

## VISIBILITY LOW



All four major global economic blocks of the Euro Zone, the USA, China and Japan look to be entering the second stage of the ongoing credit crisis. Simply put, too much debt and debt funded deficits have resulted in a global economy that is structurally constrained by the necessary deleveraging process.

To date the response to the global debt crisis has been largely left to central banks, ironically attempting to pump more debt into the global economy. Any attempts to kick start the system so that business and economic cycles can simply pick up from where they left off prior to the GFC have been and will be futile, until the structural changes required in the global economy can be made.

The central forces that will continue to shape economies and markets are:

- + The global economy is deleveraging
- + Government deficits are too high and unsustainable
- + Deteriorating demographics are not yet factored in
- + The financial sector is highly unstable

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## GLOBAL ECONOMIC PREDICAMENT

Simon Hunt Strategic Services  
Nov / Dec 2011 Economic report

- + The world is in a balance sheet recession which will make a second perhaps more dangerous credit crisis almost inevitable.
- + Three global pillars of the world economy, USA, Europe & China each have their own problems, but their impact is global because of the feedback loops from the financial sector to the economy.
- + US has a debt and deficit profile which is unsustainable.
- + Debt & demographics will be the determining forces to global growth.
- + European banks are under duress: government debt represents a large portion of their asset base. They are the largest lender to the rest of the world. To shore up their balance sheets they will be cutting credit.
- + The world will suffer rolling recessions starting next year or in 2013 lasting to about 2018.
- + By then (2018) global deleveraging should have run its course. The world will be a different place.

## STRUCTURAL NOT CYCLICAL, SOLVENCY NOT LIQUIDITY

*“Four years into the crisis it is surely time to accept that the underlying problem is one of solvency not liquidity—solvency of banks and solvency of countries”*

Mervyn King, Governor of Bank of England Oct 2011

The Greek debt crisis was labeled a liquidity issue and the Euro Zone instituted a rescue fund to buy government bonds when no one else would, thereby providing ‘liquidity’ to the market. We now know that Greece was insolvent. Political leaders are now labeling the Spanish and Italian difficulties in the bond market as a ‘liquidity problem’ - perhaps they too are insolvent.

Distinguishing between the solvency of a country and the liquidity of a country’s debt securities is not always easy.

Central banks around the world have united to provide liquidity to keep the financial system functioning, and so they should. However, solving the short term liquidity issue only buys time to address the solvency issues.

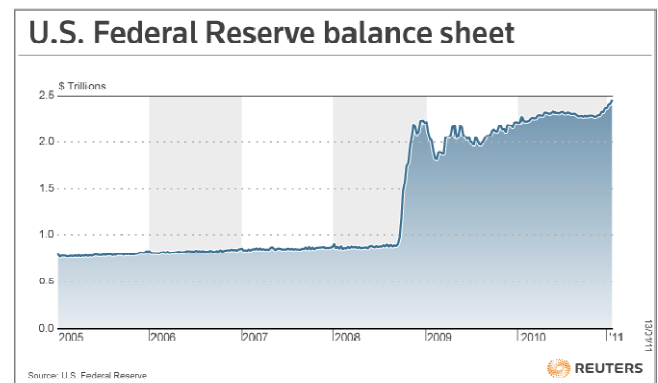
Rhetoric from Federal Reserve in the US and from the European Central Bank in Europe is imploring political leaders to make the structural & fiscal adjustments required to bring deficits and debt to sustainable levels. However the political systems in Europe and the US seem unable to make the decisions that are required to be made.

Why? Because all economic solutions available are going to bring pain to the people, rendering the required solutions not politically plausible. Such is the nature of a debt overhang and the necessary deleveraging process.

Once the availability of credit stops so must the consumption, and for a period of time consumption levels must stay down to account for what has been consumed.

Deleveraging is a painful process. When you take on debt you effectively bring forward consumption.

The best that we can hope for when central banks provide liquidity, is that we buy time for politicians to make fiscal and structural changes to their economies.



### Central Banks “buying time”

Central banks have moved from being in a prudential supervisory and regulatory role overseeing the market place—to simply ‘being’ the market place!

The US Federal Reserve Balance Sheet shows a four-five fold increase in its size since rescuing the global banking sector in 2008.

However to date, US politicians have wasted precious time in making the fiscal adjustments required.

## BALANCE SHEET RECESSION versus BUSINESS RECESSION

The differences between a balance sheet recession and a typical business recession are not always acknowledged, particularly by the equity market.

A *business recession* normally comes about due to excess capacity through overinvestment and the solution is normally provided by the Central Bank moving its interest rate lever to stimulate the economy. The economic growth coming out of a business recession is normally very high and the timeframe for recovery is usually short.

A *balance sheet recession* is characterised by an insolvent financial sector (normally as a result of taking on too much debt) and an interest rate mechanism that

doesn’t work. The recovery is very slow and painful as it requires deleveraging and repair to the financial system before the transmission mechanism (low interest rate) works. Participants in the economy need to get rid of their debt, get settled and regain confidence to take on some more debt again. This all takes time—currently we are not even at the initial deleveraging phase. The economic growth coming out of a balance sheet recession is usually very slow.

The Bank of International Settlements (BIS) has suggested that it may take until 2018 until enough deleveraging has occurred for business cycles to resume their normal trajectory. Being the only international body to accurately predict the GFC—we take BIS advice seriously.

## WHAT DOES A DELEVERAGING WORLD LOOK LIKE?

It is important to define the characteristics of a deleveraging world. Generally the characteristics are not good in an economic sense, they are deflationary, painful and provide little confidence for consumption and investment at a government, corporate and individual level.

Understanding these characteristics and the power of the deleveraging forces is crucial in the investing process as it dictates which asset classes to avoid and which asset classes will provide the best return. The key characteristics are outlined below.

### GOVERNMENTS

- + Forced to reduce deficits through increasing taxes and reducing spending
- + Forced to roll over debt in times of lower credit availability—interest costs will increase
- + Likely that most governments will have their credit ratings cut as economic fundamentals deteriorate

### BANKS

- + Increased government intervention and regulation—perhaps new banking taxes
- + Higher borrowing costs, lower margins, tighter on credit flow to the real economy

### COMPANIES

- + Flat growth, falling margins, shedding of employment numbers
- + Pressure on credit ratings from rating agencies
- + Capital structures under constant pressure, further capital raisings, asset sales likely as funding options diminish
- + Incidence of bankruptcy will increase

### INTEREST RATES

- + Structural increase in interest rates for funds sought on markets as credit flow diminishes

### STOCK MARKETS

- + Lower growth coupled with higher interest rates will see stock multiples fall
- + Macro economic uncertainty will result in high levels of volatility

### INDIVIDUALS

- + Higher unemployment, falling real wages, uncertainty, which lead to higher savings
- + Suffer from higher taxes, reduced capacity to consume

The deleveraging process will be a multi-year event. During this time there will be periods of time where the characteristics listed above are not apparent. However, until such time as debt levels return to historically sustainable levels and government deficits are reduced to historically sustainable levels, the central force will be that of deleveraging.

## BUT OPPORTUNITIES DO EXIST

The investment landscape is now structurally very different to what investors were accustomed to prior to the GFC.

It is unlikely to produce the returns that may have been available in the past.

However opportunities do currently exist and will continue to present themselves in the future.

**With change comes opportunity.**

**For further information on asset allocation and the appropriate investment strategy during this deleveraging period, please do not hesitate to contact our office.**

## CONFIDENCE, HOPE & OPTIMISM

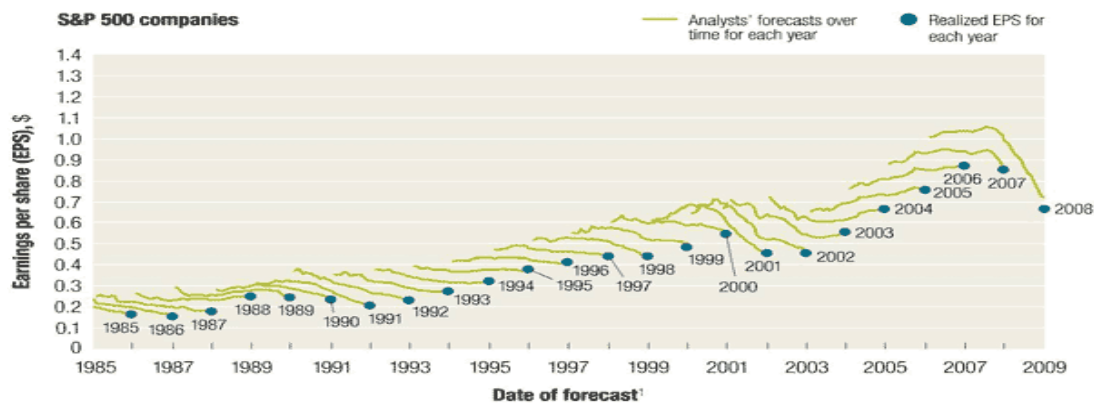
*“In August 2008, eight months after the recession had actually started, the Wall Street Journal’s poll of 53 economists found that only half believed the economy was in recession and that most expected real GDP to rise.”*

Thankfully human nature appears to be generally positive and optimistic. Optimism has allowed progress in technology, progress as a society, progress in science etc. However, when it comes to investing hard earned capital it seems that confidence and indeed common sense can easily be replaced by ‘hope’. Perhaps in this context optimism based on hope may not be appropriate.

In July 2010, McKinsey & Co released details of a study revealing that over a 25 year period, the average analyst was overly optimistic in earnings growth rate projections by a factor of 100%. (see below).

In only three of the 25 years did initial earnings forecasts actually increase as the year progressed. Over the 25 year period the average initial ‘forecast’ growth rate was 12%, while the average ‘actual’ growth rate was 6%.

As investors deploying capital, in many instances capital that has been saved over many years, we need to take great care in what we place our confidence. Furthermore, we need to understand that human nature will forecast outcomes more generously than history suggests will actually eventuate.



## BUSINESS MODELS

In the financial services industry there are many investment solutions on offer and choosing between the many investment options available can be very difficult. A great deal of confidence can be gained by the investor in selecting the right advice through understanding the business model of the service provider.

If the business model of an investment advisor requires an investor to adopt any of the following...

- + A high level of transaction activity
- + A high level of investment at all times
- + A particular bias to one asset class such as shares at all times

... then we would suggest that the information being provided by the investment advisor is probably skewed towards the success of their business model rather than the returns of the investor.

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