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Too much of a good thing…

by Andrew Fleming, Deputy Head of Australian Equities

February had it all. From the Egyptian revolution and the apparent last days of the Libyan leadership, driving Middle East tensions resulting in the oil and gold price both ending the month up more than 6%, through the UK phone-hacking scandal fading as a potential retardant to the BSkyB takeover, global events had enough of an impact upon the local market to make the traditional half yearly reporting season appear a non-event. The features of this reporting season were well flagged – resource stocks saw buoyant earnings, driven by price gains more than offsetting productivity declines; banks saw the emergence of some pricing benefit from the out of cycle rate rise undertaken late last year, and stable but low levels of credit losses reflecting low levels of unemployment; and industrial stocks mostly suffered, with the strong local currency hurting all those exposed to offshore earnings, and retailers suffering from an Australian consumer again looking to save after a twenty year long flirtation with increasing leverage.

All of these factors (bar one) are, to our mind, highly consistent with the record terms of trade all Australians are enjoying right now. Most factors – strong commodity prices, low levels of unemployment and hence credit losses, and a strong local currency – are all predictable by-products/drivers of the current terms of trade. The exception is the household saving / consumption trade off, which to our mind reflects a savvy consumer being counter cyclical with spending whilst enjoying full employment, in the face of (and possibly because of) a Government doing exactly the opposite. This combination sees an extreme bifurcation, with resource stocks forecast to enjoy 50%+ EPS growth this year, dwarfing industrial stocks sluggish levels of sub 5% growth.

Our role as investors is not to predict next week's, or month's, or year's, commodity price levels (and hence terms of trade)…and just as well. It is, however, incumbent upon us to form a view on the long run cost curve for producers of commodities, in order for us to derive an estimate of the likely long run price for that commodity. We consider our role to be custodians of our clients' wealth and to manage that wealth by reference to a set of cogent and consistent beliefs, which is anchored in a view that returns on capital ultimately anchor prices for any good or service. For commodity goods – such as primary products including resources, or money – history has informed us that this anchor can swing more heavily and more quickly around excess returns than is the case with other goods or services that benefit from a more sustainable market structure and/or competitive advantage.

RBA Governor Stevens expressed a similar view in the December Reserve Bank Bulletin; "We have to turn confidence into lasting prosperity … When the terms of trade are high, the international purchasing power of our exports is high. To put it in very (over-) simplified terms, five years ago, a ship load of iron ore was worth about the same as about 2,200 flat-screen television sets. Today it is worth about 22,000 flat-screen television sets. On all the indications available, we are living through an event that occurs maybe once or twice in a century. …. ". Whilst resource companies rejoice in this scenario (one major admitted to us after their results that they could not rationalise current commodity prices, and at current prices had a "just ship it" mentality with scant regard afforded productivity), in contrast Gerry Harvey should take his Bex, icepack and form guide, and lie down and hope Glenn Stevens is right.

Roger Corbett followed the Governor during February stating "Clearly the mining industry should pay for the opportunity it is having … We should be able to reserve some of the funds created for future generations … because the (mining) holes will be empty one day and they don't belong to us – they belong to our successors as residents of this country". Ralph Norris echoed the substance of these comments when CBA reported during February. Indeed, the most curious aside we received during reporting season was from a senior executive of a large resources stock, who commented that it is a pity that Australia has not developed any public infrastructure from the proceeds of high resource prices. It appears an RSPT style tax, with the proceeds managed by a sovereign fund, now has broad support across the business and monetary policy communities, as unlikely as that may have seemed 12 months ago.

After a frolic of outperformance leading up to the CBA result in mid February, the Banks have largely ceded those gains. One factor may be the duration of liabilities – the CBA result showed that for the first time since the GFC,

this is contracting again. NAB's valentine day massacre on retail bank returns has also not helped subsequent relative performance for the sector.

Outlook

Whilst the developing world continues to drive world growth from this developed world backdrop, it would be churlish to ignore their intent and action in slowing their own rates of growth. Equally, some parts of the developed world see strong signs of growth, with the US ISM Index reaching levels now only seen twice through the past 30 years. The major themes affecting the Australian markets of too much debt, albeit concentrated in the financial and household sectors, ageing demographics, and commodity prices continuing to trade at levels well above what we consider long term sustainable prices, all remain on foot. Our portfolio is positioned accordingly, with a bias to industrials with earnings exposure to economies where we believe upside to mid cycle exists more than can be said to be the case in Australia, or with exposure to domestic industries where cyclical debasing has already occurred, such as Pathology. Markets remain thirsty for what they perceive to be good news, and given ongoing liquidity injections will rally when it is received, as has occurred year to date. That will continue to be the case, and we need to continue to be prepared for the likelihood that this manifests itself in some assets, especially hard assets, being bid well above fair value, with our portfolios. Equally, it would be imprudent for us to ignore what we see as the ongoing risks detailed above, which only become amplified the longer they remain unaddressed. This balancing act has dominated the past three years and will continue to dictate our assessment of not just future likely returns, but also risks, in our portfolios.

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