

thebigpicture

guideposts for the private investor

Week Commencing 24 March 2003

AT LAST, THE SHOOTING STARTS

The conventional wisdom is that the attack on Iraq will be swift and, with a clear-cut result, governments can give more attention to economic matters. But will events be that straightforward?

thebigpicture, in considering the outlook, has considered five scenarios.

Scenario one: US technological prowess wins the day. It becomes very obvious within a week or so that US military might will hold sway. Although Saddam is not yet dislodged, his hold is visibly tenuous with minimal numbers of casualties among the US allied forces. Capitulation is inevitable within a few days away.

The US begins to stitch together a broader coalition including France and Russia to rebuild Iraq or to help co-ordinate the humanitarian aspects of post-war development.

The US turns up Osama bin Laden in a Pakistan cave demonstrating that its anti-terrorism campaign is intact. US intelligence averts a terrorist attack within the continental United States giving the country greater confidence that it is able to protect itself against the ongoing threat.

Arguably, this is the outcome which has already been factored in by markets. It represents upside for equities, bond yields and the US dollar and downside for gold and oil prices.

Scenario two: the Iraqis don't surrender. While initial gains are swift in the south, upon reaching Baghdad, progress stalls and the US is reluctant to storm the city. Pictures of human misery within the city begin to torment the world and pressure mounts on the US government to negotiate an outcome. The US refuses and continues the siege.

Scenario three: the plight of the Iraqis in Baghdad becomes a rallying point for radical Islamists. There are several terror attacks in major western population centres. With the US attack being seen as a grave error of judgment, the UK Labour Party splinters and Tony Blair remains Prime Minister only with the support of the Conservative Party for the duration of the war.

Scenario four: the Iraqis, it seems, were not the problem. The US military sweeps through Iraq. Saddam Hussein and his family are put through a shredding machine by a newly-liberated but uncontrollable Iraqi crowd. The US works with the UN to establish a post-war administration. France expresses its relief that its long-time ally has been so successful.

Meanwhile, however, a few of Hussein's cronies escape and, with access to a vast fortune accumulated by the family, join with Osama bin Laden to fund a renewed and unprecedented terrorism effort. Terrorism attacks become commonplace throughout western countries and among the Arab regimes which had acquiesced in the US action.

Government counter-measures appear ineffective. George Bush's popularity plummets. Hillary Clinton leads the Democrats to the 2004 Presidential election. Her win is partly attributable to a promise that her husband will be secretary of state. Kim Beazley is Australian Prime Minister and Joe Hockey leads a dispirited opposition.

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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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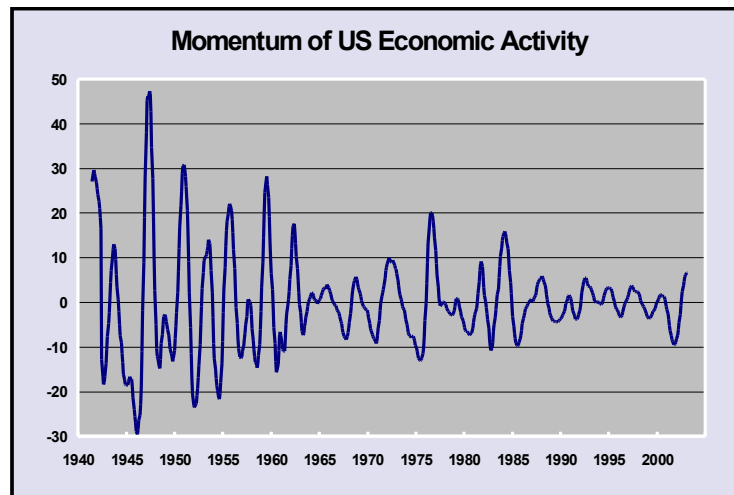
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(Continued on page 3)

THE WEEKLY CHART SPOT



Source: US Federal Reserve

*“thebigpicture
asset allocation analysis
focuses on the
momentum of economic
activity as a forward
looking indicator of
market strength.”*

The momentum of US economic activity has been improving, indicating that the worst of the economic downturn may have passed. US industrial production expanded by 1.8% over the year to February 2003. A year earlier, production was actually contracting. It had fallen by 3.9% over the year to February 2002.

This momentum indicator measures changes in the rate of growth. Shown over a period of time, it is something like an economic heartbeat: the ideal is small consistent fluctuations which indicate that the rate of growth is relatively steady. Small fluctuations also imply that the need for compensating policy changes are less likely to be required.

The best example of the ideal was probably the 1990s when there was a minimal economic cycle as the economy grew without recession for a record period of time. Larger fluctuations which typified the 1940s and 1950s, on the other hand, were consistent with periods of relatively strong growth but also more volatility in the pace of growth. In part, this reflected occasional policy adjustments which were intended to ensure that growth rates did not get out of hand by exceeding capacity constraints but also added to volatility.

thebigpicture asset allocation analysis focuses on the momentum of economic activity as a forward looking indicator of market strength. Because the market is forward looking, it seeks to anticipate higher rates of growth. Even if the indicator is negative, if it is also rising, prospective rates of growth will be higher than the growth rates which had prevailed.

thebigpicture uses activity momentum indicators for Australia and the major economic regions of the world economy to signal whether there should be a change in the allocation of assets between equities and other asset classes.

Corporate Philanthropy: Who gives A Toss? cont'd

(Continued from page 3)

working for a company with a strong philanthropic commitment better motivated to achieve the goals of the business?

Simply by the way in which these questions are framed, there is an implication that business performance and the fulfillment of stakeholder needs should be the primary drivers of decisions about contributions to philanthropic causes.

Companies, to ensure maximum transparency, should outline a rationale for their philanthropic contributions. Achieving adequate returns on the funds employed

in the business should be the primary aim and responsibility of corporate management. Once past this threshold (i.e. a rate in excess of the cost of capital), a proportion of funds for philanthropic contributions can be earmarked and made known by the company.

Criteria for contributions should also be made explicit. For the sake of stakeholder relations, companies should be prepared to accept submissions from employees, customers, suppliers and shareholders, consistent with the guidelines, for expenditure.

AT LAST, THE SHOOTING STARTS CONT'D

(Continued from page 1)

Scenario five: North Korea joins the fray. While US forces are stuck on the outskirts of Baghdad, North Korea begins to act more belligerently. There is a real fear that it will attack south Korea to unify the peninsula. There is a suspicion that this is simply an aggressive negotiating ploy to gain economic and humanitarian concessions but the US is too distracted to play a meaningful role in creating a solution. Japan and South Korea seek an accommodation which re-balances power in the region and effectively removes the US as a regional power. China uses these global distractions to renew demands that Taiwan be reunited with the mainland provinces. It is evident from the US reactions that it is in no position to take any countervailing action. ASEAN countries effectively ratify the Chinese demand on behalf of the region. Australia is unimportant.

The risk for markets (and political leaders) is that the definition of victory is unclear. The defeat of Saddam Hussein, however swift and complete, might be insufficient to restore enough certainty to create conditions for sustainably firmer markets.

Prior to any hint war, of course, there had already been a slowdown in global economic activity. Related to that was the disconnect between corporate profitability and equity market values which occurred during the 1990s and which is taking several years to work through. True, the ex-

pectation of war might have exacerbated these underlying conditions but it did not bring them about.

Consequently, no matter whether Saddam Hussein is dispatched within the week or not, investors have to grapple with the same economic issues.

As was observed in *thebigpicture* last week, in Australia, the rebalancing between corporate profits and equity market values has only recently been achieved and, even then there remains some downside risk in market values.

In retrospect, market values had surpassed profit outcomes and, even if late 1990s expectations of profit had been realized, the market might have been too high. Profit outcomes and prospective growth rates have actually fallen well short of what had been anticipated. Even seemingly depressed market values, therefore, might be too high for current levels of profitability.

Investors will need to again acquire confidence in profit outcomes before markets will be able to resume a sustainable upward momentum consistent with the rates of growth which emerge.

Building that confidence will depend on the geopolitical environment becoming more certain. While some of the above-mentioned scenarios might not be highly likely, most of them are not consistent with this process of confidence rebuilding.

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Corporate Philanthropy: Who Gives A Toss? cont'd

(Continued from page 4)

tify. Shareholders can be persuaded that they are in the interests of sustaining the business. To the broader community, they can be used to illustrate the caring side of the corporation.

However, to the extent that they can be justified in this way, they might fail the test of being philanthropic. Arguably, genuine philanthropy can have no direct business benefit and is provided simply out of concern for the greater good of the community.

But this is something which would be tolerated in only the best performing of companies.

There is some empirical evidence that well-performed companies are also companies with a relatively strong commitment

to corporate philanthropic activities. Whether philanthropy affects performance or whether relatively strong performance leads to greater indulgence of personal preferences in the form of philanthropy is unclear.

In judging whether philanthropic activities have a role in business outcomes, some views need to be taken about what motivates stakeholders. For example, does a customer choose to shop at a Coles Myer store because its shelves are well stocked with competitively priced goods and it is staffed by helpful assistants or because it supports certain community programmes? Similarly, will a supplier prefer to deal with a customer which has inferior payment terms but a more extensive corporate philanthropy programme? Are employees

(Continued on page 2)

CORPORATE PHILANTHROPY: WHO GIVES A TOSS?

Buying favours for the benefit of a company or, contrary to shareholder interests, fulfilling personal whims with company funds: these are two extreme views of corporate philanthropy. Unfortunately, there are no generally accepted benchmarks against which to assess its value.

There have been several organizations established in recent times to encourage more extensive corporate philanthropy programmes. Some, such as Philanthropy Australia and the Council for the Encouragement of Philanthropy in Australia, are actively lobbying for a more generous attitude among corporates in Australia. Several long-standing philanthropic organizations have sought to acquire more professional and well connected staff who are able to develop programmes in conjunction with business planners. They all recognize that, in an era of shareholder value oriented decisions, getting access to the corporate dollar becomes harder without a strong explanation of the benefits which will flow.

Corporate philanthropic activity is thought justified on three grounds.

- It raises the standing of a company amongst its stakeholders. Employee, customer and supplier relationships depend on a range of factors including how a company behaves in its dealings with the community at large. Selected forms of philanthropic activity can help a company bond more tightly with its stakeholders.
- A company must see itself as part of a community and, like all community members, must take some responsibility for its broader well being.
- As government is forced to target its resources more effectively in response to majority opinion, there are gaps to fill. Corporations and private individuals which have control over a growing proportion of wealth can participate in the provision of niche services.

Some would argue, however, that corporate philanthropy is not justified.

- A strong culture of maximizing shareholder value with a firm eye on the relevant measures will be contrary to any corporate philanthropy programme.
- So-called philanthropy is too often simply the outcome of a chief executive's personal preferences and, therefore, not a contributor to the company's shareholder value objectives.
- The link between philanthropy and business outcomes is ill-defined and difficult to quantify making choices between philanthropy and other resource uses subjective and less rigorous than other forms of expenditure.
- In any event, corporations, being owned by shareholders, have no right to act on behalf of the latter without their authority.
- Particularly when company performance is less than ideal, corporate philanthropy can create hostility between the company and its stakeholders.
- Under the best of circumstances, the choice of philanthropic targets can create controversy and tension amongst stakeholders who may not share the same values as the groups being helped.

Corporate philanthropy has frequently had a business relevance test. A company which has been embroiled in controversy about aboriginal land rights, for example, might be tempted to participate in reconciliation programmes or aboriginal welfare projects. A company which has been the target of environmental activists might become involved in programmes which can demonstrate its understanding of environmental issues. Manufacturers of alcoholic beverages tend to support health and welfare programmes particularly where they seek to solve problems caused by excessive alcohol consumption. Similarly, gaming companies support initiatives to assist problem gamblers.

These initiatives are relatively easy to jus-

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(Continued on page 3)