

thebigpicture

guideposts for the private investor

Week Commencing 7 October 2002

thebigpicture news

- The US Institute of Supply Managers measure of manufacturing conditions for September fell below 50, indicating that manufacturing activity is actually shrinking.

As outlined in *thebigpicture* for the week commencing 23 September, every occasion that this measure has moved below a reading of 50 has been associated with a weakening US equity market. This has been so for over fifty years.

- Despite official anxiety about record levels of activity within the housing sector, the Australian Reserve Bank kept interest rates unchanged.

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thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial analysis and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

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Housing: Yes, There Will Be A Fall!

History says that the housing market will weaken but not until interest rates begin to rise.

In a normal cycle, if such a thing exists, the Reserve Bank would be raising interest rates by now and housing activity would be declining, probably quite precipitously. With concern over international conditions delaying a return to what the RBA considers more normal interest rate settings, the duration of the housing cycle is being prolonged.

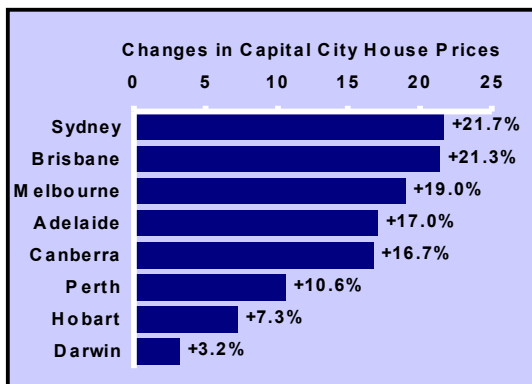
One of the features of the current housing cycle has been the extent of unit development. This has been driven by investors and by an ageing population seeking smaller and more manageable accommodation. Another feature has been the Commonwealth Government's assistance to the housing industry through the first home buyer scheme to help boost overall demand when it had faltered.

Rapid appreciation in house prices - including gains of around 20 per cent in the main east coast capitals according to the Australian Bureau of Statistics - has also supported the overall cycle. Stronger prices have compensated for the adverse effect of weakening equity markets and the burden of already accumulated debt on consumer spending.

The chart on page 4 of the newsletter shows the historical interaction between interest rates and the housing cycle. The blue line shows monthly levels of building approvals. The yellow line shows a measure of movements in cash interest rates. Rather than simply showing the level of rates, to make the relationship clearer the chart shows proportional changes in rates so that a rise from four per cent to six per cent, for example, is the same magnitude as a rise from six per cent to nine per cent. The chart illustrates three features quite clearly:

- the regularity of the housing cycle in Australia;
- the apparent inevitability of higher rates bringing a housing cycle to a close; and,
- the speed of the housing decline once it begins.

With interest rates coming from a relatively low base, the rise necessary to reduce housing activity may not be very large in this cycle.



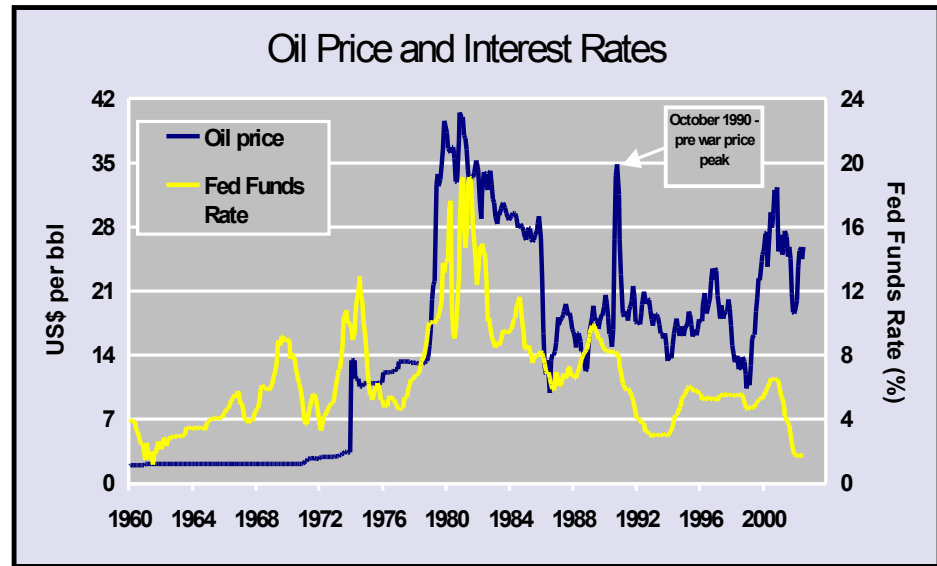
One of two scenarios seem likely to prevail.

Scenario one. International conditions do not deteriorate further and equity markets stabilize. This would allow Australian interest rates to edge upward over the coming six months. While rises may not be dramatic, they would have an important psychological impact.

Could some of the more dire warnings

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MARKETS: "START SHOOTING OR GIVE IN"



Simply from the perspective of equity market impact, it might be better for shooting to start in the Middle East or for Iraq to capitulate. Either would do; the least desirable outcome is for a lengthy stand-off.

Higher oil prices risking stronger inflation, lower economic growth, reduced business profitability and further equity market weakness are some of the concerns arising from a potential war in the Middle East.

Knowing 'if' and 'when' would take away one of the uncertainties affecting world markets.

The historical perspective indicates that higher oil prices might be a short-lived effect, however. Oil prices did rise to over \$40 a barrel in October 1990 (with an average of \$35 for the month) in anticipation of the first war against Iraq disrupting supplies. However, the price spike was relatively brief and, by January 1991, when the coalition had begun shooting, prices had fallen to around \$x a barrel.

On this occasion, the most awkward period might be after UN weapons inspectors enter Iraq, if the Iraqis are not seen as entirely co-operative. This could be the situation during late October through November 2002 when the level of uncertainty would be rising and might be similar to the circumstances which prevailed in October 1991 after Kuwait had been invaded but before the coalition had been galvanized to act.

Having had the 1990 experience, however, world markets should be more aware of the potential for world oil supplies to adjust so any uplift in oil prices might not be as severe as the one which occurred in October 1990.

A key ingredient would be whether oil producers with swing capacity, such as Saudi Arabia, are broadly supportive of action against Iraq at least in terms of their preparedness to maintain the flow of oil.

In the event that the Iraqis do appear to be co-operating with UN weapons inspectors and the excuse to go to war is correspondingly reduced, some uncertainty will linger. No doubt, based on its current disposition, the US government will continue to assert that the Iraqi regime is fostering global terrorism. Moreover, the US is likely to use any further terrorist activities as an excuse to resurrect its claims against Iraq and Saddam Hussein in particular. Thus the market problem would not have gone away - and will not - unless the US administration conceded that its suspicions had been misplaced.

In the event that the US is not satisfied with the weapons inspection process and launches its offensive (with or without a specific UN resolution), the conduct of the war will be influential. The US would need to show significant victories against the Iraqi forces within the first few weeks. If this was the case, it might be the catalyst for US markets, in particular, to begin concentrating on the fundamentals of the business environment. This still remains

"The US would need to show significant victories against the Iraqi forces within the first few weeks. If this was the case, it might be the catalyst for US markets...."

1990/91	Sequence of 1990/91 Gulf War events
Early 1990	Iraq's claims that Kuwait was taking oil from fields around their mutual border without adequate compensation become more vociferous
Mid 1990	Iraqi forces mobilize near the Kuwait border
June	US industrial production is 0.1% lower than a year earlier; the S&P 500 index averages 358.0 up 12.6% on a year earlier and the fed funds rate averages 8.3%
1 August	Iraqi and Kuwaiti representatives meet in Jiddah ostensibly for Arab mediation of their dispute
2 August	Iraqi forces attack Kuwait
September	US industrial production is 1.0% higher than a year earlier; the S&P 500 index averages 306.1 down 12.3% on a year earlier and the fed funds rate averages 8.2%
29 November	The UN Security Council passes a resolution to allow member states to "use all necessary means" to remove Iraq from Kuwait if it has not removed itself by 15 January 1991
12 January	The US Congress authorizes the President to use force to remove Iraq from Kuwait
17 January	Coalition forces begin air attacks
January	US industrial production is 1.9% lower than a year earlier; the S&P 500 index averages 343.9 up 4.5% on a year earlier and the fed funds rate averages 6.9%
24 February	Coalition forces launch land offensive
28 February	Coalition forces declare ceasefire
3 March	UN approved ceasefire conditions accepted by Iraq military commanders
March	US industrial production is 4.5% lower than a year earlier; the S&P 500 index averages 375.2, 10.4% higher than a year earlier and the fed funds rate averages 6.1%

problematic in that repeated downgrades to earnings are sapping confidence but at least one point of uncertainty would have been removed.

Another influence will be the impact of policy. By the beginning of 1991, US economic activity had already slowed and the federal reserve was in a position to support business activity through a series of interest rate reductions. Policy became overtly supportive. The Fed Funds rate which had been 7.25% at the end of 1990 was reduced to 5.75% by the middle of 1991.

With interest rates already near record low levels, it will be more difficult for the Fed to react so aggressively on this occasion. Nonetheless, it would be reasonable to assume that it would take steps in this direction should economic conditions

appear to deteriorate further due to war-related effects. Not to do so would be unpatriotic. Such action might be needed if the weapons inspection process is not proceeding by the end of October and the debate about going to war is underway against a backdrop of troops being deployed.

One difference between now and 1991 is that equity markets have already adjusted to changed business conditions and are on a falling trend rather than a rising trend. The downside potential to arise simply by the event of war has been greatly reduced, therefore. This would also limit the extent to which policy might have to be brought to bear to support market conditions.

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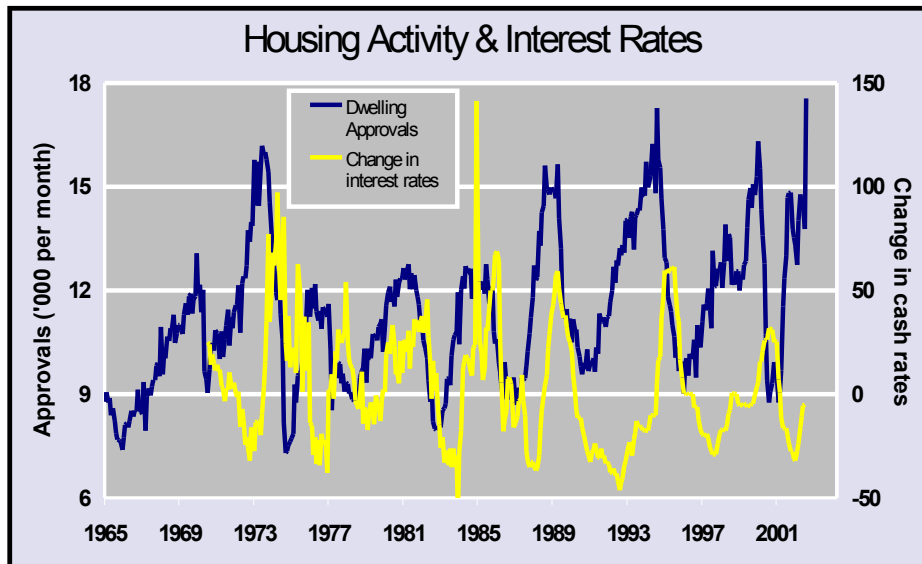
HOUSING: A DEMOGRAPHIC FOOTNOTE

As *thebigpicture* newsletter outlined in its issue for the week commencing 16 September 2002, changing demographic influences will have an impact on patterns of demand.

The housing industry will not escape. Demand for the family home could decline as the proportion of older people in the population rises and the proportion of children falls. This might create additional demand for unit and medium density development,

for example. It would, however, reduce demand for new family houses, probably in outer areas. Demand for existing houses in inner-city metropolitan centres should be sustained, through scarce land value, if no other reason, although price appreciation may be somewhat more subdued than longer term averages with overall demographics being less supportive than in the past 20-30 years.

Housing: Yes, there will be a fall! cont'd



(Continued from page 1)

of housing price falls come to pass? The answer is "yes". Near the top of a cycle, housing prices have usually risen strongly. Values set at the peak typically fall by large amounts subsequently. Indeed, that is the definition of the peak in the cycle.

Present circumstances appear to be consistent with the history. The ABS estimates that established house prices in the eight capitals rose by 18.9% in the year to June which was the largest increase since the September quarter of 1989.

Buying a house in the coming six months runs a serious risk that its value will be lower at the end of 2003, for example, than its purchase price. It could be lower by as much as 20-30 per cent.

It might be the next cycle before the value can be recouped. This would not be unusual and would not necessarily be an argument against purchasing if an investor, as all home buyers are, had a genuine long-term perspective.

What might be different this time?

Scenario two. The potentially different influence on this occasion is the geopolitical issue. The US appears intent on eliminating the current Iraqi government, an option available only through war or complete and imminent capitulation.

In this alternative scenario, the USA goes to war in the Middle East causing equity market instability, a rapid rise in oil prices, disruption to international growth patterns and a deterioration in Australian growth with rising unemployment and lower income growth rates.

While interest rates might not be on the rise under these circumstances, overall conditions will become less supportive of housing activity as the risks become more apparent. A decline in housing activity and prices could ensue.

However, interest rates might be forced lower in response to weaker overall activity. This could generate a third leg to this housing cycle before the more traditional (and more dramatic) return to around the base level of activity as interest rates are subsequently moved back to higher levels.

Consequently, we can be reasonably sure that, one way or another in the coming year, housing activity will decline – perhaps precipitously. We can be equally sure, however, that there will be another upswing in activity within 24 months of that occurring so that, in the long term, investors should not be scared to maintain a position in residential real estate.

“Could some of the more dire warnings of housing price falls come to pass? The answer is ‘yes’.”