

# thebigpicture

guideposts for the private investor

Week Commencing 16 February 2004

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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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## INTERNATIONAL EQUITIES MORE ATTRACTIVE

*thebigpicture* half yearly review of market conditions shows a macro environment more favourable for international equities. International equity market conditions will help support the Australian market but domestic profit momentum will be constrained by monetary policy changes.

*thebigpicture* uses a range of macroeconomic momentum indicators to make judgments about the likely direction of equity markets in the six months ahead. The indicators include profit, activity and monetary measures with a history of having an impact on equity values.

Taken together, the indicators show whether investors should be more bullish or bearish about equity market conditions. The stance suggested by the indicators is illustrated by the bars in the two charts.

The first chart shows the track record for the set of Australian equity market indicators since 1998.

They called for a progressively more bullish stance until the first half of 2000. By mid 2001, the indicators were suggesting the most bearish possible stance. While the market did move somewhat higher after this, it had essentially reached its peak and tracked at those higher levels for the succeeding year.

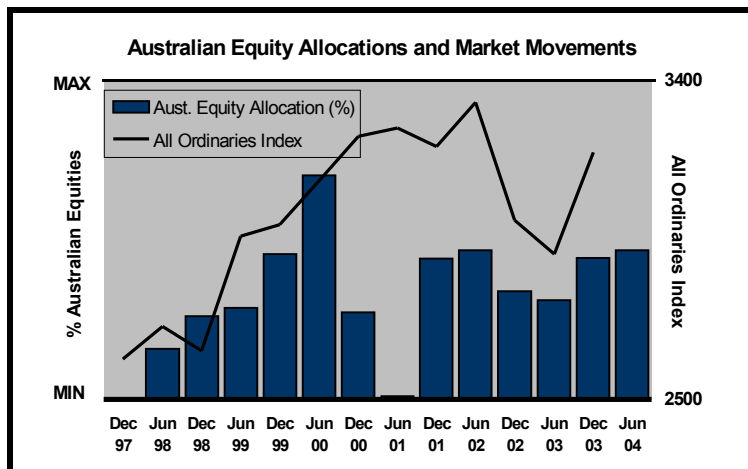
The circumstances of individual investors will determine the actual level of equity holdings implied by the minimum or maximum recommendations from the model.

For the current half, the readings are very slightly higher than they were for the prior six months. Even so,

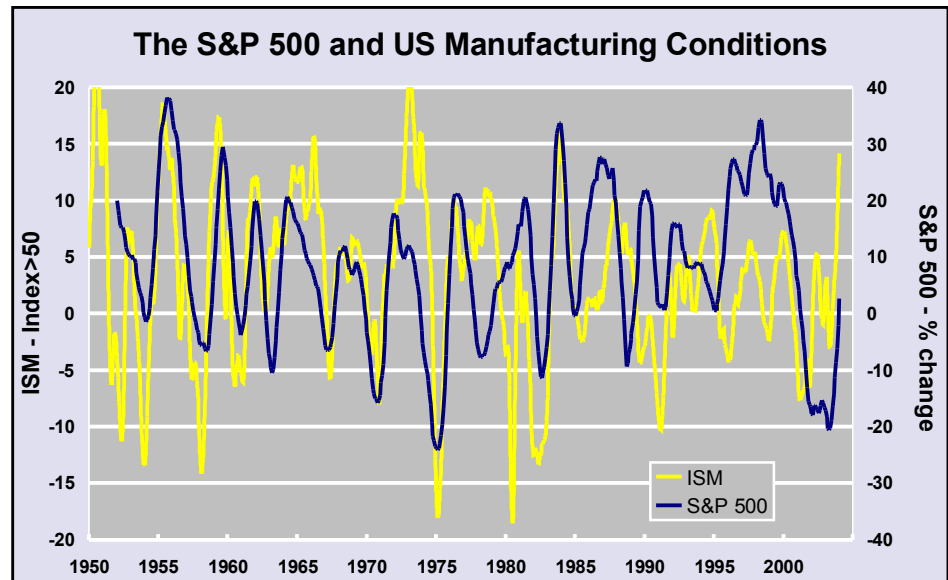
the overall tenor is one of caution with the indicators essentially neutral to slightly bearish in terms of their position within the range of possible outcomes.

For Australia, activity, profit and monetary indicators are suggesting less strength

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## THE WEEKLY CHART SPOT



Source: Institute for Supply Management and Standard and Poors

Old rules-of-thumb die hard. Over the past 50 years, the monthly US purchasing managers survey has provided a leading indicator of the state of US manufacturing and a useful precursor to changing stock market conditions.

The index from the (now renamed) Institute for Supply Management monthly survey has risen for six out of the last eight months. The average of its last three monthly readings is higher than for any similar period since early 1984.

Following the rise has been a more buoyant US stock market. The broad based Standard and Poors 500 index has jumped by 17% over the past six months (to be 36% higher than a year earlier). The turn in the two indicators provides some comfort that the change in market direction might be sustainable after struggling for nearly two years to achieve a turn which has usually taken just four months in the past.

## FREE TRADE? NOT REALLY CONT'D

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with Australia as a precedent to hold back agricultural imports from other countries. Ironically, it will also be harder for US agricultural interests to argue for greater market access for their own products now that their own government has set the (double) standard in international trade negotiations.

Other countries could also be slightly miffed at the agreement. For example, US direct investors will now receive relatively favourable treatment. Scrutiny by Australia's Foreign Investment Review Board will be reduced for them. Justifiably, there are already some mutterings from Japanese interests that similar rules should apply to them.

In theory, at least, US investors will be given the edge over investors from other countries. By treating bidders for Australian assets differently, determining fair

value for Australian assets is made more difficult and their value is potentially eroded by selectively excluding potential bidders.

Economists will generally prefer to eliminate all impediments and to allow comparative advantage to hold sway in determining patterns of trade and capital flows. If there are impediments, they will also generally agree that there are gains if all parties are put on an equal footing where once they had not been.

On this argument, giving one group greater access is not necessarily beneficial. Whether it reflects the relative negotiating power of the participants. In the case of Australia's new trade agreement with the USA, the net benefit could go either way and, at this stage, we are none the wiser. In short, therefore, do not conclude that the deal will help improve investment returns.

*"Seeing other countries pursue their national interests...will have comforted the protectionist Europeans.... smaller developing countries for which agriculture is an important source of income will be less likely to accept lectures from Australia about how they should stand up against the larger industrial countries."*

## FED v RBA: WHO'S RIGHT?

**There is a difference between the US Federal Reserve Board and the Australian Reserve Bank in the conduct of economic policy. The Fed seems more investor friendly than the RBA.**

At 1%, the Fed Funds rate is a full 4¼ percentage points below the Australian cash rate. Inflation at 2% and 2½%, respectively, does not explain the difference. The Australian authorities have been more timid in loosening policy and are being more aggressive on the way back up.

The Federal Reserve is taking a cautious approach to raising interest rates. In its Monetary Policy Report to the Congress on 11 February, Fed Chairman Greenspan reviewed an economy for which "the odds of sustained robust growth are good". That led to a conclusion that "the real federal funds rate will eventually need to rise toward a more neutral level."

However, he was not in any hurry: "with inflation very low and substantial slack in the economy, the Federal Reserve can be patient in removing its current policy accommodation". The decline in the US dollar did not incline him to act more quickly.

On the other hand, according to the Reserve Bank in its report on monetary policy released on 8 February, it moved to raise rates late in 2003 because "it became increasingly apparent that such an expansionary policy setting was no longer needed, and that it would add to medium-term inflation risks if maintained for too long a period".

## INTERNATIONAL EQUITIES MORE ATTRACTIVE CONT'D

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in market upside

The most notable change has been on the international front. The model is showing some of the highest readings from the past five years.

There are stronger readings for Japan, Germany and the UK. The USA readings have been high for the past six months and are looking similarly high for the coming half year.

That is not to say that all these economies are performing well. It simply means that the momentum is improving. Momentum changes are signs that equity market ex-

Nothing much has changed since "the macroeconomic data becoming available since the December meeting have confirmed the assessments made at that time", according to the Bank. In referring to its decision to hold rates for the time being it advised that "a further development taken into account was the additional appreciation of the Australian dollar since December" signalling that cash rates would have been pushed higher if the dollar had not been so strong.

If Australia's policy makers are right, the economy is going to put in a solid growth performance with some obvious upside to inflation in the coming year or so. This would be good for investors. Improving demand and greater pricing capacity is the stuff of stronger markets.

Against this prognosis, the Reserve Bank is prepared to err on the side of curtailing the momentum lest it get out of hand.

Despite seeing robust growth ahead, the Fed, on the other hand, seems prepared to err on the side of letting the economy have its head.

One of the reasons is that the inflation performance of the US economy has continually surprised policy makers with stronger than expected productivity growth offsetting the effect on business profits of weaker pricing power.

In Australia, too, inflation has been a relatively benign force. However, the authorities remain fearful that the once inflation-prone Australian economy will revert to its old ways and are acting accordingly.

*"...the Reserve Bank is prepared to err on the side of curtailing the momentum lest it get out of hand. Despite seeing robust growth ahead, the Fed, on the other hand, seems prepared to err on the side of letting the economy have its head."*

pectations could be modified in coming months

Think of it in terms of the car on the highway. When will you get to your destination? Knowing where you are is part of the picture. Current speed gives you a better idea. But measuring the rate of acceleration is more helpful still. Knowing the rate of change of acceleration gives a further edge.

For equity markets, economic growth accelerating from 1% to 3% might be more significant in forecasting a change in market performance than having it remain unchanged at 4%. That is the underlying rationale behind the indicator analysis.

## FREE TRADE? NOT REALLY

**The Australian government has done a market access deal with the US administration. The US has conceded on matters which are not important to it. The Australian side has conceded on some of its priorities. Free trade it is not.**

There were already relatively few impediments to trade between Australia and the USA. Agriculture was the most notable exception. Little has changed with the agreement.

For investors the key is in the growth impact. Over the past forty years, the value of Australia's domestic product has grown at an average rate of 9½% a year. That comprised 5½% inflation and 4% output growth. With lower inflation and lower population growth, a 5% outcome (made up of 2½% output and 2½% inflation) is closer to reality for the longer haul. With a halving of our income growth prospects, corporate profit growth will fall accordingly. Market appreciation will reflect this.

In this growth scarce environment, anything which delivers extra growth at the margin is good for an Australian equity investor. A genuine free trade agreement might have made a meaningful difference.

To decide whether the actual bilateral trade agreement between Australia and the USA is likely to deliver significant benefits might require some further study. Without anticipated benefits for the sugar, dairy and beef industries, the largest benefits identified in earlier analytical studies will not be realised.

The overall impact might become clearer as Australian and US legislators review the agreement and the extent of promised compensation for the sectors missing out is clarified. It is clear, however, that the value of the final agreement is well below its potential. Even government ministers are admitting that the anticipated gains were probably overstated.

Trade diversion effects will have to be considered in making a judgement about the overall picture. For example, tariff free access for US cars to the Australian market confers a potential benefit on the

USA (if it decides to produce cars with right hand drives). All other things being the same, an Australian car buyer will have an incentive to buy a US car rather than a Japanese or European model. This and other similar examples from clothing to media programming might help boost US-Australian trade but should not be treated as an outright benefit from the pact. It effectively hinders freedom of choice. That comes at a cost.

The Australian government is now saying that holding out for gains in agricultural trade would have jeopardised other benefits. It was in the national interest, therefore, to take what it could from the bilateral negotiations. Whatever was forthcoming, on this argument, was better than nothing.

This pragmatism could be justified on national interest grounds if the net benefits are big enough but the end result hardly warrants being tagged a free trade agreement. In fact, it might be setting back the cause of genuine free trade which occurs when capital, goods and services can move across borders without having to refer to specific bilateral arrangements.

In deciding not to pursue greater market access for sugar and dairy products and to allow a prolonged phasing of easier access for beef the Australian and US governments have risked compromising the global push for freer trade in agricultural products. Australia's moral authority will also have been compromised.

Seeing other countries pursue their national interests when it comes to the final choice will have comforted the protectionist Europeans. They will also be comforted by seeing the Australians, at the end of the day, endorsing this behaviour when it comes from its friend, the USA.

On the other hand, smaller developing countries for which agriculture is an important source of income will be less likely to accept lectures from Australia about how they should stand up against the larger industrial countries.

The USA will be able to use the agreement

*“In this growth scarce environment, anything which delivers extra growth at the margin is good for an Australian equity investor. A genuine free trade agreement might have made a meaningful difference.”*

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