

The global situation – what can policy makers and investors do?



The global situation has not improved as fears grow about an advanced economy recession and the state of the European financial system. Matt Sherwood, Perpetual's Head of Investment Market Research, indicates that the problem now is primarily a lack of confidence, and relevant authorities need to take action to demonstrate they are ahead of the problem. Meanwhile, investors need to ask if their 'search for yield' is enough to get them through these times.

Key takeouts:

- European authorities appear to be dithering about solutions, but Greece is likely to receive its next tranche of bailout support.
- The US Fed's 'Operation Twist' has done nothing to improve confidence as investors now know the problem is the impact of household deleveraging, not the price of money.
- Asia and Asian-related economies are well placed as they typically have significant policy stimulus left to use.
- Investors search for yield may not be enough as there has been an inverse relationship between an asset's yield and its income growth since 1983.

Introduction

The greatness of Ancient Greece is considered by historians to have begun with the date of the first Olympic Games in 776 BC and ended with the death of Alexander the Great in 323 BC. During his brief reign, Alexander's army subjugated the kingdoms of the Medes and Persians and with other conquered territories he conquered all the land stretching from Egypt and Greece in the west, to India in the east, within 13 years. Although Alexander's kingdom was divided into four regions after his death and eventually declined, Ancient Greek civilization has been highly influential on language, politics, educational systems, philosophy, art and architecture for the subsequent 2,300 years. Indeed, Ancient Greece is considered by most historians to be the foundational culture of present day western civilisation.

Modern day Greece is hardly something that Alexander would have envisaged

Between then and now, Greece has gone from controlling the known world, to the known world controlling most of it, following the total mismanagement of its government finances over the past decade. Greece is now a country which is more or less insolvent, as government revenue cannot maintain services and pay its debtors. For example, Michael Lewis, the author of *'Liar's Poker'*, detailed the state of the Greek railroad system in the magazine *Vanity Fair* and stated that the network had revenue of 100 million Euros per annum, but annual expenses of 700 million Euros. Indeed, as it turns out, it would be cheaper for the Greek government to put every rail commuter in a cab each day, take them to their destination and pay the bill than to continue running the rail network. There are similar stories in the Greek education system. This inefficiency has culminated in the Greek government now being completely dependent on global funds to remain functioning. This situation, and its flow on effects to the European financial system, has become a headwind for investor confidence worldwide.

Three broad problems

Currently, there are three broad problems that are negatively impacting global sharemarkets; the Northern hemisphere debt situation, heightened fears of financial system stress and weak growth in the advanced economies (with rising inflation) due to broad-based deleveraging by households and governments. Accordingly, the International Monetary Fund has cut its global growth forecasts for 2011 and 2012 (by 0.3% and 0.5% to 4.0% and 4.0%, respectively). The emerging Asian region is forecast to grow a rapid 8%, whereas the growth slowdown is centred in the advanced economies (led by the US and Europe). Indeed two

French banks were downgraded over the past month due to their weak growth profiles and debt exposures in stressed European economies and China has banned foreign exchange futures and swaps with France's banks, most probably due to elevated counterparty risk.

French and German leaders (Sarkozy and Merkel) have stated that Greece will definitely remain part of the Euro, but this was probably a case of telling markets what they want to hear rather than telling them what's likely to happen. They did not say that Greece won't default or that there won't be a major restructure of Greek debt, as a significant amount of the debt of Greece, Portugal and Ireland will have to be written off, with creditors (namely, the European banks, wearing the write-downs on their balance sheets with several probably having to be partly nationalised) wearing the impact.

Periphery Europe's problems are spreading into the larger economies

With the Greek economy in a sizable downturn and with the Greek banking system continuing to lose deposits, many consider debt default as inevitable. This view is reinforced by statements that Greece is 'exhausted' from the reform process when a lot more reforms need to be undertaken and the increased European hostility of using tax payer's funds to finance bailouts. Nevertheless, Greece is not the main concern as its economy is about the same size as the state of Victoria and its bond market is not overly large. Indeed, European banks only have 4% of their tier one capital exposed to the debt of Greece, Ireland and Portugal (see Table 1), whereas 60% of their capital is exposed to the debt of Spain, Belgium and Italy. These six countries have around €3.5 trillion of bonds on issue, 14% of which is held by the banks listed below and by far the biggest exposure is to Italy, whose credit rating has just been cut by Standard and Poor's.

Table 1: European banks net exposure to stressed sovereign debt (% Tier One capital)

| Bank | Portugal, Ireland, Greece | Spain, Italy, Belgium | Total |
|-----------------|---------------------------|-----------------------|-------|
| St. Chartered | 0% | 0% | 0% |
| Lloyds | 0% | 0% | 0% |
| Credit Suisse | 0% | 2% | 2% |
| UBS | 1% | 7% | 7% |
| HSBC | 2% | 6% | 7% |
| Deutsche | 5% | 13% | 18% |
| Barclays | 3% | 31% | 35% |
| Soc Gen | 9% | 29% | 38% |
| Credit Agricole | 4% | 40% | 44% |
| ING Bank | 4% | 50% | 54% |
| Commerzbank | 16% | 64% | 80% |
| Santander | 7% | 80% | 87% |
| BNP | 10% | 78% | 89% |
| Bankinter | 0% | 100% | 100% |
| UniCredit | 1% | 100% | 102% |
| Banco Popular | 7% | 96% | 103% |
| Others | 3% | >160% | >160% |
| Aggregate | 4% | 60% | 64% |

Source: RBS as at September 2011.

European authorities only have two options

Given the current state of things in Europe, the regional authorities have two options on what to do. They can either continue on the current path where austerity measures are producing a severe recession and driving a worsening in the Greek Budget Balance, or they can partially write the debt off and restructure it. The main function for the authorities is to inspire broad-based confidence and the first potential solution is what is currently happening which is like trying to put out a fire by smothering it in paper.

Europe needs a debt restructure

The key question for policy makers regarding the second option is 'what do we need to do to underpin an orderly restructuring of debt in the stressed markets'. This question would require a substantial write-down of stressed debt (in Portugal, Greece, Ireland and so on), a refinancing of existing debt to an extended term, capital injections into the European banking system, an extension of the deadlines for repayment of coupons on existing debt and a lowering of the interest rate (including the coupons). In exchange for this, the stressed debt governments would have to agree to permanent widespread austerity measures and limitation on future deficits.

... but the process need not be disorderly

The market reaction to this will depend on how well the European authorities handle the situation, but the process need not be disorderly. However, it is important to keep in mind that the total European government bond holdings with European banks would lead to some institutions being partly nationalised. However, these developments might also give investors comfort that the authorities are finally getting ahead of the problem, rather than simply reacting to it. This may well inspire investor confidence that the crisis will eventually end – at the moment the European authorities seem to be dithering and telling the population that policies which are clearly not working, are likely to continue.

US monetary policy is impotent, but still important

There is little doubt that over the past month, tier one economic data in the US has been 'less-bad' than what the market has expected. However, the past two attempts of US authorities to improve growth prospects have not worked. Indeed President Obama's jobs package and the US Fed's 'Operation Twist' (to flatten the US yield curve by buying long-dated assets and selling short-dated assets) have prompted sell offs in the risk markets. Why? Because even if you lower interest rates, US households still do not want to borrow, and credit demand has declined.

It appears that US monetary policy is now exhausted as investors have seen rates drop to 0%, have had two subsequent rounds of quantitative easing, and now a process to flatten the yield curve, yet growth and confidence remain anaemic. However, monetary policy is still very important as keeping interest rates low means households can accelerate principal repayments and reduce their debt much faster. Accordingly, monetary policy's job is not to support growth in the short-term, but to support growth in the long-term and shorten the duration of the deleveraging process.

The US needs an urgent fiscal circuit breaker

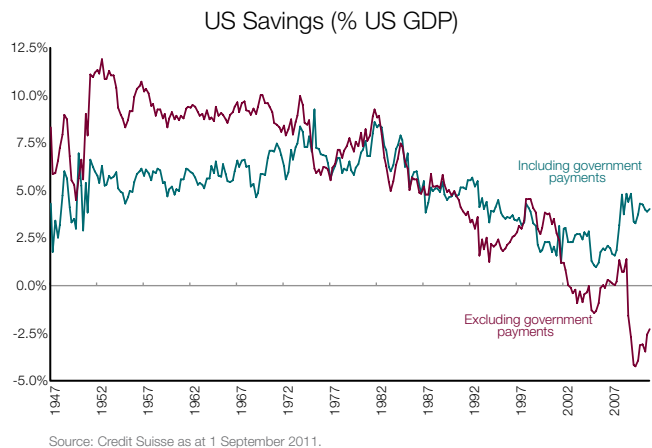
Consequently, the issue of supporting US growth in the short term becomes a political one. That is, the US needs a circuit breaker from the Government to support spending. One significant problem for the US is that rates are low, but house prices keep declining, and a significant amount of households are sitting on negative equity. As such, these people cannot take advantage of lower rates by refinancing their mortgage. If this were somehow to be allowed, then consumer confidence could rise. One other issue is that the US savings rate may be around a 20-year high, but it has been entirely funded by the US Government (see Chart 1) and one has to wonder how much longer the Obama Administration can continue to borrow funds from global investors and the US Federal Reserve to fund the US consumer.

The trade impact of the northern hemisphere's problems on Australia will be modest.

The direct trade impact from the northern hemisphere situation on the Australian economy is likely to be minor. Although the US and Europe have historically been our major trading partners, our exposure to these regions has progressively been declining

over the past 20 years from around 15% in 1990 to 8% now (see Chart 2). Australia's trade base is now dominated by Asian economies and this means that the Australian economy should continue to benefit from the 'fast lane' of global growth. However, global events can certainly still impact Australia through its effect on household and business confidence and the extent to which this influences spending decisions and unlike trade, the transition through this channel is much more fluid.

Chart 1: How much longer can the US government borrow money to fund the consumer?



RBA's next move depends on global events

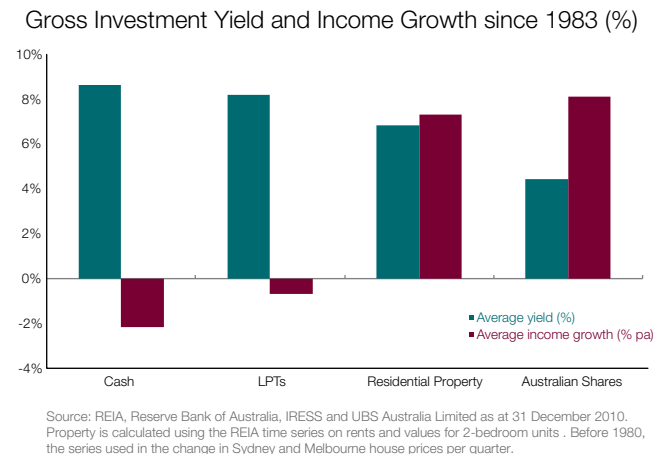
Given the global situation, two consecutive rises in the unemployment rate and a revision to recent inflation results, many investors have indicated that they expect the RBA to cut rates to support growth. However, the RBA has stated that the near 1.5% of rate cuts priced into futures markets appears (at least at present) quite excessive. Until the US and European authorities establish and implement a viable solution, risks remain to the downside. It could be the case that the RBA wants to preserve as much policy ammunition as possible, until it is forced to use it. Indeed, any rate cut before heightened market volatility would lose its impact immediately. This suggests that despite the current state of inflation and unemployment, the RBA's next move will depend on global events.

Buying high yield is not sufficient

This environment is likely to be one where investors are not rewarded for taking large risks in their portfolio, but are rewarded on a relative basis for investing in companies with sound business models, that have strong balance sheets and can deliver earnings and dividend growth in a difficult climate. At this time, investors are searching for yield, not only from a return point of view, but also from a risk management perspective. Dividends may have been a smaller proportion of investor's total return than in the past, but now the search for yield is paramount. However, investors should be wary of simply searching for the highest yield, as the highest-yielding investment since 1983 has provided investors with the least income growth through time. For

example, the interest rate in the cash market has averaged 8.7% since 1983, but the income received each year has declined by 2.2% per annum. Conversely, the yield from Australian shares has only averaged 4.4% (see Chart 2), but the income has grown at 8.1% per annum (despite the GFC). Income growth is a very important consideration as it is required to offset the potential impact of inflation and maintain real spending power.

Chart 2: There is an inverse relationship between yield and income growth



Implications for investors

The key question in this environment is how to manage risk. On most occasions Alexander the Great had less troops and inferior equipment and yet was unbeaten in battle. Had he simply charged into an open field to attack the Persians or the Medes, he would have been slaughtered. Instead he minimised risk and operated in an environment that gave him the highest probability of success. Similarly, investors could consider how to minimise risk. 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 and dividend growth, and who are shareholder focused in their payout strategies, are likely to outperform peers with weak business models and weaker balance sheets. There is little doubt that markets will remain volatile, but investing conservatively, in proven business models may provide more stability in portfolios in what could be a somewhat uncomfortable ride.

Matthew Sherwood
 Head of Investment Markets Research
 Perpetual Investments

This analysis has been prepared by Perpetual Investment Management Limited (PIML) ABN 18 000 866 535, AFSL 234426 for the use of financial advisers only, it is general information and is not intended to provide you with financial advice. The views expressed in the article are the opinions of the author at the time of writing and do not constitute a recommendation to act. Any information referenced in the article is believed to be accurate at the time of compilation and is provided by Perpetual in good faith. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information.



Further information

Adviser Services 1800 062 725
Investor Services 1800 022 033
Email investments@perpetual.com.au
www.perpetual.com.au