

INVESTMENT IMPLICATIONS

PORTFOLIO IMPLICATIONS

We are fortunate that in Australia you can earn 6% in a bank account—that for the time being is guaranteed by the government. Should you want to earn a higher return than cash, our core theme is to invest in corporate debt.

We have mentioned that large corporations are currently more solvent than many governments – consequently we would prefer to invest in them than in government bonds.

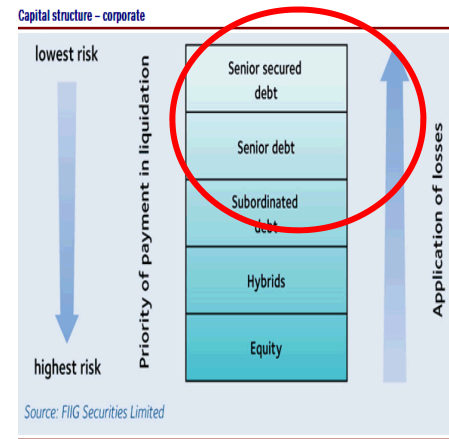
This is a poorly understood sector in Australia and warrants more attention.

These large corporations are in constant need for funds to fund their day-to-day cash flow requirements. Large corporations raise this cash themselves from the debt markets more cheaply than from the bank. If we consider recently Telstra has raised debt in European debt markets at a rate less than that of many European sovereigns can raise in the same market.

Corporate bonds or corporate debt is relatively under-utilized in Australia and is poorly understood—therefore it is considered risky. However the chart above shows that corporate debt, which is typically Subordinated Debt or Senior Debt is way up the risk spectrum from basic shares.

We want to lend our funds to these companies.

It just so happens that we are in a point in time where this “less risky” form of investment is also more than likely going to be the “highest return” available—when compared to equities.



Source: FIG Securities Limited

WHAT ABOUT SHARES?

Share values are typically calculated by brokers as being a function of future cash flows discounted by a desired return on capital (this desired rate of return moves with interest rates). We believe that analysts are way too optimistic on two fronts:

- (1) earning expectations are too aggressive for companies operating in difficult macro economic conditions, and
- (2) the interest rate being used as a discounting mechanism is being kept artificially low by the Federal Reserve in the US. This affects Australia too.

Consequently, we do not see a solvency risk with investment in companies—rather a valuation risk.

Each investor has an individual tolerance for volatility, risk of losing capital and desired return. Should you wish to discuss further any issues raised in this newsletter or your investments in general, please contact Greg Newbury on 8226 1655.

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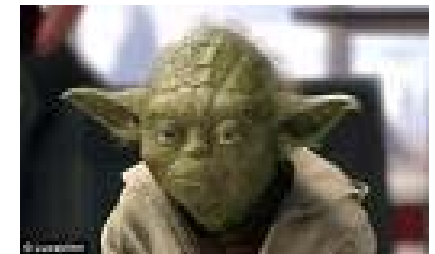
Source: FIG Securities Limited

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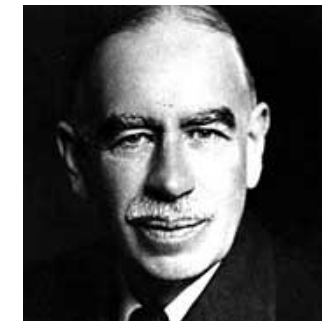
MAY THE FORCE BE WITH YOU

Macro economic forces are now so strong that a trillion dollar bail out package by the European Central Bank in the Euro zone and a \$600 billion QEII program in the US have not been able to stop the deleveraging forces at work. The size and scope of the global macro economic forces at work are too powerful it seems for government intervention to prevent them taking hold.

In this newsletter we remind ourselves of the forces that will determine economic and investment outcomes generally over the next secular phase. There have been times in history where the strongest economic forces have been government policy. It seems for now that political pressures around the world are preventing adequate government policy responses and that economic & market forces themselves will be the guiding light. For example it appears that neither political party in the US has the political will to make structural changes necessary to an economy that is clearly on an unsustainable fiscal trajectory. It is our view that the decisions that need to be made politically will not occur until the bond market demands it by cutting off access to debt. The same predicament is unfolding in the Euro zone.



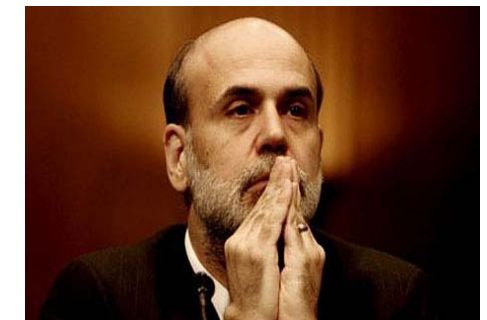
It is difficult to understand the forces at play in this cyclically recovering yet structurally impaired world.



John Maynard Keynes

John Maynard Keynes in his General Theory of Employment & Money (1936) provided governments around the world with the confidence to free up the flow of credit as a means to achieving full employment. And it worked. However once the developed world reached a level considered to be full employment—credit kept flowing freely and cheaply. Credit then became a tool not only for productive enterprise as Keynes intended but for speculation on asset prices. This started to come undone with the first stage of the GFC. Perhaps this is the Keynesian endpoint.

At the height of the GFC, when the financial sector was clearly insolvent, the Federal Reserve (US) decided the best course of action was to keep the Keynesian dream alive and do all it could to keep the credit flowing. This policy has bought time—however a solvency problem can not be solved by issuing more debt. Ben Bernanke has probably played all the cards he has. What he needed was some back up from policy makers and significant structural reform. There appears no political will to do this—so we wait for the bond market to do it for us.



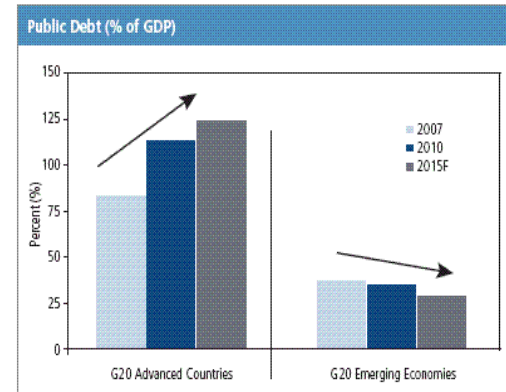
Ben Bernanke, Chairman Federal Reserve Bank USA

MAJOR MACRO ECONOMIC FORCES

One of the difficulties in Australia is that we have a very noisy investment landscape—encouraged by the policy of compulsory superannuation, which forces us all to become investors (like it or not) and fuelled by the media sector fixated on high levels of activity chasing short term gains. However, we prefer to anchor our thought process around the large macro forces at work, which seem unstoppable, even by large unilateral government actions. This allows us to sift out the noise, focus on the inevitable and bear with short term volatility.

FORCE 1: DEBT – DELEVERAGING

After bailing out the world’s banking system (for now) the debt overhang we now live with is going to stymie growth for many years. Consumer behavior has already changed and will continue to do so—as paying down current debt, a reluctance to take on new debt and a new frugality reduces economic activity—that for so long has been reliant on debt fuelled consumption. We note that corporate balance sheets are somewhat deleveraged in relation to governments and individuals and provide a sanctuary for funds from the deleveraging process. (See investment implications page 4).



Source: International Monetary Fund Figure 3

FORCE 2: DEFICITS THIS BIG MATTER

Deficits have a place from time to time—however the size and structural nature of deficits will have ramifications on economic growth. The difficulty with the current level of deficits is two fold: (1) the deficit needs to be funded (borrowed) and that government borrowing crowds out the private sector’s ability to borrow. Unfortunately nearly all job growth and productivity increases come from the private sector, (2) ultimately the deficit needs to be fixed with tax increases. The result being in both instances that deficits this big lead to long term economic growth issues.

OPTIMISM

It is “un-Australian” not be optimistic. However a quick glance around the globe shows significant instability in Europe, USA, Middle East, Japan and of late China is even experiencing some issues of its own. When it comes to financial markets these countries matter.

At this phase of the GFC, when government efforts appear to be exhausted and global economic recovery is tepid at best. We prefer caution over bullish optimism for the time being.



FORCE 3: DEVELOPING COUNTRIES

The developing countries of China & India with several hundred million people each moving into the middle class (and little debt—see graph above) contrasts significantly with the developed world where aging populations are putting significant drains on already fiscally stressed budgets.

US GOVERNMENT RESPONSE

Why then have share markets gone up?

As discussed, the US governments response to a solvency crisis has been to try and keep credit flowing. It has done this by keeping interest rates near zero and pumping huge levels of liquidity into the financial system. The Federal Reserve Balance Sheet (adjacent) shows how dramatic government involvement has been with size of the Fed’s balance sheet nearly tripling since 2009.

Although the QEII process has been unsuccessful in generating any credit flow into the productive part of the economy, it has had two effects:

- (1) it has significantly devalued the US dollar—which helps the US export, and
- (2) it has kept the interest rates at near zero.

When you take into account inflation, you have a negative real interest rate, which results in investors actually losing money to hold Fed Funds forcing them into “riskier” assets (from the inner circle to the outer circle—adjacent).

Given the risk free rate is NIL—equilibrium in the economy forces up the price of speculative assets until they too represent a return approximating zero, being the risk free rate.

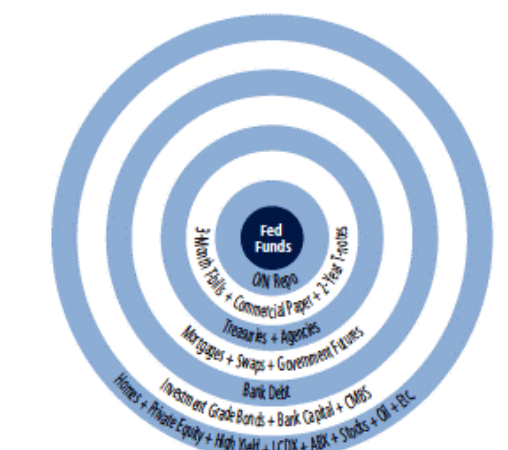
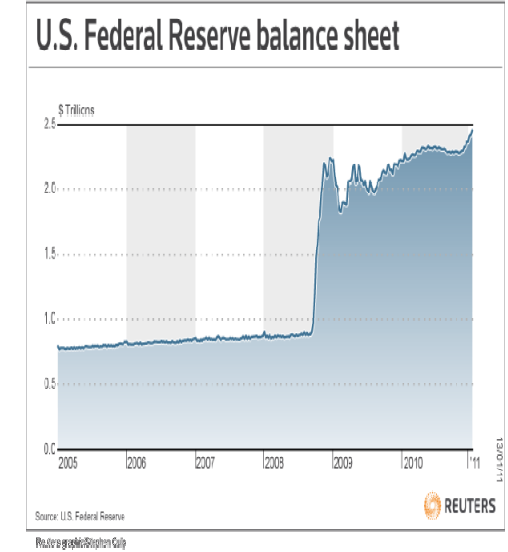
The Federal Reserve has indicated that it will take approximately five years to normalize its balance sheet. We expect asset prices (shares) to grow below trend during this time as the Fed will be forced to lift interest rates.

PEOPLE POWER

The power of a country’s people has been evident all across North Africa in recent months and has led to the toppling of many governments—many of which needed to be toppled!

However it is Europe that is causing concern—with the simple arithmetic of the European Debt situation indicating that at sometime, somewhere, losses are going to have to be realized.

Voters in Germany are less and less willing to bear the losses of peripheral European countries and voters in Greece are less and less willing to have austerity measures imposed them. The political will to fix the structural shortcomings looks unlikely to prevail until the bond market intervenes. The people must be careful what they wish for.



Source: PIMCO 2011



25,000 Spanish protestors on the eve of the Spanish elections 21 May 2011.