

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

THE AUSTRALIAN ECONOMY: CHANGING GEAR

According to recent economic statistics, the Australian economy is changing down a gear. However, a slowdown with higher interest rates seems to have already been factored into equity prices. The market appears slightly undervalued.

Australian business performance is being affected by three broad economic currents:

- the overall positive effect of the global economic cycle;
- relatively high Australian interest rates (by international standards and compared with domestic inflation) with decelerating domestic demand growth; and,
- a long term decline in activity driven by slowing population growth.

The net effect of these three influences is that Australian growth seems to have passed its peak for the current cycle. Australia is facing a cyclical slowdown within the context of a long term reduction in potential growth.

However, the profit valuation model used by *thebigpicture* to flag movements in the Australian market suggests that some combination of higher interest rates and slower profit growth have already been factored into Australian equity prices to the extent that the market appears undervalued against its historical performance in similar circumstances.

The Australian economy is tied surprisingly closely to US economic conditions, a relationship highlighted by the chart showing movements in US GDP and movements in Australia's corporate gross operating surplus, an economy-wide measure of profitability.

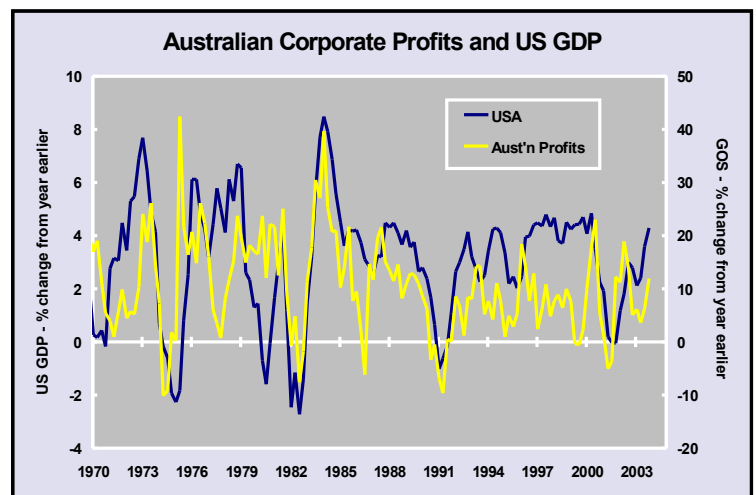
Gross operating surplus, reported quarterly in the national

accounts produced by the Australian Bureau of Statistics, is approximately equivalent to earnings before interest, depreciation and direct taxes at a company level.

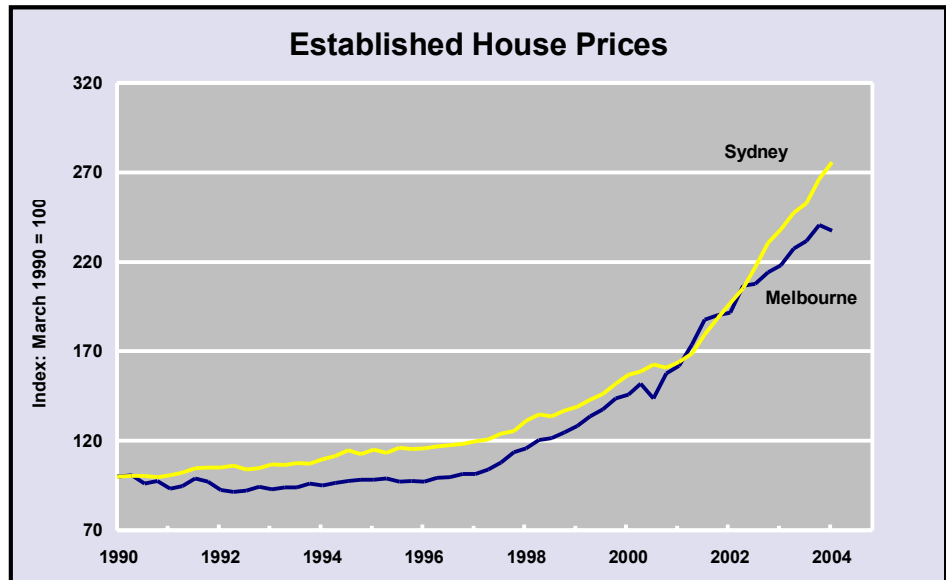
While gross operating surplus growth is a more volatile series than US GDP growth, the coincidence of the turning points is quite marked. Australia seems to have only a very limited capacity to break away from the US economic cycle. Evidence of sustainable US expansion is, therefore, good news for Australian business profits.

However, the recent acceleration in US growth cannot be maintained indefinitely. All going well, growth will revert to something slightly lower but more sustainable. Higher interest rates, as the Fed moves back toward more normal settings, will also take the economy in this direction. Given the connection between the two economies, the pace

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THE WEEKLY CHART SPOT



Source: Australian Bureau of Statistics

Nationwide, average prices of established houses increased by 2.5% in the March quarter to be 17.9% higher than a year earlier. However, the first signs were evident of a weakening in the Melbourne housing market where prices dropped 1.3% in the quarter. Sydney prices were up by 3.5%.

Since the beginning of 1990, Melbourne prices have risen at an average annual rate of 6.3%. Sydney prices have increased at a 7.4% pace. The national average has been 6.7%.

THE AUSTRALIAN ECONOMY: CHANGING GEAR CONT'D

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of profit growth in Australia will also tend to be slower, without slumping dramatically.

High oil prices are also dampening activity. They raise business costs as well as reducing the purchasing power of consumers. Prices persisting above US\$40 a barrel will mean lower business margins and lower business sales volumes, everything else being unchanged.

OPEC members, led by Saudi Arabia, have become concerned at the effect the high prices might have. High oil prices could increase conservation efforts and reduce global growth undercutting demand for crude oil. These were the circumstances which pushed oil prices down to \$12 a barrel after the second oil price shock at the beginning of the 1980s.

None of the OPEC members want to be responsible for a repeat of that outcome. Their meeting in Beirut has been considering production policies which would keep prices in the US\$22-30 a barrel range rather than above \$40.

Specifically domestic conditions will also have an impact at the margin. The national accounts data for the March quarter showed that the Australian economy had

Australian Profit Cycle				
	Historical ¹	Current ²	Prospective ³	Long-term ⁴
Volume	3.3	3.0	4	2
Prices	6.4	3.4	2	2-3
Costs	0.1	0.1	-	-
Growth (%)	+9.8	+6.5	+6	+4-5

1. 1970 to date
 2. Year to March quarter
 3. 2004-05 Australian Government budget
 4. Including impact of population growth slowdown

grown by only 0.2% in the quarter to expand by 3.2% over the year. Significantly for the Australian equity market, corporate

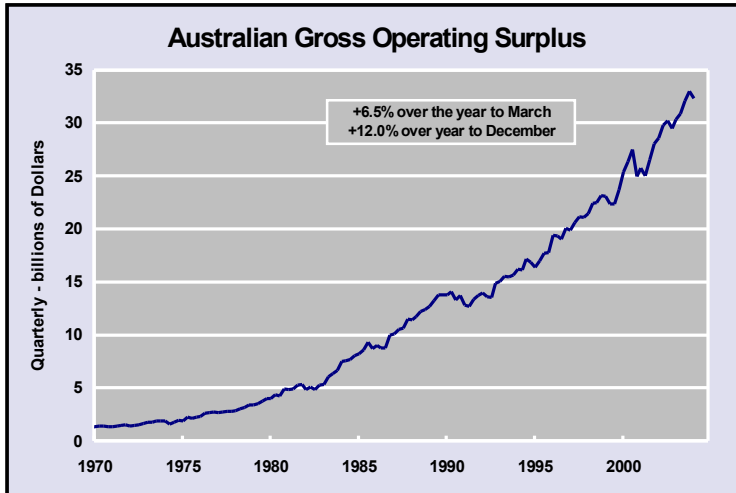
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"...the recent acceleration in US growth cannot be maintained indefinitely. All going well, growth will revert to something slightly lower but more sustainable."

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gross operating surplus contracted by 2.1% to be only 6.5% higher than a year earlier. Based on this, the 12.0% increase in profits over the year to December 2003 is looking like the peak in the profit growth cycle.



Fortuitously, the government has initiated a programme of fiscal stimulus just as it is needed. The benefit payments and tax reductions flagged in the May budget will hit their targets just as the economic slowing would otherwise be occurring. While the government had been adamant (before the evidence of slowing growth) that the size of the stimulus was being overstated by some analysts, no-one should be surprised to see it claim credit for its prescience before the end of the election campaign.

At budget time, it had looked as if fiscal stimulus was going to offset tightening monetary conditions as the Reserve Bank continued to push interest rates higher. While there are some mixed messages in the housing market (e.g. lower auction clearance rates v strong credit growth), the urgency in dealing with an asset price bubble seems to have diminished and this takes away some of the need for further interest rate rises.

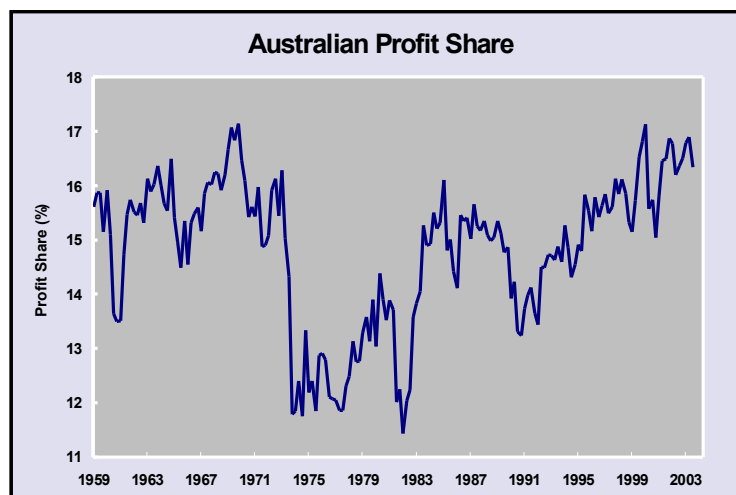
So, too, does Australia's relatively high cash rate which is a full 4¼ percentage

points higher than the US Federal Funds rate. With inflation keeping low – the ABS reported that its preferred measure of consumer price inflation rose by just 1.4% over the year to March – there is little upward pressure on rates from this source.

The other feature of the Australian profit cycle evident in the national accounts is the relatively high share of profits in the economy. Since the beginning of the 1990s, annual profit growth has averaged 6.3% and the share has risen from 14.8% to 16.3%. The share movement added the equivalent of 0.75 percentage points to the annual profit growth rate.

The chart at the bottom of page 3 shows corporate gross operating surplus as a percentage of non farm GDP. At 16.3%, it is near the upper end of the range recorded by this measure over the past 45 years.

History says that once the profit share is at the upper end of its range, other parts of the economy (e.g. labour) become more aggressive in trying to raise their share. Times might have changed. There is some argument that labour, for example, is in a less strong bargaining position than it used



to be. Nonetheless, at this point, there is no convincing evidence that the historical nexus has been broken and that business

“Australia’s population growth rate is dropping toward 0.2% a year after tracking at over 1% a year. With this fall, overall rates of economic growth will decelerate from an average of around 3.5% over the past forty years to something close to 2% (or possibly lower).”

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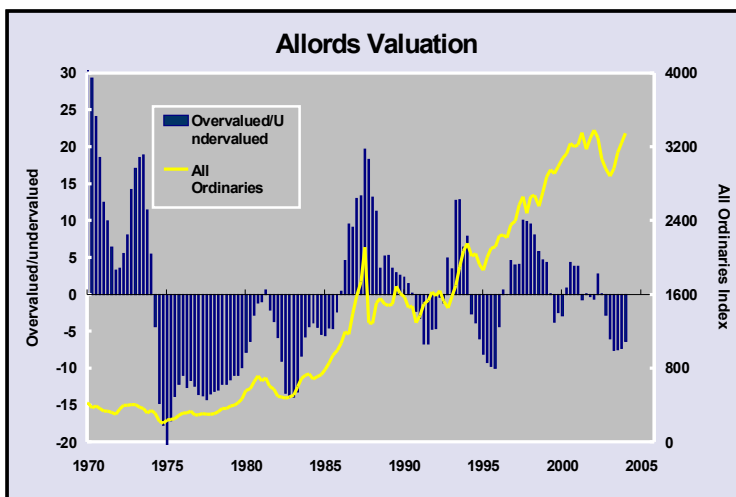
profits can grow relative to the rest of the economy to any substantial extent.

From a business perspective, the profit share could be interpreted as a measure of economy-wide margins. To the extent costs rise (and other factors of production are taking a larger share of national income), the profit share will fall. Competitive influences on business pricing also impose a limit on how far companies can

population outcomes; or,

- an exogenous source of population growth (which means aggressively stepping up the national immigration intake perhaps through a type of guest worker scheme favored by some European countries).

The community appetite for higher migration probably makes it premature to consider the latter and there is no evidence as yet for productivity changes large enough to compensate.



push their prices, and their profit share, without losing volume.

Australia's long term economic momentum is also changing. A once-in-a-millennium change in growth conditions, due to changes in demographics, is occurring now.

Australia's population growth rate is dropping toward 0.2% a year after tracking at over 1% a year. With this fall, overall rates of economic growth will decelerate from an average of around 3.5% over the past forty years to something close to 2% (or possibly lower).

These forces will be extremely difficult to avert. They reflect the fertility reductions which have been underway for decades and whose economic impact is now beginning to be felt more acutely.

The only possible offset to these effects will be some combination of:

- better than expected productivity growth to compensate for the weaker

With these three economic influences – international conditions, short-term domestic policies and longer term demographic impacts – indicating lower rates of business profit growth, undervaluation alone might not offer sufficient impetus to cause a rising market.

Other factors might also be needed to act as a catalyst for this potential value to be realized. Possible spurs might include:

- evidence of lower exchange rate risk for foreign investors;
- weaker energy prices; or,
- more confidence about a US economic expansion.

Nonetheless, for longer term investors less concerned about the timing of investments through the cycle, there should be some comfort to be had from the fundamental historical indicators suggesting that the downside valuation risk is relatively low.

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