



Investment Newsletter

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From the Editor....

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Market Update

Apologies for this newsletter being late, but I have just returned from annual leave.

With US reporting season now behind us, the key question on investors' minds is whether the majority of companies delivering a positive surprise indicates that corporate earnings have now turned the corner - we don't think so. We believe that bottom line earnings beat expectations in many cases due to widespread cost cutting, rather than improved demand conditions. The optimists on the other hand, believe that these companies have shed excess pounds and are therefore better leveraged to the recovery.

With the Australian reporting season about to ramp up to its mid-August crescendo, we shall soon see whether corporate Australia can deliver a similarly positive set of results. We believe that there is a massive risk that expectations have been ratcheted up too far in the wake of the US experience, which will provide the catalyst for some profit taking and a well overdue pullback in the short term.

Certainly, the sheer weight of fundamental data hitting the Australian market through the course of reporting season will potentially be the primary determinant of near term market action.

As with all company reports, the data is historical and therefore mostly already reflected in current share prices, other

than the positive and negative surprise factors of individual results. Of particular interest in the announcements are the so-called 'outlook' statements, which will signal the potential earnings upgrades or downgrades that will determine the direction of share prices going forward.

The recent statement from, Marius Kloppers the chief of BHP Billiton, the world's largest miner, gave a guarded outlook for global commodity demand, sending a worrying signal for weaker rivals, after a slump in metals prices triggered its first profit decline in seven years – a decline of 62% in profit compared with the previous year. Kloppers said the last 12 months were the toughest he'd seen, and it would be hard to tell whether real demand has recovered until next year.

"Over a 12-month period, we went from a situation where rampant demand couldn't be satisfied to where demand simply evaporated and, lately, stabilisation," he said.

"It'll be 2010 before we see a clean set of underlying demand figures".

Some recent positive data out of the US served to boost investor enthusiasm, with the Dow Jones marking a new 9 month high recently, closing at 9370 points, With the US index gaining over 1300 points or +16.7% from its July lows, many momentum indicators have moved into significantly 'overbought' territory. It's a similar story for the UK and Australian markets.

With this in mind, we believe the risk of a correction is heightened over the coming weeks. We then see the possibility of one final rally above the recent highs in stock markets globally.

We will go out on a limb here and say that after this final rally, markets will fall heavily and will take us down to new lows on the stockmarkets across the globe—yes, below the lows reached in March this year. With the ASX200 currently trading around 4400 points and the low reached on the 5th March at 3188, we are expecting a fall of 27.5% from current levels, at a minimum

The speed of this decline we feel will be sharp and for people who don't believe that this could happen—just remind yourself of what has happened over the past 2 years.

To the relief of policy makers around the globe, their actions to date appear to have provided some evidence that we are in the recovery phase of this financial crisis. However, their toughest challenge will lie ahead in terms of the timing and extent of the exit strategy.

In order to offset the deflationary impact of the global financial crisis, policy makers dusted off their tool box and pulled out pretty much every bit of armoury they had. The aim was simple. Pump liquidity into the system until 'normal' lending activity resumes. While such action is inherently inflationary, the risk that inflation could escape control in the future was a simple acceptable cost of avoiding the more visible serious deflationary scenario.

However, we believe that deflation across all asset classes on a massive scale are just around the corner and feel that given all the stimulus packages that have been thrown at this crisis to date, doubt that they

have any armour left to fight the next wave in this truly horrible crisis.

Unaffordable or just plain expensive?

Ever noticed why you don't hear property commentators say that housing is expensive rather than unaffordable? Maybe this would have something to do with the fact that 'expensive' would sound like we have a 'bubble' on our hands whereas, 'unaffordable' doesn't.

Based on metrics like disposable income-median property price or relative debt levels, Australian house prices appear extraordinarily expensive. Housing price data is thumbing its nose at our claims, continuing to rise (significantly in the most recent quarter), even as GDP remains stagnant or falls and unemployment edges higher.

Recent data released by the ABS indicated that financing commitments for owner-occupied and investor housing grew by a further 1.8% in June (0.3% on a seasonally adjusted basis).

There have been many 'reasonable' explanations provided for ever increasing residential property prices (the median house price in Sydney is now \$547,000 — almost ten times median income levels). Most common is the 'supply' argument: that hundreds of thousands of people are moving to Australia and they need to live somewhere. Or that Australia is a highly urbanized country and this vindicates a median house price which is more than double that of the United States.

Those reasons would normally appear to make sense. But then again, during a bubble lots of things appear to make sense which in hindsight, are ludicrous.

Remember the dot.com boom, when it was commonly thought that business over the internet would take over from bricks and mortar? This meant that at one point the loss-making pets.com was worth more than US\$100 million before collapsing into liquidation after 268 days.

There are two major causes for the recent residential property bubble – first, government meddling (specifically through the first owner’s grant, but also bank funding guarantees). This is providing house buyers with more cash which is then leveraged up substantially to purchase their dream home.

The second reason for the bubble is the Big Four banks’ continued willingness to lend money to home buyers on exceedingly generous terms, upwards of 90 percent loan-to-valuation ratios. If banks took a more prudent approach and cut LVRs to say 70 percent, we would witness a rapid, almighty slump in property prices (most notably at the lower end). Banks of course don’t want this, the collateral (security) underpinning the loans they have already made are other houses. Banks don’t usually like to destroy the value of their collateral – it isn’t good for business (or more pertinently, for bankers’ salaries).

The supply argument is not actually incorrect. Supply issues are clearly having a short-run effect on prices. However, eventually (and it may take years for these structural changes to transpire) the supply curve will adjust. If property prices become too expensive, immigrants will opt to relocate to other countries, where the cost of living is more bearable.

People will also move further away from expensive cities. Japan is a far more urbanized country than Australia yet since 1991 Japanese city property prices have suffered a remarkable downturn, falling for 15 consecutive years.

It took a decade for Japan’s property boom to finally burst but eventually, supply readjusted and prices plummeted, even in Tokyo, which has a population of more than twelve million but is far smaller in geographical size to Melbourne which has a population of less than four million.

Residential property isn’t the only asset bubble – just witness the dramatic collapse in commercial property prices in Australia, rapidly increasing vacancy rates and sharp losses in equity values last year.

However, simply because there are other asset price bubbles which are more obvious and more reactive to economic conditions doesn’t mean that the price of much of Australia’s urban residential property has not far exceeded its intrinsic value.

As long as Australia’s banks have an interest in propping up residential property, the bubble will be tentatively kept alive. However, the risks of this path are significant. As Dan Denning noted recently:

“The bigger risk ... is that Australia’s banks will become increasingly reliant on rising house prices to spur demand for new mortgages. That’s the process that contributes to earnings and keeps the balance sheet ticking along. The loans made to mortgagees go on the balance sheet as assets. They are funded from money borrowed abroad, which goes on the balance sheet as a liability.

The trouble here is that assets can change in value while liabilities do not. The debt has to be repaid, even if house prices fall. Australia’s banks are gambling with the capital structure of the entire nation, sinking more and more borrowed money into residential housing. It’s the biggest and riskiest bet yet”.

Yes. Big, risky and very stupid. As no doubt Japanese banks can attest.

 Information in this Newsletter is drawn from various sources, including extensive and comprehensive research by Fat Prophets, FN Arena, Bloomberg and the local press.

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