

Quarterly Critique

December 2009

Recently I have bought a few Christmas gifts online - and several items as Christmas gifts to myself in the same way. It's not purely because I am following the herd into shifting my consumption patterns to the internet. The main reason has been the extraordinary strength of the Australian dollar and the much maligned US dollar's weakness.

In November stockbrokers rushed out research tomes on companies benefiting and suffering from the Aussie at parity. This seemed a sure sign that the most likely direction for our currency was actually down, not up towards parity and beyond. My suggestion to friends was that they should be opening US dollar savings accounts and buying goods online in USD or pounds sterling.

The level of disdain for the US dollar was incredible. Trader sentiment surveys for weeks indicated dollar bulls at about 2%. Of course, when the US dollar was much higher early this year, most traders were bullish. Almost everyone believes - or did very recently - that the "easy money" Fed will continue to debase the currency almost without limit, with the widespread belief that the place to hide from such reckless monetary discipline is gold.

Gold at \$2000 became the new mantra for many, with a new exchange traded fund based on the junior gold miners' index recently launching in the US. The gold price has been rallying for ten years yet it was apparently a good time to invite investors to lose some money by launching a fund while the price trajectory of gold was parabolic,

typically indicative of a blow off that usually reverses violently.

Some people might remember how even in Australia, with no Silicon Valley, enthusiasm for speculating in technology and the internet was running so high that local fund managers launched technology funds like the BT Time Fund mere months before the Nasdaq bubble's peak. At the time of writing, gold has fallen more than \$100 and more than 10% from its peak in a short space of time. Contrary to some sage commentators' pronouncements that gold may never be under four digits again, I would expect that it will head below the magic \$1000 in the not too distant future, although asset prices almost never move in straight paths.

One of the refrains of the funds management industry over time has been that it is not "timing the market, it is time in the market". While I accept that it is usually extremely hard to time markets and to take a market view, there are times where the risk reward trade off is clearly unbalanced.

A great example is property, which most people believe to be something that has an upward bias over time. People believe that over a ten year time span Australian property would not lose you money. Indeed, according to Jones Lang Lasalle, retail sector capital values are now 87% above the September 1990 level, the time of the last property peak. However, office capital values at December 2008, the latest reading, were still 21% below the September 1990 peak. This is during a time when the Australian economy has grown and the service

sector, which is a major renter of office space, has expanded. Jones Lang Lasalle quotes specific examples such as the former Macquarie Bank headquarters, 20 Bond St in Sydney, valued at \$500m in June 1990 and now, 19 years later, is valued at only \$300m; surprising as it houses my popular gym. Despite the rapid growth in retail property space, I imagine most people will extrapolate the retail capital growth as indicating that retail values will never fall.

I believe that the incredible euphoria and optimism surrounding the gold price and the corresponding pessimism towards the US dollar presents an occasion when a market view once again makes sense. The technology bubble's aftermath and the property example above demonstrate that having no market view can be costly at times. The trend towards index management to save fees means that over 3% of portfolios would be devoted to gold stocks, for example, irrespective of their outlook or valuation. An excessive portion of portfolios would have been directed by indexing to energy stocks as crude oil went up towards \$150 a barrel, sustained by hype around "peak oil". Interestingly, an executive of a North American gold mining company recently claimed the world was nearing "peak gold". Since gold can be recycled and tends not to disappear as a material - the way crude does when burned as a fuel, it is a curious implied comparison.

Why has the US dollar begun to rise? Short term interest rates remain firmly anchored around zero by a Fed determined to see no harm come to borrowers and speculators while creating a great disincentive to saving. US government debt levels continue to scale frightening heights. Everyone who asked me how I could expect the currency to rise was dismayed when I could not identify a compelling catalyst other than "everyone thinks it is going to fall and is positioned for that to happen". A small stutter in the credit markets is being attributed as the trigger for the recent reversal. First Dubai World defaulted on debt payments. No one could have guessed that was a bubble, right? There is such a shortage of desert that you need to build the tallest skyscrapers and artificial islands in an area with no natural advantages. Now the markets are concerned Greece is in trouble. The credit markets have been advance indicators of financial asset stress which the equity markets may ignore at their peril.

While optimism abounds, many would think me a Cassandra to be reading anything into these problems in the credit markets. One of the cultural indicators that can point to trouble in a contrary fashion is "the magazine cover indicator". When a prominent financial figure is placed on the cover of a magazine like *Time* or *Newsweek* they are usually at their zenith of popularity or approval. For example, Jeff Bezos, the CEO of Amazon, featured at the end of 1999, just ahead of Amazon's share price falling 95%. *Time's* Man of the Year for 2009 is Ben Bernanke.

I have shared in my commentaries my dismay at the fact that people seem to believe Mr Bernanke understands what is going on (if he does, I suggest he is being economical with the truth). Bernanke's predecessor, Alan Greenspan, is no longer viewed as the hero although few seem to have really come to grips with the devastating implications of the unwinding of the credit bubble that the Fed presided over. While free markets mean that regulators cannot control bad lending decisions, the regulatory environment and interest rate settings determine how easy it is for banks to become lax with credit and to become increasingly involved in complex financial products that no one seems to understand. *Time* obviously did not consider the weakness of the US dollar as a judgement on Bernanke's monetary policy as the gold bugs do. Nevertheless, his cover appearance could signal that's the Fed's monetary policy efforts will not be welcomed or successful in 2010, even though the US dollar may rise.

Time is applauding Mr Bernanke for his significant intervention in markets which may have mitigated the financial crisis. Governments are using the crisis as an excuse for a wide range of

interventionist measures. In the US President Obama and Congress have enacted a far reaching health care bill, and have taken aim at how compensation works at financial firms. Government has initiated rescues of AIG and the auto firms, which Treasury secretary Geithner admits is likely to lose the taxpayer over US \$60 billion (*Bloomberg*, 10 December).

In Australia, the mood of the government is similar. The federal government has acted against the pathology industry which earns very high returns for a low risk business with revenues paid by government. Telstra is now the target of extraordinarily draconian legislation reflecting the government's interventionist mood. While Telstra earns high returns, it is interesting that competitors have invested very little to compete with the industry leader. They prefer to buy capacity from Telstra at regulated prices, suggesting that the return on the replacement cost of Telstra's assets is not that excessive. The government's disregard for the interests of shareholders and private property to further their grand policies such as the NBN is concerning. The government has provided our big banks with a great deal of support and removed much of the risk. Under such conditions, bank returns are arguably unjustifiably high, and moves such as Westpac's significant lift in borrowing rates after the RBA's last hike have attracted very unfavourable public and political comment. It would not surprise me if banks become a target for regulation that damages their profitability.

Hugh Giddy,
24 December 2009, Sydney