UPA Investments Pty Ltd

Investment Newsletter

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From the Editor....

Market Update

Stockmarkets globally continue to trend higher and the rally off the March lows has the markets fully pricing in the expectations of a V-shaped recovery out of recession.

In the US, Wall Street cheered on some recent further data that suggested the worst economic contraction is over. The Fed's 'beige book' reported that 11 out of 12 regional Federal Reserve banks saw signs of a "stable or improving" economy in July and August. The notable exception was the St Louis Fed which said "the contractions' pace appeared to be moderating".

With each day that passes seeing equities price in more certainty of near-term economic recovery I thought we should have a look at the state of the all-important US consumer. How Mr & Mrs "Joe Public" holding up and will they "spend us out of recession"?

Consider the fact—**1 in 9 Americans (35 million people) are on government food stamps, 1 in 6 Americans is under/unemployed, and 1 in 7 US mortgages is either delinquent or in foreclosure.**

I think the US unemployment rate masks the bigger problem that is underemployment. The weblink below to the US Labor Department shows you that total unemployed, plus all marginally *attached workers, plus total employed part-time for economic reasons, as a percentage of the civilian labor force plus all marginally attached workers* is now a seasonally adjusted **16.8% of the US workforce.**

www.bls.gov/news.release/empsit.t12.htm

That's a huge number and with the data showing American households are paying back debt at a record rate I can't help but wonder where the consumer spending is going to come from to truly drive US economic recovery? You have record underemployment (in an economy that already has jobs such as washroom attendants that no other economy has) and much tighter consumer credit standards due to high regulatory capital ratios for banks. I think its fair to say the all-powerful US consumer will be in his shell for some time to come and that is the one key reason why we are not anywhere near as positive than some other share market cheerleaders out there at present.

Another huge point to consider is the fact that the US Consumer is no longer spending anywhere near the rate they once were.

A record US$21.6 billion drop in borrowing by Americans added to evidence that consumer spending will be slow to recover as banks and credit-card companies tighten lending standards and households pay down debt.

Consumer credit fell by 10% at an annual rate in July to US$2.5 trillion.

Underemployment isn't just a problem in the US, it is also a problem in our own back yard.

Recent figures state that Australia's jobless rate of 5.8% is well below the OECD average rate of more than 8%.

The jobless figures for August published by the ABS, show a continued and disturbing trend in the under-utilisation rate in the Australian economy: that is the gap between how many hours people want to work and how many hours a week they are actually working.

The trend estimate of labour force under utilisation fell from a high of 14.2% in August 2001 to a low of 10% in May last year. It has since risen sharply and now stands at 13.9%. Australian employers have responded to the downturn of 2008-09 by cutting back hours worked with various schemes. And the fall in full-time jobs has also been offset by a rise in part-time jobs.

But the ABS's figures show a higher than expected fall in full-time employment over the month, down by 30,800 during the month and double the level expected by the market. The fact is that with the economy weak for the past year there has been a rise in discouraged workers who have now simply given up looking for jobs.

Roy Morgan Research executive director Gary Morgan **estimated that there were more than 1.6 million people in Australia at present who were either unemployed or underemployed. Morgan estimates that the real unemployment rate in Australia is more than 14%.**

Bottom line—if people don't have jobs they can't afford to spend. How long is it going to take for economies worldwide to recover from this? In our view, longer than what the stockmarket is currently pricing in.

It is worth noting that US consumer spending equates to about 70% of US GDP.

Bank Stocks

Bank stocks worldwide appear to be overbought at current levels. The simple fact of the matter is that **global banks are going to have to hold much higher tier-1 capital ratios through the entire economic cycle and the make-up of what is considered tier-1 capital will change.** Leverage ratios will also be regulated. This will lower ROE's (returns on equity) because more equity is required, and further alienate domestic shareholders who have been diluted at the expense of institutional investors in the recent round of bank capital raisings. I think retail bank shareholders better get used to this shabby treatment. Australian banks are going to have ongoing regulatory and growth capital needs and they are going to turn to the instant response of the institutional market over the retail investor market. In our view, this will lead to a higher proportion of institutional bank ownership which will in turn lead to a higher volatility in bank shares. We think that Australian banks are making a strategic error favouring institutional investors over retail investors but only time will tell if we are right on that.

Protectionism rears its ugly head

The Global Financial Crisis (GFC) has proved to be a truly global event, impacting the entire industrialised world to varying degrees. Such an affair requires a unified response between countries, which has largely been the case. However, the trade dispute that has recently emerged between China and the US risks policy makers focussing on their own best interests.

President Obama raised China's ire over the weekend, following his decision last Friday to increase import tariff's on Chinese tyres entering the US. With US unemployment as it is, stemming further job losses is a major priority for Obama.

Following advice that Chinese tyre imports are costing American jobs, Obama wheeled out his protectionist playbook and ratcheted up import tariffs on the offending items. Perhaps in order to garner domestic support for his healthcare reforms, Obama did not appear to hold back. He raised the tariff from 4% to a lofty initial level of 35%.

China has predictably moved to retaliate, restricting US imports of chicken and auto products into the country. Beijing has also raised the issue with the World Trade Organisation, who originally supported the view that China's tyre imports to the US are unfairly cheap.

Putting tyres and chickens to one side, protectionist measures are never conducive to a healthy global economy or equity markets. The prospect for this issue to escalate beyond its current tit-for-tat level therefore presents a potential headwind for the wider recovery.

Apart from the fact that cheap Chinese tyres are a positive for the US consumer, the US tyre industry is so small that its union merged long ago into the United Steel Workers Union. As such, it is questionable that protecting the country's tyre industry will have a material impact on America's job market. It will however ramp up costs to the embattled US consumer.

The irony in all this is that America's rather shaky economic foundation is reliant on China's ongoing purchase of US Treasuries. China has of course previously funded such purchases largely through recycled dollars sourced from America's appetite for cheap Chinese imports. Upsetting the status quo does not seem like sensible policy on Obama's behalf and we would be surprised to see him continue down this path.

Think the stock market is cheap?

The most commonly used valuation measures are without doubt dividend yields and price-to-earnings ratios (P/Es).
Dividend yield is easy to figure out and there's no margin for interpretation or adjustments whatsoever. Just divide the annual dividend payment by the share price - plain and simple. Historically, the stock market was a bargain when the dividend yield was averaging 6% or higher. **Right now the dividend yield is a paltry 2.8%for the Dow Jones Industrial Average, 2.5% for the S&P 500 and only 0.4% for the Nasdaq 100. So according to this time-proven indicator, the stock market has to be rated expensive.**

Now, calculating a P/E is not as straightforward as it once was. Back in the day, all analysts based the price-to-earnings ratio on earnings calculated using Generally Accepted Accounting Principles (GAAP).
But during the 1990s, when stocks got ever more expensive, Wall Street analysts came up with new earnings concepts allowing them to stay bullish. And they tended to adjust reported earnings subjectively. In our opinion, GAAP earnings are the best way to get a proper picture of what's going on.

The normal historical range for the GAAP P/E is less than 10 (undervalued) to 20 (overvalued). The current figure is an astonishing 137 – a record high! So according to this indicator, stocks are extremely overvalued. And even if we use a non-GAAP earnings measure, like operating earnings, and use forward estimates, the market is now trading at twelve times its two-year forward earnings. The historical mean for the two-year forward multiple is about seven.

Bottom line: Based on the two classic valuation methods, this market definitely does not look cheap.

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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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Doug Henderson

Authorised Representative
UPA Investments Pty Ltd

UPA Investments Pty Ltd

A.B.N. 37 102 708 725
AFSL No.226360

Office Address

Level 3, 64 Marine Parade,
Southport, QLD 4215

Postal Address

P.O. Box 3360 Australia Fair,
Southport, QLD 4215

Contact Details

Phone:(07) 5591 1661
Fax: (07) 5591 1772
Email: doug_henderson@upa.com.au