

Quarterly Critique

September 2009

The role of economists is to make weather forecasters look good. Economic forecasts are often akin to declaring it will always be sunny and fine (I'm assuming an Australian forecast, not one for Manchester or the town of Forks in the *Twilight* saga). Of course it will rain sometimes, but if it is sunny 270 days in the year, say, your forecasting average will look quite good.

I must confess upfront to having a Masters in Economics, but I remain sceptical of the value of most economic forecasts. For many economists a forecast consists of extrapolating the recent data. It might seem to reflect some competence that longer range forecasts are close enough much of the time. Most economists forecast around 3% economic growth as repetitively as a Harvey Norman commercial, and since the trend of the economy is to grow this works much of the time. The value of a good forecast is to warn of a bump in the road, but almost no economists foresaw the dangers of the credit bubble and one of the deepest recessions since the Depression.

I have warned readers before of paying heed to the pronouncements of senior officials and monetary authorities. The track record of most is extremely poor, including people revered during their time in office. A colourful US hedge fund manager, Bill Fleckenstein, has written an excellent book detailing former Federal Reserve chairman Alan Greenspan's speeches and testimony and the devastating mistakes that ensued (housing bubbles, the tech wreck, the Savings and Loan crisis, Long Term

Capital Management, and many more). Buying *Greenspan's Bubbles: The Age Of Ignorance At The Federal Reserve* from Amazon is a worthwhile outlay of \$15 (not much more in AUD given our surprisingly strong currency).

I am sure a similar book will be written about Bernanke's term at some point. On many occasions in 2008, after the credit crisis had already taken hold, Bernanke and others said the US was not going into recession. Then we were told the banking system was stable, before, ahem, Bear Stearns, Lehman Brothers, and AIG got into serious trouble and Citigroup and others were on the edge of the precipice.

Fast forward to the present. Should we believe Obama, Bernanke and others that the global recession is over? Perhaps it is, and it would be great if they were right for a change, but given the track record of such prognostications I prefer to draw my own conclusions from the available evidence. That evidence is not particularly pretty right now.

I do not have enough space to go through all the data points. Of course there are things that undoubtedly suggest that things are getting better, mostly financial indicators (which confirm that speculation and risk taking is very much alive but not necessarily well). However, there are many reasons for caution too, such as:

- high commodity stockpiles in China (the inventory rebuild is over or close to it),
- a weakening Baltic Freight index, the major index of

shipping rates, reflected also in container port volumes in Australia (down about 14% on last year; an economy that escaped recession, we are told),

- continuing increases in unemployment,
- the cycling of big fiscal stimulus packages in many countries,
- an increasingly harsh regulatory environment for businesses ranging from banks (requiring more capital), to healthcare and telecommunications,
- continuing unwillingness on the part of banks to lend,
- reluctance on the part of most consumers to get even deeper into debt.

Countless anecdotes reflect that this is no ordinary recession around the world. On 26 August *USA Today* reported that municipalities across the US are turning off streetlights in an effort to save money. For example, Santa Rosa in California will remove 6000 of the city's 15000 street lights, and place a further 3000 on timers that mean they are off between midnight and 5.30am. The city will save USD 400,000 pa in electricity bills. Boston's John Hancock Tower, one of the tallest skyscrapers in the world, sold earlier this year for half of what it traded for just three years ago (*Bloomberg*, March 31). The situation in Europe is extremely poor. For example, Spanish banks are sitting on very questionable loan books. According to *Variant Perception*, "the value of outstanding loans to Spanish developers has gone from just €33.5 billion in 2000 to €318 billion in 2008, a rise of 850% in 8 years. If you add in construction sector debts, the overall value of outstanding loans to developers and construction companies rises to €470 billion. That's almost 50% of Spanish GDP." There are widespread problems for borrowers in Central and Eastern Europe who cannot hope to repay loans from Swiss, German and Austrian banks. Iceland may be a basket case, but it is not unique in having borrowed too much. Some people may think this has nothing to do with Australia, but credit markets since the high in 2007 suggest otherwise.

Why do so many people continue to pay heed to the pronouncements of people who have a poor track record and have offered few insights? Why don't people make their own judgement of the facts? I think the problem is that under conditions of uncertainty very few people are able to make rational judgements. It feels safest to herd and to join and swell a consensus that starts to build. As a view takes hold it becomes almost self-fulfilling that it seems the correct view. Once the media reports that [the authorities hope that] there are 'green shoots' some businesses will believe the recovery has started and lift production rates. People invest in shares in anticipation of an imminent earnings recovery. The share market rises. The media slant on the economic data becomes more favourable, even if the news is not that great.

Do people really herd? Surely only animals do that whereas humans are rational individuals? Why then do SUVs ("Toorak tractors") suddenly become very popular? People join Facebook in droves and Twitter is the new phenomenon. Most people wore dreadful hairstyles in the Seventies and Eighties – just because everyone else did the same. Even things like the public's belief in global warming wax and wane synchronously without any additional factual information coming to light.

As belief in the economic recovery has taken hold, the financial markets have become very enamoured of the banks. It is unarguably the case that the big four banks have less competition as they have swallowed smaller rivals (St George and Bankwest), and the GFC has undermined non bank competitors (RAMS, Wizard). However, this is not new news, nor is the fact that such conditions have allowed banks to expand their lending margins. After the share prices rose by more than 50% off their lows, the bank 'analysts' have issued a flurry of upgrades. *The Australian Financial Review* joined the cheerleading chorus with a front page article on 30 September titled "Cash rich banks ready for growth opportunities." The optimism is so strong that the major banks trade at a premium to the market in general based on forecasts for 2010 earnings (for example,

on Cannae's estimates ANZ is almost on 20 times earnings versus the market on less than 18 times). Banks normally trade at a meaningful discount because they lack transparency and are extremely leveraged with share capital only a small percentage of assets.

Paul Keating gave an interview on the Australian banking system to *The Sydney Morning Herald* on September 23. The article notes that Keating feels that "banks should be fundamentally viewed as utilities, given their significance to the economy, and therefore subject to heavy regulation by Canberra." Keating states "Banks had modest capital for their level of risk compared to other industrial companies – that is why their rates of return are so much better. They were able to operate like this because...the likelihood of the government letting any of them go insolvent was low." Keating is not the only voice highlighting that many banks around the world are considered too big to fail, yet are able to take excessive risks precisely because of that tacit guarantee.

The herd seems to have decided banks are a good place to place the bet for the next race. Interestingly, a seasoned bank insider seems less sanguine about the outlook. At the Trans-Tasman Business Circle lunch on 30 September, Ralph Norris, the CEO of CBA, noted "It's hard to, at this stage, see any real improvement in the fundamentals of those economies [US and UK]." (*Australian Financial Review*, 1 October). Further, "he said that, while international share prices had surged, it was hard to see a rationale for the swift recovery in equity markets."

The major banks have been at the forefront of the recovery in Australian share prices, particularly of late as everyone piles in, fearful not of losses but of missing out on the gains. The big four banks currently account for about 25% of the Australian share indices. As a portfolio manager I have not seen a better environment for being truly selective about which shares to own since the peak of the technology and media bubble in 2000. Nevertheless, shaken by negative returns, some guardians of the nation's retirement savings are choosing to index an increasing portion of their investments. This means one out of every four dollars is invested by default in the major banks at a time when they are extremely well owned, expensively priced and likely to be fundamentally challenged as regulation increases and the public, as a herd, learns to save a little more and borrow much less.

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