Financial Markets Update

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In the blink of an eye, in the context of time, the actions and intentions of the political and economic leaders of the world's major nations have shifted profoundly. The once co-ordinated stimulus policies designed to avert economic melt-down have now been replaced by unilateral policies designed to promote self survival.

Managing the Global Economy - From Co-ordination to Chaos

Markets today are trading in a broad range of +/- 20% as expected. We are currently enjoying a purple patch where optimism reigns, but confidence remains brittle. Investors are jittery. With global tensions rising, 2011 may not be as predictable or profitable as first thought.

Much has changed from 2008 when the first Group of 20 (G20) leaders summit was held in Washington DC. At that time, leaders representing both developed and developing nations came together in an understanding that their individual best interests were served by mutual co-operation and agreement. The outcome of that summit was that all governments would undertake "stimulus" programs to revive economic growth and restore confidence in the global financial system. To a large extent, the short term objectives of that meeting were met and world markets have returned to "normal".

However, like the passing of a storm, the light of a new day has revealed the extent of the underlying global imbalance in both national debt and trade. Most of the developing nations have restored their pre GFC growth rates and are travelling quite nicely. On the other hand, most of the developed world is faced with tepid growth, high unemployment, crippling fiscal deficits and spiralling sovereign debt.

With such differences in economic fundamentals, the policies adopted by governments in 2010 have become more divergent and no longer co-ordinated. Indeed, there is a price to pay for government bail outs. With the Western world now economically weak, it is struggling to come to terms with the new world order.

Although China overtook Japan as the 2nd largest economy in July this year, it is important to keep China's scale in context. The US and Eurozone countries produce goods and services of approximately 5 TIMES that of China. Whilst China's growth is explosive, it is from a very low base. It is also very reliant on the developed nations for its income. Having just reached an average per capita income of $US 7,000, history suggests China's next growth phase will be slower. With domestic consumption largely comprised of government spending, we are mindful that sustainable global economic prosperity still relies on a growing US and Europe. This is unlikely. China and Asia alone, cannot even remotely support global growth. However, the factors that directly impact China and Asia, indirectly and eventually impact us.

We suggest you take a moment to glance down the table of nations to get a feel for which nations really have economic clout. We suspect you will be surprised by the relative positions of the old and new world. Although Asian growth trends are firmly in place, the region inherits a handicap of 100 years of Western rule. This will take decades to alter.

AUSTERITY GRIPS EUROPE

Since our June 2010 update only a few short months ago, much has changed reflecting our earlier sentiments of nations fighting for survival. The Eurozone, a major economic region, has become embroiled in civil unrest as a result of severe austerity measures.

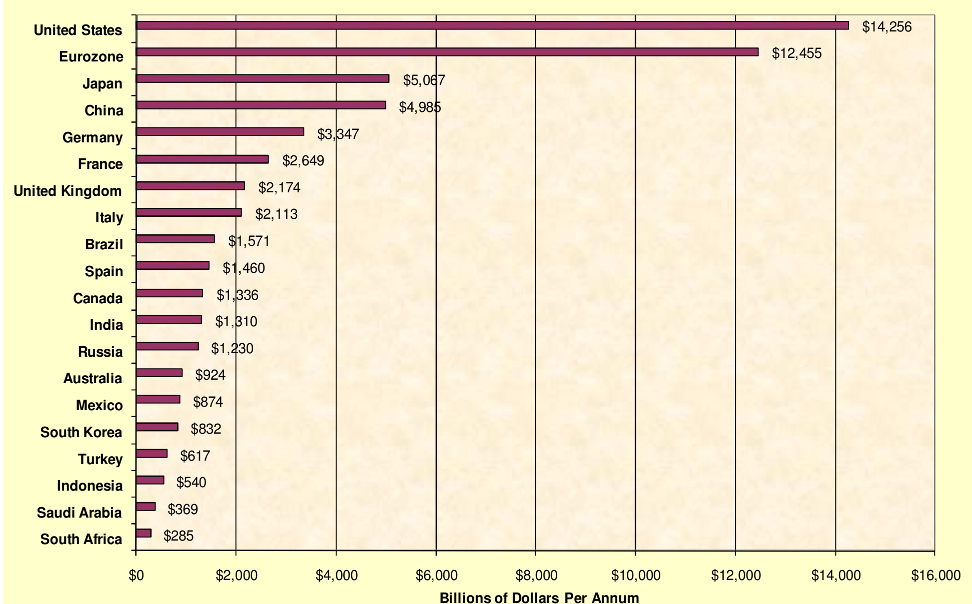
WHY DOES IT MATTER?

Australia relies heavily on trading partners to fund our ever increasing current account deficit and private debt. To this extent, the focus of this commentary is to redirect client attention to the competing forces which will largely determine Australia's economic destiny in the years ahead. Whilst economic conditions for us are "not bad" they are also "not good" as we rely on fewer trading partners to generate more of our income.

THE GROUP OF 20 NATIONS (G20)

Although we all hear about the global economy, many clients may not be aware of the global ranking of individual countries. To assist in putting this discussion in context we have tabled the G20 countries in terms of nominal GDP (output).

The GDP table shows just how dominant the US has been as well as the scale of the Eurozone. Both are presently under immense economic stress and are unlikely to recover for some years.



Source: The World Bank: World Development Indicators database. World Bank. 27 September 2010

One by one, European countries (excluding Germany) have announced significant economic changes to reign in government debt. In both Greece and France, public payrolls are being cut and the pension age increased. Predictably these measures were met by public protest and social unrest, with the resulting general strikes causing havoc to industry. The people of Europe are not yet prepared to bear the pain of indulgence. In time they will.

Spain (with 20% unemployment) and Italy have introduced measures to free up their labour force. Hitting the lowest paid workers hardest, these measures together with increased taxes paint a haunting picture of what lies ahead for lower income citizens.

The UK announced the most sweeping government changes since WWII with a plan to sack 490,000 public servants over the next 4 years, reduce defence and welfare payments, increase taxes and place a levy on the banking system. English VAT will also be increased to 20%. Ireland, which is in a deep property induced recession, has introduced similar measures in order to finance the public bail out of the Anglo Irish Bank, leaving it with a €45 billion bill.

CRAZY MOVES ALMOST CERTAIN TO DOUBLE DIP

Europe has squandered most of its 20th century bounty by developing an essentially socialist welfare state. With a declining income and an ageing population, the region can no longer support rising health costs, pension costs and infrastructure maintenance. The unravelling of this relatively inefficient system will be slow and painful.

Unfortunately, we suspect that the knee jerk response of removing government support too soon and too sharply, whilst well intended, is likely to lead to a second European recession in 2011/12. We expect a better outcome may be obtained if periphery nations defaulted on their debts and started again. This is no easy path, but may be inevitable as German taxpayers are becoming increasingly reluctant to bail out their poorly managed neighbours.

WHILE THE US SPENDS

In total contrast to Europe, the US government and Treasury continue to employ heavy economic stimulus measures in order to promote growth and initiate a private sector recovery.

In addition to running large government deficits, the US Federal Reserve has also employed “quantitative easing” (QE) to ensure their system is liquid. With interest rates near 0%, traditional monetary policy is ineffective. QE measures, which in simple terms amount to “printing money”, represent the last hope of engineering a US recovery. It is yet to be seen whether this strategy will work.

To compound US fiscal policy, Republicans recently won back control of the House with Democrats retaining the Senate. Gridlock introduces a new element of uncertainty into the US economy. Politics will now very likely hinder economic growth where views are divided between the role of government, the size of government and whether stimulus should be in the form of welfare spending or tax cuts. It appears memories are short in the land of Uncle Sam.

The jobless recovery in the US has undermined property prices with foreclosures showing no signs of abating. Retail sales remain weak, confidence in “change” has been sapped and personal debt remains a problem for many. Meanwhile, US government bonds paying sub 2% p.a. appear to be a bubble just waiting to pop.

JAPANESE TRADE

Our discussions to this point have revolved around high consuming creditor (indebted) nations. Japan is a debtor nation and until recently, the second largest economy on the globe. However, although Japan trades profitably, its domestic economy relies on export income to extend and service its extreme levels of government debt.

Over the last 12 months the rising Yen pitted against an undervalued Yuan has adversely impacted Japan’s exports and given rise to trade tensions with China. Presently, the dispute between Japan and China has not gone beyond political jousting, but any escalation from this point could compromise relations and spill over into broader world trade disputes. In earlier times, wars were seeded from such disputes. Today, the more likely outcome is less bloody but no less destructive.

EXPORTS, CURRENCIES, TRADE & GOLD

The only idea that seems to have universal support today is that a country can export its way out of trouble. This is a crowded space.

Export powerhouses like China, Germany, Japan and Asia are trying to protect their “turf”. Meanwhile, the US, UK and remaining countries in the Eurozone are looking for more of the action.

One of the best ways to grow exports is to have a weak currency which discourages imports but promotes exports via competitive pricing.

The US has succeeded in debasing its currency via a “near zero” interest rate policy and QE. This is no accident. But in doing so, it has also depreciated the value of the Chinese Renminbi (Yuan) which is a regulated currency loosely pegged to the $US. This has assisted China to artificially undercut most of the European and Japanese exporters. Amidst other less desirable information, WikiLeaks has revealed the extent of discontent amongst China’s many trading partners. This is not good.

“We can’t solve problems by using the same thinking we used when we created them”. Albert Einstein

World trade is a zero sum game. For every winner there is a loser. As such, creditor nations have employed a currency “race to the bottom” to stimulate local jobs and manufacturing. This tactic will further unfold in 2011, as may the story of GOLD.

The combination of sovereign risk and currency depreciation has seen the lustre return to precious metals, particularly gold. It is anyone’s guess as to where the price of gold may finish, but many experts see prices much higher than the present US$1,400 level. That may indeed be so. In our view, gold/commodities trading is extremely speculative as the asset generates no income. It can be very profitable but has been characterised by a boom/bust cycle over many centuries.

CONCLUSION

With so much economic “noise” surrounding us, it is challenging to draw any firm conclusions as to 2011. However, since investors measure performance annually, we are bound to form a view.

With a backdrop of most major developed nations lurching from one crisis to the next we find it difficult to build a case for broad based global recovery. Similarly, we remain unconvinced China can indefinitely regulate its currency without retaliation from trading partners and/or mounting internal inflationary problems.

With Australia vulnerable to both weak global trends or potential Chinese asset bubbles, we prefer to retain defensive client portfolios. We see the next 12-18 months delivering greater risk of capital loss than capital gain and unashamedly put that view to print, though we certainly wish it were otherwise. With surprise being an investors worst enemy, we suggest clients be prepared for modestly challenging times.

We wish you all a safe Christmas and look forward to working with you in 2011.

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