

# thebigpicture

guideposts for the private investor

Week Commencing 14 June 2004

## **Publishing and Subscription Information**

*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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## US ELECTIONS: ADDING VALUE

The US electoral cycle does have an effect on equity markets. Returns are more likely to be positive and above average in 2004 because a presidential election is due in November.

The table summarizes the impact of the presidential election on US equity market outcomes.

The average quarterly appreciation in the S&P 500 index since 1950 has been 2.1% (or an annualized 8.2%). On average, the first half of the calendar year has been stronger than the second half. The third quarter, covering the US summer holiday, is seasonally weak with an average gain of only 0.8%. The chance of a negative quarterly return is fairly evenly spread through the year with a one in three chance of a fall in the market in any of the four quarters.

The returns shown in the table measure only index movements and do not include dividend payments.

In an election year, the average quarterly return increases to 2.5% compared with the 2.1% average over all years and a 2.0% return in years without a presidential election. At the same time, risk is also lowered. The chance of a negative return is cut by more than half in a presidential election year.

The biggest difference in quarterly outcomes between election and non-election years is in the third quarter. The average appreciation in a non-election year is 0.4% compared with a 2.4% increase in an election year.

This is likely to be more than coincidental. Political decision making is likely to push returns higher in the approach to an election. Incumbent presidents will want propitious economic conditions during their election campaigns. They might not decide ex-

**Presidential Election  
Impact on S&P 500**

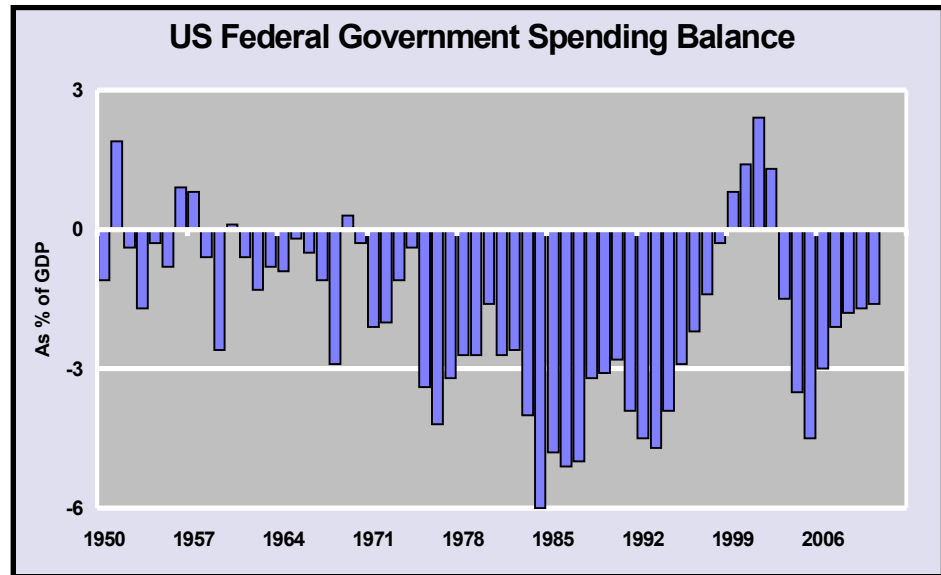
| Quarter   | Average change since 1950 <sup>1</sup> | Chance of negative return (%) | Average election year change | Chance of negative return (%) | Average change in first year of term | Chance of negative return (%) |
|-----------|--|-------------------------------|------------------------------|-------------------------------|--------------------------------------|-------------------------------|
| March     | +3.4%                                  | 33                            | +3.6 %                       | 21                            | +1.5 %                               | 50                            |
| June      | +2.3%                                  | 28                            | +1.8 %                       | 7                             | +1.2 %                               | 36                            |
| September | +0.8%                                  | 38                            | +2.4 %                       | 14                            | -0.3 %                               | 43                            |
| December  | +1.9%                                  | 30                            | +2.6 %                       | 14                            | +0.4 %                               | 36                            |
| Average   | +2.1 %                                 |                               | +2.5 %                       |                               | +0.7 %                               |                               |

1. 3.4%, 2.5%, 0.4% and 1.8% quarterly returns excluding the presidential election years.

PLICITLY to boost markets in the period leading up to their election. Nonetheless, their actions imply that effect. The timing of policy decisions is likely to be geared to delivering benefits in the 9-12 months leading to an election. Where decisions are expected to have a negative effect on economic conditions (and equity market values), they are

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## THE WEEKLY CHART SPOT



Source: US Office of Management and the Budget

The US Federal budget deficit was US\$347 billion for the first eight months of fiscal 2004 according to the Congressional Budget Office (CBO), about \$56 billion more than the same period last year. The CBO's most recent estimate of the fiscal 2004 deficit represented 4.2% of GDP. The forecast trend over the coming decade toward a balanced budget provides comfort to the government bond market that the deficits can be accommodated. However, the trend requires US GDP growth to be sustained at something above 3% a year (combined with government spending and tax discipline).

## CORPORATIONS: STILL RISK AVERSE CONT'D

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chart, as a proportion of gross operating surplus. There was some subsequent cyclical recovery in the mid-1990s but levels of investment have been relatively low and in a downtrend ever since.

As in the USA, this period of investment weakness coincided with improved business productivity as Australian companies sought to extract more from the resources already committed to their businesses.

However, the decline also heralds a change in the type of industrial development being undertaken by Australian companies. Deployment of new technology in services required less spend than con-

struction of new manufacturing plants or new mine developments of the type which characterized much of Australia's investment in earlier years.

The aversion to more capital intensive investments represents a drag on economic performance, business profitability and market valuation. In part, this might be a structural change reflecting industry relocation and relative global production costs. However, in Australia as in the USA attitudes to risk have also been modified by some traumatic commercial experiences. The memory of these might have to dim before a more risk-friendly approach to investment can ensue.

## US ELECTIONS: ADDING VALUE CONT'D

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more likely to be postponed if political tacticians think that they will put a favourable election outcome at risk.

The flip side of the beneficial presidential election effect is the negative influence of the first year in office. The average quarterly market gain in the first year following a presidential election is 0.7%, well below

the average gain for the market in an election year.

Across all quarters, the first post-election year is more likely to have negative returns. Between 36% and 50% of the time, quarterly returns in the first year of an administration have been negative. The average return in the seasonally weak September quarter is actually negative.

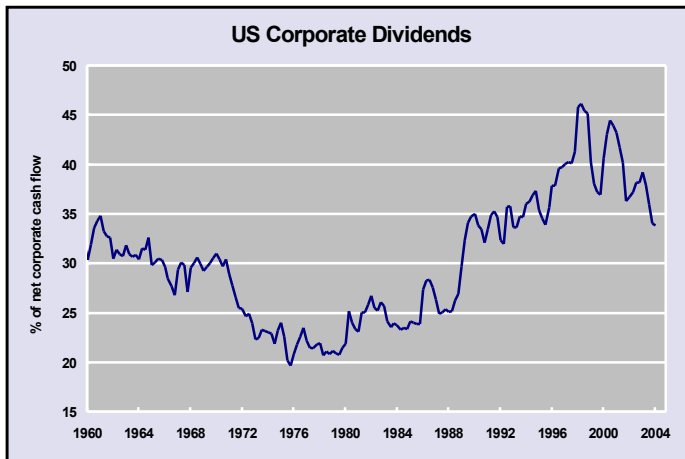
*"Despite this strong growth in corporate profitability, US companies have been reluctant to spend on capital equipment or employ more people."*

## CORPORATIONS: STILL RISK AVERSE CONT'D

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equipment and software has fallen to some of the lowest levels in the past 45 years measured against corporate cash flow, after having been at record high levels between 1998 and 2001.

There is some evidence that companies failed to get the expected advantages from the late 1990s investment binge.



The disappointment from that has had two effects.

- Companies have become more wary about investing in technology biased business process improvements.
- Managers have become keener to get the originally advertised advantages from 1990s investments now that the economy has improved and demand is rising (before undertaking new investment initiatives).

The reduction in investment spend relative to available cash flows has not resulted in a stronger flow of dividends to shareholders. The level of dividends relative to cash generated has also been falling from the high levels reached in the late 1990s.

Implicit in these changes is that companies were more ready to borrow in the late 1990s than they are now. They are conserving their financial firepower.

Coinciding with the precipitous fall in business investment activity and the more cautious approach to financial management is the

emergent corporate regulatory environment.

Accountability standards for directors and senior management are higher than they used to be. Standards are being policed more vigorously and directors, in particular, are being held responsible for a more extensive range of corporate decisions. Executives, too, are being scrutinized more closely and subjected to more criticism for business decisions not meeting targets.

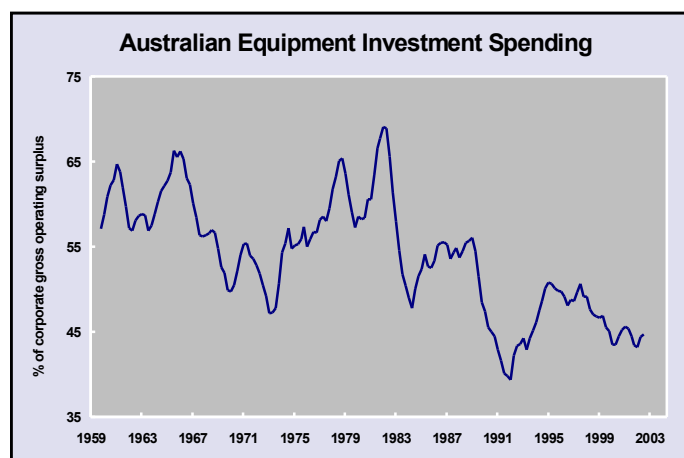
Confronted with a choice between investing and not investing in a project directors are more likely to balk at the commitment (even if executives are prepared to risk their reputations by presenting it).

Another aspect of the changed regulatory environment has been the considerable resource commit-

ment needed before mandated changes can be implemented. At the margin, these distractions inevitably draw the time of senior executives from growth oriented tasks to compliance duties.

Australian business has been affected by some of the same themes although the investment boom which characterized the late 1990s in the USA was not so apparent in Australia. Arguably, Australian business was already in a more timid frame of mind from experiences a decade earlier.

The 1990/91 recession in Australia drove business investment spending to record low levels measured, in the accompanying



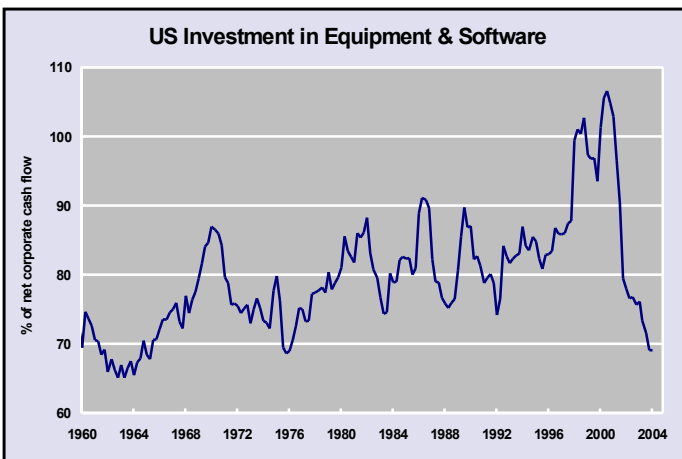
*“... companies were more ready to borrow in the late 1990s than they are now. They are conserving their financial firepower.”*

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## CORPORATIONS: STILL RISK AVERSE

**Corporations in the USA and Australia have been reluctant to employ or invest. The new regulatory environment is aggravating the reticence to take risks.**

Recent statistics published in the USA and Australia show that corporations have become very cautious in how they use their financial resources. The phenomenon is relatively new in the USA but, in Australia, dates from the 1990/91 recession.



Over the year to the March quarter, corporate profits after tax in the USA rose by 14.3%. Over the past three years, the average annual rate of improvement has been 9.6%.

Despite this strong growth in corporate profitability, US companies have been reluctant to spend on capital equipment or employ more people. Indeed, part of the reason for the strength in business profitability has been the emphasis on working existing corporate resources harder.

This has meant activity at three levels:

- improving the productivity of employees through more efficient organisational and production practices;
- using prior investments in technology more effectively; and,
- pursuing cost improvements (especially where economic power over suppliers of intermediate goods can be used to improve contract terms).

By the standards of previous recoveries, business investment spending and employment growth have been very weak. Both are lower than they have been at similar points in earlier economic cycles.

This difference has created some ambivalence in markets about the profit improvement. Because profit growth has not been accompanied by the confidence boosting effects of employment growth or the multiplier benefits of added investment spending, in this cycle, its market impact has been reduced. That is, there has been some tendency for price earnings ratios to contract.

Looked at one way, investors are saying that they prefer the flashier growth which comes with more headlines than the more operationally oriented growth which has prevailed.

Alternatively, they might be expressing a belief that the duration for this growth is limited without more robust 'animal spirits' emerging to sustain further profit improvement.

Over the past three years, labour productivity has increased at a 4.5% annual rate. With hourly compensation payments growing at only 3.2% a year, unit labour costs have declined by an average of 1.2% a year. These costs account for two-thirds of total non-farm business costs.

Data for the March quarter reported at the end of May contained the first signs of an up-tick in labour costs reinforcing evidence seen elsewhere that US labour market conditions had begun to tighten. For example, payroll numbers increased by 1% over the year to May having risen at an annualized rate of 4% over the first five months of the year.

However, companies have not used their newfound financial strength to support additional investment. Investment in

*"...in Australia as in the USA attitudes to risk have been modified by some traumatic commercial experiences. The memory of these might have to dim before a more risk-friendly approach to investment can ensue."*

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