

# thebigpicture

guideposts for the private investor

Week Commencing 20 December 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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## END OF YEAR: MACRO STATE OF PLAY

The Australian equity market is hitting record new levels as the year ends. This issue summarises the year end bigger picture. The first edition of *thebigpicture* in 2005 will look further ahead at what might unfold.

In one sense, 2004 was as good as it gets for an equity investor with the economic cycle working in favour of higher prices. Global output growth accelerated to an expected 5% according to the International Monetary Fund in its latest World Economic Outlook, the strongest outcome in 28 years. This was higher than the 3.9% growth rate recorded in 2003 and higher than what is generally expected in 2005.

A slowdown in global activity is now widely expected, influenced by:

- the natural deceleration in US economic growth rates as a more sustainable growth path is established;
- higher oil prices which are draining spending power from the industrial economies;
- weaker growth in Asia, especially China, as attempts to maintain control of the economy through tightening monetary conditions has an effect;
- continuing structural constraints in Japan and Europe which are limiting the growth upside in these regions; and,
- a weaker US dollar which is reducing the competitiveness of Japan and Europe at a time when improved export performance would have been expected to help boost activity there.

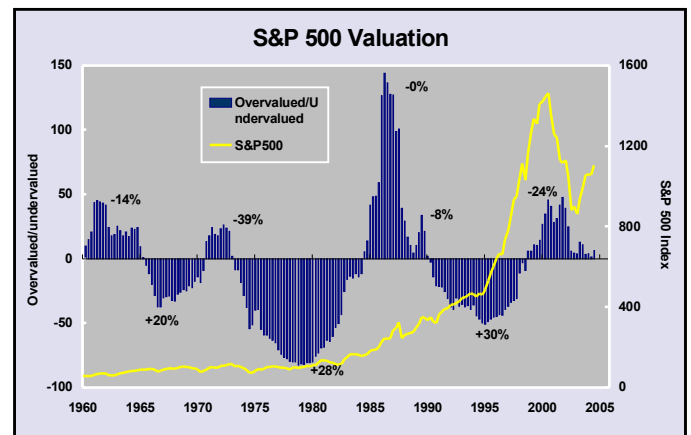
As the year finishes, forecasters are trimming back their expectations for the coming year. The end results are not a dramatic change but added evidence that the momentum is turning.

Slowing economic momentum would normally foreshadow some reduced pressures on commodity prices giving supply a chance to catch up with demand.

Inflation has generally been held within the bounds of what is acceptable to monetary authorities in Australia and the USA. In Europe, inflation is consistent with economic weakness. There is little or no pressure for higher interest rates from this source.

Much of the upward pressure on interest rates has been in the minds of policymakers. That is, they have had some notion of what is a normal level of rates and have been biasing policy toward returning to levels more in line with historical averages.

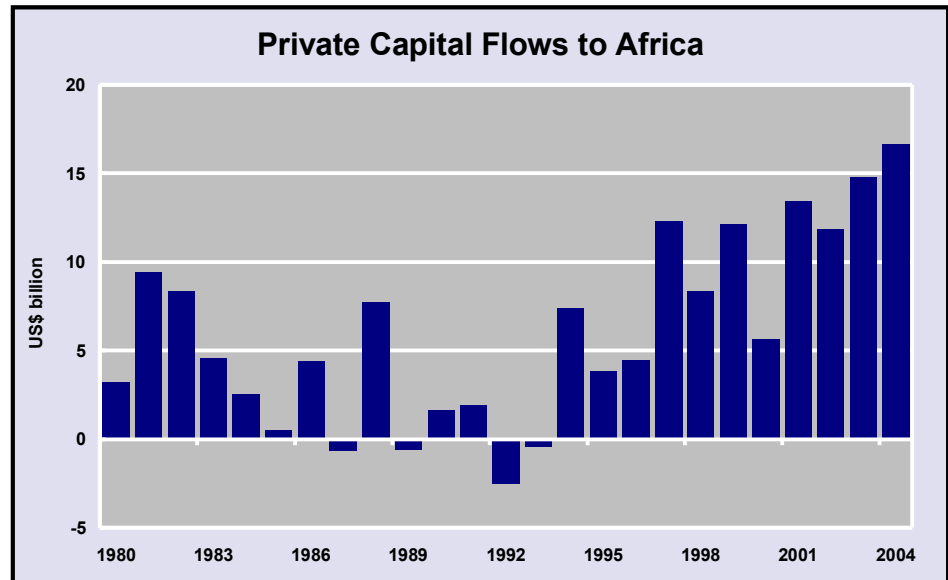
However, a year ago, commentators in Australia and the USA would have been forecasting higher interest rates than we now have. In Australia, where rates had not been



(Continued on page 2)

## THE WEEKLY CHART SPOT

Capital flow statistics suggest that Africa is gaining more attention from the rest of the world as an investment destination. Africa was in danger of being the forgotten continent despite accounting for an increasingly large proportion of the world's population. An unstable combination of poverty and burgeoning population mark it as a region whose economic development will become an increasingly important global policy issue.



Source: International Monetary Fund

## END OF YEAR: MACRO STATE OF PLAY CONT'D

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pushed as low as in the USA, the upward pressure has largely dissipated and there are some who think that current levels represent the top of the cycle.

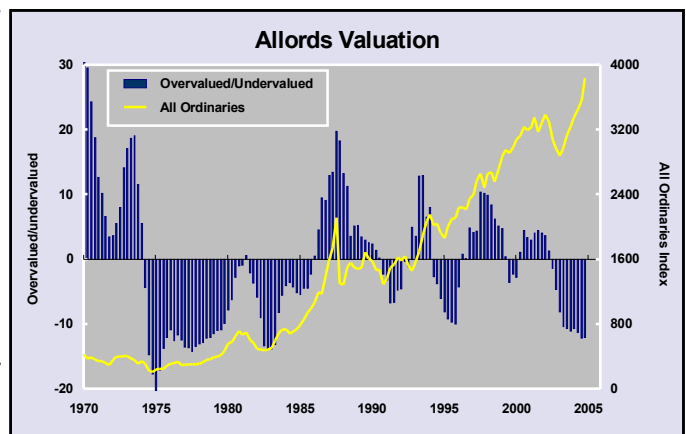
As the year ends, bond yields have been dropping. A benign inflation outlook coupled with a lowering of economic growth expectations are at work here.

In the USA, profits after tax over the six months to the September quarter were some 14% higher than they had been a year earlier. The profit performance in Australia has been similarly strong. Across the economy, non-finance corporate profits were 12% higher in the six months to September compared with the same period a year earlier. The share of profit in the economy reached record levels during the past two quarters for which data are available.

Improved profitability has underwritten the strength of the Australian stock market. The underlying financial performance of smaller listed companies has been especially notable. As discussed in prior issues of *thebigpicture*, the performance gap between the largest industrial companies and the smaller end of the market has largely disappeared.

The closure of this gap has some significant implications for the relative riskiness of stocks and how funds should be allocated between smaller and larger companies as the cycle turns. The convergence in economic performance suggests that themes which focus on large companies versus small should be less relevant than has been the case in prior years. Now, there needs to be more emphasis on relative financial performance irrespective of size.

Despite the Australian market being 23% higher since the beginning of 2004, the indicators used by *thebigpicture* to judge whether the market is undervalued or overvalued signals that it is still undervalued. In other words, the market apprecia-



(Continued on page 3)

## US Economy: Settling In cont'd

(Continued from page 4)

porting occasionally on the condition of the US economy using four guideposts:

- employment,
- industrial production,
- disposable income, and
- business sales.



These four indicators are consistent with the principal activity measures used by the National Bureau of Economic Research (NBER) as guides to the position of the US economy in the economic cycle.

The NBER is the organization with the job of officially defining whether the US economy has been in recession or is expanding.

The speed of US employment growth has been disappointing compared with recoveries from past recessions.

Over the last year, non-farm payrolls have increased at a monthly average rate of 171,000, below the average 190,000 monthly pace during the last recovery phase between mid 1991 and early 1995. This increase also seemed slower than usual because it followed a false start in 2003, illustrated in the first chart, when employment growth stopped and other activity indicators seemed to stall.

On this occasion, there seems to have been a greater determination on the part of US business to secure its own fortunes before boosting employment.

## END OF YEAR: MACRO STATE OF PLAY CONT'D

tion has been validated by improved business conditions.

The US model still suggests that the market there is sitting at around fair value.

The flip side of disappointments on the employment front has been surprisingly strong productivity and profit growth.

Employment and investment spending commitments by business have tended to lag well behind measures of business performance during the current cycle. Some have suggested that the stricter corporate

regulatory environment has made business more risk averse and has adversely affected its willingness to commit to new people or new capital.

In any event, there has been sufficient excess industrial capacity from earlier rounds of investment to meet rising demand.

A 0.3% rise in industrial production in November took industrial output 4.2% higher than it had been a year earlier.

The chart shows a deceleration but the rate of growth is now consistent with the pace of output growth through much of the 1990s.

Disposable personal income, the key ingredient for household sector demand growth, increased by 5.2% over the year to October 2004. Meanwhile, consumption spending growth of 6.6% over the year was the highest since the last quarter of 2000.

The strengthening growth in consumption forced the personal savings rate to a near record low. While this indicates, in the short term, a relatively confident group of consumers, it leaves open the question of how consumers will adjust their consumption in the longer term to accommodate likely levels of income.

Business sales growth, despite decelerating slightly, remained strong. The 10.9% expansion over the year to October suggests that the forces affecting business sentiment are positive. Buoyant sales should engender more confidence and underpin growth in business profitability, employment and investment, the drivers which sustain an economic expansion once it is underway. ■

That is not to say that the US market will not go higher but there is little impetus from valuation for it to move ahead. The models flag better value in Australia. ■

***“Growth rates have subsided reflecting reversion to more sustainable rates of economic activity. In doing so, the overall pace has eased potential worries on the policy front.”***

## US ECONOMY: SETTLING IN

Recent data suggest that the US economy is settling onto a sustainable growth path.

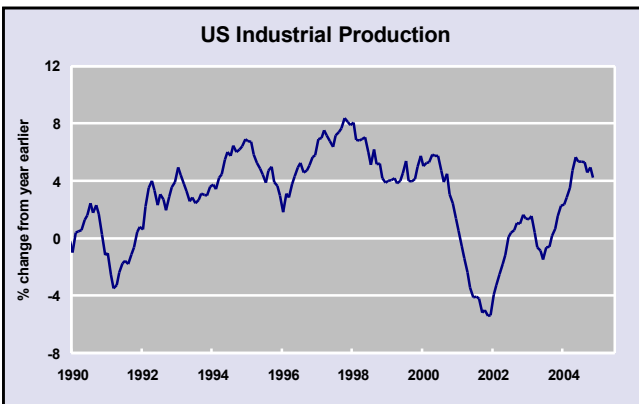
When the last review of the US economy was published in *thebigpicture* in early August, the sentiment among commentators was changing from concern about growth stalling to concern that interest rate rises might have to be more emphatic with clearer evidence of an acceleration in activity.

The view expressed in *thebigpicture* was that an acceleration in activity rates from mid 2003 through the first half of 2004 had pushed growth to an unsustainably strong

generally favourable view of the US economy. Growth rates have subsided reflecting reversion to more sustainable rates of



economic activity. In doing so, the overall pace has eased potential worries on the policy front.



pace which would subsequently subside to something more in keeping with a maturing expansion phase.

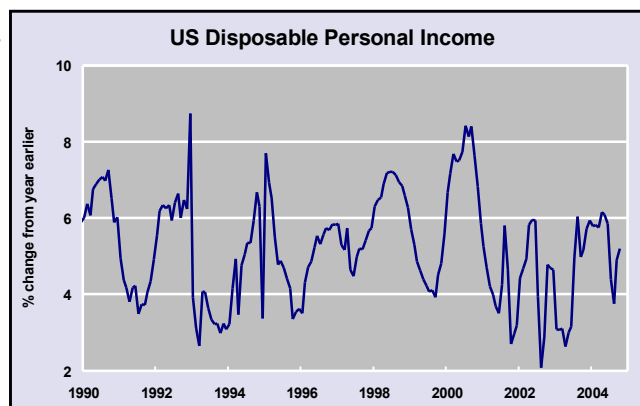
There was little evidence of the pace of growth being threatened seriously by outside factors. True, there were risks including the geopolitical sort and those associated with higher oil prices but, against these, policy remained very supportive with the Fed Funds rate then only 0.5 percentage points higher than the record low of 1% first set in the summer of 2003.

Over the past several months, the flow of statistics has reinforced this

There has been some acceleration in the rate of price increase as the cycle has matured. One of the price measures relied on by policy makers, the personal consumption deflator, was 2.4% higher over the year to October. However, this remains within the bounds which are generally acceptable to policymakers.

In other words, there is no sign in the data that a speedier reversion to more normal levels of interest rates than its "measured pace" needs to be contemplated by the Federal Reserve.

*thebigpicture* has been tracking and re-



(Continued on page 3)

*"The flip side of disappointments on the employment front has been surprisingly strong productivity and profit growth."*