

Quarterly Critique.

March 2008

This is the first of our letters to our investors on our view on financial markets in general. While we are first and foremost stockpickers, it is impossible not to consider the environment in which we operate and the trends that are taking hold in the world as well as Australasia.

I'm angry, as Dave Hughes used to say on The Glasshouse, thought to have been axed by the ABC for perceived bias against John Howard's government. I'm angry because of the parlous state in which the world finds itself, and the certainty I have that it was all avoidable.

For many years the US Federal Reserve Bank, the guardian of what has been the world's reserve currency, has acted with an asymmetrical bias. Alan Greenspan applauded every form of financial innovation (a subjective term!), waxing lyrical that the burgeoning use of leverage and complex derivatives created a more efficient market economy. When a crisis arose and markets began to panic (the Asian currency collapse, Long Term Capital Management, the technology bust), Greenspan would always ride to the rescue with interest rate cuts and offers of assistance. Markets coined the term "Greenspan put" and have applied the same term to his successor Ben Bernanke.

Governors of the US Fed should be ashamed to have the reputation embodied in this phrase. It reflects the perception that there is virtually no risk in excessive speculation or risk taking, with the consequence that commercial and investment banks in the US (in particular) and elsewhere, have run amok. While it may seem intuitively appealing to have central banks step in to avoid crises, surely their mandate needs the symmetry of preventing the excesses which lead to crises

developing by not allowing asset price bubbles to flourish in the first place. Greenspan, who spends a great deal of time asserting that he never said what he actually did say (perhaps he, like Hilary Clinton, "misspoke"), and could never see what everyone else who cared to look could, said bubbles can only be identified after the event. This seems a weak excuse for allowing credit excess and underwriting the profits of financial firms and bonuses of finance sector employees in good times, with little risk of bad times.

The cost of credit has been far too low. As has been remarked, the US interest rate cuts - in the face of inflationary pressures - mean that the savers are disadvantaged to rescue the speculators. All measures of credit relative to income in the major Anglo Saxon countries (chiefly, the US, UK, Canada and Australia) are almost off the charts, having been quite stable until the Eighties. This has been matched by record trade and current account deficits as savings have been minimal and debt has allowed consumers to be spendthrifts. It has also fostered huge growth in financial services, with layers of leverage in hedge funds, swap trades, complicated derivative strategies and the like. The credit crisis has also exposed typical hypocrisy: during the Japanese bust Japan was criticised for not allowing banks to fail by allowing them to not mark investments to market (the Nikkei is still 2/3 below its peak 18 years ago!). After the Asian crisis the IMF criticised the financial regulators in Asian countries and cautioned that weak banks must be restructured or closed, and monetary policy kept tight to avoid inflation and currency depreciation. No such admonitions are being aimed at the US now.

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The rewards from finance have been so much greater than from manufacturing that there is very little employment in primary and secondary industries in the US or Australia. China has taken on the role of manufacturer for the world, but the situation is effectively sustained by China keeping its currency undervalued and “vendor financing” the West to buy Chinese goods, a situation that is far from sustainable. China is building up a large balance of low returning, risky (because of currency depreciation) US dollars.

Intuitively, why not have an asymmetric bias in favour of fostering apparent growth and of saving the system, theoretically in favour of prosperity? The problem is that prosperity is not built on excessive credit or asset price appreciation. Traditional wealth creation was built on saving and building useful things (such as factories, buildings, computers and wind turbines). In modern Western society people mistakenly have believed that higher house prices or share prices reflect wealth accumulation whereas they really reflect a fall in the value of paper money (inflation) combined with a relative price adjustment (housing becoming expensive relative to cars or food say). In the end such a relative price adjustment has become problematic, as the prices of real commodities such as rice, wheat, fuel, milk and so forth have skyrocketed – hardly surprising given the persistent underpricing of one key thing – global money and credit.

My anger could be dwarfed by the widespread dissatisfaction with economic management that could take hold. In developing countries the price of food is becoming an important issue. In the developed world, people forced out of their homes and losing their jobs will have little sympathy for investment bankers who have been rescued by the Fed having received jaw dropping bonuses during the good times. It would not surprise me to see the yawning gap in executive compensation which has developed begin to narrow again.

When recession strikes the US, which seems inevitable despite the best efforts of the Fed to postpone one, it should become apparent how illusory much of the growth has been. Growth in consumer spending has been on credit, growth in housing (which is in deep decline) was again funded by credit and speculation, growth in employment has been the result of massive retail and finance sector expansion. The evaporation of consumer confidence, the unwillingness of banks to lend, and the disappearance of white collar jobs in real estate and finance, combine to form a potent cocktail to drag the economy down.

Australia may seem immune, thanks to the continuing resources boom (the vaunted decoupling of Asia, especially China - where the stock index has almost halved - and India, comes to mind). However, mining sector employment is a small percentage of total jobs, and despite the boom our current account deficit is disquietingly large at around 7% of GDP.

Like the US we are addicted to credit, even though it has been more rationally priced here. As a consequence of the house price boom Australians have taken on very high levels of leverage relative to income (198% of income relative to 137% in the US). From a distance it may seem the US credit problems are a result of reckless lending (which is true) which we have not experienced. However, Australian levels of indebtedness could be equally problematic if we start to see a decline in the elevated levels of house prices and job losses in what currently seems to be a robust economy. Opes Prime and Lift Capital provide a hint of the vulnerability that might lie beneath the surface of the Australian financial system. It will be a most fortunate escape if we only suffer a slowdown in growth.

Hugh Giddy,
April 2008, Sydney