



Over the past few months, investors have had many queries regarding the 2009 outlook. Matthew Sherwood, Senior Manager, Investment Markets Research at Perpetual Investments, answers the nine most frequently asked questions in relation to global credit markets, the global and Australian economies and sharemarkets and the Australian dollar.

#### 1. When will credit markets recover?

Credit market strains escalated following the collapse of Lehman Brothers in September 2008 which resulted in banks in the US charging an unprecedented 3.5 percentage point premium (above the swap rate) to lend to other banks. However, recent reductions in official interest rates and deposit guarantees by national governments have led to a marked decline in these premiums. This suggests that bank funding in credit markets has begun to thaw, which is a necessary, but not sufficient, condition for any economic and sharemarket recovery.

The key issue for investors is what else has to happen before credit markets return to normal levels in the U.S. The prospect of asset writedown from the financial crisis and the global economic downturn is forcing banks to hoard cash. This may be alleviated when the banks are able to move these illiquid assets into a publicly instituted 'aggregator bank'. This bank would be similar to the Resolution Trust Corporation established in 1989 in the wake of the Savings and Loans Crisis. This institution would be established by the US Congress and would purchase illiquid real estate and financial assets from banks and, in the process, free up capital for broader lending.

#### 2. How bad will the US recession be?

In 2008, US house prices experienced their largest nominal decline since the Great Depression, the US labour market had its worst quarter of job losses since the end of WW2 (1.5 million jobs lost in the December quarter 2008), US industrial production (-7.8%) was at its weakest level since 1974 and manufacturing activity declined to a level only seen during the two oil shocks of the 1970s.

With US house prices set to decline further, households cutting spending to reduce debt and firms reducing workers to align production to lower demand, there is little doubt that the 2009 US downturn will be painful. At present economists have the US economic contraction in 2009 ranging from US\$300 billion to US\$800 billion. This latter figure would represent the largest contraction in percentage terms since the end of WW2 (see Chart 1).

Importantly, some of the building blocks for an economic recovery are falling into place such as reductions in interest rates, taxes, oil prices and inflation and increases in government spending. Other variables are yet to fall into place such as the stabilisation of US house prices, credit markets returning to normal levels and an end to the household de-leveraging process.

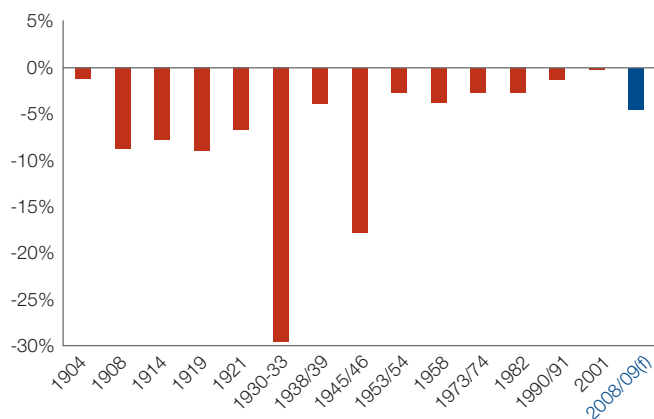
#### 3. Should investors be nervous about large fiscal deficits or the printing of money?

With the US and global economies experiencing their largest decline in many generations, it is not surprising that government's revenue bases around the world have deteriorated and spending has increased, resulting in larger deficits. In fact the US government has now spent more money in real terms on the current Crisis than on any of the wars in Iraq, Vietnam, Korea, WW1, the New Deal, the Apollo Moon Program or the purchase of Alaska from Russia (see

Chart 2). Deficits are not necessarily a bad thing for an economy as long as inflation remains low and the spending program is targeted and contained.

### Chart 1: US Economic downturn could be the worst in 60 years

Declines in Real US Economic Output (total decline, %)

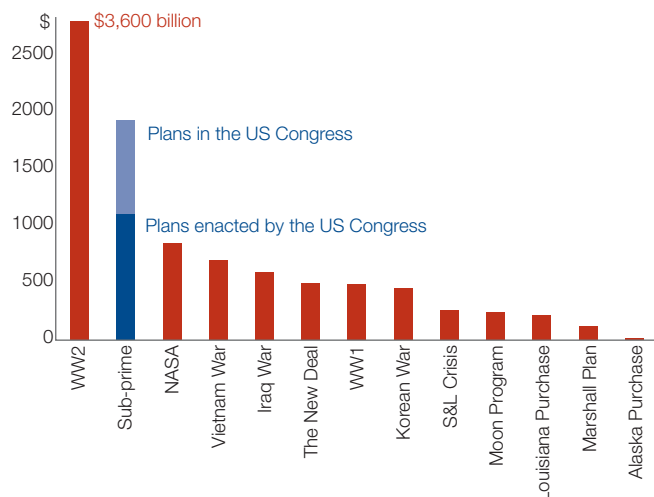


Source: US Bureau of Economic Analysis as at 31 December 2008.

Recently, the US central bank has begun the process of a quantitative easing, or simply printing money. Is this inflationary? Quite possibly, quite likely, but not necessarily. It will only become inflationary when the US economic recovery gains traction. At that stage the US Federal Reserve will face the delicate task of reducing the money supply without negatively impacting the economic recovery. If they fail to remove the additional money supply they would face the prospect within a few decades of the US Dollar reaching parity with the Zimbabwe Dollar, where your average American would walk down to Walmart with a wheelbarrow full of \$100 notes to buy a DVD, only to find he needed two more wheelbarrows relative to yesterday.

### Chart 2: US Government spending on the current crisis has been immense

Cost of US Government Programs (\$US billion, adjusted for inflation)



Source: Goldman Sachs JBWere, Macquarie Equities and Wikipedia as at 31 December 2008.

### 4. How long will interest rates remain low?

The global economic downturn has led to an environment where headline and core inflation in the US, UK, Europe and the emerging markets have all declined markedly. With oil prices having declined by 75% and economic activity moderating around the world, the outlook for inflation in 2009 and into 2010 appears more reasonable and as such there is unlikely to be a need for higher official interest rates to combat rising consumer prices. Even though official cash

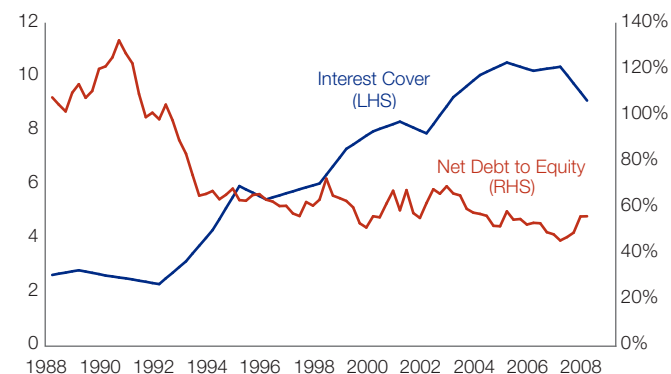
rates around the world are at historic lows and will boost household disposable income and spending, at some point of time central banks will have to return interest rates to more normal levels, even if inflation remains contained. When this will be is unknown at this stage, but until the economic growth rises to an above-trend pace, interest rates are likely to remain low.

### 5. How well positioned is corporate Australia relative to 1991/92?

There is little doubt that in 2009 corporate Australia is in a much better position, relative to the last recession, to cope with increased economic volatility. In the early 1990s, corporate Australia was highly indebted in the wake of some loose lending from domestic financial institutions. At that stage the debt-equity ratio for the Australian business sector was well over 100%, whereas at the end of 2007/08 financial year it was around 55% (see Chart 3). The high debt of the late 1980s and record high interest rates at the time meant that corporate Australia did not possess the required earnings to cope with the massive rise in interest costs as the Australian overdraft business interest rates hit 21% and interest cover declined to two times. Nowadays, interest rates are considerably lower and the interest cover for corporate Australia is around nine times earnings. Meanwhile, the labour market is now a lot less regulated than in the early 1990s, which means businesses are better able to align their costs to changes in production levels, which can reduce the downside risks to earnings. However on the negative side, corporate Australia is now more exposed to the over-leveraged consumer than before.

### Chart 3: Australian corporates have low debt and high interest cover

Australian Corporate Sector: Debt-Equity Ratio and Interest Cover (% , X)



Source: Australian Bureau of Statistics and Datastream as at 30 September 2008.

### 6. What is the key for Australian share investments for the next three years?

In the prevailing economic climate, investors are likely to be valuing balance sheet safety and earnings visibility more than anything else. Quality companies with unquestionable balance sheets, sustainable business models and high cash flows are likely to outperform their market peers in 2009 as investors manage portfolios for downside risks. When the economy and markets stabilise, and it will at some point in time, these same companies will be in the strongest position to grow their businesses organically and deliver sustained dividend growth to investors. These 'quality' companies may be looking to acquire their weakened peers and purchased market share at distressed prices.

In the current climate some investors believe that investing with an index manager will reduce risk as it removes the possibility of paying management fees for underperformance. Many investors had the same thought earlier this decade. While the fee for an index manager is certainly less than for an actively managed portfolio, indexing also means you have to buy every stock in the portfolio; the good stocks, the overvalued stocks, the bad companies and the ones that will go

bankrupt. This can be highly dangerous for investors as we saw in 2000 when 36% of investor funds in an indexed US share portfolio were invested in the overvalued tech stocks, which did not produce any earnings and were declining in price. In the subsequent nine years, the tech sector, as represented by the NASDAQ Composite Index has declined by a cumulative 71%. The key for investors in this environment is not buying every stock in the index, but rather buying quality companies that have been oversold.

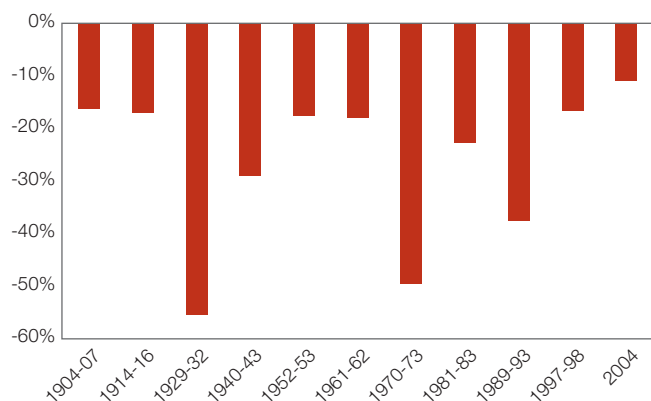
## 7. Dividends versus cash?

After periods of rapid share price decline the cash market can outperform. For example, over the seven years to 31 December 2008 cash returned 5.6% p.a. to investors, whereas Australian equities returned 5.2% p.a.. Although most investors know that cash's outperformance is temporary in the current climate, some investors may be unsure of which asset class to choose as cash market returns are declining as the Reserve Bank of Australia (RBA) reviews official interest rates and listed companies are likely to cut dividends in the prevailing economic climate.

If the current cash rate is further lowered to 3.5%, the dividend yield (adjusted for 100% franking credits) to earn the same cash return is around 2.5%, which means that Australian dividends would need to decline by around 60% to be equivalent to the cash market return. Dividends have never declined by this amount, even during the Great Depression (where dividends declined by 55%) or during the build-up to and during the early 1990s recession (-37% – see Chart 4), the 1982 recession (-24%) or any other economic downturn. In fact, the decline in dividends would have to be more than double the historical average (of 28%) for the cash market to offer investors higher cashflow. Furthermore, industrial shares have a higher dividend yield (8.2%) than the broader Australian sharemarket (6.4%) and as such the decline in industrial share dividends would have to be even larger (around 70%) to equate income with cash.

**Chart 4: Australian dividends have historically decline by an average of 28%**

Cuts in Dividend Income: Australian Sharemarket (%)



Source: Australian Stock Exchange and Global Financial Data as at 31 December 2008.

## 8. Will the Australian dollar recover to its 2008 levels?

2008 represented the Australian dollar's worst decline in 59 years relative to the US dollar. The currency declined in response to four factors; a 50%-plus drop in most commodity prices, contracting interest differentials relative to the US (and most other major economies as the RBA aggressively cut rates), a reversal of the carry trade and increased demand for the safety of US Treasury bonds (with US yields down to a post-WW2 low of 2.6%). These four variables will drive the Australian Dollar in 2009 and it is hard to see any reversing in the prevailing economic climate as commodity prices and domestic interest rates are unlikely to rise in the current global economic malaise. Although currencies are notoriously hard to predict, there is unlikely to be a major structural rise in the Australian dollar until the global economic picture improves.

## 9. Australian house prices to decline as unemployment rises?

The Australian housing market will experience many cross-currents in 2009. On the negative side households are in the process of decreasing debt and banks have increased their lending standards. In addition, unemployment is set to rise to above-6%, with BHP Billiton, Rio Tinto, Harvey Norman and David Jones recently announcing job cuts. Importantly, in the past two recessions, house prices have stabilised and begun to recover around half way through the upward trend in unemployment. On the positive side, interest rates are at historical lows, the Federal Government has increased the First Home-Owners Grant, provided tax cuts and spending increases and some State Governments have reduced development costs. Meanwhile, Australia's population is set to rise in 2009, which will boost demand for housing and limit house price declines. On balance, the outlook for Australian house prices in 2009 has greatly improved over the past few months and will improve further as rates continue to be reduced.

## Implications for investors

Global economic growth will be weak for much of 2009 and risks remain tilted to the downside. This backdrop will negatively impact earnings and some companies will need to raise equity to strengthen their balance sheet, which will dilute earnings per share. Stocks with a strong 'cached-up' balance sheets and high levels of earnings certainty are likely to find favour with investors. These stocks have good downside protection and are also well positioned to lead the market recovery (whenever it may be). The key for investors is determining which stocks have reasonable earnings outlooks and a strong balance sheet and yet despite this 'quality' have been oversold.

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**For further information speak with your  
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