ZANACORP

Financial Markets Update

November 2012

Since our June 2012 newsletter, the financial world has enjoyed an unexpected rally in both investor confidence and global share prices. This has restored the pre GFC capital of all Zanacorp clients. Media headlines were hijacked by the Carbon Tax, then the London Olympics, and finally the US electoral battle. Little room was left for troublesome economic news, especially of the European variety. Sadly, the welcome distractions have ended, as has the strong rally in Australian share prices. At least for the moment. But astute investors will have noted that it took only four months for equity prices to rise by 11% and no one saw it coming. Be alert to the next opportunity.

Are We There Yet?

Recovery from the Global Financial Crisis was always going to be a long drawn out process. A frustrating series of steps forwards and then backwards until the excesses of the past are erased and new habits adopted. We have stated this many times in recent years.

Over the last 12 months, markets are evidencing a dulling of investor emotions. Fear has waned and expectation has risen that future investment returns will return to "normal" as if the painful journey is over. Our more sobering view is that we still have some way to go.

Currently, fierce debate exists as to whether the road to recovery lies in Western governments going deeper into debt to stimulate growth or adopt economy wide cuts to government spending. It is a vexed question, but one we have faced before. In Europe bond markets demand austerity, but what is needed is structural reform.

THE PARADOX OF THRIFT

During the Great Depression, J.M. Keynes developed the theory known as the Paradox of Thrift. Essentially, the concept maintains the view that if too many participants in an economy save their income (i.e. adopt thrift), rather than spend it, then the demand for goods and services diminishes, jobs are lost, profits and income fall and eventually savings fall. Herein lies the paradox, the more we save now the less we will have to save in the future. Therefore the secret to saving more is spending more!

Before younger clients rush out to the shops 'to save money', the concept needs a little more development. It only holds true if the entire economy saves more and spends less, as was the case in the 1930's. Governments cut spending, businesses cut spending and individuals cut spending deepening the Depression. Keynes believed that in order to break this vicious cycle, one or more groups must spend. He maintained that during times of recession, government should **SPEND MORE** by running budget deficits to compensate for businesses and individuals having less income. Once the economy recovers, people will again be employed increasing spending, profits and savings, and generating greater taxes for government who can then reduce their spending and pay back their deficits.

Simplified, readers will notice that the Paradox of Thrift makes sense.

Things become more complex when you introduce debt (credit) and welfare into the equation. Debt creates consumption and investment but (eventually) needs to be paid back out of future income. Likewise, social services and welfare redistribute income into the hands of less affluent individuals in need of assistance. But welfare programs place an increasing fixed cost on the annual running of government, draining resources and impairing its future ability to cushion the economy.

It is a form of moral hazard demanding astute balancing of common interests for the greater good. What to do?

Bringing the concept into the 21st century requires adding another layer of complexity. Advancements in communications, technology and logistics have essentially made the entire world one economy. This means the deficits of one country represent the surpluses of another. This is decidedly different from the 1930's Depression era.

The savings of thrifty countries (predominantly Asian) have became the borrowings of others (predominantly Western nations). We have a mutually interdependent zero sum game. However it is one that significantly alters the destination of future profits, income and wealth. Formerly rich nations are becoming poor and the poor becoming rich.

Grasping the principles of this model should help clients to understand how we can maintain a positive view on equities. This is so, despite nations being apparently bankrupt. **We invest in companies NOT countries.** Companies will direct their capital to any country or industry where there is growth. Business profits generate investment, jobs and dividends, which in turn generate future income that investors value and own via shares.

This is why we recommend all clients should own great multi-national companies like Google, Samsung and Sanofi which profitably deliver software, hardware and healthcare to both developed and developing nations. But we digress.

We believe the complex interaction of consumption, debt and welfare, goes to the core of the plight of most Western countries. It also explains why emerging countries now prosper. Developed nations became victims of their own success. Like all fallen empires of the past, the work ethic gradually gave way to complacency. Over many decades the West has borrowed the savings of the East in order to consume cheaper goods manufactured in the East. A lose/lose combination. Meanwhile the East sees its savings converted back into domestic production and jobs. A win/win combination.

The 2008 GFC announced the year of reckoning and both greater Europe and the US have to date been found wanting in their preparedness to accept and adopt change. Poor leadership and governments rightly carry some blame, but so too should those that borrowed or took risks seeking taxpayers to carry their losses. Many governments bailed out failed banks (that financed people's debt fuelled dreams) solely to avert a systematic meltdown. But this left them weakened and poorly equipped to run the deficits needed to support their economies through the long period of tax, labour and welfare reform.

Carrying overwhelming debts, western nation stimulus has turned into austerity. Like the 1930's, governments are cutting spending, jobs are being lost, income is falling, economies are shrinking and savings are falling. The UK and Europe have followed this path for 2 years now, and are in recession in 2012, just as we forecast in our December 2010 update. It is now time for the US to confront its economic demons. Meanwhile, the East feasts on the fire sale prices of quality assets.

ARE YOU A SAVER OR SPENDER?

Our discussion so far has focused on the larger (macro) level of thrift. At the individual level lies the ultimate paradox of modern living causing grief to both Europeans and Americans alike. Behavioural finance studies universally categorise people as being either 'spenders' or 'savers'. Like people being inherently 'introverts' or 'extroverts'.

Further, they observe that en masse people are heavily influenced by 'herd' behaviour. We tend to take risks if we see others take risk and experience fear if others experience fear. These traits seems to be hard wired, more or less, into the human condition.

Generally, in every problem economy (as in Australia) the 'spenders' are usually under 60 years of age, have taken on too much debt or have inadequate savings. Many either rely on some form of welfare, or expect to in retirement, in order to maintain their lifestyle. Collectively they tend to spend whatever they earn, even in tough times.

The 'savers' are debt free or have manageable debt burdens. They are thrifty, with money set aside for retirement. Collectively, this group will not spend freely, even though they can afford to. Ironically, the financial well being of the savers is influenced by how well the spenders can manage their finances. Recently, this has not been well.

How do you get 'spenders' to save, and 'savers' to spend? Apparently you cannot, or at least not quickly. Easy access to credit over the last 25 years has allowed 'spenders' to continuously enjoy life to the full without restraint or consequence. Globally, service sectors have been built around them, like the tourism industry, that relies on their ongoing custom. The vulnerability of this industry to changed conditions can be seen in our own struggling far north Queensland region.

So welfare cuts, lost jobs and falling house prices have shrunk the size of economies from sunny Spain to dour Ireland.

The generally Western trend to consume beyond its means has also had other effects. Affluence has brought with it the expensive expectation of state funded entitlement (welfare). Europe is drowning in it.

> ***'The quality of the recovery is proportional to the quality of the surrender'*** *- Unknown*

People in developing markets live differently. They see their income related to their efforts. Welfare systems are immature. These cultures, often isolated or war torn, value their legacy to future generations. Parents forego current consumption to provide for their old age and educate their children. Just as depression reared Westerners did.

Try as it may, China has been unable to change its people's savings culture. Growth continues to be driven by external exports and government spending. **China has run domestic budget deficits for 14 of the last 15 years.** So deficits do create growth when correctly spent.

Getting a feel for why the West is in poor shape and the East is not?

Personalising these issues, we respectfully guide clients to be conscious of their character type. Knowing this assists in determining the age you should be considering retirement and the lifestyle you can expect to enjoy. This is a deeply personal choice. There is no shame in having a full life, but there is a cost. Savers (or accumulators) may be in a position to retire early and still maintain their lifestyle. Spenders (or consumers) should consider working a little longer as they will require a greater pool of capital to fund their higher living costs. Let's learn from the current European pension experience, not relive it.

THE FISCAL CLIFF

With elections out of the way in the United States and the change-over of power in China, the eyes of the world are now re-engaged on serious economic matters.

Many clients may not recall the US debt crisis of August 2011. It was effectively 'resolved' by the enactment of the Budget Control Act (2011) regulating automatic government spending cuts, to contain the budget deficit.

Added to this, amidst the abyss of the United States recession, so called 'Bush tax cuts' and payroll tax concessions were extended in order to support US taxpayers and the economy in a period of crisis.

The Bernanke coined 'fiscal cliff' which you are now hearing about is the term used to describe the simultaneous repeal of the tax cuts on 31/12/12 and enforcement of the Budget Control Act on 01/01/13.

In very simple terms, the fiscal cliff means that without legislative change, on New Year's Day 2013, nearly all American people and businesses will pay more taxes and Uncle Sam must slash spending.

The combined economic effect of these measures is estimated to be a GDP contraction of 3% to 4%. The US will almost inevitably be plunged into an austerity induced recession. Markets will respond accordingly.

Reeling from recession, the US government borrowed and spent trillions that have failed to ignite US growth. Wallowing in debt, the US finds itself mimicking the same ill fated austerity path as Europe. With limited choices, Congress is confronted with a 'damned if you do and damned if you don't' conundrum. Damn that Paradox of Thrift.

But is there an alternative? Although Democrats and Republicans see very different solutions to the US economic woes, they are both conscious of the dire economic consequences of the fiscal cliff. Under intense scrutiny to negotiate a compromise, we expect Congress to pass a series of measures over many months and avert disaster.

We expect the process to be protracted, messy and politically charged. The rich will pay more taxes and spending will be cut but each would have been heavily diluted. Economic outcomes will be uncertain. In this climate, weak volatile markets must be anticipated.

Whilst none of us want this, we must accept it as substantially better than the alternative of a US recession.

PEERING OVER THE VALLEY

Despite the short term outlook in both Europe and the US being grim we remain convinced that by this time in 2013 compelling evidence of a US economic recovery will be in place. This is our expectation.

We introduced clients to the US shale oil and gas revolution in our June 2012 update. In 5 years, this energy source has come from nowhere to everywhere, revolutionising American energy consumption, slashing energy costs and emissions, and creating 1 million jobs. Shale gas has already overtaken coal as the top source of power generation.

Once worries of the fiscal cliff subside, the new Obama administration has four years to get things done. Politics aside, the US is well past its economic low point. Housing appears to have bottomed, employment is rebounding and the low US dollar is producing precisely its desired effect to stimulate exports and promote domestic manufacturing and competitiveness. These are all things absent in the European Union.

We see little progress made in Europe, but expect the economic fall out will now most likely be localised rather than globalised.

Unlike the Australian Government, we do not take comfort from our logistical location being Asian based. Our mores are firmly Western entrenched as are our society's expectations. Make no mistake, we have become a quarry for developing markets and a sunny destination for their holiday makers. When the mining investment boom ends and it will, our high cost economy will need structural reform. But that is a couple of years away and the world has bigger problems.

As 2012 draws to a close, we extend our best wishes to all clients for a safe and happy Christmas and New Year. It promises to be interesting.

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