2008/09. Back then, 45% of bank funding came from deposits, now its 60%. However, with Australia's national savings rate at 12% and domestic credit growth currently only at 3%, banks have too much funds. Consequently, the premium that term deposits had over the RBA Target Cash Rate (1.4% at end 2010) has halved over the course of 2011. In contrast, the yield premium of shares has doubled over the same period and is well above its 10-year average (of 0.6% - see Chart 3) and is more than term deposits for the first time since the GFC, as are Australian corporate bonds.

Chart 3: Term deposits are yielding less than shares and corporate bonds

Yield Premium Relative to the RBA Target Cash Rate (%)



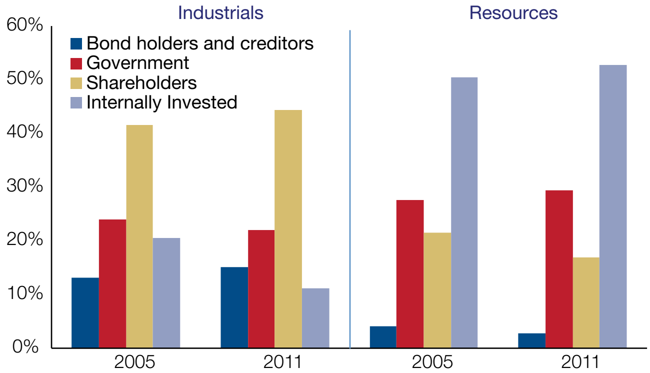
Source: UBS Australia Limited and Reserve Bank of Australia as at 26 October 2011. Corporate Bond premium is the yield of the UBS Australia Corporate Bond All Maturities Index.

Operating profit has almost doubled since 2005, but who is receiving more profit share?

The key to income payments and growth is earnings. Since 2005, operating profits (that is, profit before interest and tax) in the Australian sharemarket have doubled to AUD100 billion. Shareholders and bond holders are receiving a larger share of this profit pool, whereas governments and retained earnings have declined (see Chart 4). Industrial companies have clearly reduced their investment growth and increased their payout ratios to reward investors. Meanwhile, resources companies have had to fund more of their investment off their balance sheet, given heightened risk aversion and the global shortage of capital and have reduced their payout ratios to shareholders and bond holders as a result.

Chart 4: Industrial bondholders and shareholders are receiving a higher share of profits

Where are Australian Listed Operating Profits Going? (%)



Source: UBS Australia Limited. Industrials exclude the impact of the banking sector.

Implications for investors

The key question in this environment for investors is how to have exposure to productive enterprise and how to manage the risk of this exposure. Regardless of whether investors invest in equities, credit securities or other assets, the best defence against market volatility is 'quality'. Listed companies with a strong balance sheet, consistency in cash flow generation, reliable earnings growth are likely to outperform their peers with weak business models and weaker balance sheets. Although Australia's economic outlook is considerably brighter than Europe's or the US's, domestic investors are unlikely to avoid the global trends and markets will remain volatile in the period ahead. Income is one way to offset price volatility and its growing importance as a source of total return is not a new paradigm, but the old paradigm that had been the case for the 100 years before 1983.

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