Quarterly Critique

June 2008

Is the oil price a speculative bubble or is it driven by emerging market demand for energy coupled with supply constraints resulting from years of underinvestment? The latter argument certainly has its merits, but remember that the fundamental underpinnings of the internet stock boom of 1999/2000 (namely, that the internet would achieve high penetration of communities and businesses and transform the way we are able to communicate and do commerce) had merit too.

Guessing the direction of the oil price and its likely peak has become such a popular pastime it actually reinforces the case for it being a bubble. There is a vast literature on "peak oil" – referring to peak levels of output and associated supply constraints – and recent public focus on oil and gasoline prices is substantial (see magazines such as the Economist with cover after cover featuring energy themes). Sentiment amongst energy traders is at an unheard of bullish extreme. Sadly, in such instances most people are proved painfully wrong and the lonely naysayers correct. I suspect oil is likely to have one last brief "blow off" rise before falling sharply in an undignified heap. However, it would seem most unwise to try to benefit from such a spike because timing the inevitable collapse would be extremely challenging.

Politicians in Australia seem to dislike being at the mercy of such market forces, and so large sums seem destined to be wasted on a crowd pleasing "Fuel Watch" scheme. We have been promised savings of as much as 2c a litre, a myth which can never be entirely refuted as we will never know for sure what the situation would be without government intervention. Given that a refining and marketing company such as Caltex makes less than 2c a litre profit (on a huge invested capital base) achieving such a saving for any length of time would involve the refiners becoming underfunded charities.

Governments generally don't like higher prices if their electorates are suffering. The prices of staples have risen for many people, with vast rises in rice, milk, wheat and corn prices. Food riots could spread. Inflation appears to be popping up all over the world. Some of the blame, it seems, lies with the oil price. The US mandated higher ethanol output in response to the oil price surge, shifting crop production from food uses to ethanol inputs.

I believe that the global economy is now a very interconnected entity, and the roots of all these issues are the same as the issues overhanging asset markets in general: easy credit and excessive leverage. Financial deregulation has lead to excessive consumption, lending and asset speculation. Bubbles are popping in housing markets (so far most notably the US, UK, Spain and New Zealand, but several more to follow), stock markets (all), and credit markets. The last place to speculate for practitioners of "financial innovation" (Greenspan's cheerleading description), also known as hedge funds, has been commodity markets. Of course,

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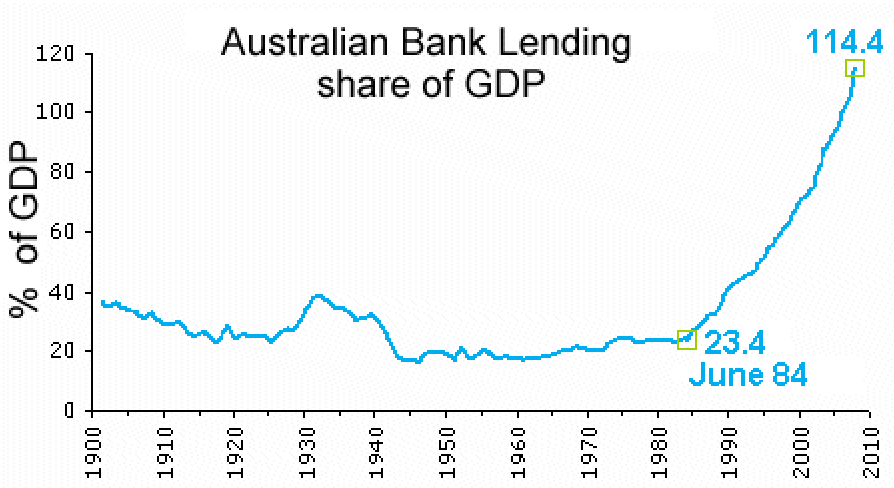
who am I to label this a bubble when the US Fed said you can only identify a bubble after the event? In hindsight, I think people will finally realise that lax monetary policy has a lot to answer for.

In the Anglo Saxon world, savings have become very unfashionable. Even in Australia, the incentive to save has been woeful. A prudent person with money in the bank now earning circa 8% (much higher than usual) is barely keeping pace with inflation once tax is taken into account. With the lower interest rates which have prevailed for some time, it is hardly surprising that consumers have embarked on an orgy of consumption (often debt funded) while financial players have used cheap leverage to speculate freely.

Most furniture and appliances are offered on “low interest”, “no deposit” finance so people have been able to get what they want long before they have the money to pay for it. What is seldom understood is that the growth we have experienced, fuelled by debt-financed consumption, is not the norm. Without that leverage, growth would have been much lower, but built on a more solid foundation.

The following chart, courtesy of Gerard Minack at Morgan Stanley – from RBA and ABS statistics, reveals that excessive leverage is as much a problem in Australia as in the much maligned US with its sub prime woes.



Australians seem to feel we are largely immune to the credit problems elsewhere, a heroic assumption given the leverage implied by the chart above. It may be that it takes longer for the problems to come home to roost, but such a high debt burden makes the economy inherently vulnerable.

Such a sanguine view of the outlook is not uncommon. Many people feel that the US economy will only suffer a mild recession. This shows a basic misunderstanding of how we got into this mess. George Soros in his recent book, *The New Paradigm for Financial Markets: The Credit Crisis of 2008 and What It Mean*s, comments on the unwinding of the finance sector mania:
"Both the financial markets and the financial authorities have been very slow to recognize that the real economy is bound to be affected. It's hard to understand why this should be so. The real economy was stimulated by credit expansion. Why should it not be negatively affected by credit contraction? One cannot escape the conclusion that both the financial authorities and market participants harbor fundamental misconceptions about the way the financial markets function.

These misconceptions have manifested themselves not only in a failure to understand what is going on; they have given rise to the excesses which are at the root of the current market turmoil." Furthermore, for those relying on “Helicopter” Ben (Bernanke, so named for his belief in dropping money out of helicopters to stimulate the economy), Soros states: "The Fed is constrained in its ability to protect the economy by the fact that it's done so too often. In my view, this financial crisis is not like the others which have occurred in recent history."

Perhaps it should not be surprising that stock markets are very inconsistent given so few people appreciate the backdrop of why there is a problem and what the future might hold. In the Australian market, despite the overall market weakness, speculators freely continue to back “blue sky mining” stocks – companies whose value can only be justified on “exploration potential”, future planned production increases beyond the immediate horizon – without paying heed to the infrastructure required to commercialise the resource - and so forth. Despite the historically high prices for energy, investors are often paying high valuations for what may be boom time earnings. Can the booming economies of Asia protect these speculators from severe losses?

At the other extreme, investors have mercilessly sold off many industrial companies, particularly smaller companies, even where debt levels are reasonable and the earnings will only suffer if a painful recession is in prospect. Several solid property companies are trading as though property prices will fall more than 10%. If the market is right on these thematics, it is unlikely to be a good time for banks, whose earnings are generally expected to rise next year. The most sane recent action of the market has been the punishment meted out to highly geared infrastructure trusts, which had often traded on yields which were not backed by cashflow. Overall the market is extremely narrow, with its decline being slowed by a very small number of popular stocks. Figures from Merrill Lynch reveal that it is the most narrow market since the tech boom. In time there will be great stock picking opportunities, but in the short term speculators and momentum traders still abound and prosper.

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