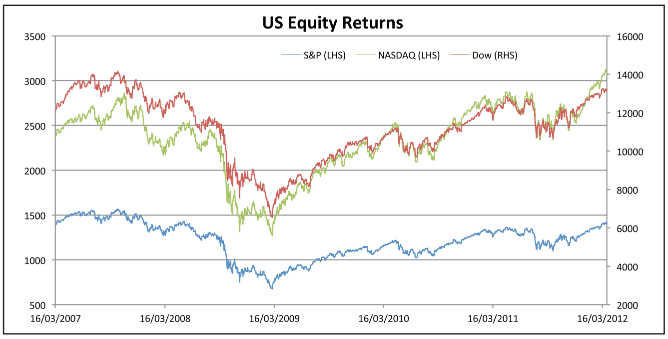
March 2012

Welcome to a state of delusion

A delusion refers to 'a belief held with strong conviction despite superior evidence to the contrary'.

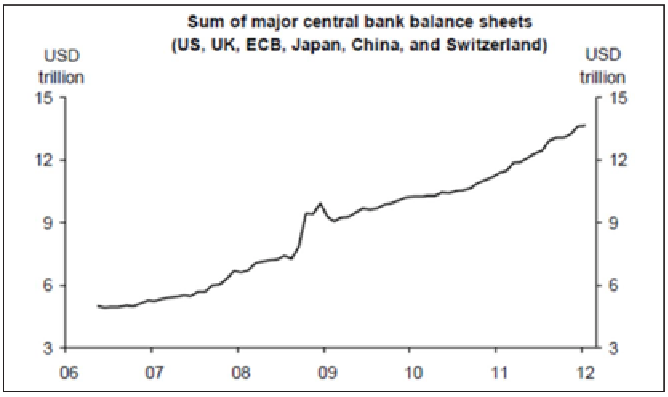
Are financial markets in a state of delusion?

Recently, financial markets have been behaving similarly to the delusion of man. While equity markets have almost recovered most of the losses incurred as a result of the global financial crisis, this recovery has been the product of massive injections of money into the global financial system.



According to Deutsche Bank, major central banks have printed $8 trillion since 2007 to save the global financial system. The United States Federal Reserve is under pressure to deliver another round of quantitative easing (round 3), which in simple terms is basically printing additional money over and above the already $3.5 trillion they have printed since 2007. Similarly, the European Central Bank (ECB) has printed about $4 trillion during this period. However, as history has shown, the effect of these programs in terms of boosting markets is getting shorter and shorter. The fact remains that easy money will drive asset prices higher for a finite period of time and when that stops, markets turn. If central banks continue down the path of printing more money, where will that money go? How will it be repaid, by whom, and when?

Major central banks have printed $8 trillion since 2007. Where did that money go?



You can expect to foot the bill

M Many want to believe that the US is growing fast enough to hold up the world, others see China and the European Union dragging all investments back down. Ultimately when economic growth stabilises, unemployment rates start to fall, and the housing market starts to recover, the US Federal Reserve, the ECB and other central banks will need to start to drain liquidity from the system. While this may be many years away, the process of how the liquidity is removed becomes critical, as a premature rise in interest rate will hurt any feeble economic recovery. Tax payers (and savers) in most countries will eventually have to foot the bill for an enormous bail out of a financial system. Governments around the world will have to figure out how to pass on the costs of the bail out to its general populous.

Given all the headwinds faced by global financial markets – the question we continuously ask ourselves is, 'are financial markets in a state of delusion by ignoring fundamentals and if so, for how long?'

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All about jobs

On the jobs front, a disappointing US payroll report in April (120k jobs vs. expectations of 225k) contributed to further losses in equity markets. Overall, the jobs report had an undeniably weak tone, raising doubts about the strength of the labour market. Should this be viewed as a correction or just noise? On the positive side, the trend in job growth is solid with private payrolls expanding on average by about 85,000 jobs per month in 2010, 150,000 jobs per month in 2011 and over 210,000 jobs in the first three months of 2012. Yet we are still another couple of years away from recouping all of the jobs lost as a result of the global financial crisis. We continue to believe that the US is in recovery mode, however without substantial gains in employment and stabilisation in the housing market, the US will not be able to continue down the path of stronger growth.

The RBA

The Reserve Bank of Australia (RBA) left its rates unchanged at 4.25% in April. The RBA clearly indicated that it intends to lower the cash rate in May this year, subject to any surprises in the next CPI release on 24 April. The RBA highlighted their ongoing concerns with Europe and noted that growth was somewhat lower than previously expected. The bigger question for the RBA is, whether any of the 'Big 4' Australian banks will pass on any or part of its rate cuts to their consumers? Due to increased funding pressures, the banking sector has been reluctant to pass on any cuts to its customers. On the fiscal side, the government expects additional fiscal tightening of discretionary spending to balance the budget. This measure might force the RBA to cut rates further. The markets however have fully priced in this action as a given, with three year government bonds now trading at 3.3%, a full 100 basis points below the official cash rate of 4.25%. While we believe a rate cut is on the cards, we feel that the market is pricing in too much policy easing over the next twelve months.

Additional headwinds

There are a number of factors that that could cause the reversal of recent gains made in equity markets:

- US earning season has commenced and expectations, as per usual of late, are set very low. The devil will be in the details however barring some major misses, investors will be more focussed on the economic data due in the second quarter;
- Problems in European periphery persist ranging from budget issues in Spain to elections in Greece. Spanish debt is under pressure given the backsliding on Spanish deficit targets and pressure for renewed austerity. Spain is forced to deal with monthly fiscal targets or suffer higher rollover rates, and if they fail to meet targets they run the risk of losing access to external funding. These issues are compounded by the fact that the growth picture remains poor and the initial flush of liquidity from the Long Term Refinancing Operations may be fading;
- Our belief is that the ECB will continue to be reactive in the face of sovereign fears and will not come to the rescue with a large purchase program before new reform plans are on the table; and
- Geo-political issues ranging from tensions in the Middle East, Syria, and Iran, to nuclear testing in North Korea.

Portfolio implications

1. We continue to believe that markets are range bound in the short term – a pull in higher risk assets as more money is pumped into the system compared to a fall in rates if economic growth falters;
2. We expect market volatility and liquidity concerns to remain high;
3. We continue to avoid exposure to sovereign bond markets, as we believe that sovereigns are borrowing at teaser rates;

4. We prefer to own high quality corporate assets in Australia and Asia – floating as opposed to fixed rate assets; and

5. We favour financials stocks in Australia ('big 4 senior' and subordinated), Asia and the US, and are avoiding the European banking and sovereign sector.

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