

### Sovereign Solvency

The question of whether countries simply go broke - may well become a real issue for investment markets.

We have already seen the UK being put on negative credit watch by ratings agencies. Given the similarities between the US and the UK in economic fundamentals, Bill Gross (PIMCO), has suggested that it is not "if" but "when" the US gets re-rated down from its AAA status.

As sovereign solvency becomes more problematic, this will impede global trade.

### Results for the OECD

The result for the OECD world may well be a prolonged period with the following characteristics:

- + Lower growth
- + Higher taxes
- + Inflation concerns
- + Increased savings by consumers
- + Higher interest rates
- + Reduced Government spending (and rising interest payments)
- + Prolonged higher unemployment levels

The effect on investments is best described by Bill Goss (PIMCO July 2009)

"the new normal, where growth is slower, profit margins are narrower and asset returns are smaller than in decades gone past".

**As a result, our investment recommendations will continue to be Australian centric for the foreseeable future.**

### Changing consumer behaviour

In twelve months, the average US consumer has gone from saving 0.25% of their take home pay to 4%. That is a 16 fold increase. This pattern has been replicated in the UK and Australia and we foresee this trend continuing.

If consumers are not spending, this will have further implications on growth rates - particularly for the consumer driven United States, which represents 70% of their economy. Further, the home can not be used as an ATM.

### Australia - a more positive story

On a more positive note, Australia appears to have avoided to this point, "a recession".

What makes Australia different to our OECD companions?

- + A well regulated banking system that did not need government injections as the world's banks collapsed in 2008
- + Accumulated government surpluses that were available for immediate stimulatory spending
- + Resource deposits required by the emerging economies
- + A residential housing sector that has not collapsed, due predominantly to the "undersupply" of housing in Australia.

In the years to come Australia will not be immune from higher taxes, higher interest rates and lower growth rates. It appears that the growth rates forecast in the much maligned 2008 federal budget may well eventuate.

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**Accru<sup>+</sup>**  
Financial Planning

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# Wealth Creation

## News | Views | Clues

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Welcome to the mid year edition of Accru's Financial Planning Newsletter. Inside we look at the recent market rally, key themes we expect to shape the world after the global financial crisis, and how Australia is faring compared to our OECD companions.

## 2009 Bear Market Rally

The June quarter of the 2009 calendar year will be remembered for a remarkable market rally of nearly 30% (6 March 09 All Ords: 3112 - 12 June 09 All Ords: 4061).

However, given that the market is still down 22% from the start of the financial year, this market rally can best be described as a "bear market rally".

There are numerous reasons the bear market rally has occurred, including:

+ extremely low rates being paid on cash, combined with the volume of cash sitting on the side lines,

+ confidence that the financial sector was not going to completely melt down after all, and

+ unprecedented government responses to the financial sector collapse and rhetoric that governments will pull out all stops to ensure that economies keep moving forward.

The market has indicated that the freefall is finally over.

### Is the rally sustainable?

The bear market rally seems to have reached a plateau and is waiting for further guidance.

In Australia, the reporting season for the financial year ended 30 June 2009 will be upon us shortly. If companies can give some clear direction in regards to (1) solvency, (2) security of cash flow and (3) future earnings stability - then the market may continue to rally.

Conversely, the market may well take back some of its gains if the reporting season is disappointing

or, if cracks start to re-emerge in the financial sector.

Governments around the world have launched significant stimulus packages to reinvigorate growth. The jury is still out as to whether these initiatives can be funded or will even work. Failure of announced government policy and concerns over massive government debt levels - may also spook the market into another retreat.

If no clear guidance comes on some of these issues, then market volatility may continue on a news driven basis.

### How relevant is the Recession?

Much debate continues as to whether Australia will fall into a technical recession or not. It appears that we may not.

In formulating investment strategies, we continue to distinguish between the following:

- + a cyclical recession, and
- + a structural and systemic failure of the world's financial sector.

Whether we enter a recession is irrelevant to us in terms of investment strategy.

What is much more important to Australia is what the world will look like moving forward in the aftermath of the Global Financial Crisis ("GFC"). At some point the recession will end and the world will move on.

It is our belief that the post "GFC" world will be significantly different to the pre 2008 one - and our investment strategies will need to be built accordingly.

## The New World

While trying to predict the future is at best a futile exercise, particularly in a world where things are changing so rapidly, we can identify some themes that will shape the "new world".

Put very simply and crudely, the Global Financial Crisis was the result of the private sector borrowing far more than it could ever repay, based on asset levels that were inflated. This debt has simply been taken off its hands and placed on the balance sheets of governments. THE DEBT HASN'T GONE AWAY!

### Funding the debt

Given that most developed countries (US & UK predominantly) consumed whatever surpluses they had in bailing out their financial sector and buying back "toxic assets", the government spending that has been promised to stimulate economic growth will be funded through issuing government bonds.

Further to that, most countries are forecasting "deficits" for the next few years. This too will be funded

Couple the above with massive fiscal policies (stimulus policies) announced by governments around the world to kick start stalled economies - all funded with MORE BORROWINGS - the debt continues to rise.

The new world will clearly be shaped by massive government debt - and finding away to pay it off.

by issuing bonds, and to some extent, printing money.

Given nearly every country in the OECD is planning to rapidly increase its bond issuance - a massive supply of bonds has and will become available.

The ramification will be a fall in the price of bonds and an increase in the yields being offered as demand falls short of supply.

### Can the debt be funded?

Who is going to buy the bonds? This is a particular problem for all countries as clearly there are not enough willing bond buyers. China, the country with the biggest cash reserves already holds 65% of its reserves in US treasuries (\$2 trillion) - it doesn't want any more and has already expressed concern with the US's ability to repay these.

The Bank for International Settlements has warned that world bond markets might force governments to abandon stimulus packages, slash spending and lift taxes.

This would result in deficits for years to come and an extended period of stagnating economic activity.

This begs the question of how to pay off the debts being accumulated by governments - this question has been asked by the Japanese now since 1998, which has resulted in the "lost decade".

This has further ramifications for social security, education, health, law and order, defence etc...

**Outcome 1:**  
As bond yields rise this will put upward pressure on interest rates.

**Outcome 2:**  
Extended period of stagnation in global growth rates.

**Outcome 3:**  
To pay off debts governments are going to be forced to "lift tax rates" and "cut their own spending".

**Outcome 4:**  
Fears over sovereign solvency, could lead to currency concerns, reduced trade and further market jitters.

**Outcome 5:**  
Consumers have already started to spend less and save more.

**Outcome 6:**  
Higher taxes and inflation will be inevitable at some point in the mid to long term.