

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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COMPANY GROWTH EXPECTATION LOWERED

The stock market has been downgrading the growth prospects of Australia's larger companies. That is probably good: the overall outlook is now more realistic when viewed against potential business conditions.

It is possible to estimate the growth rates which investors are attributing to companies by separating the current enterprise value of each company into three components:

- the value of the existing profit stream;
- a discount rate which is assumed to be the company's cost of capital; and,
- a growth rate.

The enterprise value of a company measured by the sum of its market capitalisation and its net debt is an approximate market value. With that known, the growth rate can be inferred mathematically from the existing profit stream (which is also known) and a calculated cost of capital.

The growth rates calculated in this way will vary with changes in market prices.

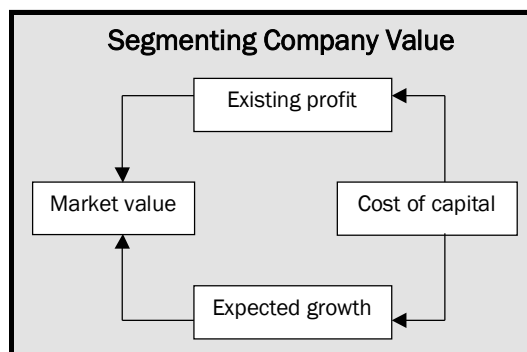
When investors are becoming more bullish the implied growth rates will rise until people recognise that they have become unsustainably high at which point a market collapses. When investors are very bearish the growth rates can become exceedingly depressed.

What is a reasonable growth rate? A true investor will use the underlying growth in the economy as an important guidepost for judgements about what is a reasonable growth rate.

The Australian economy has been able to grow at around 6% a year. This has comprised 2.5% price increase and about 3.5% volume. If these rates are exceeded or appear likely to be exceeded for any significant time, the Reserve Bank is empowered to act to bring them back into line.

Such a constraint was not always in place. However, for all practical purposes, a 6% underlying growth rate now has official endorsement.

"...as a rule, an investor should be nervous if market prices say growth for a well established company will continue indefinitely at more than 6%."



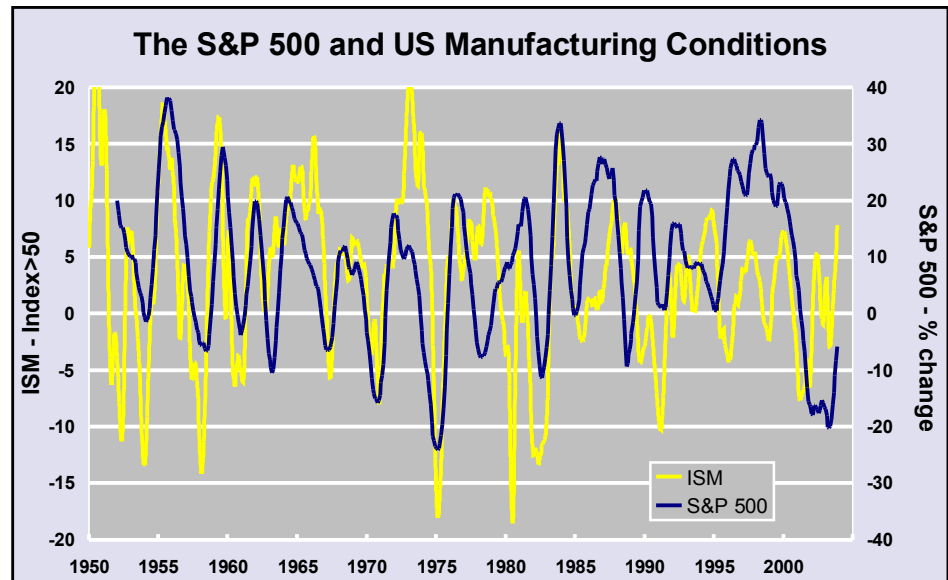
Even a 6% growth rate might be too high as a guidepost for investors. The slowdown in population growth is the problem. The Australian Treasury has forecast that Australian economic growth will subside to 2% a year as the population grows less quickly from now on. As that happens, a rate of 4.5-5% a year might be a more reasonable benchmark for prospective corporate growth.

Australian-based companies may be able to take advantage of export or overseas market development opportunities. Sometimes, this can supplement the domestic growth profile. However, none of the industrial economies appears able to sustain growth rates higher than Australia's.

(Continued on page 3)

THE WEEKLY CHART SPOT

The ISM index says that the US manufacturing sector has been expanding for the past five months after contracting for seven of the prior ten. With the expansion has finally come a bounce in equity market values although the market is still 6% below where it was a year earlier.



Source: Institute for Supply Management and Standard & Poors

POLITICS v ECONOMICS: IRRELEVANT LEADERS

Political leadership does not matter. The Reserve Bank is the primary economic policymaker. Politicians have detached themselves from the macro-economic outcomes.

Some are saying that the Labor Party has embarked on a radical experiment with the election of Mark Latham as its new leader and prospective alternative Prime Minister.

Earlier in the year, within the Liberal Party, there was a choice between the current Prime Minister and the Treasurer. Somewhat against expectations, Prime Minister Howard decided to stay indefinitely. The Nationals went through a less noticed reflection on their leadership without change.

In years gone by, the choice of leaders would have led to considerable discussion of what it meant for economic policy outcomes.

In none of these cases has the choice, or even the uncertainty leading to the choice, seemed to perturb the investment markets or cause the slightest unrest.

One reason for the restrained market reaction is that economic policy is now out of the hands of the politicians. While a national leader was being chosen in Canberra, the Reserve Bank was deciding on

the nation's economic policy without reference to any of them. There is little clearer evidence of how the balance of power has changed.

The Reserve Bank has acquired sufficient independence for markets to believe that the critical inflation and growth outcomes will not be changed by personality movements at the head of the political process.

Another reason for the absence of investment market interest in the political leadership is a strong policy convergence across parties. And, as the Labor election showed, even a group which had once displayed a pronounced ideological cleavage, now finds difficulty moving beyond the personalities.

The upshot is that there is no longer any choice between macroeconomic outcomes at the political level. Even the conservative side of politics has adopted its own version of 'tax and spend' fiscal policy, a point on which it had long chided its opponents.

As the next election approaches, there are gathering signs that the government will use rising tax receipts to placate interest groups rather than build a budget surplus. This tactic worked very effectively for the government prior to the last national election as it set about restoring its slipping

(Continued on page 3)

COMPANY GROWTH EXPECTATION LOWERED CONT'D

(Continued from page 1)

Exposure to Asian markets might provide an additional growth fillip but companies with a meaningful exposure to the region are limited in number and then correspondingly more risky. For most of the larger listed companies such exposure is marginal, at best, in terms of the profit impact.

Cost improvements or other business reforms can also boost growth. However, almost inevitably, this only provides a one-off change. Also, the benefits are sometimes hard to keep in a competitive environment.

Of course, an early-stage company starting from a narrow profit base or a loss will be able to deliver explosive profit growth for a short period of time before settling into a more regular growth profile. But that will be the exception.

Promoters will always claim exceptions. However, as a rule, an investor should be nervous if market prices say growth for a well established company will continue indefinitely at more than 6%. Convincing evidence should be sought for such a claim. A benchmark around 5% might be safer still and more reasonable as time goes on.

POLITICS v ECONOMICS: IRRELEVANT LEADERS CONT'D

(Continued from page 2)

electoral fortunes. Its duplication is hardly surprising.

At the same time, the primary argument for conservative fiscal management remains, namely, the need to build the national savings rate.

Consumption exceeded household income for the sixth consecutive quarter according to the national accounts data released on 3 December. The household saving rate was nearly nine percentage points higher ten years ago when this was a more widely discussed matter of public importance.

Fiscal policy had never been free from electoral politics. However, a newly emerging set of fiscal and political principles is being embraced by all parties.

Their genesis is the idea that monetary policy is the primary cyclical economic policy tool. Having then passed its conduct to the Reserve Bank, politicians have freed themselves, in their minds, from the responsibility of having to conduct economic

thebigpicture has analysed the pricing of the 30 largest Australian industrial companies listed on the Australian Stock Exchange. The key ingredients for calculating their aggregated growth prospects are summarised below:

Enterprise value	\$257,031 million
Existing profit	\$15,709 million
Cost of capital	8.8%

The implied growth rate for this group is 5.2% a year and within the bounds of what is likely to be sustainable within the Australian economy and, more generally, other northern hemisphere industrial economies.

As profits have been expanding over the past two years market values have changed little. This has helped bring down the implicit rates of growth to more realistic levels.

Within the aggregate numbers, the range for the 30 companies is -2.0% to 13.2% so that choices are still required.

There will be a review of individual company growth profiles in **thebigpicture** next week.

policy. That being the case, the temptation to use the available fiscal resources to further one's political interests has become overwhelming.

There is a new fiscal principle: use the taxes before your political opponents can earmark them to shore up their own electoral fortunes.

The emergence of this more pragmatic policy approach across all parties has meant little constituency building for targeted long-term fiscal policy outcomes. Notwithstanding the occasional budget document which dutifully reports the outlook, Budget surpluses as part of a programme to rebuild national savings are no longer a serious discussion in Australia.

Subtly, but definitely, there has been a meeting of minds that potential surpluses will be used tactically. Liberals, Nationals, Labor, Democrats, Greens and others are now looking for the most electorally effective way to deliver the largesse.

"A true investor will use the underlying growth in the economy as an important guidepost for judgements about what is a reasonable growth rate."

THE PROPERTY BUBBLE: *deja vu* AGAIN

The demise of a major property investment promoter in the past few weeks highlights how little cycles change. What is surprising is that so many people are so surprised when history repeats. Will the critical next stages which usually broaden the hardship also be played?

John Kenneth Galbraith, the celebrated Harvard economics professor, made his reputation partly for his writings on the nature of speculative bubbles. Their repetition over hundreds of years intrigued him greatly because people seemed to learn little from the earlier occurrences.

This was especially worrying since, in his view, there were few differences in their nature:

“...there are no new forms of financial fraud; in the last several hundred years there have been only small variations on a few classic designs....paying off earlier investors with the proceeds of the sales to the later ones. The earlier ones, because they are getting a handsome return, bring in the latter ones, sometimes with an uncontrollable rush.”

Galbraith also observed in his writings the tendency for those he regarded as financial fraudsters to be their own victims:

“It is a fixed feature of all such disasters that many of those involved expropriate themselves.”

This he attributed to self-delusion and the tendency for financial genius to be confused with a rising market.

The demise of “property spruiker” Henry Kaye conforms to the pattern. His experience is entirely consistent with the history of financial levitations which could not withstand the forces of economic gravity.

To that extent, the majority can shrug him off as another example of how people succumb to their own weaknesses.

The danger is in the aftermath. As it alerts everyone to the swindle, a bursting bubble can cause such a change in the economic psychology that other purchas-

ing and business decisions are affected.

The historically outstanding example of this possibility was the Great Depression. More recently, with the Japanese deflation of 1990, the psychology turned to such an extent that fundamental flaws in the economy were exposed and recovery has never fully occurred.

Locally, the interaction between interest rates and the economic psychology was exemplified during 1988 and 1989. Between the beginning of 1988 and November 1989, the then government raised cash rates from 10% to 18%.

This induced what was later celebrated as the recession we had to have. However, for much of the time, motivated by their political self-interest, the Prime Minister and Treasurer downplayed the significance of the rises. They tried to portray them as not needing to have any effect on day-to-day decision-making.

In the end, their attempt to have their cake and eat it too meant that 18% interest rates were needed to change the psychology. The subsequent hardship and adjustments became so much greater.

The current Treasurer and Reserve Bank Governor had been attempting to talk the residential property market into a smooth landing over several months. However, their bully pulpit was not powerful enough against the stronger forces trying to take the market the other way. Their ineffectiveness had been one of the strongest arguments for a rise in interest rates.

With the Kaye collapse, property investment risks have been highlighted once again. Demand for property will have been reduced. One of its more speculative funding sources will have been removed.

Now that the psychology has turned, there is less need for interest rate activism than before. However, the Reserve Bank is continuing to notch up the pressure on an economy which is generally not in need of calming.

And, once again, by losing control of the changing psychology we face the risk of historical repetition .

“The demise of ‘property spruiker’ Henry Kaye conforms to the pattern. His experience is entirely consistent with the history of financial levitations which could not withstand the forces of economic gravity.”