

thebigpicture

guideposts for the private investor

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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 and business evaluation 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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MONETARY POLICY: A BLOW WITH A BLUNT INSTRUMENT

There is an element of panic in the latest US interest rate cut by the Federal Reserve and the reaction by Australia's Reserve Bank. That should not be surprising at this point in the cycle. It is also better for markets than the alternative courses which were open to the authorities.

We are in the no-man's land between having monetary stimulus in the pipeline but there being insufficient effect yet evident. Do we take the risk that there is enough already flowing through or should we make sure? If global conditions are also deteriorating, doesn't that mean that more might be necessary at some stage? If so, why not act now?

Such reasoning highlights the uncertainties associated with implementing monetary policy. It also highlights the tendency for interest rate changes to overshoot at either end of the economic cycle.

Monetary policy is a notoriously blunt and imprecise instrument. Because central bankers appear to have had such a good track record in recent years managing the US economy, a sense has emerged that monetary policy is a more precise instrument than it actually is. In fact, the environment has been a particularly benign one for policy makers with productivity growth and global market liberalization helping to contain inflation and reduce pressure on policymakers.

As economists, we know that interest rates pushed high enough will elicit a fall in economic activity. Pushed low enough they are supposed to make capital cheaper and stir the animal spirits of entrepreneurs and individuals who will invest and consume. But at what point those effects begin are not known.

Current day Japan illustrates how zero interest rates might not be sufficiently low to stimulate activity. In the late 1980s in Australia, rates had to go into the high teens before the effects on activity were evident.

So, how far is far enough? The answer is: 'it all depends'. Offsetting structural characteristics can have an effect as in Japan where demographics, the financial capacity of the lending institutions and political shortcomings are a heavier influence. Equally, if debt levels, for example, are relatively high, any given interest rate rise is likely to have a greater effect than if debt levels are low. What, then, is the measure of high and low debt? That, in turn, depends on income and employment expectations which are sometimes hard to fathom.

So, the idea that there is a carefully calibrated monetary policy mechanism is a thought to be disregarded.

Bear in mind, too, that monetary policy only works with lengthy (and variable) lags. The elapse of six months between a monetary policy change and an impact on activity would not be unusual. Indeed, anything sooner would be a surprise.

With such uncertainty over monetary effects, policy can easily overshoot at both ends of the cycle through a combination of public pressure, impatience and lack of confidence.

(Continued on page 3)

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US ELECTIONS: NOW LESS UNCERTAINTY

The almost unprecedented US mid term election outcome is a good stepping stone for markets because it takes away one further element of uncertainty.

The conventional wisdom in the US had been that electors were reluctant to place all the key branches of government in the hands of one party. It seems, however, that the conventional wisdom has been overturned and that the voters are saying that they want action and they want it quickly. So, uncertainty on the political front has been removed but not on three other fronts on which changes need to occur for market conditions to be stronger.

Domestic politics: the electorate has endorsed one group to remove any doubt about the legitimacy of its ability to act forcefully.

Geopolitics: will there be shooting in the Middle east? War is not necessarily going to be bad for markets. Markets will want to know if there is going to be war and, if there is, for shooting to start quickly and, then, for evidence that the Iraqis will be routed in much the same fashion as they were in Desert Storm. The worst outcome

for markets is hesitancy over whether to start shooting.

Earnings: patchy outcomes need to give way to a more consistent performance. Even relatively weak growth might help to support markets if it is seen to be sustainable.

Policy: this uncertainty has been removed with the announcement that the US Federal Reserve has cut its policy rate from 1.75% to 1.25%. This has flagged that the Fed is now prepared to err on the side of support for markets and the economy. There might have been some doubt about this before.

The economy: while lower rates remove the policy uncertainty, they also convey a second message: that those who should know best actually fear the worst. Otherwise, why would they consider the need to reduce rates to historically low levels?

The key ingredient in each of these market guideposts is the element of certainty. Giving the market sufficient confidence to create a robust turning point requires that it has a more definite view of how each of these factors is likely to play out over coming months.

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SHOULD MANAGEMENT TAKE ANY NOTICE OF INVESTORS? CONT'D

(Continued from page 4)

continue to lament the loss of that relatively stable income from commodity oriented activities and its alignment with the Australian market. So, there is now a reaction to what went before.

The second force is making the data fit the conclusion. As it happens, if the current BHP product portfolio had been in existence during the past decade, according to the BHP analysis, there would have been little variation in cash flow because of the portfolio effects. Strong prices for one commodity would have offset weakness elsewhere. Why not make a virtue of this?

And yet, what would actually happen if BHP were to deliver no change in financial outcomes for ten years. Investors would be saying that they want growth; probably, too, that they would accept more volatility to be able to get a stronger growth profile.

The strategy should be about delivering value. In the view of *thebigpicture*, this means rates of return in excess of the

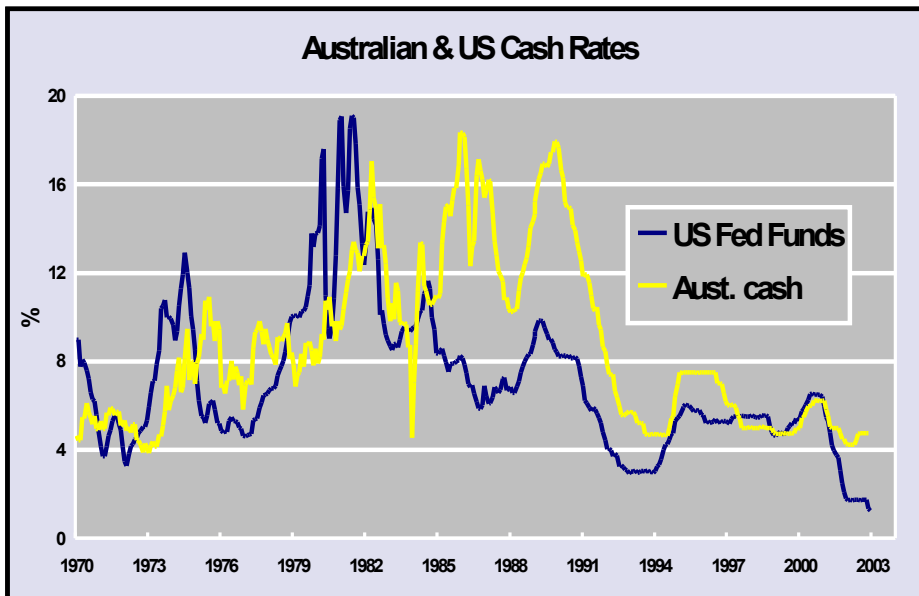
company's cost of capital. Growth may or may not be an intrinsic part of this as long as the income is being returned to shareholders in a way which continues to place a tension on the rate of return.

Then, find the right investors for the strategy. Those that do not like the strategy can go somewhere else. Investors are driven by their portfolio requirements. Today, they might value certain characteristics. Tomorrow, something might have changed and different corporate characteristics might be important.

The needs of a portfolio can change, at the margin, far more quickly than a company can change its strategy. The danger, therefore, in finding out what investors want is that a long term strategy is being defined by shorter term, more flexible targets. This is not a recipe for success.

As long as the company can sustainably add value, there will be investors there for it.

MONETARY POLICY: A BLOW WITH A BLUNT INSTRUMENT CONT'D



(Continued from page 1)

Concern at recession and not being able to wait for the lag to elapse will probably mean that interest rates are cut too far. Concern at losing control of inflation and having to wait for the lags will probably mean that rates will go too high at the other end of the cycle.

That can be good for equity markets on the downside but bring them to a shuddering climax on the upside.

Some such effect is evident in the USA. There, interest rates have again been lowered because economic conditions are perceived to be more parlous than once thought likely and, with the US possibly heading into war, the economic psyche is fragile. Better, in this case, to be safe. Moreover, the Federal Reserve is not exempt from the pressures of nationalism. It will want to be as supportive of the nation's wartime cause as any other individual or institution.

thebigpicture newsletter for the week commencing 19 August 2002 questioned the wisdom of a rise in interest rates in Australia. It suggested that a danger for the equity market was that the pressures on the Reserve Bank to "do something" might be too strong to resist. At the same time, the article cautioned, commencing the adjustment to more "normal" rates may not give the corporate sector the breathing space it needed to begin to build profitability at a sufficient pace to justify market values.

This was written against the backdrop of

an All Ordinaries index at 3100 and which had been as high as 3400 with some evidence, outlined in *thebigpicture* newsletter, that it had run too far ahead of the corporate profit contribution. An adjustment through a combination of higher profits and a lower market would be necessary.

The market is now some 15% below its peak and is, therefore, less out of line with profitability than it once was. However, there is also now some greater risk to the sustainability of profits.

The severity of the Australian drought is becoming a starker reality which will detrimentally affect income growth. Forecasters are suggesting that it might reduce GDP growth from near 4% to under 3%. This would be a highly significant outcome. A growth rate below 3% would not be sufficient to hold unemployment and, therefore, lower income, consumption and business profitability growth would ensue.

The emerging consensus is that the Reserve Bank will now delay any rise in interest rates until, perhaps, the middle of 2003. This would be a welcome outcome which would give the corporate sector some additional breathing space while profitability can be brought back more into line with current market values.

Moreover, given where we are in the cycle and the pressures to ensure that growth is sufficient to contain unemployment, it is possible that the next change will be a reduction even if hindsight might eventually prove that rates are taken lower than might have been needed.

"...uncertainty over monetary policy effects [will mean] monetary action is likely to overshoot at both ends of the cycle because policy makers will be keen to ensure that their immediate concerns are resolved and, in the process, are quite likely to become impatient."

SHOULD COMPANY MANAGEMENT TAKE ANY NOTICE OF INVESTORS?

Management should seek to understand how investors choose stocks for their portfolios but they should not allow investors to dictate strategy.

There have been several examples in the recent round of post result briefings and Annual General Meetings of companies justifying their strategic directions by referring to what investors have said they want.

The first question to ask is 'which investors'. Generally, management is referring to the institutional investors with whom they speak privately. Consequently, there can be little corroboration for what they are saying.

Secondly, ask whether the reported conclusion is the result of a carefully crafted survey weighted appropriately as between existing shareholders and non-holders and taking account of the size of funds under management, among other relevant characteristics.

Far from it, the conclusion is usually drawn from a roadshow and reactions during the course of one-on-one presentations. Under these circumstances, expressions of opinion are biased toward those who want to express a view. Investors are little different from any other audience. Mostly there is no reaction to a presentation. There are a few genuine questions from people trying to understand aspects of the business and, then, most of the views expressed are from people pushed by a desire to be seen and heard.

There is no such thing, in this context, as an unbiased viewpoint. Where views are expressed, they are generally from those who have a strong view about the company either because they are already shareholders or because they have decided that they will not be shareholders. Some of the latter group might be acting on blind prejudice and others on well reasoned arguments about what best suits their portfolio structure.

Those that do not know the company

and, therefore, those who a company would most like to cultivate by improving their understanding are, almost by definition, least likely to express an opinion. So, there is a real danger that the people being listened to are biased toward the group which should be least influential.

There is another phenomenon: management seeking to justify itself and looking for a conclusion to suit its position. This can be achieved easily. You are a CEO of a major corporation. Travel around the world. Meet fifty fund managers. You'll get at least five different views about how you should run the company. Choose the one you prefer and say: "investors have expressed the view that they want ABC".

And, of course, there is always the biased question to help out: "if I could achieve an improved rate of return by doing ABC, do you think we should implement ABC?" Most times the answer is "yes". Conclusion: investors have endorsed our decision to implement ABC.

So, guidepost one: be suspicious of management which cites investors, in a nebulous fashion, to justify its strategic decision-making.

One good example: BHP Billiton. The new Chief Executive Officer said recently that the "mantra" at the company is now "stability + growth". Mr Gilbertson asserts that he knows what this means but the explanation is not something which trips off the tongue very easily. Nonetheless, he is insistent that it is something which investors want. They have told him.

There are two forces at work here. One is the reaction to history. BHP had once been regarded as a relatively safe resources sector investment insofar as its bulk commodity exposures gave it a less volatile earnings profile than the metal makers whose product prices were set on a day-to-day basis by international commodity markets. Then management acted to change BHP's product profile. Volatility befell it, too, and it lost its constituency among fund managers many of whom

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(Continued on page 2)