

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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INTEREST RATES: MORE GROPING IN THE DARK

Interest rates are being cut in the USA and possibly in Australia. Should this make us more confident or is it a sign of policy failure and a warning signal for investors?

The short answer is that no-one knows. Policy makers are groping in the dark and hoping that they are getting it right. And a word of warning: the commentators who appear nightly on our TV screens, radios and in the press are paid to guess what the policy makers will do - not assess the consequences. The fact that they might guess the next change correctly means nothing for investment returns.

The conduct of monetary policy always contains an element of panic because the linkages between an interest rate change and levels of economic activity are indirect at best and, at worst, sometimes do not exist. Judgements about whether policy adjustments are already working are more acts of faith than a matter of record.

The theory: lower interest rates make borrowing cheaper encouraging business people to invest and individuals to buy consumption goods or build houses creating additional employment and higher incomes as demand grows.

A cut in rates would usually signal a belief by the central bank that there is sufficient excess production capacity to allow an expansion in production to happen. A cut also implies that the existing momentum of the economy is not sufficient for the capacity gap to be filled anytime soon. Conversely, if capacity limits are being reached or exceeded, interest rates are raised to reverse the sequence and create excess capacity.

"These are judgment calls for policymakers who have never faced this set of circumstances....persistent inflation is no longer the problem."

The impact on capacity utilization will influence inflation expectations which are usually the ultimate target of a central bank.

To the extent that the additional liquidity which comes with lower interest rates is not used to demand more goods, it would be available for investment in financial or other assets including equities. So, the expected response to lower interest rates will be some combination of greater demand for goods or financial assets.

Ideally, fluctuating interest rates are a normal response to the cycles in the economy ensuring that it operates within the bounds of its capacity limitations to prevent inflationary pressures emerging. The ideal presupposes that the link between rate changes and the activity effects is a tight one.

However, timing is uncertain. Because interest rates do not act directly on either activity or prices, there can be long and variable lags between a decision to change rates and their impact. Normally, at least six months could be expected. In the extreme, lower interest rates might never have an effect. The latter would characterize a depression where business and consumer psychology is so fragile that no matter how low interest rates fall, there is no response.

The USA has now had its thirteenth official interest rate reduction taking nominal rates to their lowest level since Eisenhower was president. Real rates - nominal rates adjusted for inflation - have been lower on several occasions in the intervening period but for all practical purposes interest rates are now at historically low levels.

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THE WEEKLY CHART SPOT



Source: Australian Bureau of Statistics

“Statistics indicate that underlying Australian business profit growth has been quite robust over the last two years....many of the better performing companies are outside the Australian stock market leaders.”

The company profit data in the national accounts published by the Australian Bureau of Statistics indicate that underlying Australian business profit growth has been quite robust over the last two years.

Over the long term illustrated in the chart, the average rate of private corporate gross operating surplus for the Australian economy - similar to after tax earnings before interest for a company - has been just on 10% a year. Over the year to the March quarter of 2003, the rate of growth was 9.5% and over the past two years the annualized rate of growth has been 10.6%.

This picture is consistent with the broad impression of the Australian economy as having been relatively resilient while the US and European economies have been slowing and the Japanese economy has been mired in recession.

Unfortunately, over this period, the equity market itself has not reflected this performance in any significant value appreciation largely because of the excessive prices which had prevailed earlier. At the same time, there have been many examples of Australian listed companies falling short of investors' expectations through strategic shortcomings or through bad business decision-making.

In many instances, these failures have been an affliction most evident among the larger listed companies in the Australian market. Because of their profile, there is an impression of a far more widespread malaise than might actually be the case amongst the large unlisted companies or among smaller companies.

Partly for this reason many of the better performing companies are outside the Australian stock market leaders. The mid cap 50 stocks (i.e. those between 50 and 100 ranked by market capitalisation) and the small ordinaries (i.e. those between 100 and 300 ranked by market capitalisation and which account for just 6% of the market) have performed relatively strongly over the past year.

	26-Jun-02	26-Jun-03	% change
20 Leaders	1886.3	1753.4	-7.0
50 Leaders	3244.1	3048.9	-6.0
Mid-cap 50	2595.7	2660.4	2.5
ASX 100	2604.2	2472.7	-5.0
Small Ordinaries	1583.9	1585.0	0.1
ASX 300	3173.7	3025.0	-4.7

The worst performing segment of the market - the 20 leaders which fell by 7.0% - dropped 9.5 percentage points relative to the mid-cap 50 companies.

INTEREST RATES: MORE GROPING IN THE DARK CONT'D

(Continued from page 1)

Is this enough? What if more cuts are needed? Should US authorities wait or cut again soon? Do the consequences of waiting outweigh the costs of cutting by too much now?

These are judgment calls for policymakers who have never faced this set of circumstances before. Virtually all their working lives the current generation of policy makers have been focused on how to reduce inflation. Many would regard themselves as expert at how to do this. And yet that knowledge might be irrelevant because persistent inflation is no longer the problem.

The psychology is complex. It is bound up with equity market values, the expectations which had been generated through the 1990s, the debt burden, the geopolitical environment and the demands for corporate managers to effectively become more risk averse.

There may not be cause to worry. Business profits are rebuilding perhaps not spectacularly but steadily enough to underwrite equity market stability and, later, some modest appreciation. This will eventually engender greater confidence. Consumer demand and business investment will begin to recover. On this view, patience is more necessary than added stimulus.

If, on the other hand, this is wrong, we are entering largely uncharted waters. The only comparable cases of persistently ineffective interest rate adjustments might be the 1930s depression and the current Japanese condition. And yet in both of

these cases one could point to countervailing actions which hindered recovery. In the case of Japan, there are crucial structural problems which have not been addressed including an overextended banking system, high levels of corporate debt and an economy with limited flexibility to

Lower Interest Rates: How Investors Benefit

Investors can benefit in three ways. Firstly, lower interest rates mean that the discounted value of an income stream (and hence share prices) should be higher. However, the relevant interest rates determining value are longer-term rates and usually a 10-year bond yield would be the benchmark measure. All things being the same, a fall in bond yields from 5.5%, for example, to 4.5% would imply a valuation upturn of a little over 10%.

Longer-term rates are more market driven and have already fallen. In fact, yields have recently risen from 4.83% a month ago to 5.0%. Rate reductions by central banks might not have any effect on these longer term market rates which will be influenced mainly by inflation movements and other variables which reflect financial and economic risk.

Secondly, higher rates of economic activity brought about by lower interest rates drive higher levels of profitability. The valuation impact is higher the greater the starting growth rate. An improvement in the profit growth rate of 5 percentage points, for example, other factors remaining unchanged, could improve share valuations by over 50% and as much as 80% starting from average growth rates.

The third way in which investors can benefit from lower interest rates is by gaining access to the increased liquidity which comes with them. Banks and other financial institutions are more willing to lend for investment purposes the lower the rate of interest.

Equity markets are likely to be at their strongest, therefore, when interest rates are falling and profit growth rates are accelerating with banks ready to lend.

adapt to changing conditions. The 1930s depression was worsened by policy which ran contrary to what we understand today to be necessary to boost demand.

In other words, if the optimistic view does not hold, we are in a genuinely unique set of circumstances for which there are no known policy solutions. While a scary thought, there might be some comfort to be had from this. The absence of any comparable examples could mean that the more optimistic view is the more accurate one and that, with the benefit of hindsight, we will see that lower interest rates will have had their effect.

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HOUSING: TOO PROTECTED? CONT'D

(Continued from page 4)

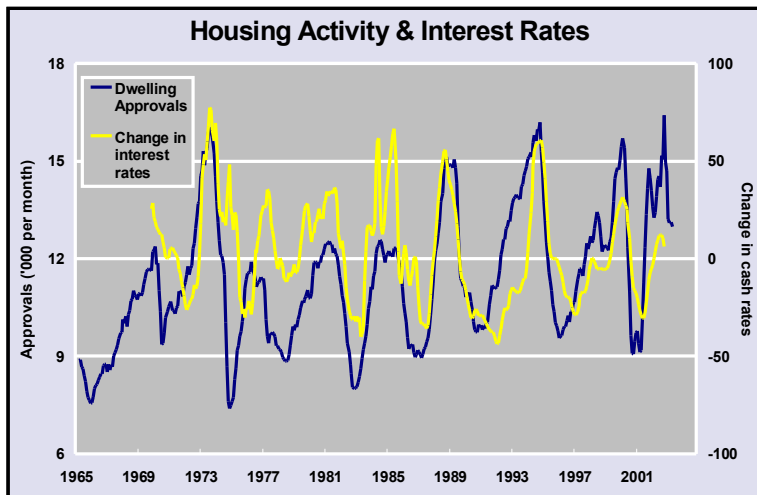
budgetary funds are becoming increasingly strained and there is a clear attempt to shift the focus of politics to health, education and welfare policies, this might be a

tempting target while many other sacred cows are also being jettisoned. It might be one way in which a government could demonstrate that it was making a real attempt to set priorities.

HOUSING: TOO PROTECTED?

In Australia, the housing market exerts a strong influence on monetary policy. It might be time for housing to lose its privileged position and stop disadvantaging other parts of the economy.

The chart helps to illustrate how tightly entwined changes in interest rates have been with the building cycle in Australia. The chart shows proportionate changes in official interest rates (in the yellow line and measured on the right hand axis) and quarterly levels of private sector building approvals (in the blue line and measured on the left hand axis). The interest rate series has been lagged by eight months to highlight the connection.



Private dwelling investment in Australia (new building and renovation) is equivalent to 6% of GDP. Although a statistically significant element of the economy, it is a relatively minor part whose role in determining movements in monetary policy is, for that reason, surprisingly prominent.

The status of housing is tied up with the cultural history of Australia. Home ownership has been a cherished ambition for generations of families. At the same time, since rapidly rising housing values are a feature of large cities, the concentration of population in Australian capitals has also meant that a large proportion of individual wealth in whatever city one lives has been tied to housing values.

A more decentralized population might have been less influenced by the housing wealth effects and with more diverse interests being represented to them policy makers might have been more inclined to address themselves to a broader spread of constituencies. But that has not been the case.

In practice, property development has been a privileged business: witness extensions or restoration of various forms of housing assistance such as the first home buyers grant and negative gearing for investment properties when these have been threatened or when the cycle was moving against the industry. Any suggestion of taxing property values has been

regarded by electoral tacticians as suicidal. Few other Australian industries have been beneficiaries of such largesse over such a long period of time.

However, some tension is beginning to emerge with the Reserve Bank now at the centre of policy making in Australia. It must conduct policy for the nation as a whole. It cannot differentiate between industry sectors. Confronted with a buoyant housing market and a decelerating broader economy, it must choose which to favour.

Keeping interest rates low for the well being of the rest of the economy might require other tools to be deployed against the periodic bouts of irrational exuberance in the property market.

What other tools can be deployed? Since the speculative end of the housing market is usually the segment which is most prone to excess, the tool which comes readily to mind is the availability of negative gearing for investment properties. Historically, its removal was electorally dangerous. However, at a time when

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