

# thebigpicture

guideposts for the private investor

Week Commencing 19 July 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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## RETAILING: AS GOOD AS IT GETS

Conditions for Australian retailers have been about as good as they could get in the last year. Personal spending is likely to be facing more headwinds in the year ahead.

According to data from the Australian Bureau of Statistics (ABS), retail spending in the year to May 2004 was 7.6% higher than in the year to May 2003. That compares with an average ten year rate of growth of 5.9% a year. The acceleration in the growth rate is also reflected in reports of strong sales increases among the larger listed retail stocks. However, like the ABS data, the listed companies are also showing some signs of a tapering in performance through the course of the last twelve months.

The higher levels of retail spending reflect the convergence of several supportive factors, including:

- household income growth of 7.4% over the year to the March quarter 2004;
- near record levels of consumer confidence; and,
- anticipated boosts to social benefit payments from the government.

The growth in household income reflects, in turn, the combined effect of its two key ingredients: employment (up 2.8% over the year to April) and growth in average weekly earnings (up 4.4%). Both employment and earnings

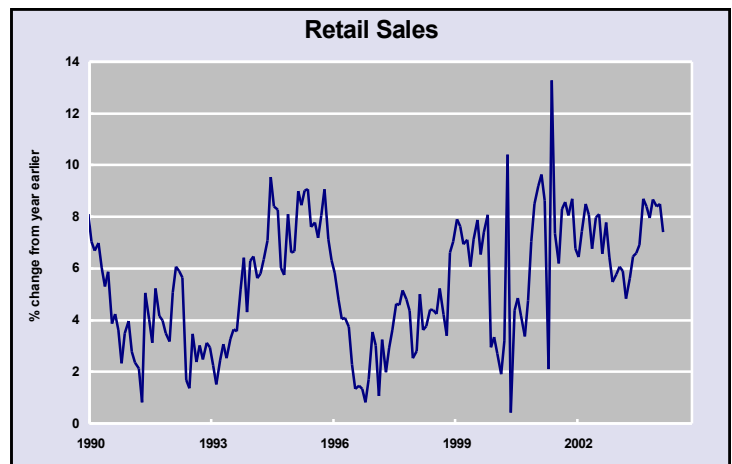
growth rates have been pushing toward the higher ends of their sustainable ranges so that household income growth is also at the upper end of its range, above its ten year average growth rate of 5.8%.

The Westpac-Melbourne Institute consumer sentiment index of 119.5 in July was a near record reading in its 30 year history and 12% higher than the average reading over the past ten years. Factors which have helped to sustain the positive attitude of consumers, in addition to the strength of household income growth, include:

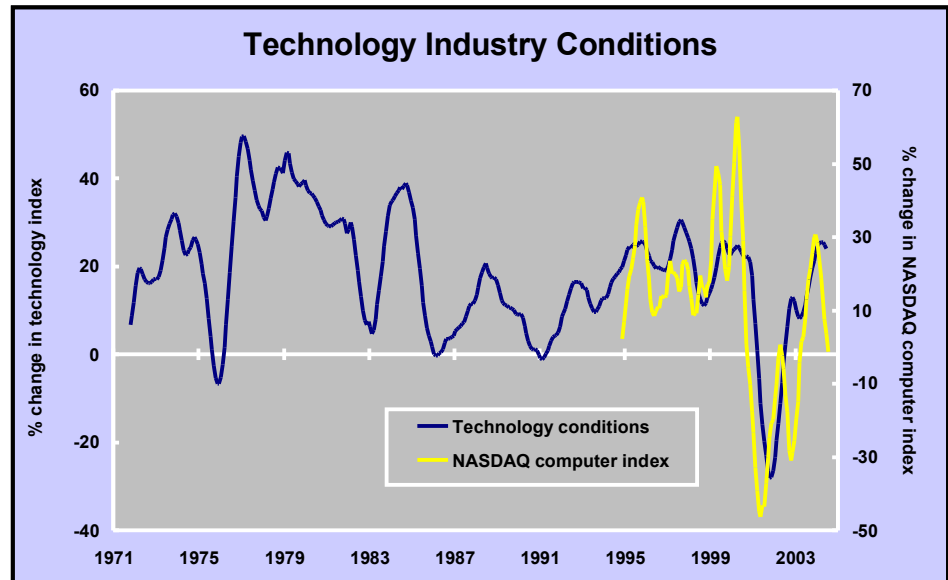
- a relatively strong stock market with the key market indicators in Australia up by 16% over the past year after four years of effectively no change;
- exchange rate movements which have made consumer durables less expensive;
- relatively stable interest rates over a lengthy period of time; and,
- higher housing prices which have delivered a wealth gain for home owners encouraging them to spend higher proportions of their incomes.

One indicator of the strength of consumer confidence has been the preparedness of

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## THE WEEKLY CHART SPOT



Source: New York Federal Reserve Bank and NASDAQ

The index compiled by the Federal Reserve Bank of New York to track technology market conditions in the USA has started to show some signs of easing momentum.

The Bank's technology conditions index moved up sharply in the middle of 2003 pointing to a strong recovery in the sector from recession-like conditions which had plagued the industry for some three years. Compared to this latter period, industry conditions are relatively buoyant. The industry conditions index rose by 1.6% in June. Its monthly rate of increase has not been below 1.5% since the early months of 2003.

From a stock market perspective, even slight changes in momentum can have an impact on share values. Often momentum changes (i.e. changes in the rates of growth) can be useful leading indicators of more substantial changes ahead in business conditions which will also be reflected in market values.

In this context, there has already been a market reaction to the changing momentum of industry conditions. The NASDAQ computer index is 16% lower than its peak value in January 2004 and 1.3% lower in the last six months than in the prior six months.

*“Even if interest rates are not raised, the proportion of income required to service higher debt levels has been rising and this is likely to be an ongoing restraint on further growth in spending.”*

## RETAILING: AS GOOD AS IT GETS CONT'D

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householders to dissave. The national accounts data from the ABS show for the seventh successive quarter households spending more than their incomes in the March quarter of 2004.

This willingness to overspend (at least relative to income if not total wealth) has been supported by financial institutions. They have backed consumer bullishness with continuing growth in finance. In the March quarter, new personal borrowings were equivalent to 13.2% of household disposable income.

In the short-term, these growth and confidence factors are being supplemented by the tax and welfare benefits which were foreshadowed in the government's May

budget. Anticipation of their receipt is likely to have held spending rates aloft where they might not otherwise have been so buoyant.

All of this says that the best of circumstances for Australia's retailers might be around the middle of 2004; that is, now.

Looking ahead, the most influential factors are likely to be less strong combining with some emerging negative influences over the coming year.

- Financial institutions are becoming more sensitive to credit risk making them more reticent to fund spending.
- Whatever the attitude of financial pro-

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viders, households will have to begin reassessing their debt positions soon as the servicing obligations take up a larger proportion of disposable income.

- With a less buoyant housing market, it will be harder for valuations to be able to support growing debt commitments.
- Forward indicators are suggesting that global economic growth is likely to be decelerating, an outcome from

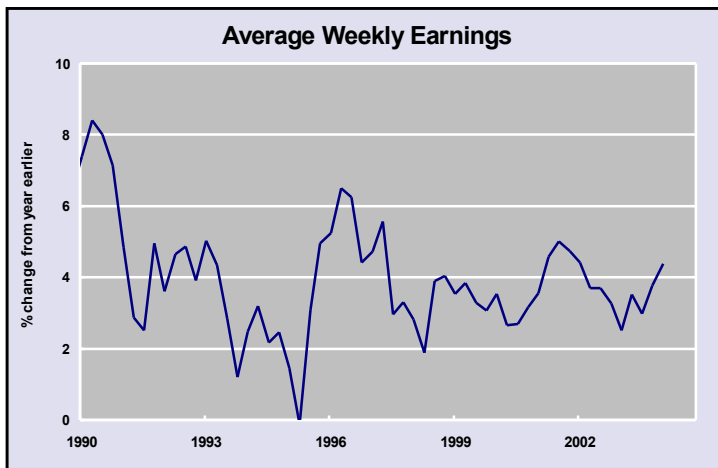
Nonetheless, the emerging combination of circumstances warrants greater caution about assuming sustained strength in spending growth.

Although inflationary conditions have not changed sufficiently to warrant a sharp adjustment in interest rates – and there are some arguments that rate rises might not be needed in Australia for the foreseeable future – financial institutions are reviewing their lending guidelines to ensure that they do not take undue risks as the policy cycle begins to turn from being supportive of growth to being less expansionary.

Even if interest rates are not raised, the proportion of income required to service higher debt levels has been rising and this is likely to be an ongoing restraint on further growth in spending.

Any adjustment on this front will show up in a rise in household savings rates.

*“Embedded in every share price is an implied growth rate for that particular company. If the implied growth rate is higher than what the economy might allow the company to achieve, the stock is potentially overvalued.”*

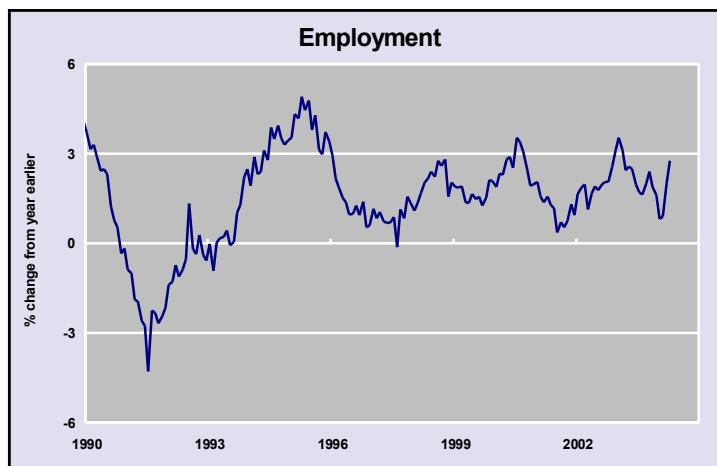


which Australia cannot usually escape, especially when it is happening to the USA.

- Lower domestic growth rates are likely to be reflected in slower employment and income growth, the two key spending ingredients.
- The normal electoral cycles in the USA and Australia, with their effects on post-election expenditure priority changes, will put a short term crimp in the momentum of government spending.

And, even if growth is stronger than expected boosting income and employment growth to higher rates than anticipated, a reappraisal of household balance sheets could still be necessary.

The maths in the year ahead is more likely to look something like the following:



None of this suggests a dramatic change in economic conditions. Also, the consumer has proved to be remarkably resilient throughout the last several years, surprising on the upside in his determination to increase spending. Underestimating this determination might remain a forecasting risk.

- employment growth of 1.75%;
- earnings growth of 3.5%;
- overall household income growth of

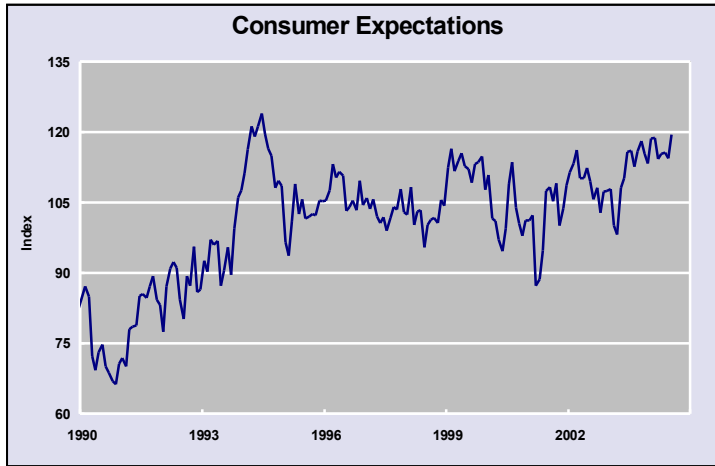
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5.25%;

- an attempt to reduce household



overspending possibly taking one percentage point from growth; leaving

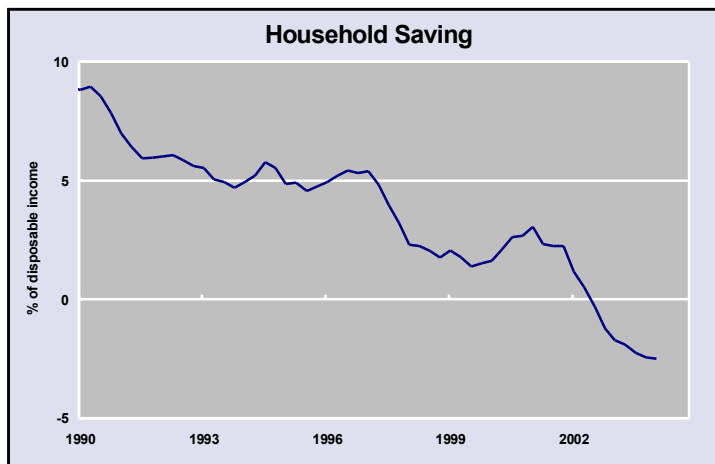
- income available for spending to grow by 4.25%.

This is a lower level of potential spending than the 7-8% retail spending growth in the past year and a slowdown which can have a meaningful impact on the financial outcomes for local retailers.

How should investors react to these circumstances? Within an allocation to Australian equities, these changes imply that there should be some reorientation away from consumer discretionary stocks.

However, in the Australian market context, it is often difficult to make these adjustments because of the bias in the market toward financial stocks. That is, having taken a view that a portfolio should have less exposure to consumer spending, there might be very little alternative choice.

A key guidepost for an equity investor in this context is to ensure as far as possible



that stocks selected for a portfolio are not anticipating higher rates of growth than can be delivered by the economic outlook.

Embedded in every share price is an implied growth rate for that particular company. If the implied growth rate is higher than what the economy might allow the company to achieve, the stock is potentially overvalued.

The price of Coles Myer, Australia's leading retailer, implies a continuing growth rate in the vicinity of 8% a year, for example. The share

price of David Jones, on the other hand, implies a less demanding 5-6% rate of ongoing growth.

There might be legitimate reasons for both these being appropriate assumptions for these companies because of the way in which each is positioned in its market. Alternatively, the differences might represent pricing anomalies which can be used to advantage as the cycle turns.

*"The national accounts data from the ABS show for the seventh successive quarter households spending more than their incomes... supported by financial institutions. They have backed consumer bullishness with continuing growth in finance."*

Investors should now be reviewing consumer sensitive stocks to assess the extent to which the growth implied by their share prices might be too demanding for the environment which is ahead.