Investment Markets – 2007/08

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Agenda

- What I said last year (July 2006)
- Market performance over 2006/07
- Prospects going forward
- Key risks
- Conclusions

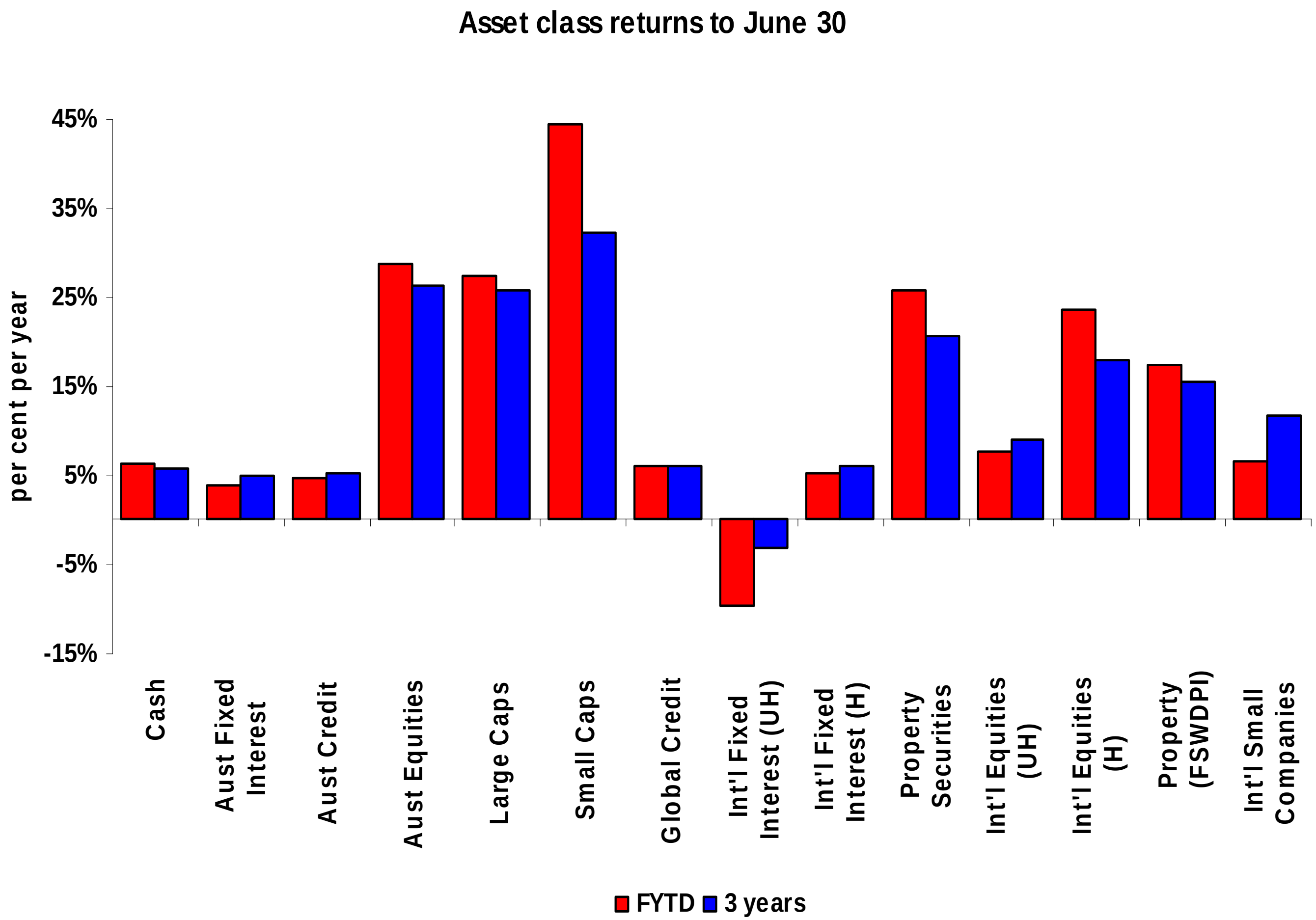
Conclusions – driving forces (July 2006)

- Inflation appears to be under control
  - downward pressure on prices from foreign imports
  - upward pressure from AUD a complication
- Interest rates will benefit from continued low inflation
  - economic growth will determine cyclical pressure on rates
- As for economic growth
  - long run trend growth looks good
    - low inflation, low interest rates, high productivity
  - short run cyclical downturn led by the US likely

Conclusions – implications for assets (July 2006)

- The environment is favourable for growth assets
  - shares, property, infrastructure, private equity
- But short-run volatility likely when at turning points of cycles
- High-beta assets could suffer the most
  - emerging market shares and debt
  - commodities
- Expect normal return of assets – say 8.5% on shares and 5.5% on bonds – except if something happens to alter this outcome

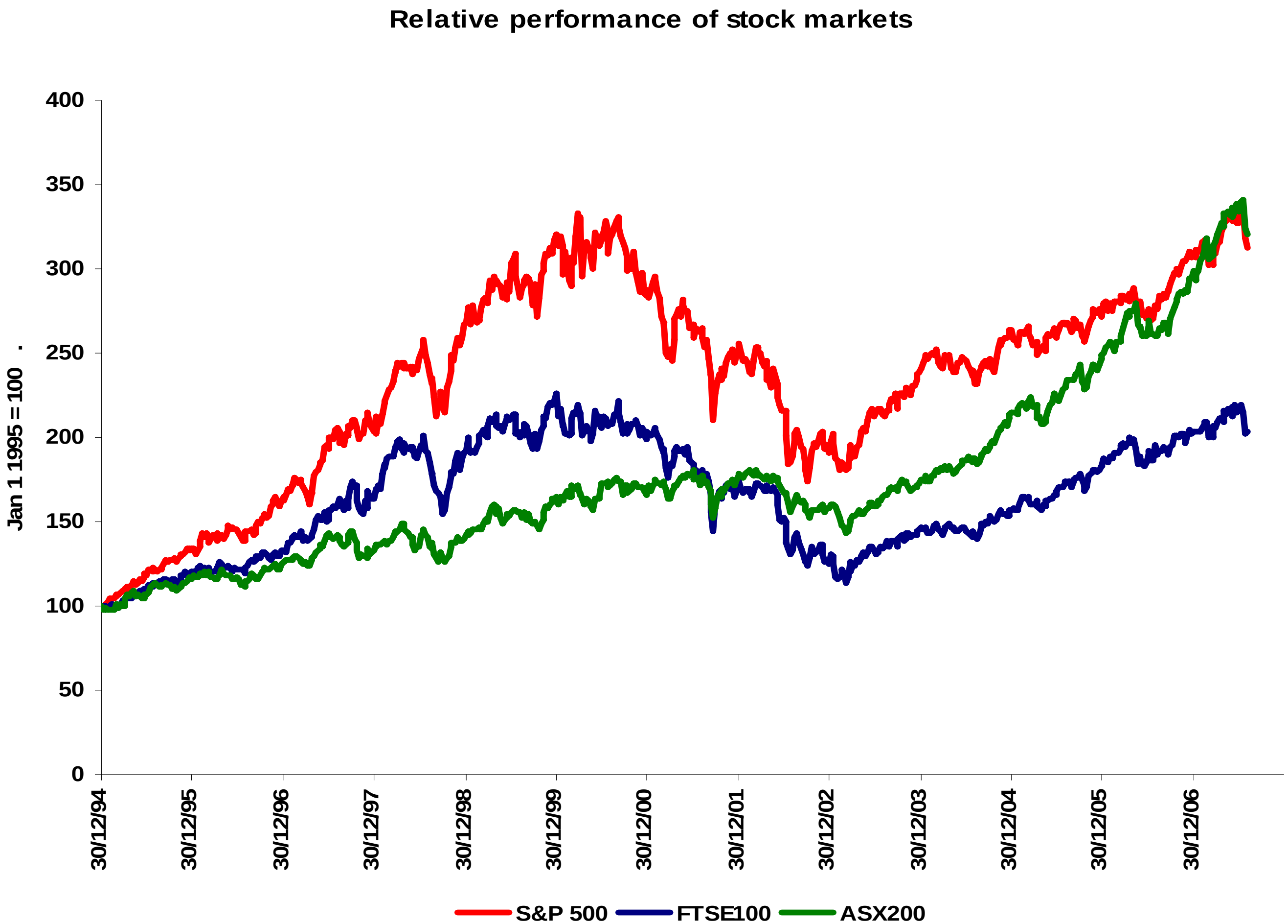
Market returns – one and three years



2006/07 was a repeat of the previous three years – an environment favourable to growth assets

Bonds performed less well as interest rates edged up over the latter half of the year

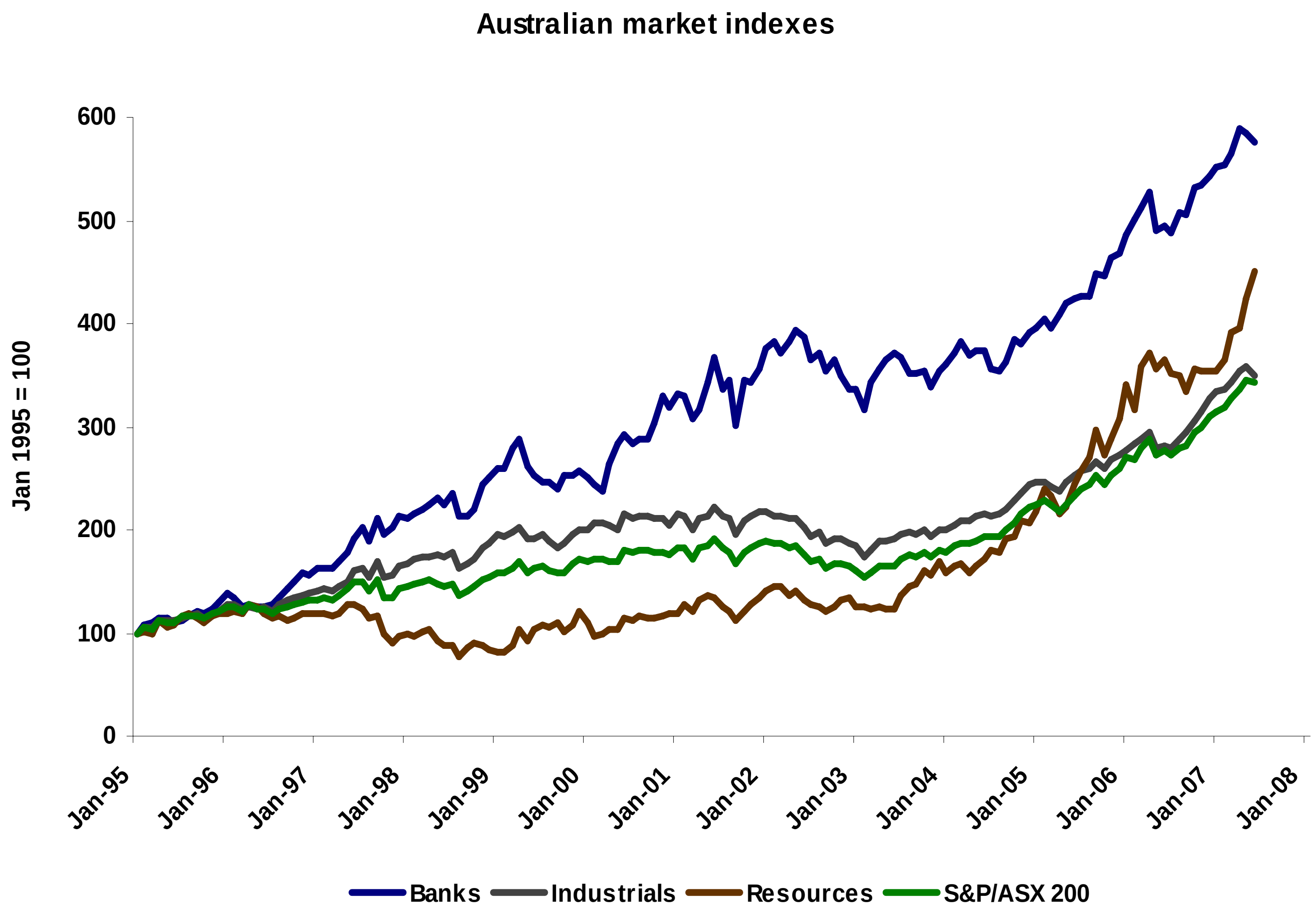
Stock markets since 1995



The Australian stock market didn't "benefit" from the global equity bubble that started in 1995. And so did not suffer the severity of the subsequent crash

It has, therefore, performed equally well over the longer run

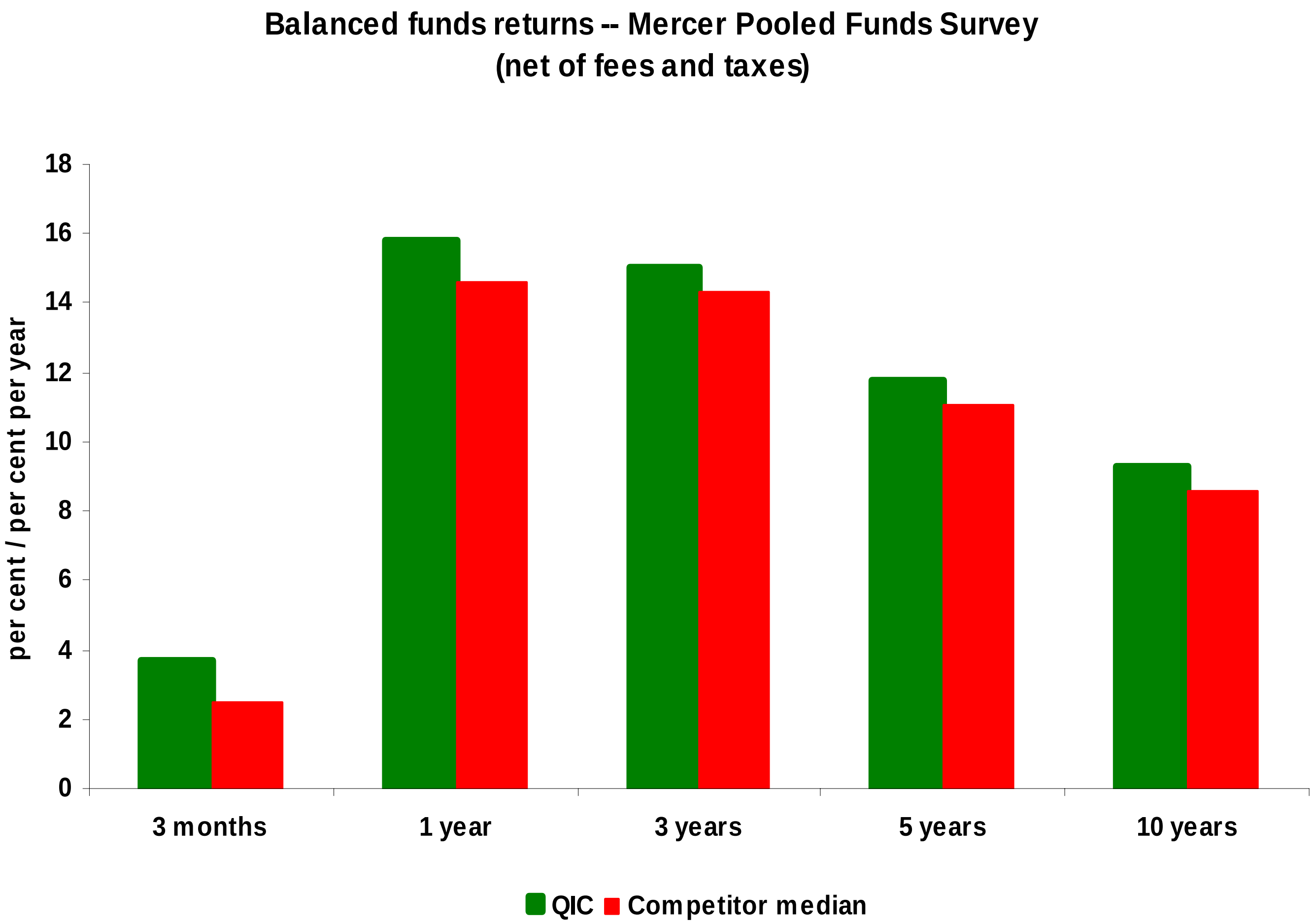
Sector performance of S&P/ASX



Banks were the best performing sector up until the early 2000s.

The resources boom on the back of a commodity price boom has seen resource stocks out-perform since 2004

A “typical” balanced fund – QIC Growth Fund



Funds long equities and other growth assets have done well over the last four years.

But the ten year returns are about what we would expect over the long run – and going forward

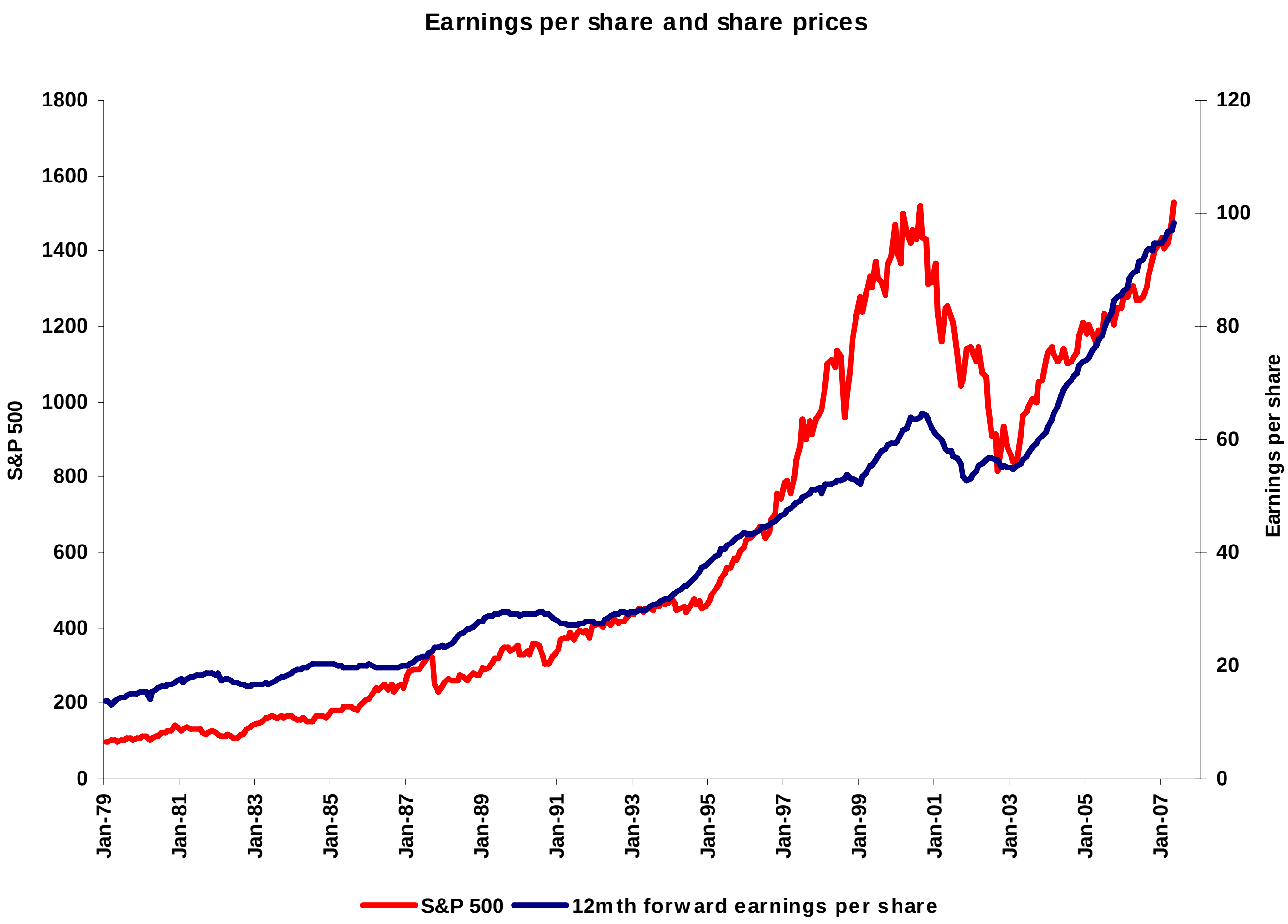
Markets today

- Markets recently have been more volatile than has been the case
- Factors exercising the mind of market participants are:
  - Repricing of risk
  - A potential liquidity squeeze, on the back the US sub-prime mortgage debacle
  - Contagion from the US housing market to the broader economy
  - Sustainability of corporate earnings
  - Strong global growth fuelling rising inflation
  - Capacity constraints adding to inflationary pressures
  - Unwinding of “global imbalances”

What determines the value of shares?

- Put simply – the value of the underlying companies determines fundamental value
- And this is determined by the value of their corporate earnings
- And this is determined, on average, by the underlying strength of the economy
- Where share prices go tomorrow depends on today's share price relative to fundamental value

Stock market indexes and EPS



Not surprisingly, therefore, there is a high correlation between measures of earnings per share (EPS) and market values

So, the future of stock prices depends on …

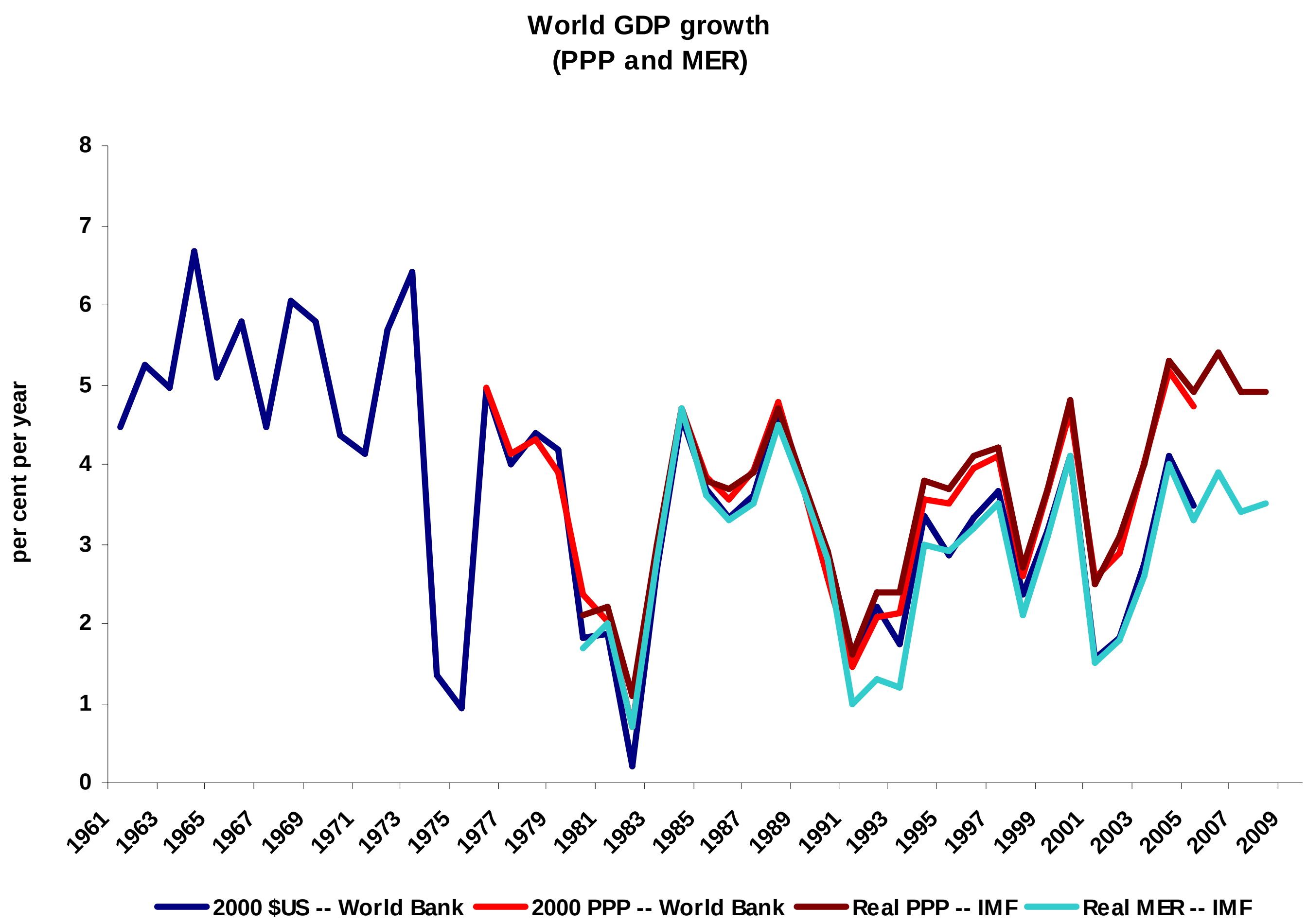
- Where
  - ∗ future real GDP growth
  - ∗ future inflation
  - ∗ future interest rates

  all go

- and on where they are now
  - ∗ i.e. current valuations

- Get these right and the rest is easy!!

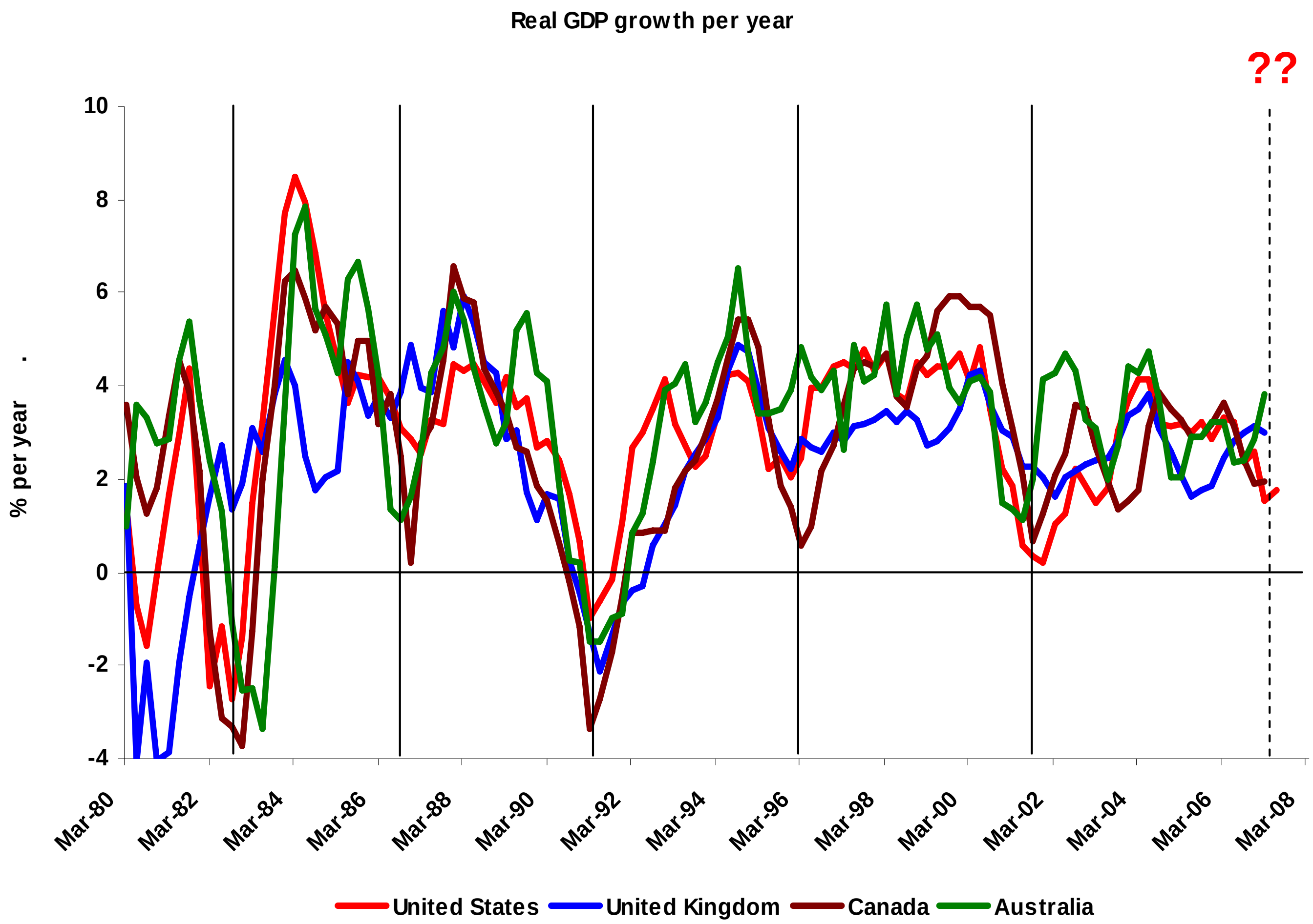
Real global growth



Global growth is strong, though not a record levels

The presence of the emerging economies is finally being reflected in the data

The global growth engine – Anglo economies



However, the engine of global growth remains the Anglo-economies

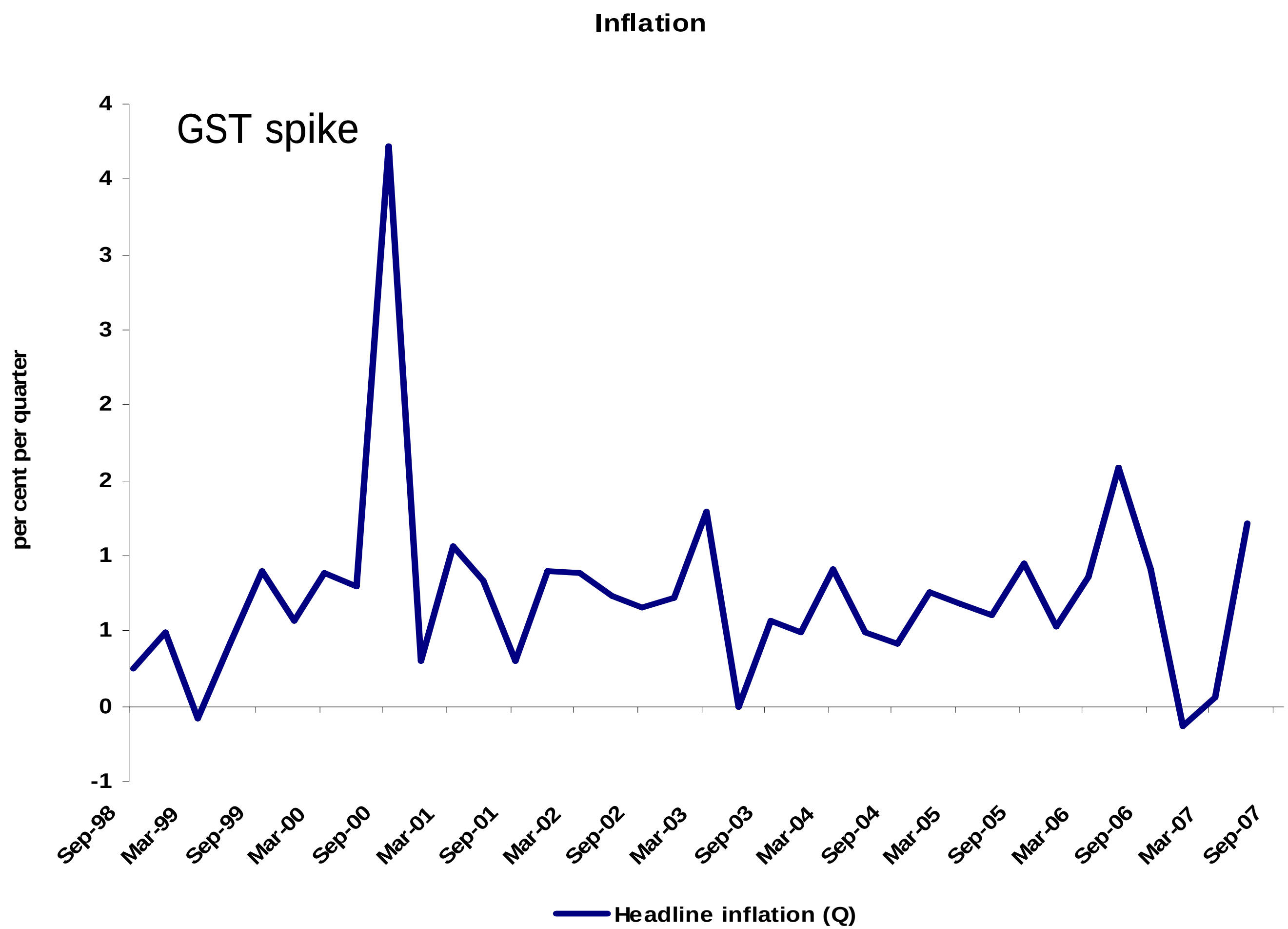
Of these, the US is the "locomotive

It would seem that the engine economies have passed through the trough in a typical business cycle and an expansionary phase has been entered

Conclusions on growth

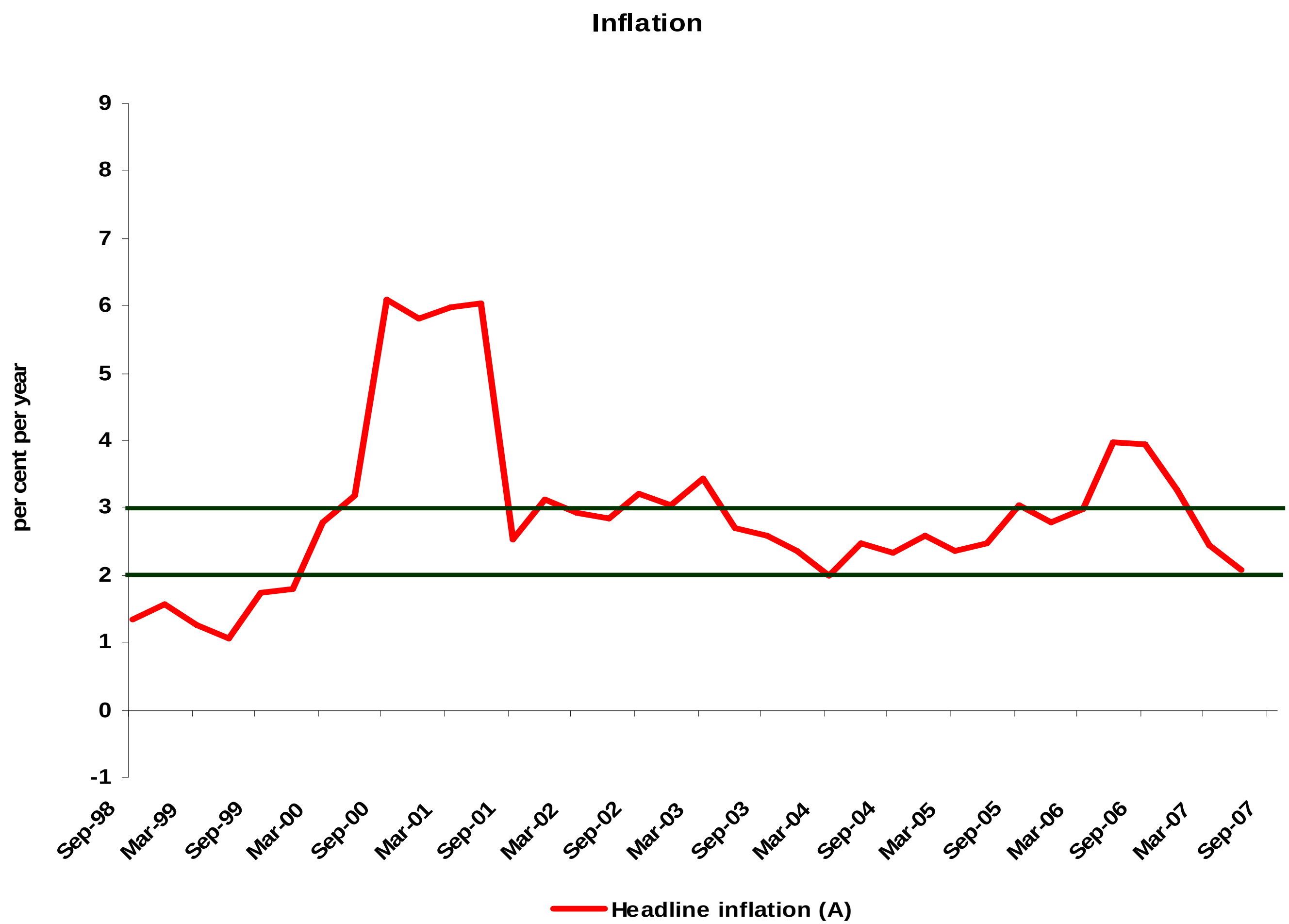
- Global growth is strong, with emerging economies – China and India – contributing
- The Anglo business cycle is entering an expansionary phase
- In the US
    - Consumption is holding
    - Business investment, ex housing, is recovering
    - Housing remain weak (as it does in Australia)
    - The labour market remains firm
    - Leading indicators point to future expansion
- Europe and Japan also are adding to global growth, for a change
- In Australia consumption, investment and the labour market all appear to be robust

What about inflation?



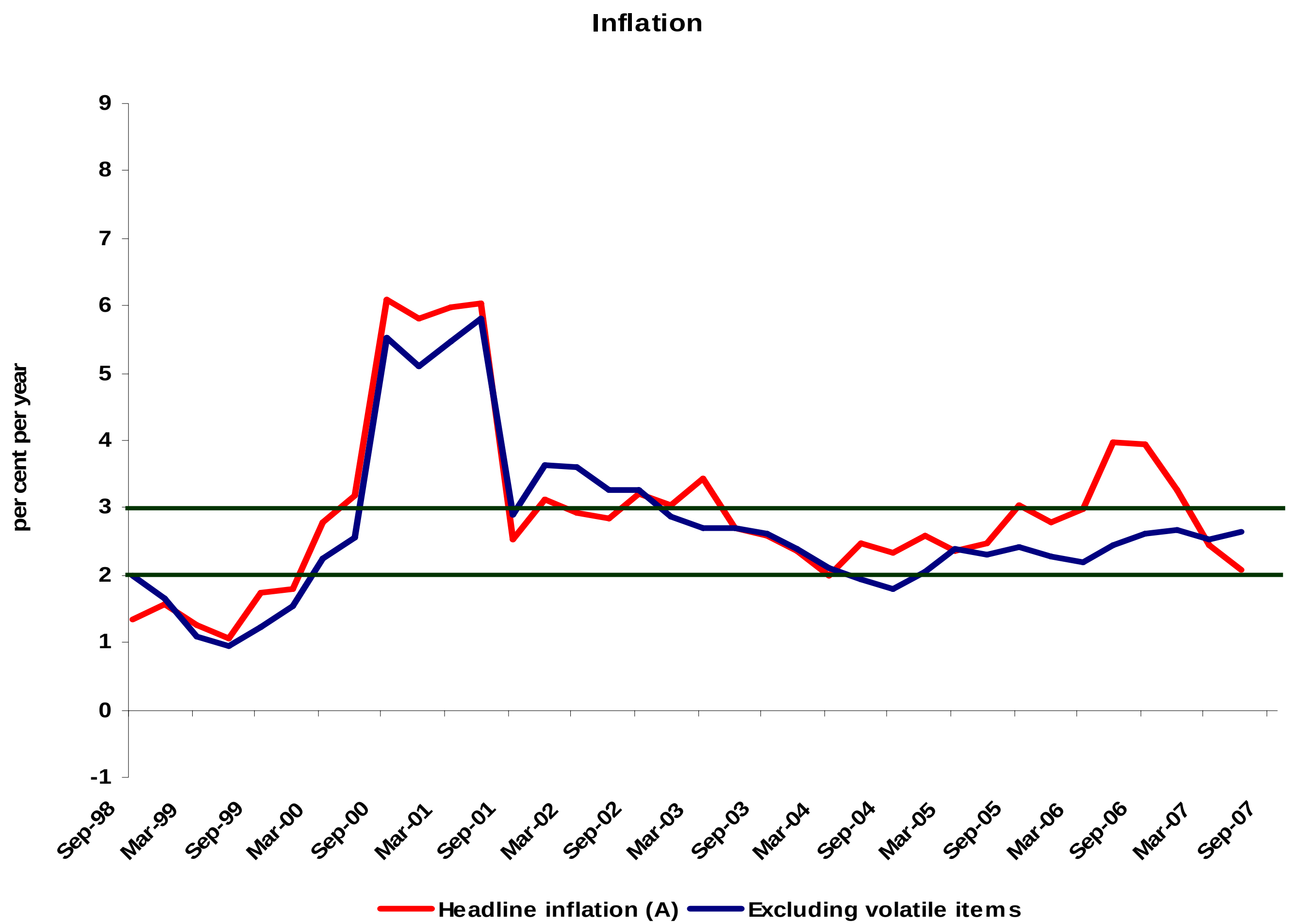
The recent up-tick in the June quarter inflation number was enough to cause the RBA to raise cash rates again, to 6.5%

But annual headline inflation is still falling



But the previous June quarter had an even bigger up-tick so, annualised, inflation is falling!

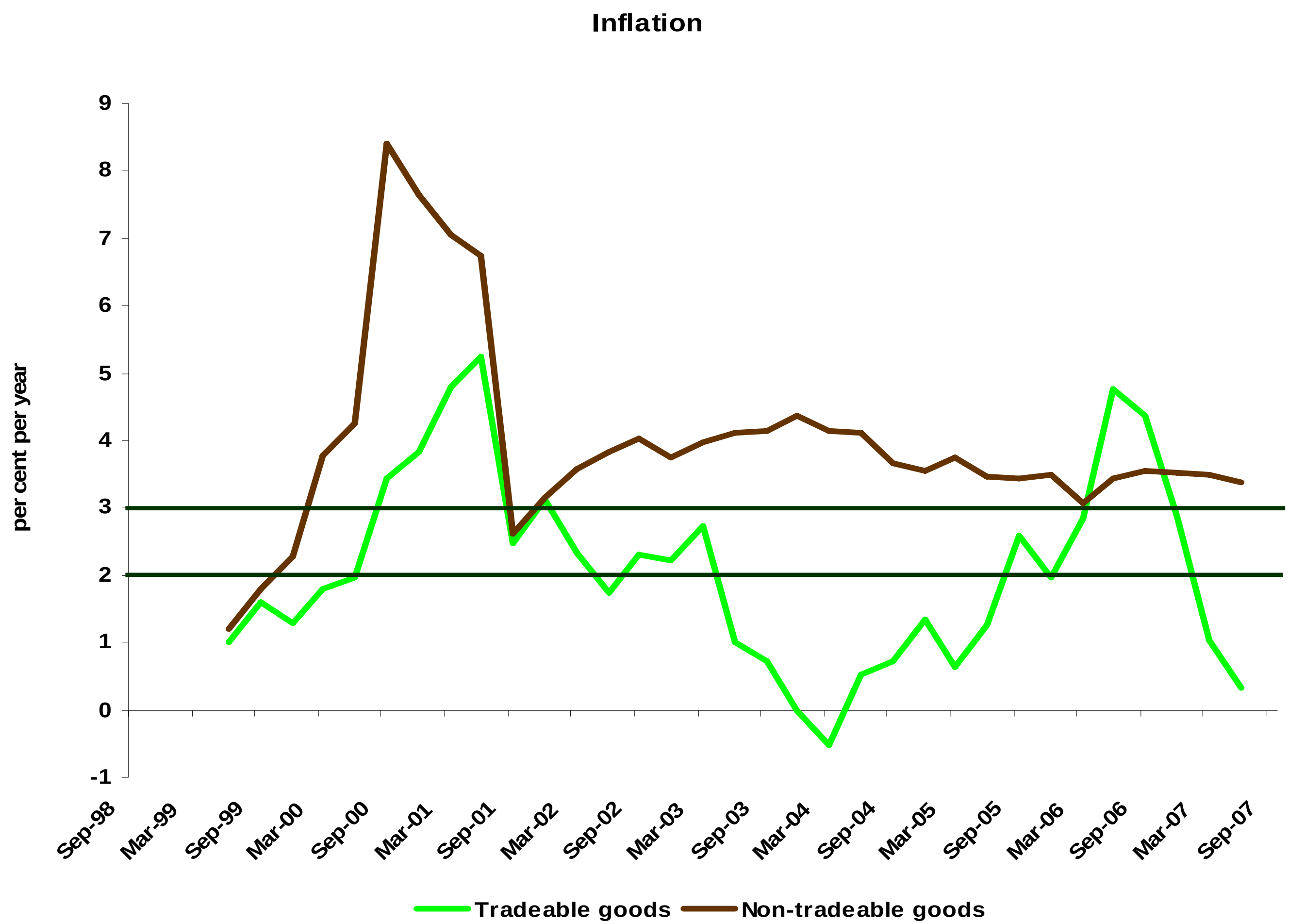
Less volatile measures also within ranges



Excluding "volatile" components sees underlying inflation more stable and within the RBA's target zone

One could make the case that the less volatile measure is edging up

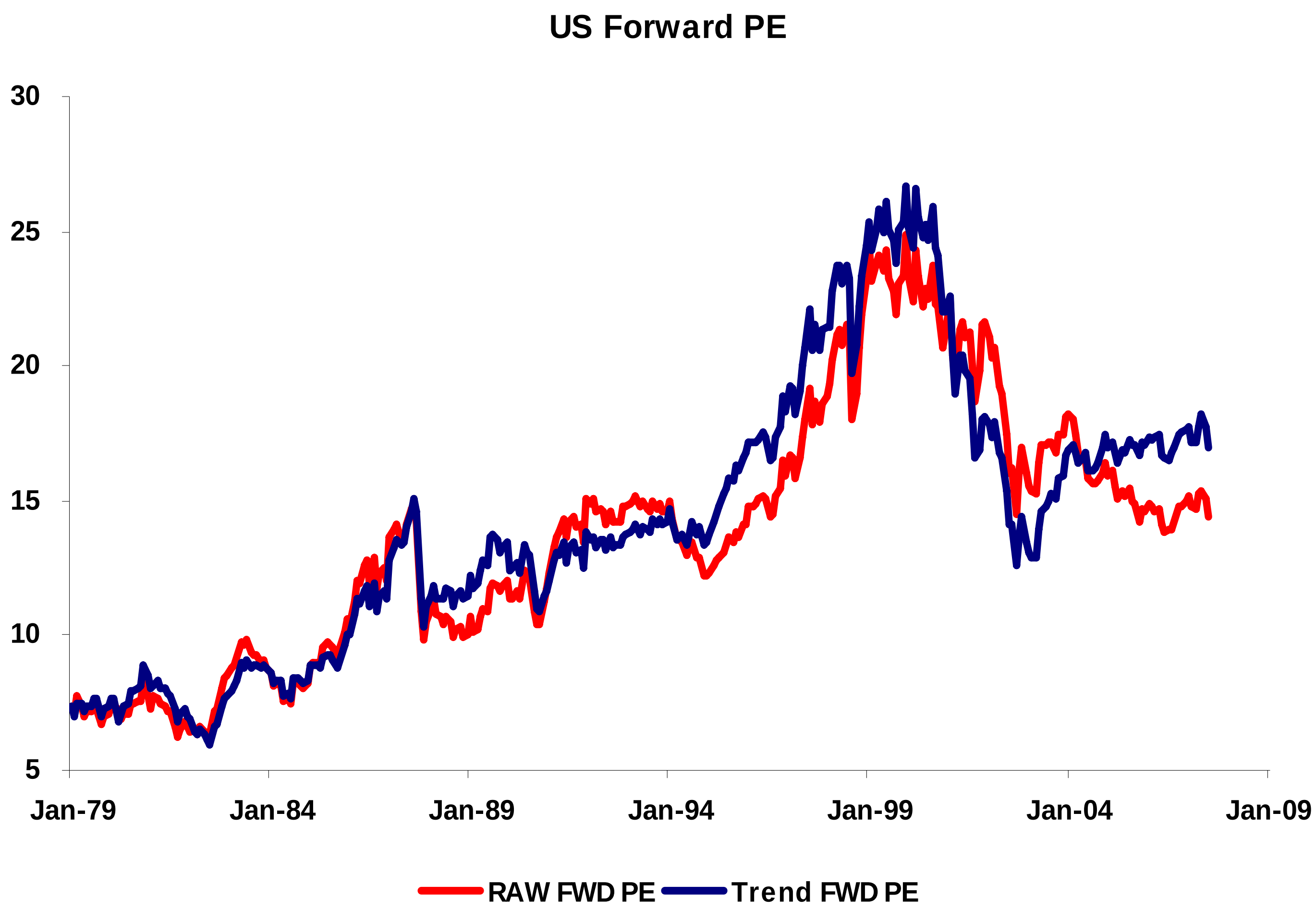
All volatility in inflation due the other factors



Non-traded goods inflation, while above range, is steadily falling

All the recent volatility in headline inflation is due the traded goods inflation – affected by foreign goods prices and the exchange rate – not the RBA

What about valuations?

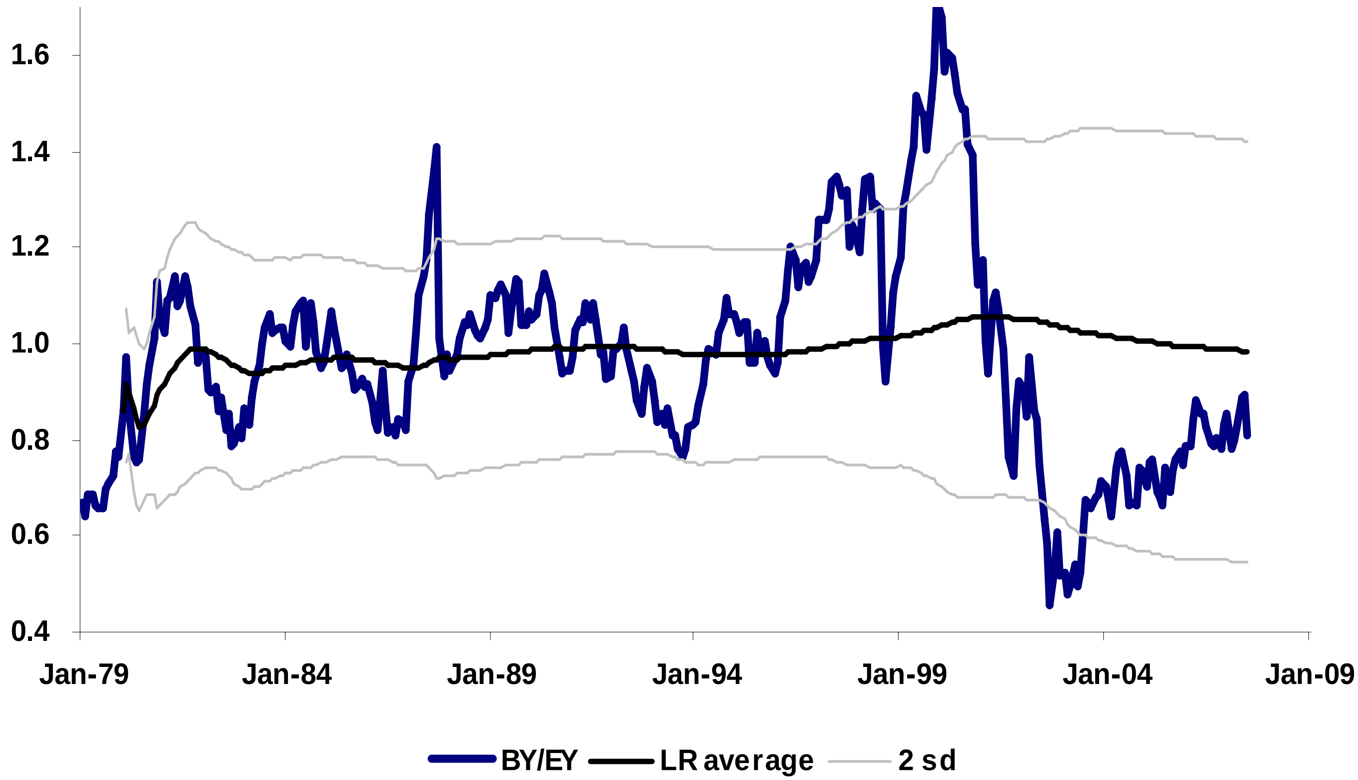


US PEs are back at long run averages following the equity bubble impacts from 1995 to 2003

Trend PEs above raw PEs indicate a downgrading of future earnings forecasts

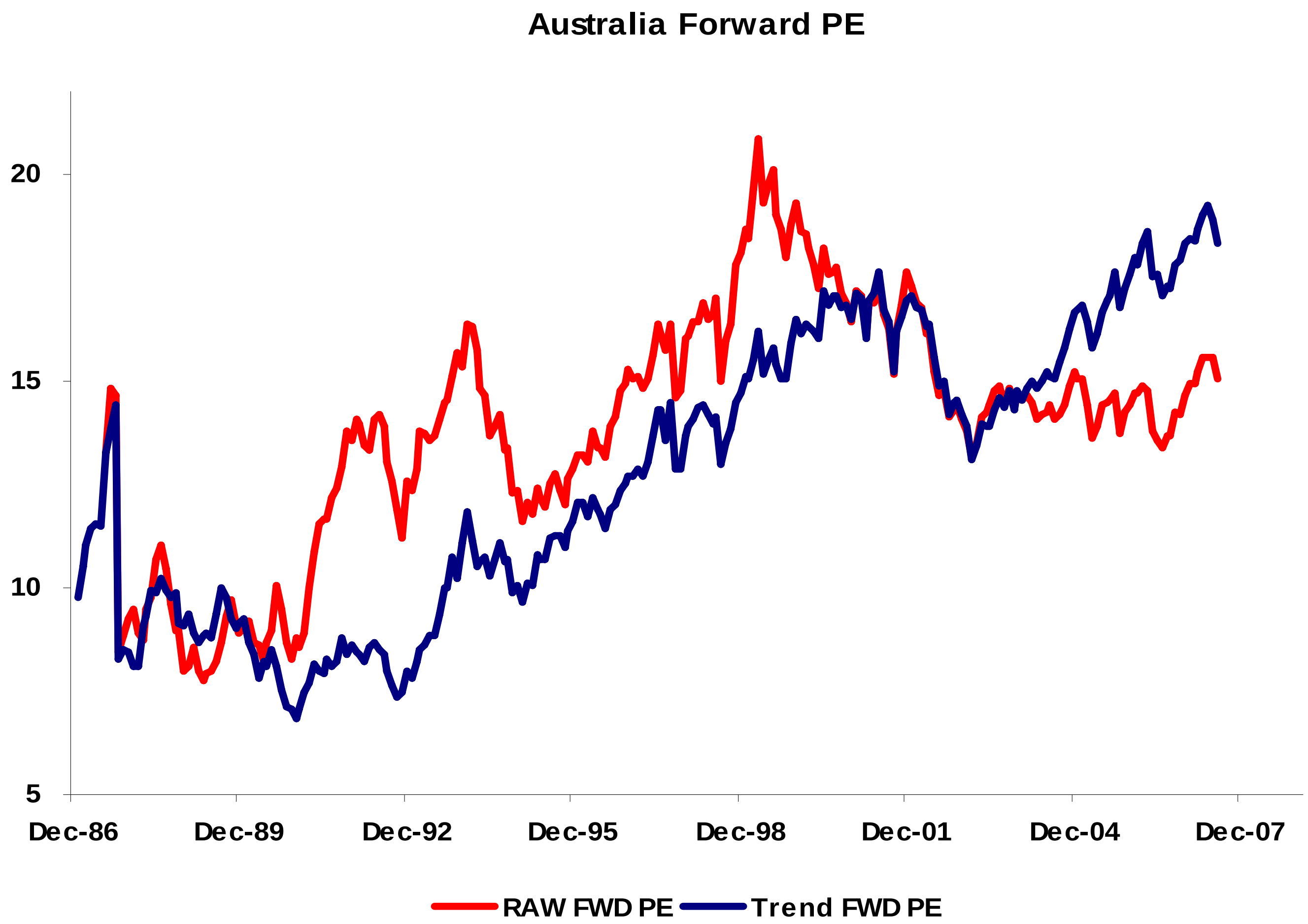
What about valuations?

US BY/EY



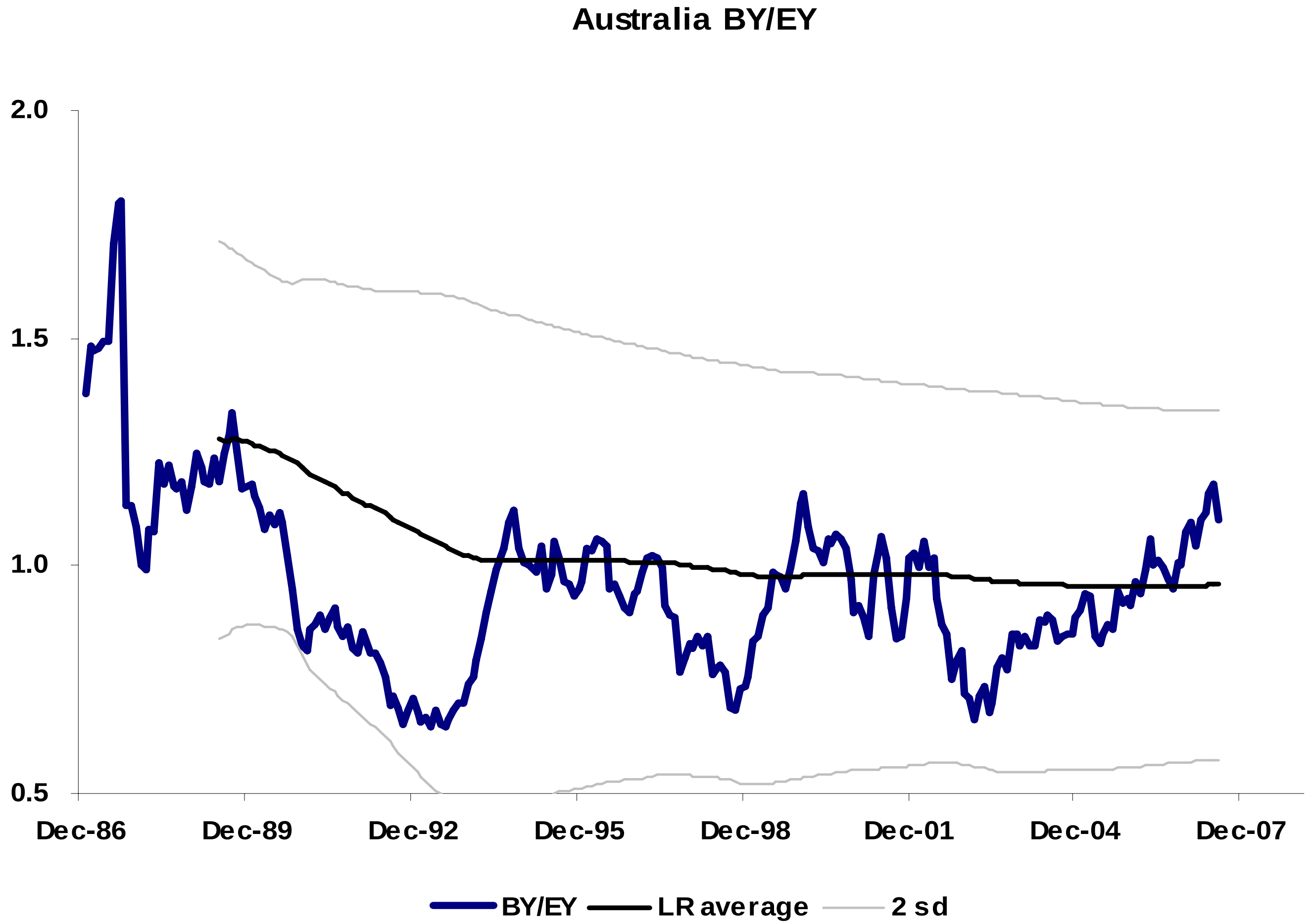
Equities do not look expensive relative to bonds

What about valuations?



A similar story for Australia, although valuations based on past earnings growth look more stretched here

What about valuations?



Equities look more expensive relative to bonds in Australia

What can we conclude?

- Global growth, US growth and local growth all look like holding up, even improving as the Anglo-economies enter into a normal expansionary phase of the business cycle
- Inflation in Australia, and elsewhere looks like it is under control, notwithstanding the pre-emptive moves by the RBA
- Valuations do not look stretched, although equities in Australia may be more fully valued than elsewhere
- All things considered, it remains a good environment for growth assets

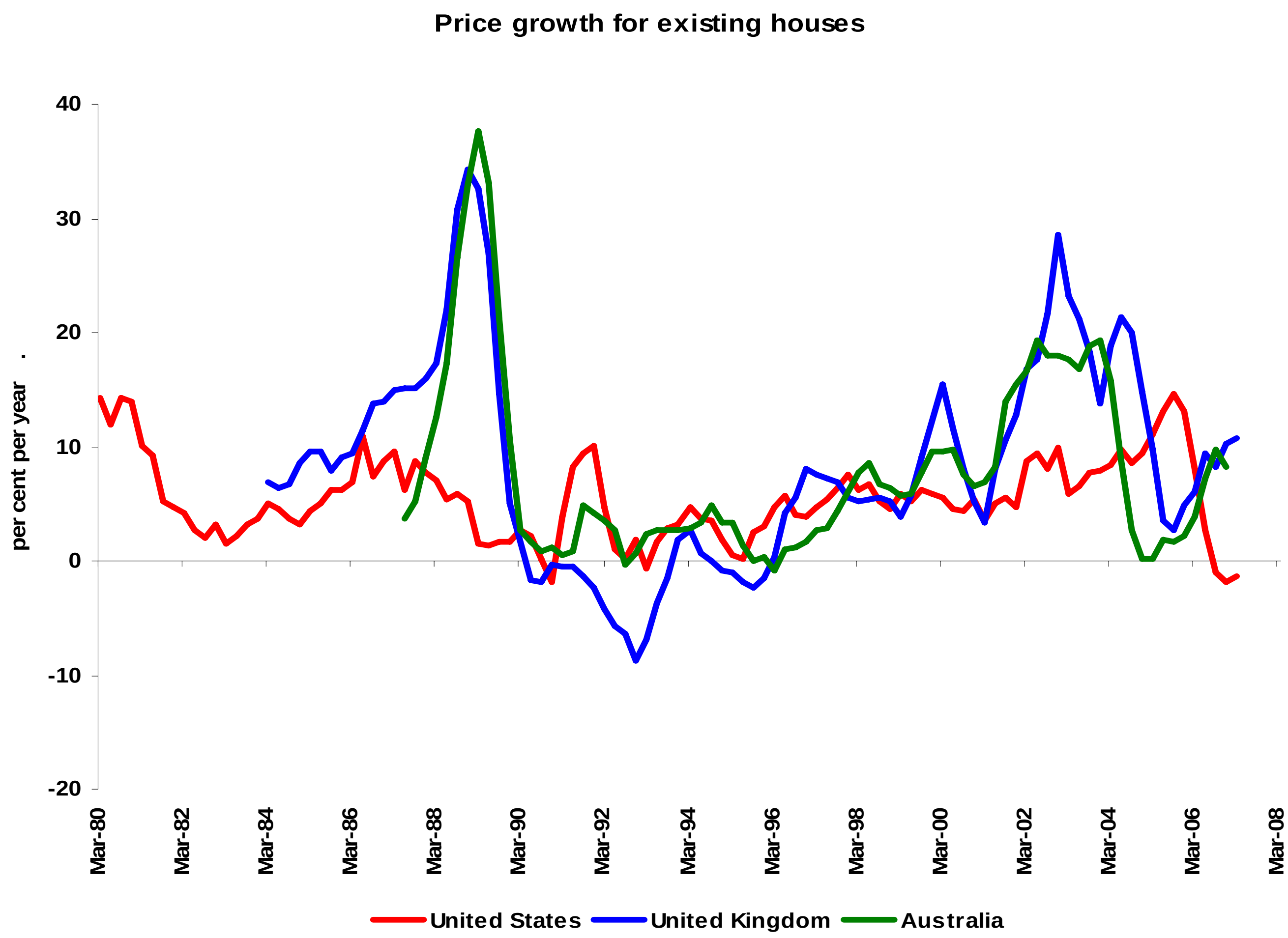
What about the risks

- US housing and sub-prime markets
- Are current earnings sustainable?
- Collapse of commodity boom
- Australian housing market and housing affordability
- Other risks

US house price growth collapse

The collapse in the growth of house prices has been the trigger for all kinds of concerns, including chatter about the US economy falling into recession

But …. put in a broader context

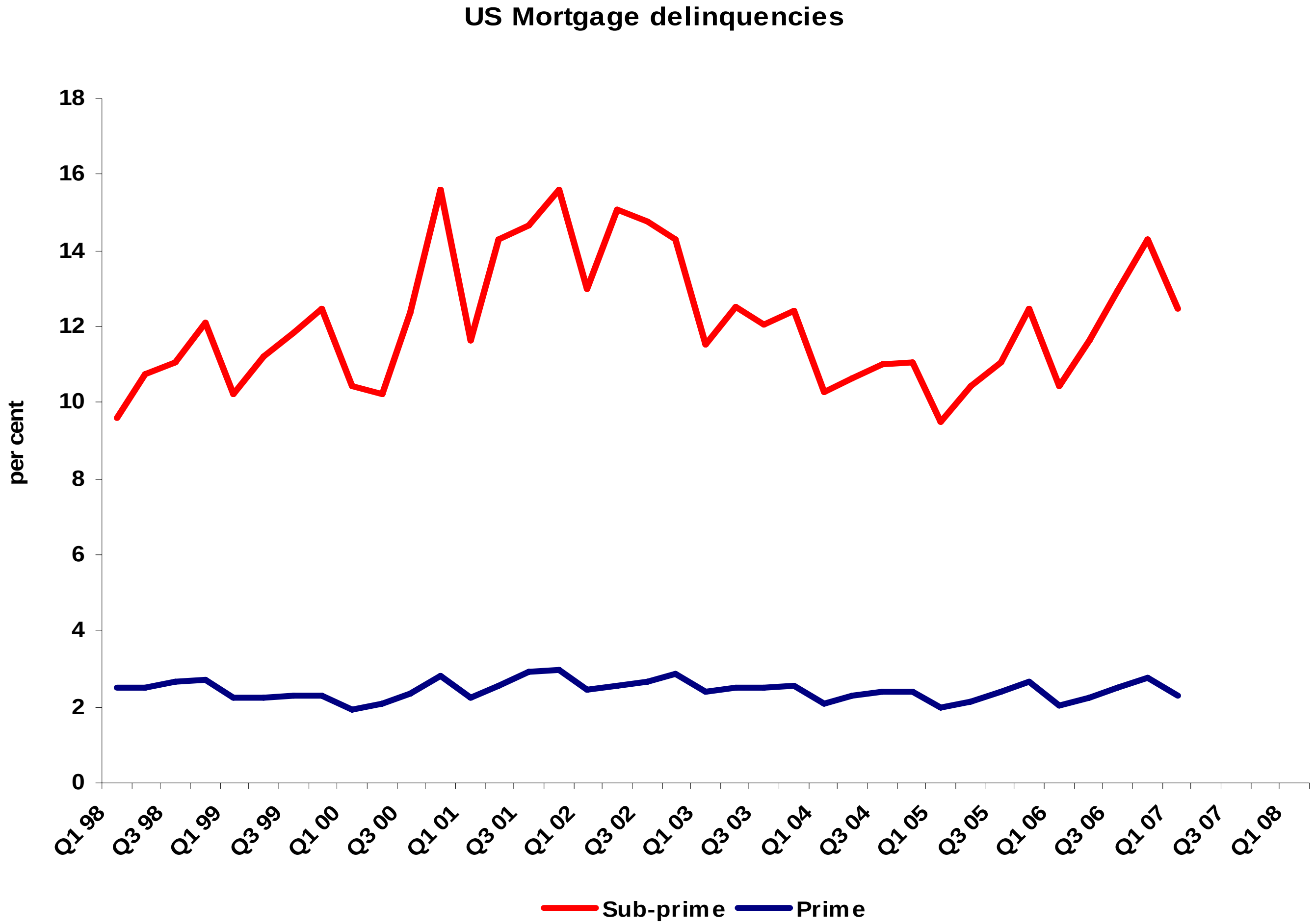


The recent US experience is not unusual in a broader context

Australia and the UK went through much bigger house price booms than did the US without the necessity of it "all ending in tears"

We need to find other causes to draw the bow of US recession

Delinquencies not beyond expectation

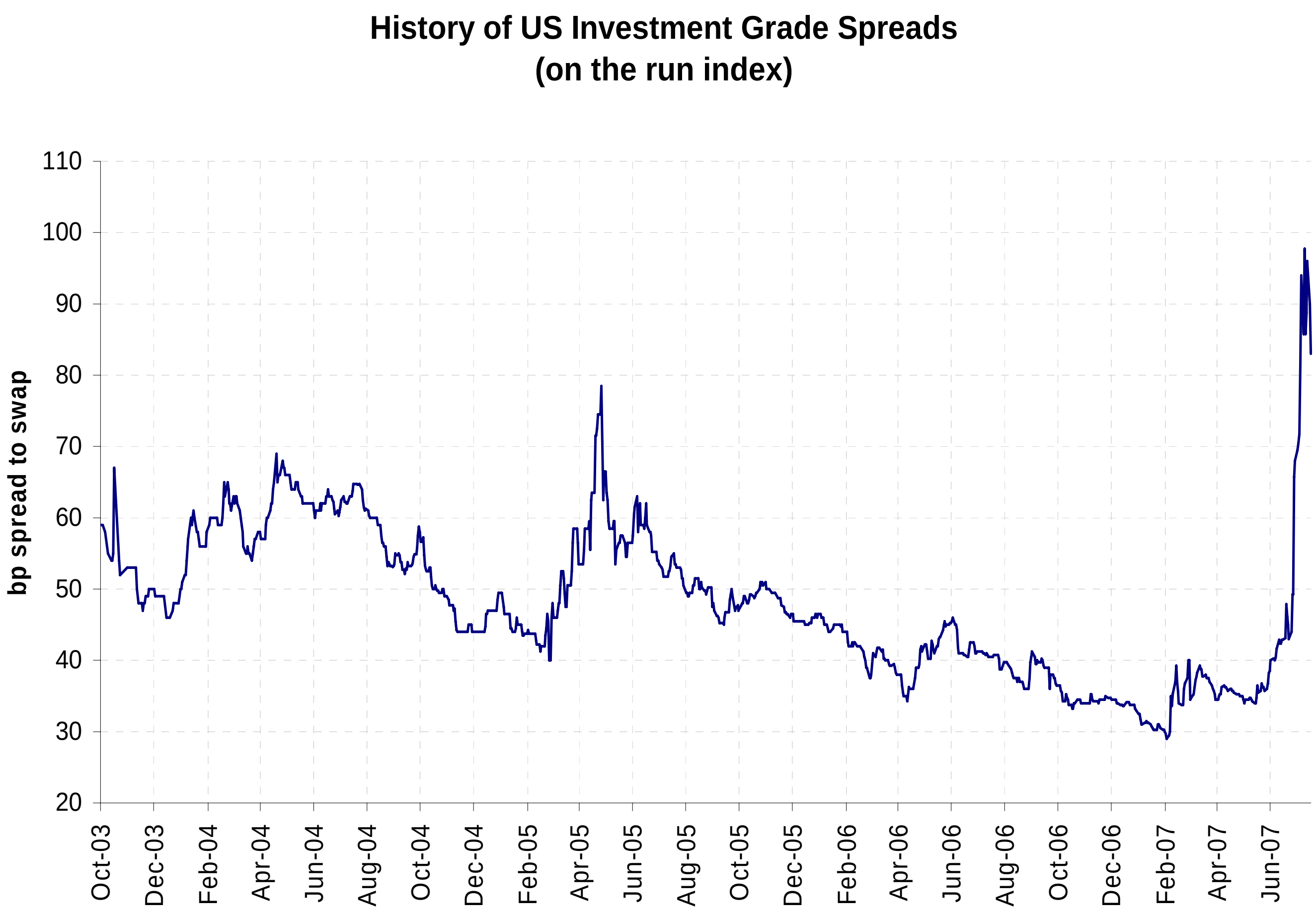


The collapse of US house price growth has certainly focussed attention back on the riskier end of the market

But the sub-prime market is about 15% of the US mortgage market which is about 40% of US bond markets

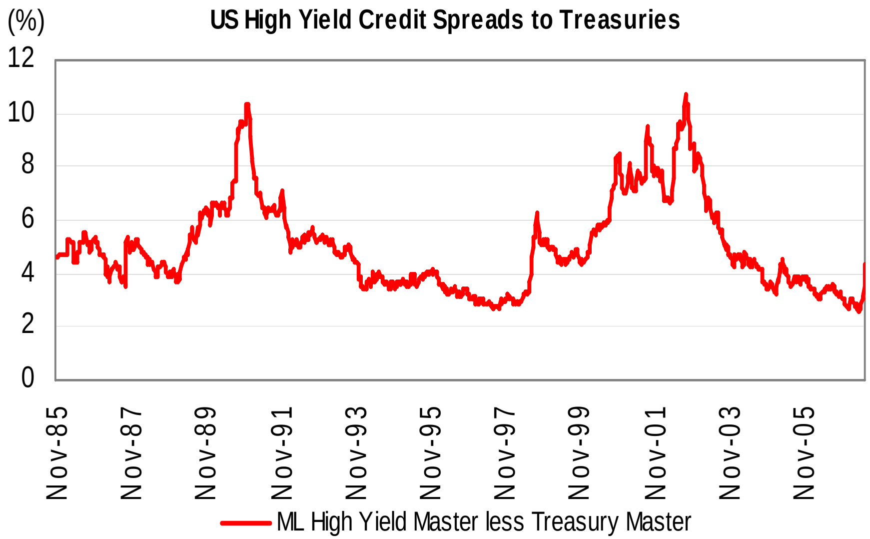
Roughly 15% of sub-prime mortgages are expected to fail

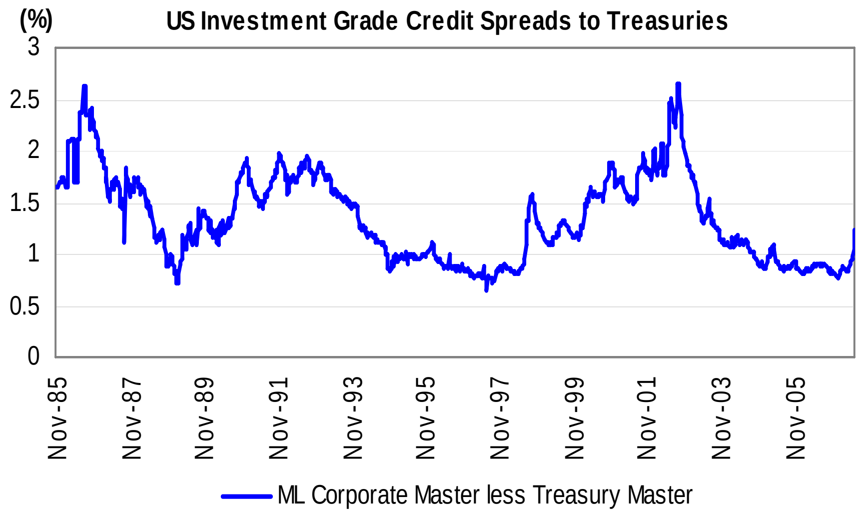
Credit spreads



The concern is that the sub-prime market problems will cause a broader liquidity crunch ringing about a collapse in spending, putting us on the vicious downward spiral into recession

Credit spreads





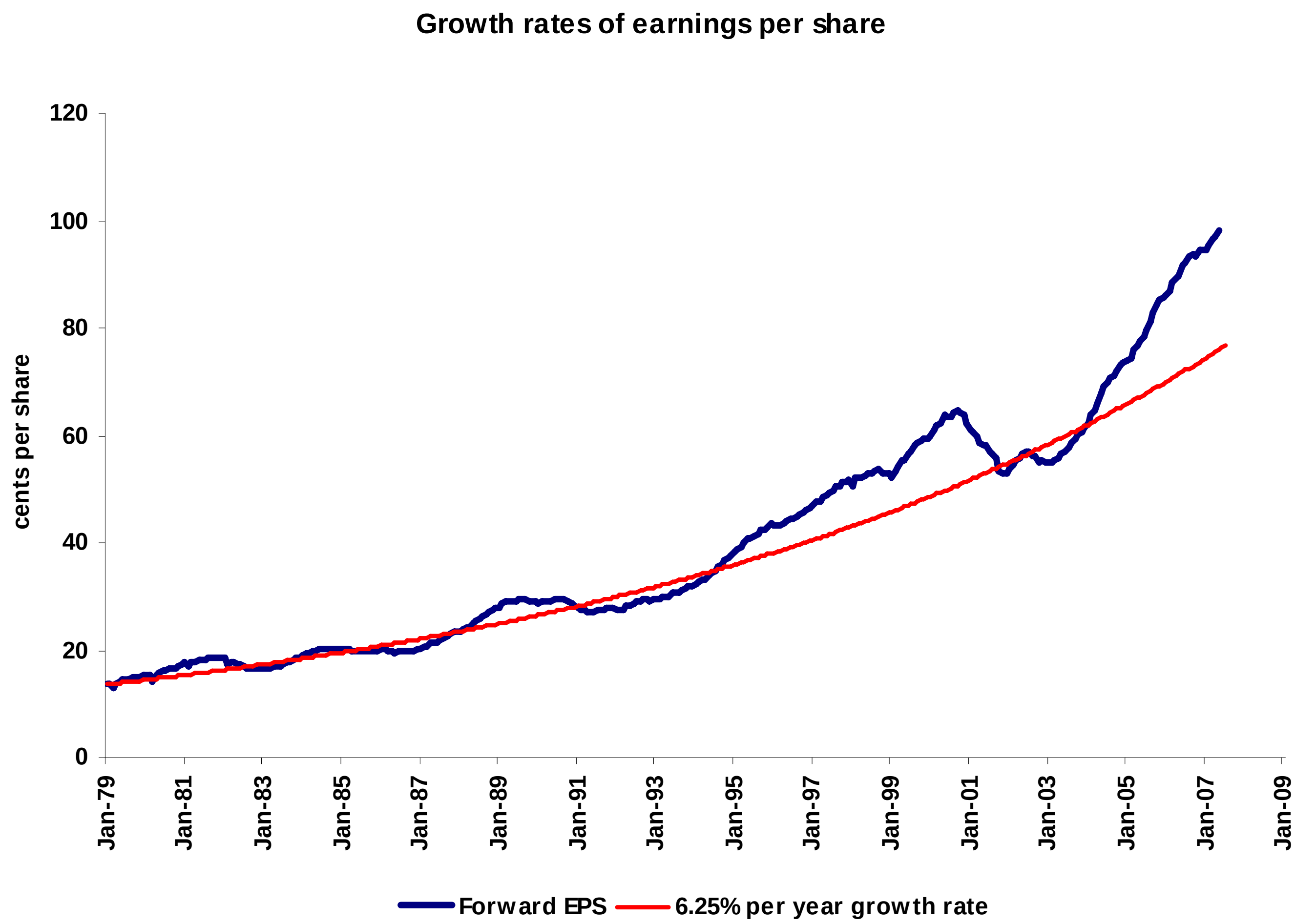
The concern is that the sub-prime market problems will cause a broader liquidity crunch ringing about a collapse in spending, putting us on the vicious downward spiral into recession

But all we see at the moment is the repricing of risk back to something approaching normal levels

Impacts of re-pricing risk

- Moderately tighter credit conditions – effectively a monetary policy tightening
- A pull-back from financial innovation and financial engineering of financial products, and wash-out of high risk borrowing
- A halt in M&A activity based on leveraging corporate balance sheets – a pullback in private equity activity
- A return to yield and “quality” earnings in stock markets, reversing the drift to value stocks on the hope of public to private buyouts
- Potentially real spending effects as households and corporates face higher borrowing and debt servicing costs:
  - Although the impact of this should be minimal based on the underlying strength of household and corporate balance sheets, coupled with the underlying strength in the labour market

Are past earnings growth rates sustainable?

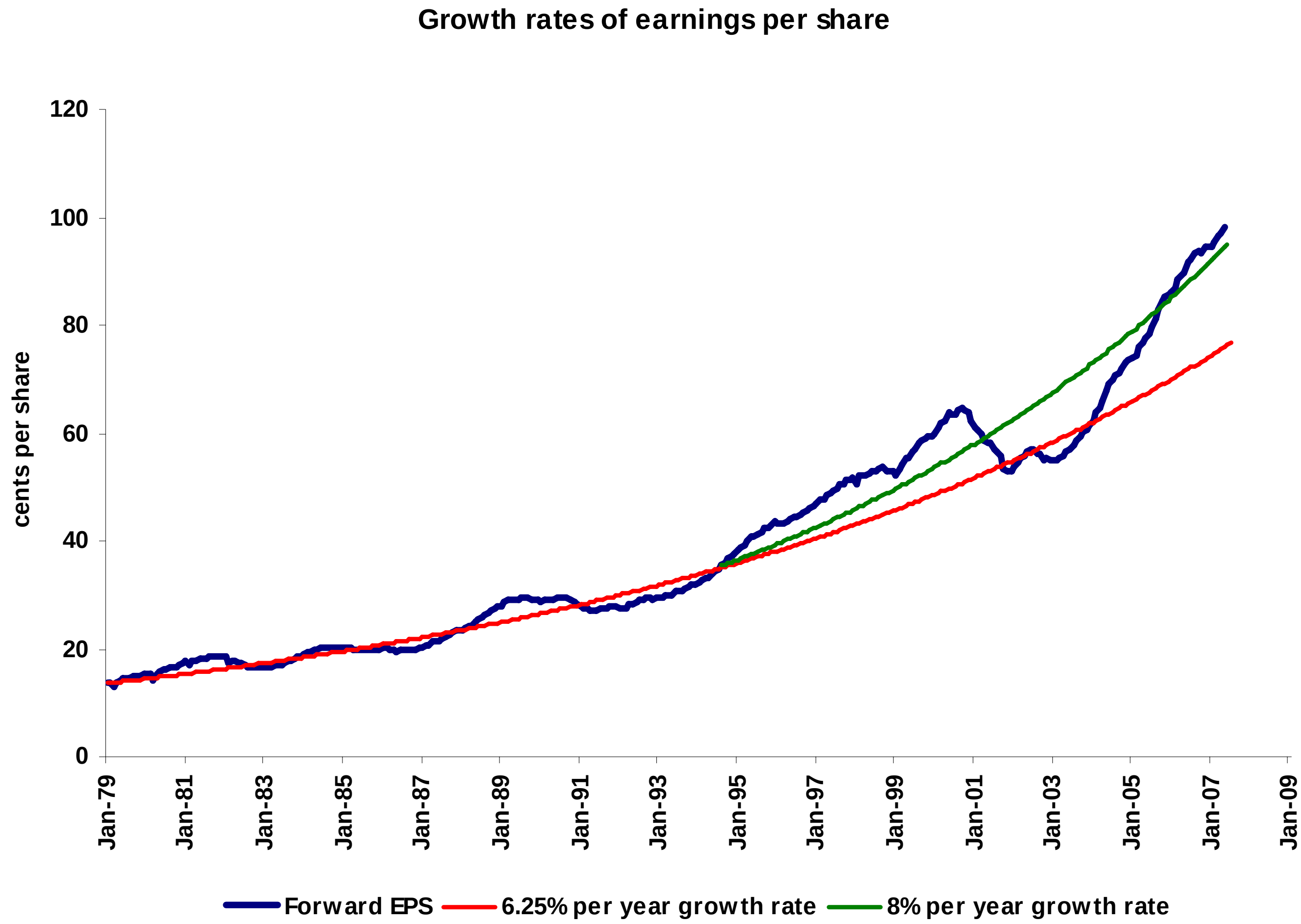


This gets to the question about current equity valuations, which on the surface look good.

But are they based on unsustainable forecasts of earnings going forward?

On some historical measures, yes.

Are past earnings growth rates sustainable?

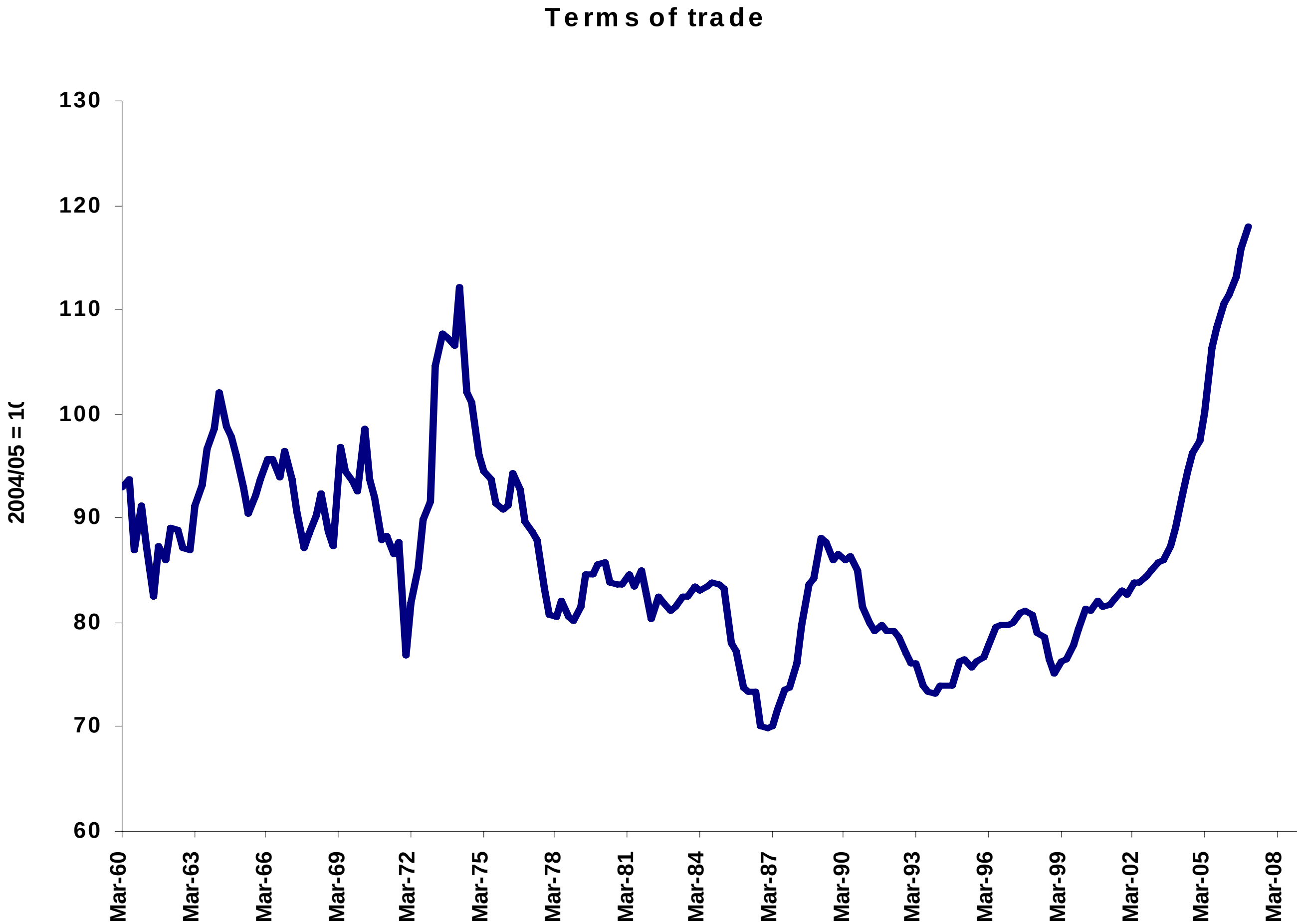


But, earnings growth potential also depends on the economic environment of the day

We live in a very good environment which, I think, is here to stay for w while

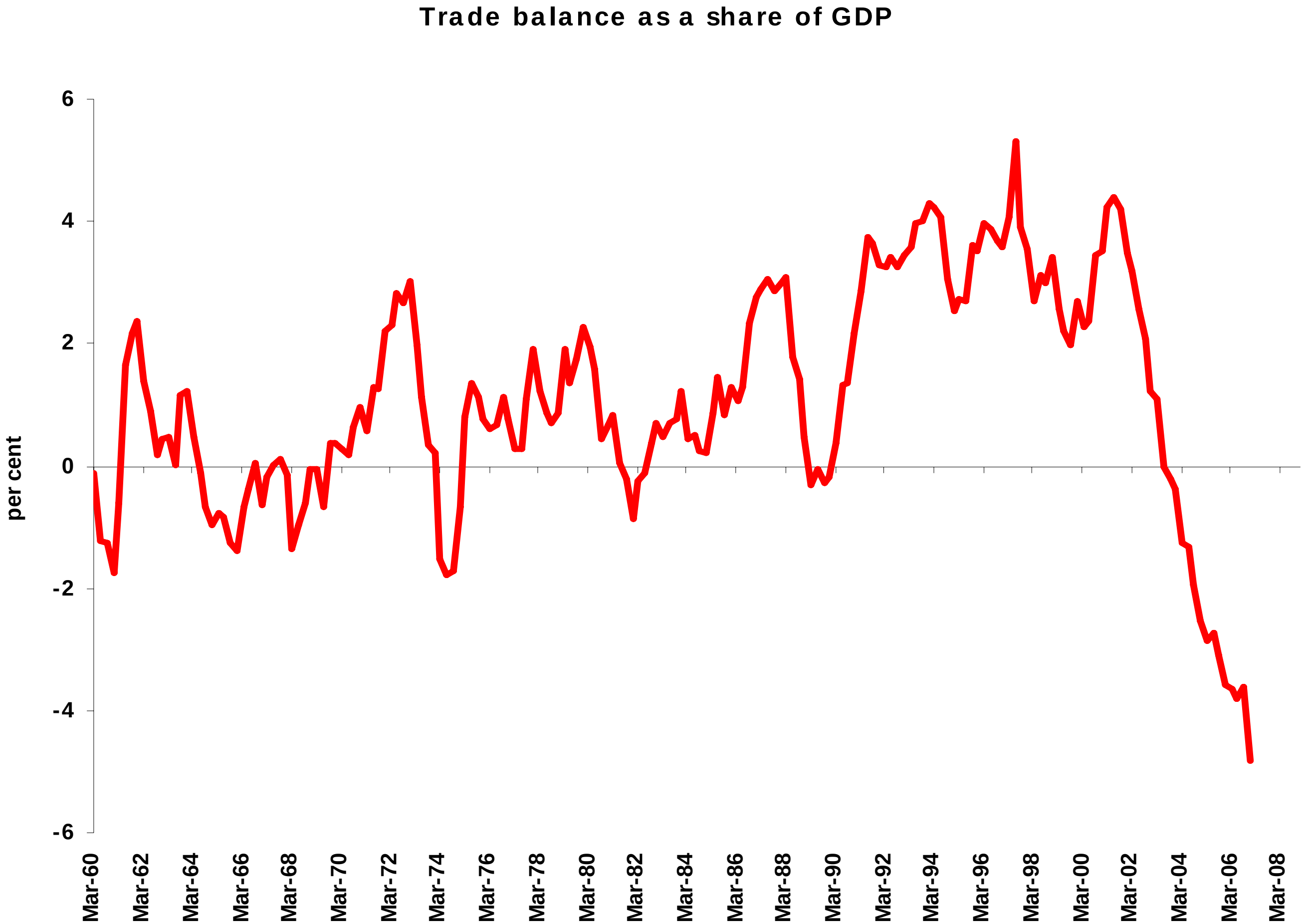
However, the experience of the past four years is unsustainable

What about the commodities boom?



The commodities boom is really a price boom, fuelled by lagging global supply against growing global demand, as reflected in the very high TOT

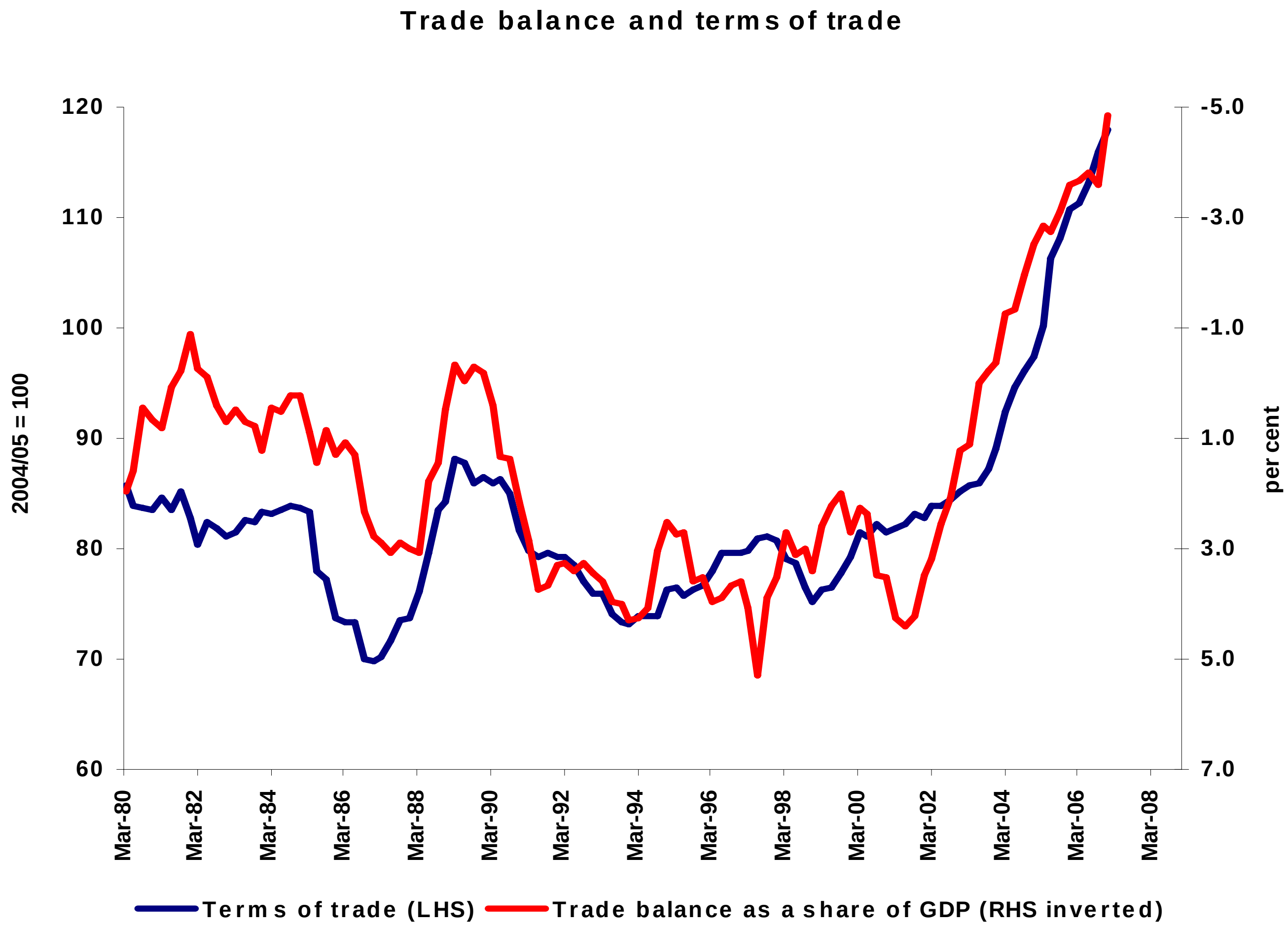
Causing a problem for trade balance



But it is a two-edged sword

The trade balance has collapsed because of the currently overvalued exchange rate

This used to be known as the “Dutch disease”

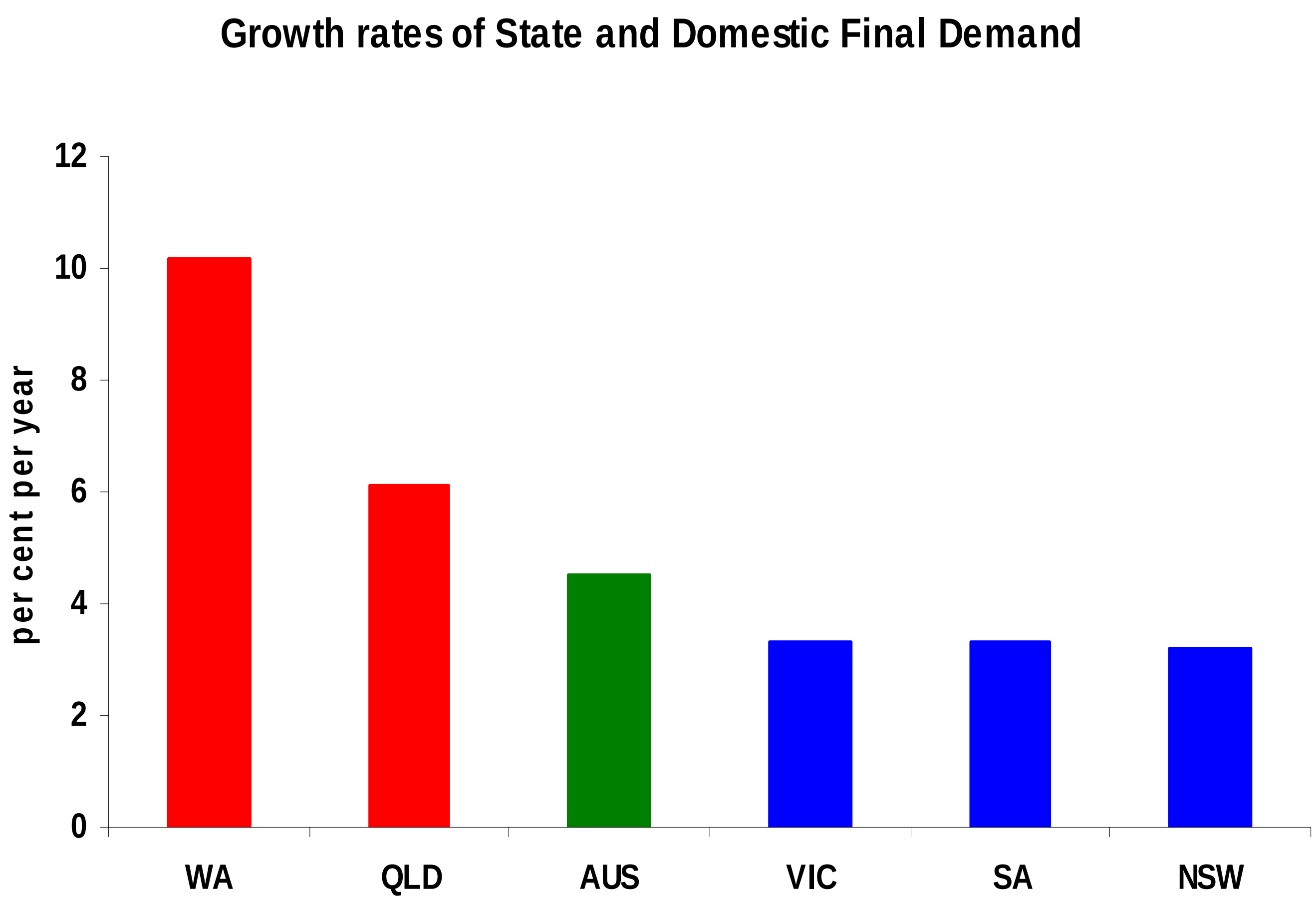


Every time the TOT improve, the trade balance worsens

This is counterintuitive when one thinks of a commodity boom leading to improved export performance

In fact, the very opposite happens

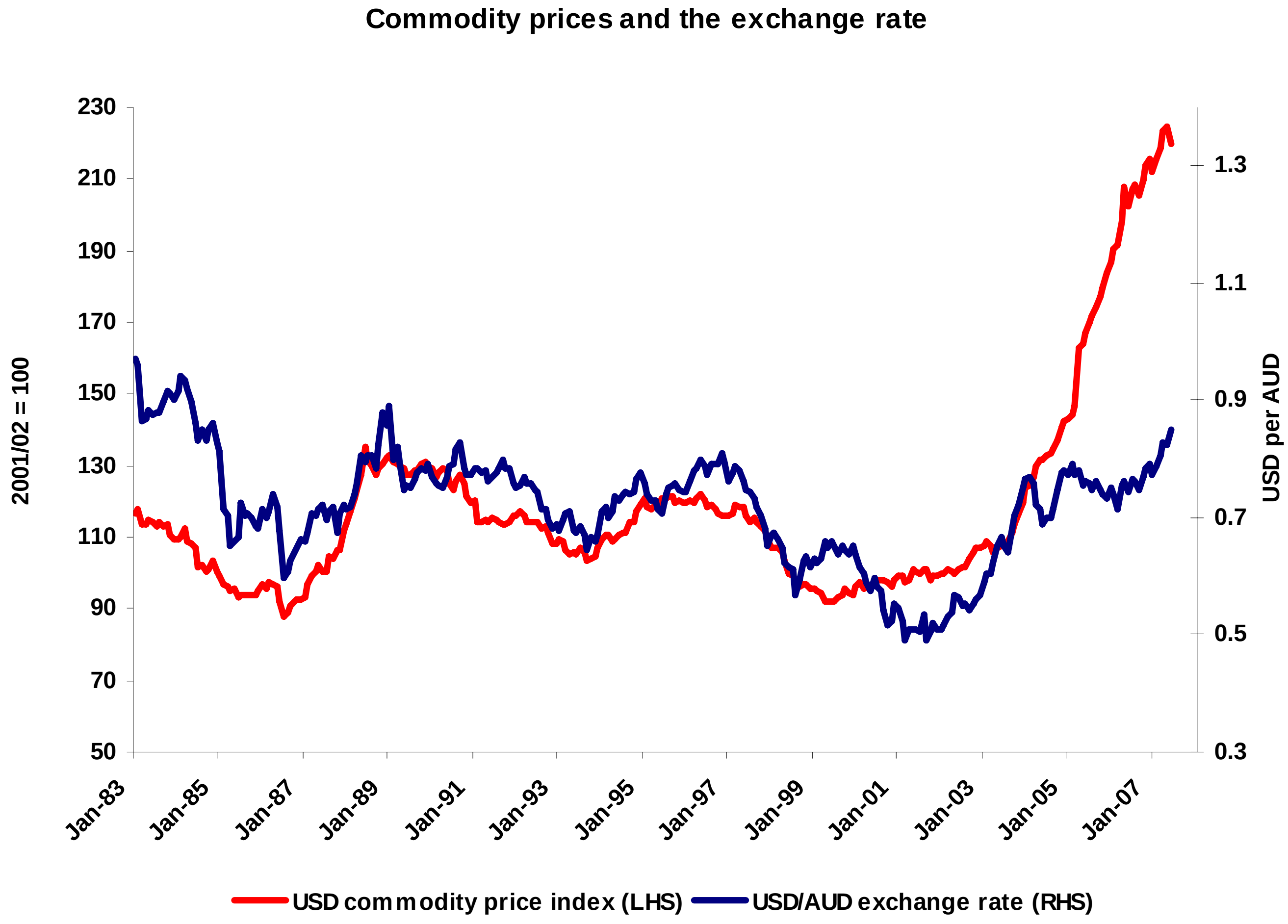
Creating a "two-speed" economy



The Dutch disease has created a two-speed economy

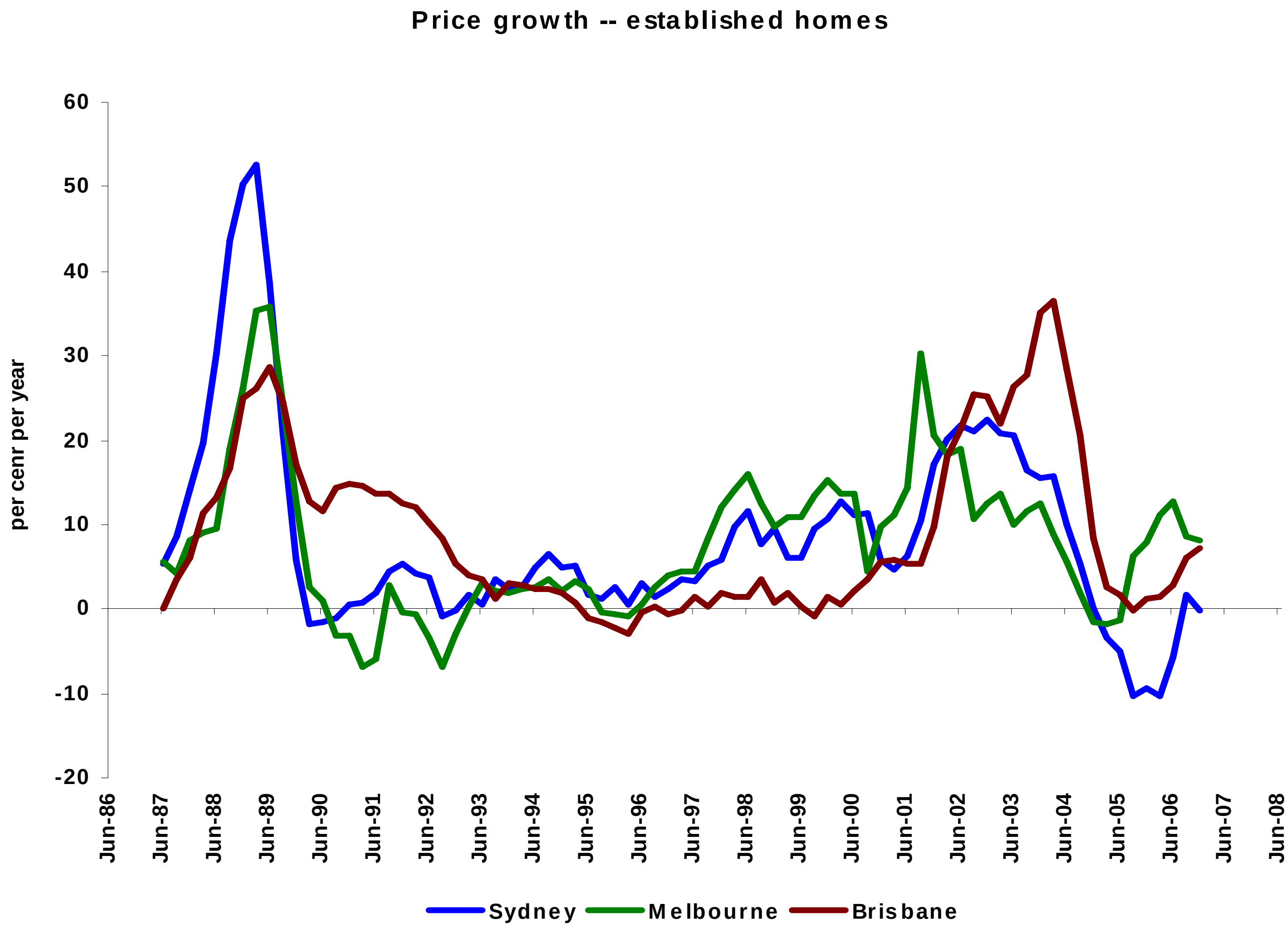
A further complication for monetary policy management

Is the AUD still a commodity currency?



When the TOT collapse under the weight of increased global commodity supply, the exchange rate should depreciate, restoring competitiveness to the rest of the Australian economy at the expense of the resource sector

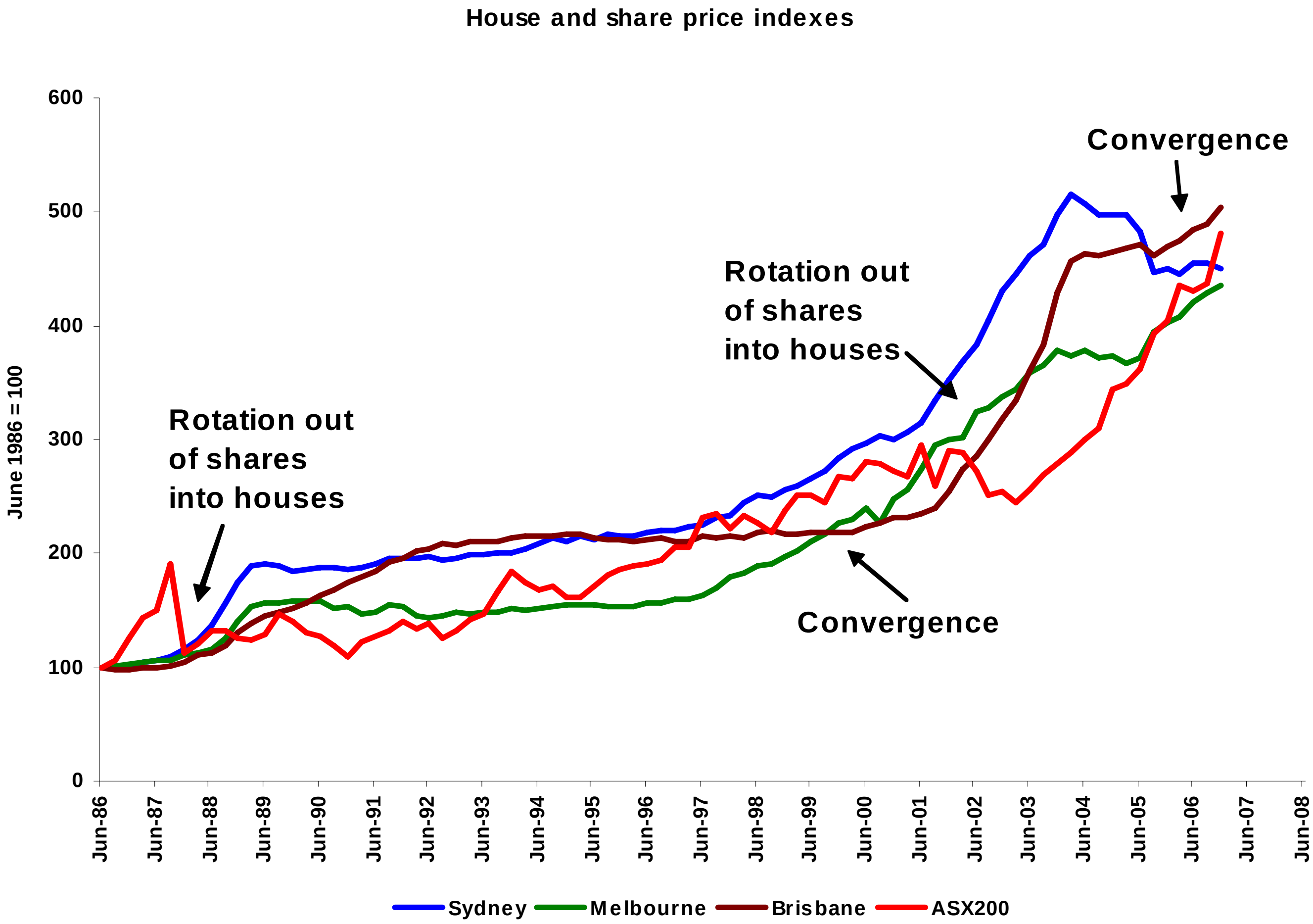
And house prices?



We have been through an extended house price boom, although nowhere near as strong as in 1987-89

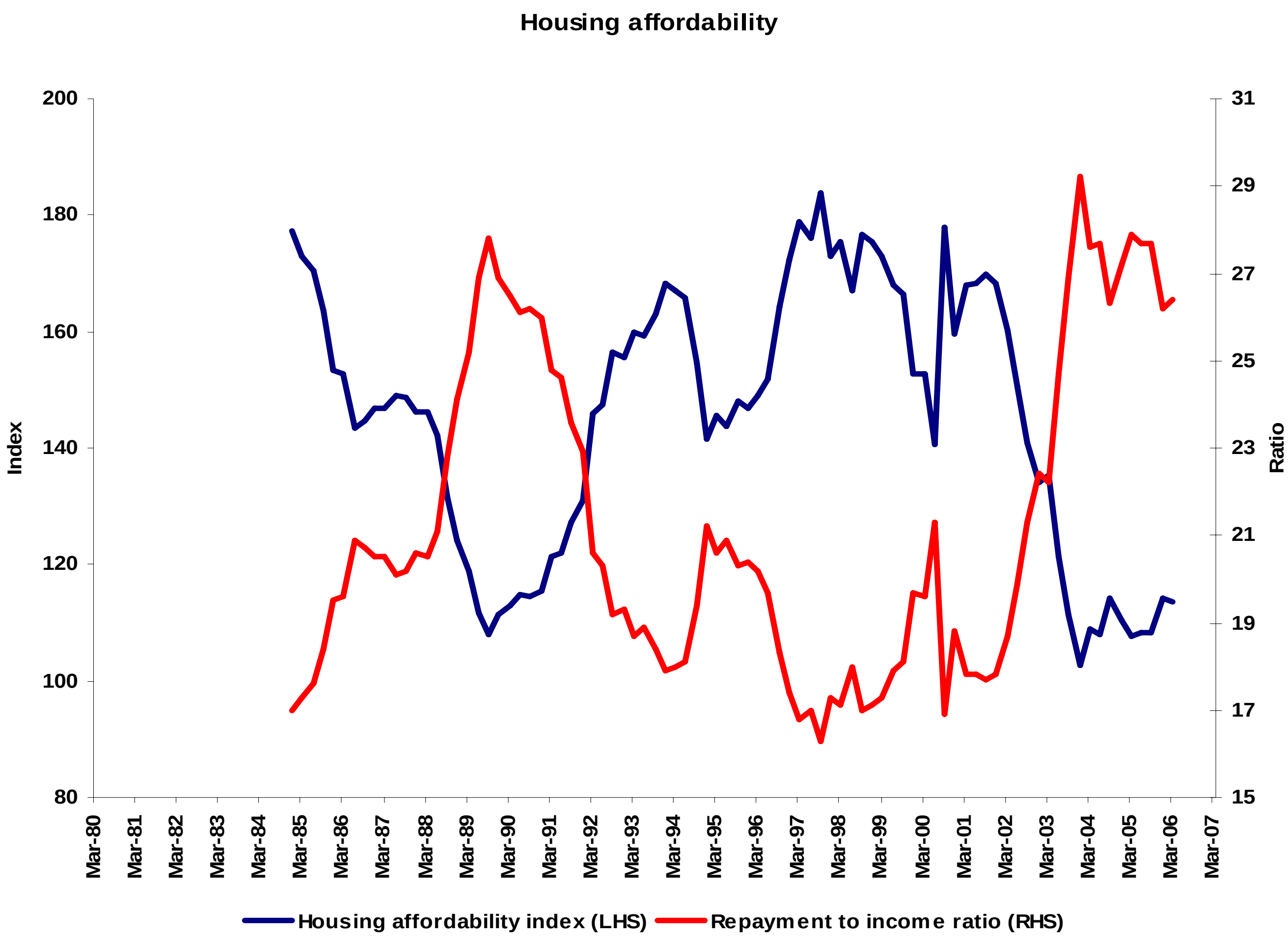
House price growth appears to be recovering and will be further stimulated if equity markets continue to weaken or show increased volatility

The average punter is a long-run arbitrager



Investors very sensibly rotate between asset classes as condition in markets varies

Housing affordability – been there before!



Current conditions are the same as following the 1987-89 house price boom

Markets equilibrium conditions will change

Other risks

- There are many, too many to mention them all:
- Geopolitical risk
- Oil prices
- Capacity constraints
- China falling over
- Global inflation exported from emerging economies
- Unwinding of global “structural imbalance” – US budget deficit and current account deficit
- US dollar depreciation
- Global household indebtedness
- ……

Conclusions

- Global growth is expected to remain firm, or even pick up over the next few years
- Global inflation remain firmly under control, not because central banks are doing a good job but because of the globalisation of the workforce and product markets
- The interest rate cycle will enter an up phase on the back of strong real growth
- All in all, it remains a good environment for growth assets
- However, it is inconceivable that the equity performance of the last four years can be repeated one more year
- The re-pricing of risk will see quality come to the fore
- Nonetheless, there is still the "weight of money" driven by an ageing society looking for assets to own and hold

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