

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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THE ASX: IMPROVING US\$ RETURNS

The stronger Australian dollar should provide a fillip to the Australian equity market. Overseas investors will see that some of the risk from investing in Australian equities has been taken away.

Foreign investors play an important role in the Australian equity market. Foreign-based institutional holders of Australian companies can easily account for 25-30% of outstanding shares. Even this percentage can often understate their influence in the market. They can be more prepared than local managers to initiate stock re-ratings based on comparative valuations in other markets with which they are familiar. Their influence is also felt when Australian companies are incorporated into or deleted from international benchmark indexes.

Even when decisions about investments are taken in the UK or Asia, a large part of the funds originate in the USA. Performance on much of the balance is measured in US dollars.

Some fund managers will make a geographic allocation of funds which will require them to have some money in the Australian market. Others may simply be seeking the best investment alternatives on a global or sectoral basis and will not necessarily have to hold any Australian equities. These fund managers can be especially influential at the margin when they move funds to or from the Australian market.

Whatever the value considerations of individual stocks, the Australian market has not been a particularly attractive one for overseas investors during the past 20 years because capital appreciation has been eroded by the long term depreciation in the value of the Australian dollar.

Since the beginning of 1980, the ASX 200 has risen at an average annual rate of 7.4%. Adjusted for movements in the exchange rate against the US dollar, the annual average rate of appreciation is a less attractive 5.0%. As the chart on page four shows, the recent upswing in the US dollar adjusted value of the index has only just returned the market to a level which was first reached in May 1997 leaving a US dollar denominated overseas investor with a zero six year capital gain.

% change from year earlier	ASX 300	ASX 300 Currency Adjusted
INFORMATION TECHNOLOGY	-19.3	-6.8
HEALTH CARE	-7.6	6.7
TELECOMMUNICATION SERVICES	-1.4	13.8
MATERIALS	-1.1	14.2
INDUSTRIALS	-1.0	14.3
CONSUMER DISCRETIONARY	-0.6	14.8
ENERGY	1.1	16.7
CONSUMER STAPLES	3.5	19.5
FINANCIALS	5.0	21.3
UTILITIES	8.5	25.3
Total Index	1.9	17.7

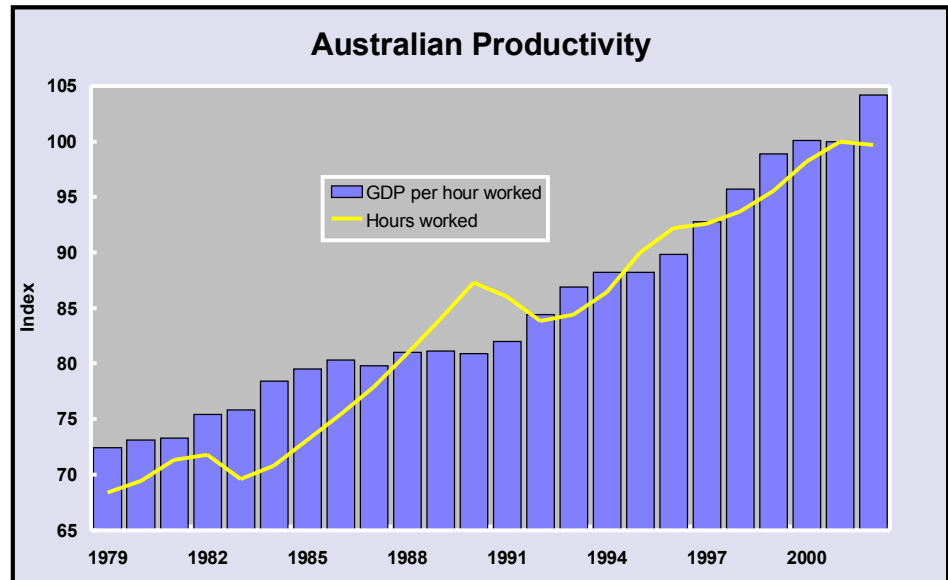
“The Australian market indicator has appreciated by 17.7% compared with a fall of 3.1% in the US dollar denominated S&P 1200 index. The superior performance is evident across virtually all sectors.”

A weaker currency makes Australian assets less expensive. In theory, this should eventually attract investor interest. In practice, the reaction will depend on whether currency depreciation is seen as a one-off event or whether there is a continuing downside risk. In Australia's case, the currency

(Continued on page 4)

THE WEEKLY CHART SPOT

“However it might be achieved, the amount of political goodwill the Prime Minister is prepared to risk on creating a more workable Parliament might well determine investment returns in the coming decade.”



Source: Australian Bureau of Statistics

The initiative by the Prime Minister to alter the powers of the Senate, launched at the Liberal Party conference in Adelaide, might be an important signal of his determination to get on with the job of financial and economic reform. Just as improving productivity within the corporate environment is a continuing task, the government's contribution is also never finished.

How zealously a government manages this task helps determine the allowable pace of overall economic growth and, ultimately, investment market returns. Despite what the present government might want us to believe, the economic reforms which occurred in the 1980s and early 1990s contributed significantly to the growth profile during the subsequent decade.

Remembering this prompts the question: what are we doing now to secure the growth performance in the next ten years.

The national growth outcome is the interaction of four forces:

- workplace productivity (i.e. how effectively labour and capital are combined),
- the overall allocation of resources across the economy (i.e. the extent to which resources are being re-deployed from less efficient to more efficient uses),
- the level of labour force participation (i.e. the number of people being employed and the duration of their employment); and,
- whether policy is managed to minimize disruption to the production processes (i.e. whether decisions are causing or smoothing business cycles).

The chart helps to illustrate the extent to which the contribution of productivity growth to economic performance during the 1990s was greater than it had been in the 1980s. Output per hour worked increased by only 4.6% over the seven years after 1984, averaging 0.6% a year, but rose at an annual rate of 2.2% over the subsequent eleven years.

While the 3.3% annual rate of output growth over this latter period might have been achieved with less productivity and a higher level of employment, this would have been a temporary achievement. The productivity based growth pushed out the allowable growth frontier for the economy and better ensured its competitiveness against businesses in other countries. It was and remains, therefore, a preferable and more sustainable source of growth and way of improving business returns.

Day-to-day management of the economy has fallen to the Reserve Bank as the government has effectively adopted a fiscal policy rule which requires small surpluses. That

(Continued on page 3)

Australian Productivity cont'd

(Continued from page 2)

leaves the government's primary role more than ever as having to deal with market efficiency and distributional matters. By their nature these issues require greater commitment by the proponents of change and a capacity to engineer community consensus.

Unhappily, the tempo of change emanating from the government has diminished. The government's zeal for the cause, including recognition that there is a long lead time between policy and result, has probably been constrained by it wanting to claim credit for a higher than average growth rate now.

Moreover, without the ability to legislate unimpeded or the willingness to manage a compromise where legislation is required, the contribution to the national growth profile from these matters on which government can exert an influence is stalling.

If the government is at all serious about leading debate on these microeconomic policies it must have a plan to deal with the Senate impasse. Otherwise, one could legitimately question its motives. Simply putting forward legislation which will be opposed in the Senate could easily be construed as a government political ploy: placating supporters by being able to point to its attempts at change but privately welcoming not having to take a reform agenda to a jaded electorate which might prefer that some of the hard issues

go away.

For this reason, the attempt by the Prime Minister to bring Senate reform to the fore is to be welcomed. But that might not represent progress either. His proposal for a constitutional amendment to allow joint sittings of the two houses of parliament without the need for a double dissolution election will meet opposition from the minor parties in the Senate.

The Opposition will no doubt seek to have some of its preferred parliamentary reforms placed on the agenda as the cost of its support. Conceding the cost will be an unusually magnanimous political act. Politically, the absence of unqualified support might be a tempting excuse for the government not to proceed.

Thus the Prime Minister is making a suggestion which he knows could easily fail at either barrier. Interestingly, the Opposition already has it within its power to allow the government to pass all of its legislation after three attempts if that is what it thinks ought to happen. To that extent, parliamentary reform could occur by mutual agreement. Constitutional practice could emerge from a meeting of the minds on what is appropriate behaviour.

However it might be achieved, the amount of political goodwill the Prime Minister is prepared to risk on creating a more workable Parliament might well determine investment returns in the coming decade.

"...without the ability to legislate unimpeded or the willingness to manage a compromise where legislation is required, the contribution to the national growth profile from these matters on which government can exert an influence is stalling."

THE ASX: IMPROVING US\$ RETURNS CONT'D

(Continued from page 4)

the US dollar which have been reflected in the stronger Australian dollar represents such a catalyst is hard to tell. As long as the US dollar remains the primary international means of exchange and store of value prolonged weakness cannot be assumed. However, enough might have changed to effect a positive reappraisal of the Australian market.

Measured over the course of the last year, the performance of the Australian market on a currency adjusted basis has been noticeably stronger than it has been for some time.

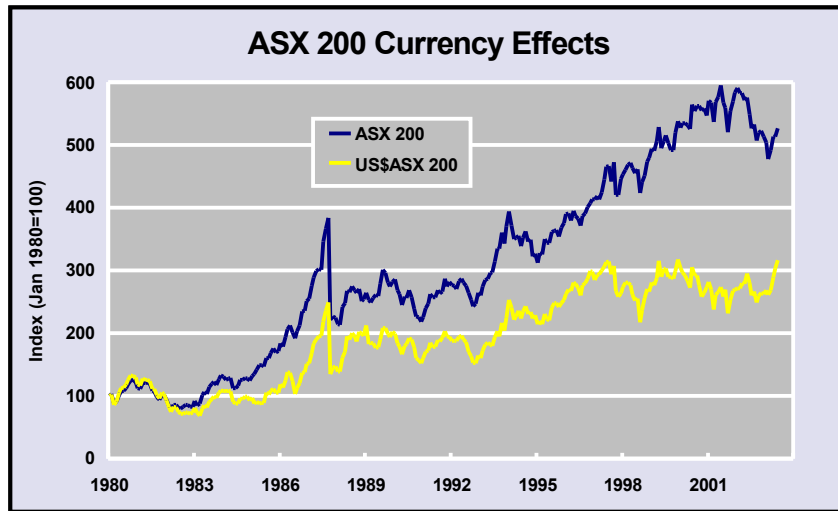
The charts on page four show the sectoral performance of the Australian market over the last 12 months compared with the same sectors from the S&P 1200 global

index.

The Australian market indicator has appreciated by 17.7% compared with a fall of 3.1% in the US dollar denominated S&P 1200 index. The superior performance is evident across virtually all sectors. Only Australia's information technology grouping has performed worse than its international counterparts.

Interestingly, the three weakest sectors in the Australian market – health care, information technology and telecommunications – were the strongest on a global basis. Key companies in the Australian market such as CSL and Computershare had an impact on this outcome which reflected some of the peculiarities of their circumstances rather than anything more general about the Australian market.

THE ASX: IMPROVING US\$ RETURNS CONT'D



(Continued from page 1)

did represent an ongoing risk which would affect investment outcomes detrimentally.

The risk could be managed through offsetting transactions using derivatives but, in doing so, costs would be higher. Unless Australia provided a compelling investment case (which it rarely has), the extra effort was not necessarily worthwhile.

Australia's history as a commodity-oriented economy has also affected judgements about when foreign investors should enter the Australian market. There was a long held view that the Australian dollar would have its level set by commodity price cycles. With commodity prices being less volatile than they once were, the speculative interest in commodity investments has diminished. The reality is also dawning that the Australian economy

has become far more diversified than it had once been and that this should reduce the influence of commodity markets on the currency outcomes.

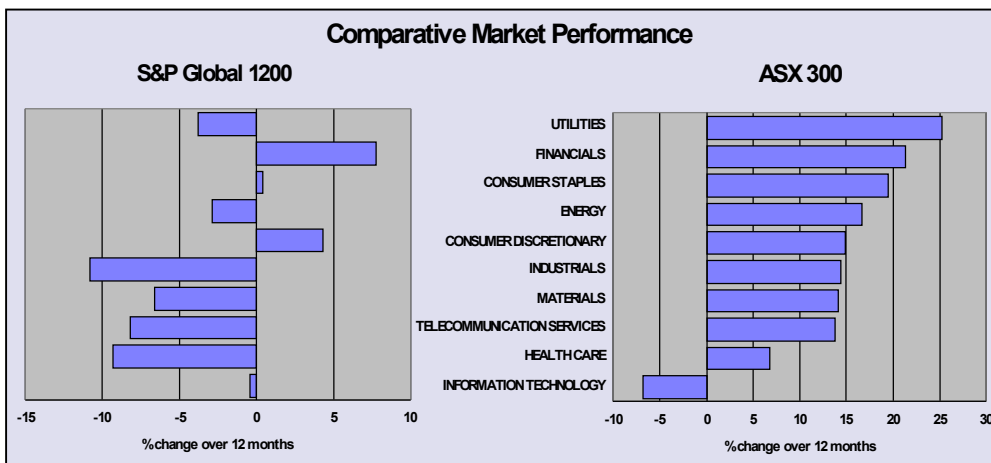
With Australia's inflation performance having fallen more into line with inflation rates in the USA and Europe, the theoretical argument for continuing currency realignment to reflect relative purchasing power losses has also been removed.

There was building scope, therefore, for foreign investors to take a different view of the Australian currency and the risks associated with investing here. Even so, it often takes some form of catalyst for the change to be fully assimilated by the market.

Whether the reversal in the fortunes of

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