

Quarterly Critique

December 2008

In the financial markets, who can one believe? I put it to my readers that much of the advice you receive is close to worthless.

At the beginning of 2008 the credit crunch was already well underway, although the depth of the problem was only anticipated by a small minority. It seemed to me then that a recession was inevitable as no banker would want to lend money as freely as before, and that would leave a hole in consumption. So much is bought on finance, and in particular in the US finance was provided to people who had been 'homeless' and people who would never be able to service a loan, let alone repay it. Few in the US thought a recession was likely (and few around the world), even though the official arbiter of US recessions now judges that a recession began in late 2007.

Barron's is the weekly financial newspaper allied to the Wall Street Journal in the US. Every year a roundtable is conducted with celebrated fund managers and investors. They provide readers with their views on markets and preferred stocks. Amongst the Barron's roundtable a year ago the most pessimistic forecast for the year end value of the S&P 500 Index was 1525 (it closed a shade above 900). Note that the roundtable participants are virtually all money managers, not stockbrokers; stockbrokers have a greater vested interest in higher prices. Stockbroking analysts had an estimate for the S&P 500 index 'earnings' in 2008 of \$84 at the beginning of the year. This estimate has been slashed to \$48 now, which puts the US market on a

trailing PE of 19 times after an index fall of close to 40%. The current estimate for 2009 is \$42, a relatively modest decline. The actual outcome could be interesting.

What made most people so sanguine about the outlook? My guess is that we have had such a long boom that few in the markets had any memory of what a deep bear market might look like, although there is a fair amount of "grey hair" amongst participants in the roundtable. More importantly, few thought that a bear market was probable, a belief sustained by one or several of the following myths (myths in my opinion, certainties for some people):

1. *The authorities would not allow such a thing to happen and had the power to stop markets from falling.* Every time in the past that a crisis loomed (often because of excessively lax credit, such as the Long Term Capital Management crisis), Greenspan provided more 'punch' (through rate cuts) to the alcoholics at the party to keep the financial speculation party going. Some believe that a 'Plunge Protection Team' exists and is mandated to avert a crash by manipulating futures markets amongst other measures.
2. *One should not 'fight' the US Federal Reserve, whose monetary tightening credentials have been almost non-existent in the past decade.* Bernanke has cut rates sharply, but this has not had a salutary effect on the stock or credit markets, or the economy, to date.

CANNAE
Capital Partners

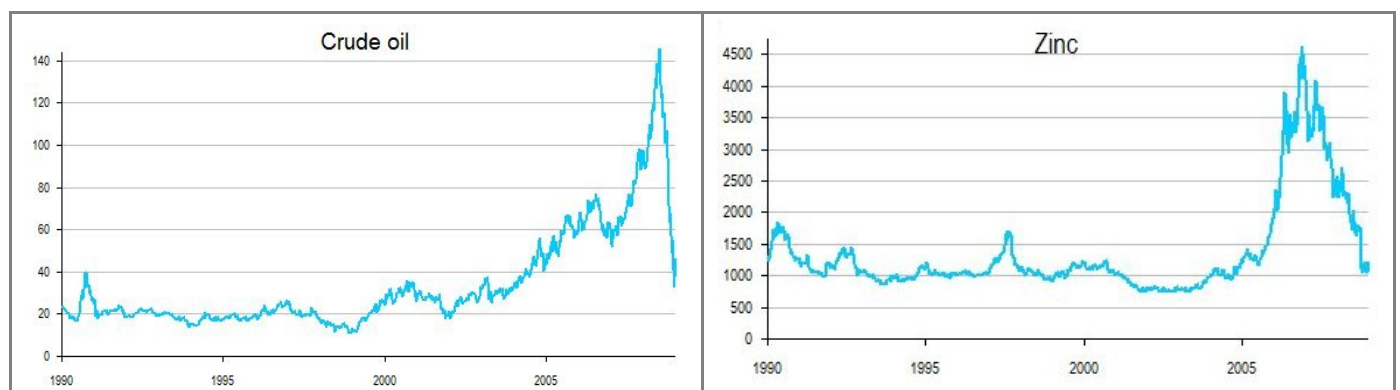


3. *Although growth in the US might slow as a result of the multi-year collapse in residential construction, the rest of the world would be largely unaffected.* In particular, China and Asia generally would decouple from any slowdown because most of their trade is intra-Asian and the urbanisation of China would continue regardless.
4. *Commodity prices were on a higher plateau because of China.* Suddenly the world seemed to be facing a shortage of oil, copper and so forth, because China is a large economy with a low but rapidly growing intensity of resource use. Buildings and infrastructure would be built at an accelerating pace and the population would increasingly move to the cities, get rich and buy cars, eat more food and particularly more protein. Demand for copper, steel, fertilizers and oil would grow and underpin the global demand for commodities.

As the year unfolded, the realisation of the seriousness of the crisis was fairly gradual. For much of the year, investors, regulators and authorities have been reported in newspapers saying that a US recession was unlikely, that Fannie Mae and Freddie Mac were sound institutions, and so forth. It seems that in terms of psychology, once beliefs become deeply entrenched (as the above myths were and perhaps still are), it takes a long time for people to realise that the foundation for their beliefs is specious.

Interestingly, in Australia there are still many who think that a recession will not occur or will at most be extremely mild, reminiscent of the common view of the US economy a year ago.

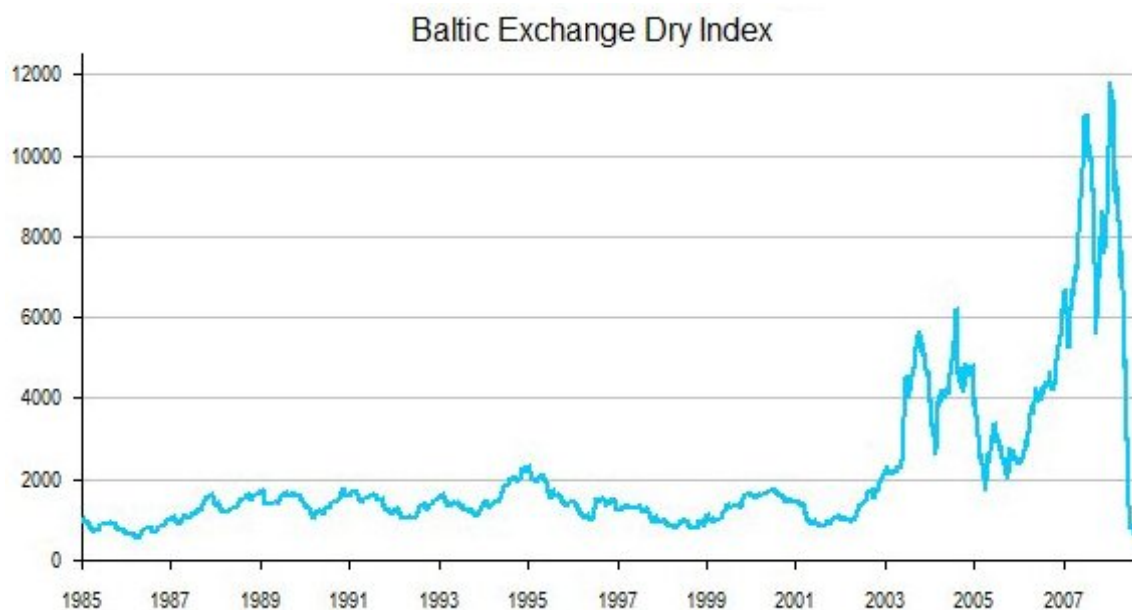
One of the reasons cited for the relative optimism regarding Australia's economic outlook is a deep seated belief in a resources supercycle. In the June 2008 quarterly I suggested the oil price was a classic bubble, and like all other bubbles the oil market would collapse, possibly after a final surge. At the time many were calling for oil to go to two or three hundred dollars a barrel. Oil peaked around \$147 and is now below \$50 a barrel, and those same forecasters continue to publish their predictions. A common theme for oil and other commodities is an expected rebound in prices, often to more than double current levels. Long term sustainable price forecasts for oil tend to be between \$70 and \$100. It would be a most unusual bubble for prices to settle at a significantly higher level than a long established market average (which for oil is closer to \$20). The Japanese market post 1989, the Nasdaq post 2000, tulip bulbs, and the South Sea company clearly do not provide any guide for oil - and other commodity price - forecasts. This time must be different. Or perhaps the exponential oil price rise was largely justified by fundamentals, and it is the current price fall that is aberrant behaviour. Below are price charts for oil and zinc; readers can decide for themselves whether any bubbles occurred.



Recently Barron's came out with their roundtable looking ahead to 2009. Unsurprisingly, after such big falls in 2008 the panel of 'experts' has a consensus year end target of 1045 for the S&P 500 (which would be +15% from then). According to David Rosenberg from Merrill Lynch, commenting on the roundtable: "Nobody is lower than 975...so +10% is at the low end of the entire spectrum. Health care was cited as a 'favourite sector' by 10 of the 12 pundits, and at least one of utilities/staples/telecom showed up on the top list of two-thirds of the respondents. So the view seems to be that we are going to have a bounce next year, led by ... the defensives. Interesting." Similarly, in an article in the Australian Financial Review, various local strategists all expect a bounce of more than 10% (and in one case about 40%) in 2009.

Predictions of a market rally may well prove correct, despite the questionable history of such predictions. *[As an aside, my own target would add nothing to the debate if I had one. I don't have one partly because I am more interested in picking undervalued stocks than buying the index. Cannae Capital Partners has found some individual stocks that are extraordinarily cheap in a market that may not be particularly so.]* However, I very much doubt the cheery view of global economic recovery later in 2009 and the quite common view that heavily leveraged Australia will not suffer much at all. Although these statistics reflect the past, recent data is far from encouraging. Recession is spreading well beyond the US. For example, Japanese exports collapsed 26.7% year on year (YoY) in November, the biggest drop on record. Shipments to the US plunged at an unprecedented 34% YoY rate. Imports into Japan sank 14.4% YoY as domestic demand weakens. In Thailand exports dropped 18.6%. Signs of deflation are also notable. Germany's import price index dropped 3.4% MoM in November on top of a 3.6% drop in October. In France, producer prices plunged 1.9% in November on top of a 0.9% decline in October. European industrial orders dropped 4.7% MoM in October on top of a downwardly revised 5.4% decline in September. This took the year-over-year rate to -15.1%, which is the worst on record. This is just a snapshot of the news; I could go on at length but it provides a flavour.

A standout commodity has been gold, where the price has remained high. If deflation takes hold around the world (despite the best efforts of the US Fed's Bernanke, also known as 'Helicopter Ben'), it is hard to imagine the gold price will hold up. The Bank of Japan tried valiantly to prevent deflation there, but in an environment of falling asset prices and confidence, injections of liquidity are not enough.



Not long ago prices seemed to be rising throughout the supply chain. Inflation, not deflation, was the concern. Capacity was tight in every industry, and shipping was a standout. Freight costs alone caused many businesses to think again about where to locate factories and how to structure their processes. The Baltic Dry Index provides an insight into freight rates, as well as illustrating further the commodity bubble graphically as the charts above do (although of course this time might be different). Marc Faber, writer of the *Gloom, Boom and Doom Report*, notes that according to Drewry Shipping Consultants, shipyards will deliver 786 coal, iron ore and grain transporters in 2009, equivalent to 15% of the existing fleet. These ships will hit a market where freight rates are under pressure and miners are already scaling back production and cutting capital expenditure that would have fuelled the volume growth ship owners were banking on. Faber also notes that South Korea, which has a 40% share of global shipbuilding, suffered a 77% plunge in ship order volume (by tonnage) between June and September 2008.

It is hardly surprising that steel mills are cutting production and do not want as much of Australia's coal or iron ore. Those who have been most surprised maintain the boom will resume shortly.

**Hugh Giddy,
December 2008, Sydney**