thebigpicture

guideposts for the private investor

Week Commencing 10 November 2003

IF THE RESERVE BANK IS RIGHT….

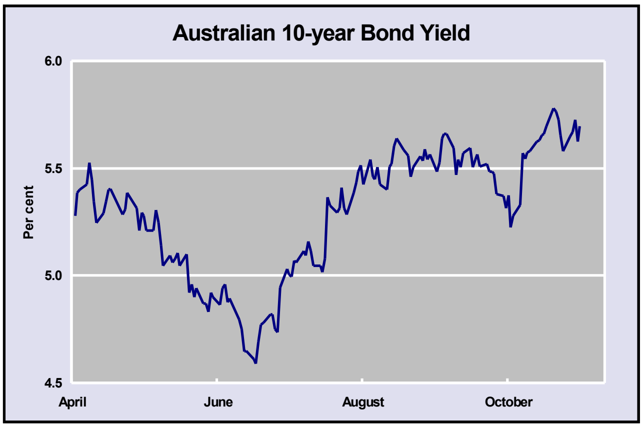
History says some stocks should decline in value more significantly than others as the Reserve Bank pushes up interest rates. But moving interest rates this early in the inflation cycle is unusual. If the Bank is right, the future could be an attractive one for share investors.

In theory, higher interest rates reduce the value of all equities. The value of an equity is the discounted value of its future income flows. Higher interest rates lead directly to a higher discount factor (and a reduction in the present value of future incomes).

Having said that, the appropriate interest rate with which to discount future flows is a long-term rate and not the cash rates which are used as a monetary policy tool .

These two rates may not vary together. Cash rates are a policy tool that may be changed periodically. Long-term interest rates float freely responding daily to changing expectations about likely inflationary conditions.

While the policy rate had been steady at 4.75% over the past six months, the ten-year bond yield, for example, fluctuated in a 1.2 percentage point range. Yields had already risen prior to the Reserve Bank's move to push the cash rate higher.



In fact, any action by the Reserve Bank to stamp on inflation early should be positive for bond values (and promote lower long term interest rates than would otherwise prevail).

The other way in which interest rate changes affect stock values is by depressing the level of future earnings through:

- raising the interest bill for companies so that those with relatively high levels of debt are likely to have a relatively large income drop; or,
- reducing the demand for the products which companies produce or sell, cutting company income due to the effect on sales volumes.

Conventional wisdom suggests that there are some industrial sectors which are affected more directly by an interest rate change. Banks which are dependent for their profits on people wanting to borrow are the most immediate example. Construction companies and sellers of consumer durable products are also thought likely to be affected detrimentally.

On the other end of the scale, producers of staple foodstuffs and brewers are usually regarded as the least sensitive. Their earnings are thought to be more resistant to an interest rate upswing.

These conclusions are based on historical experience. However, since the Reserve

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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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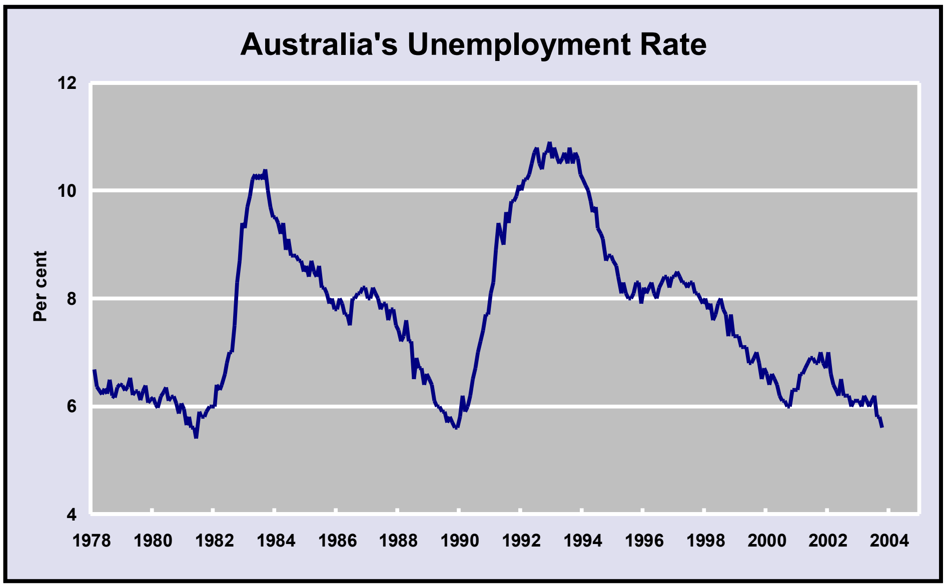
thebigpicture Economics
ABN 71 040 787 936
PO Box 333, Malvern
Vic 3144

The Weekly Chart Spot



Source: Australian Bureau of Statistics

A 20 year low in Australia's unemployment rate is rightly being celebrated.

Some potential workers have been discouraged permanently. That is not so good. For others, the quality of available work has deteriorated.

Now, with the Reserve Bank acting to raise interest rates, opportunities for further gains might depend less on strong economic growth and more on labour market reforms which make employment less expensive.

Info-tech Companies: Signs Of Life cont'd

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- shipments by manufacturers of computers and communications equipment;
- private fixed investment in information technology - hardware, software and telecommunications equipment; and,
- purchases of computers and software.

Movements in the technology conditions index reflect the major changes to occur in the industry during the past thirty years, including:

- IBM's introduction of its first PC which caused a temporary boom in the sector and boosted the rebound in the economy after the 1981-82 recession because of the continued investment in PCs and peripherals as well as investment in telecommunications;
- a tech slowdown in the mid-1980s apparently associated with the maturing of the PC market;
- revival of the market by the invention of faster processing chips, enhanced word processors and laser printers; and,
- the onset of the tech boom in the mid to late 1990s coinciding with the availability of revolutionary new technologies including the world wide web, the first browser which appeared in 1993 and the introduction of Windows 95 in August 1995.

Disparities in performance between this index and market price movements signal the possibility that equity values are running ahead of or lagging underlying business conditions.

The disparity during 1999 and early in 2000, for example, would have said that the market was running too far ahead of underlying business outcomes.

Less dramatically, the disparity at the end of 2002 would have signaled that underlying conditions were running ahead of the market and that there was some scope for further market appreciation.

"Of the 35 principal information technology stocks listed on the Australian market, only 20 were profitable at the time of their last reporting even after adjusting for specific one-off items."

IF THE RESERVE BANK IS RIGHT…. CONT'D

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Bank's policy independence has been increased, the timing of policy adjustments has changed considerably. Pre-emptive rises which are anticipating higher inflation mean that the lessons of history may be less relevant.

During most of the past thirty years, interest rates were likely to be pushed up after a period of strong growth and the onset of inflation pressures. Company profits helped by strong price rises might also have been on the rise. Successive interest rate rises were aimed at dampening expectations that these conditions were likely to persist.

On this occasion, the first rise in the cycle is occurring before these forces have clicked into action. While the Australian economy has been more buoyant than many others, growth has been constrained by relatively weak international conditions and the affect of a domestic drought. Inflation has been held within the bounds targeted for it and there appear to be few imminent pressures causing this to change.

On this occasion, the Reserve Bank seems to be anticipating rises in prices, demand and profits.

The Reserve Bank could be getting it wrong. Its overriding concern about inflation might have given it an itchy trigger finger. Perhaps global economic growth is not about to accelerate. Perhaps some of the deflationary pressures which were concerning policy makers earlier this year will still affect outcomes.

If this is so, the bank will have to hold the rises and reverse them.

The other alternative is that it is right. Prices are set to rise more strongly. Global demand growth will accelerate. Corporate profitability is going to expand more vigorously. Personal incomes are going to grow more quickly stoking demand for consumer goods.

If this is so, equity market values would be supported. As always, if rates are pushed high enough, the market will eventually be brought to heal. But between then and now the prospect is for significantly better business conditions ... if the Reserve Bank is right.

"On this occasion, the Reserve Bank seems to be anticipating rises in prices, demand and profits….the prospect is for significantly better business conditions … if the Reserve Bank is right."

EXECUTIVE SALARIES: A MISSING INGREDIENT

The Australian Financial Review recently published a lengthy analysis of CEO salaries. Unfortunately, it missed one important aspect – the gap between the salary of the CEO and the salaries of other senior managers.

The speedy ascent of CEO salaries relative to the pay of production workers has been widely canvassed. Members of the labour movement, among others, have sought to highlight the discrepancy as a sign of growing inequity sowing the seeds of workforce alienation.

But a wide gap is now often evident between the salary of the CEO and other senior executives within the same company. In some companies, the gap between the CEO and the salary of the fifth highest ranked employee (whose salary must also be disclosed) could be as much as a factor of four. In some large companies, it is higher.

Large-scale salary divergences imply that the company is extraordinarily dependent on the performance of a single individual. If that is not so, its remuneration structures are out of kilter with reality. In either case, the sustainability of the company is being put at risk.

Effective performance of larger companies will usually be dependent on a cohesive team managing the business in concert. The larger the company, therefore, the less compelling is the economic case for large salary disparities.

The stay of chief executives (often around four years) can be less than the time horizon of a long term equity investor (usually 5 to 7 years). Investors need companies which can manage the transition between chief executives with the minimum of disruption.

Executives will be more prone to leave if their value is not being recognized adequately. The attraction of staying for the higher chief executive salary will dissipate as soon as an executive sees that he will miss a chance at the top job.

Large salary imbalances risk creating instability in the executive ranks and, therefore, additional investment risks.

Info-tech Companies: Signs Of Life

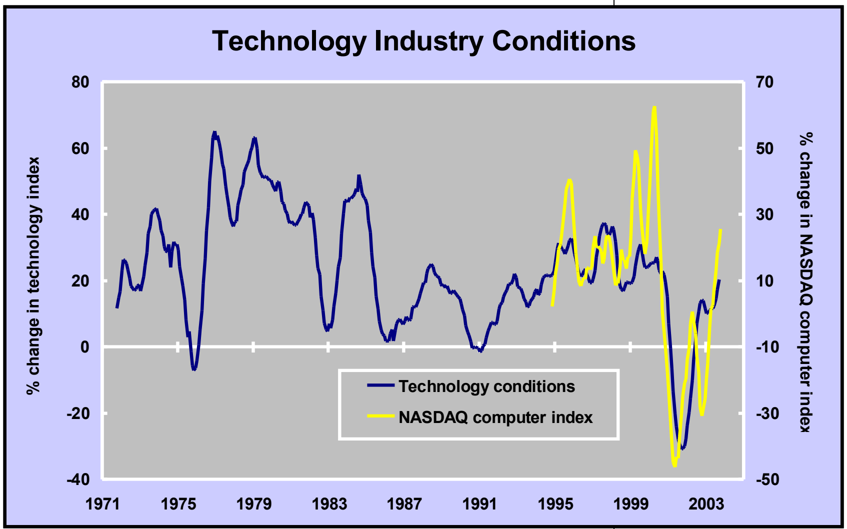
Prices of information technology stocks have been rising. Demand for their products and their services has been strengthening. *thebigpicture* highlights a way of measuring the improvement in conditions.

The information technology component within the US S&P 500 has risen by 38.1% over the past year. At the same time, the computer segment of the NASDAQ market has risen by 40.9%. Within the ASX 200, the information technology group has risen by 31.4%.

As a group, there is little in their business performance to date to make them attractive.

Of the 35 principal information technology stocks listed on the Australian market, only 20 were profitable at the time of their last reporting even after adjusting for specific one-off items.

This group, with aggregate funds employed of some $1.7 billion, showed a paltry 1.2% return. Surely, there are better investments!



However, conditions for the industry have turned. There is some solid evidence for this in an index launched in the past month by the NY Federal Reserve Bank. The index tracks conditions in the information technology market within the USA.

While market conditions in the USA might not always be duplicated in Australia, the state of the USA information technology market does have an important bearing on the condition of the Australian industry.

- Australian companies are often dependent on the US market for customers. Building their businesses frequently requires having their products adopted there by resellers or other larger companies whose endorsements count in the market.
- Many large buyers of information technology in Australia are foreign owned companies whose budgets are determined or influenced by offshore finance executives and conditions in their home markets.
- Sometimes Australian customers will be more likely to loosen the purse strings if they see companies doing so in the USA and Europe and feel the need to sustain their competitive positions.

In September 2003, the information technology conditions index was 20.2% higher than it had been 12 months earlier. Its 12-month rate of change had risen for seven consecutive months.

The improved sector momentum coincided with an improvement in equity market values. The chart shows movements in the technology conditions index in the blue line and movements in the NASDAQ computer sub-index in the yellow line. The NASDAQ indicator is only available since November 1993 when the NASDAQ market first published it.

The technology conditions index uses five coincident indicators of the level of tech-sector activity:

- total employees in four high-tech sectors - computer and office equipment, communications, communications services and computer services;
- industrial production in high-tech sectors;

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"….conditions for the [IT] industry have turned. There is some solid evidence for this in an index launched in the past month by the NY Federal Reserve Bank."