

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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TOP TEN THEMES FOR INVESTMENT MARKETS

thebigpicture top ten themes (see page 2) summarise the publication's views about the longer term trends likely to affect investment market outcomes.

Every new year brings with it events which, with the benefit of hindsight, can be seen to have shaped economic and financial outcomes. The most dramatic of these are usually the least likely to be anticipated.

The most vivid example of an unanticipated event, of course, is the attack on the New York World Trade Centre in September 2001. A similar example was the Iraqi invasion of Kuwait in August 1990. The collapse of Enron in November 2001 and its aftermath, in a different way, was a similarly defining event with lingering influences on markets.

Often, however, these events are simply catalysts which hasten the effect of building pressures. The events of 2001, for example, occurred after a clear slowing in the momentum of economic activity had commenced and after markets had been greatly overvalued.

Without those two preconditions, the aftermath of the specific events would have been very different. Their association with collapsing markets and poorly performing economies would not have occurred.

At the end of the day, underlying social, political and economic forces drove market direction as they are likely to do in the future.

thebigpicture top ten themes are intended to portray one view of the ongoing influences affecting long term investment decision-making. Their publication is aimed at acknowledging some of the underlying influences on the conclusions and commentary in the weekly newsletter. Better to get the prejudices out in the open than have them lurking in the background!

Consistent with the mission of *thebigpicture* to help distinguish the forest from the trees, the themes are chosen because they are expected to drive outcomes over many years rather than over quarters or months.

From time to time, the nature of these forces and their impact on investment markets will be reviewed in more detail. Near the beginning of the year, however, it makes sense to review what was published last year and to assess whether there is anything happening which ought to prompt a change in the world view which underpins our day-to-day thoughts.

Happily, all ten of the themes continue to strike the chord they did when originally adopted in 2002. Subsequent events have not forced any radical revisions to the thoughts framed at that time.

There will be more noise than usual this year as election campaigns in the USA and Australia get underway. However, neither election is likely to change the nature of the influences comprising our top ten.

One reason, in Australia's case, has been the recent abrogation of responsibility for economic policy by the nation's elected leaders in favour of the Reserve Bank (see *thebigpicture* for the week commencing 8 December 2003). This has some important implications for the decisions being made by all political parties about what is acceptable policy. In reviewing the top ten, this theme was one tempting addition.

"At the end of the day, underlying social, political and economic forces drove market direction as they are likely to do in the future."

TOP TEN *thebigpicture* THEMES

<u>Theme</u>	<u>Key Consequences</u>
The aging population	<ul style="list-style-type: none"> • Changing expenditure patterns, including: <ul style="list-style-type: none"> ~ reorientation of consumption spending to higher value branded goods ~ rising expenditure on healthcare ~ higher leisure expenditure • Rising taxation burden or recourse to debt funding • Pressure on individuals to stay in the workforce longer
Low inflation	<ul style="list-style-type: none"> • Historically low interest rates • Relatively low income growth rates - including business profitability • Monetary policy to err on the side of caution - lower growth • Pressure on managers to improve operational business performance; more frequent business and executive failures
Fear of Islamic fundamentalism	<ul style="list-style-type: none"> • Continuing geo-political tensions focused on the Middle East <ul style="list-style-type: none"> ~ oil price and general market volatility • Risk of 'war' shocks or terror attacks in western countries • Higher defence expenditure <ul style="list-style-type: none"> ~ higher taxation or government debt with interest rate impact ~ opportunities for military equipment and service providers
Biotechnology research advances	<ul style="list-style-type: none"> • Ethics – the debate on the nature of life probably resolved in near term in favour of commercial interests • Economics – who captures the value from research to be a continuing debate • Difficulties in raising equity for commercialization • Demands for more government funding for research and subsidizing usage of resulting products
Changing nature of work	<ul style="list-style-type: none"> • Review of government v private sector in <ul style="list-style-type: none"> ~ periodic retraining ~ educational infrastructure • Failure of companies to nurture internal skills will affect performance <ul style="list-style-type: none"> ~ corporate emphasis to swing back from cost cutting to intellectual capital development
Adoption of information technology	<ul style="list-style-type: none"> • Winners: users of IT as a tool to improve productivity • Losers: product developers facing low barriers to entry
Asian economic development	<ul style="list-style-type: none"> • Western companies will continue to seek ways to position themselves • Good sales growth but little pricing power • Highly competitive markets to constrain global inflation • Australia to have advantages as high value service provider in the region
Re-emphasis on corporate ethical standards	<ul style="list-style-type: none"> • Greater shareholder activism and public accountability for actions • Company growth rates to diminish as acquisition risk perceptions rise • Greater reliance on operational improvement to boost earnings
High company valuations	<ul style="list-style-type: none"> • Market upside dependent on improvement in sustainable profit <ul style="list-style-type: none"> ~ less reliance on valuation effects from lower interest rates • Capital to remain relatively scarce
Emphasis on environmental issues	<ul style="list-style-type: none"> • New infrastructure developments • Relocation of carbon generating industries • More intense cost management pressures • Utility providers to review pricing options • Domestic recycling and industry packaging changes

US-AUSTRALIA TRADE: DECISION TIME CONT'D

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for the foreseeable future.

There are also some domestic political issues in the mixture. If it is forced to give up, the Australian government's special relationship with the US administration will be seen to count for little.

Whatever the outcome, a free trade agreement for Australia will be less momentous than the original NAFTA was for north America. To this day, there is heated debate in the USA about the impact of NAFTA on the US economy, employment and business investment.

The AFL-CIO, the peak union body in the USA, is still sceptical. Trade among the three principal participant countries has grown but US workers have remained suspicious that manufacturing skills have been exported south of the border to be replaced by less technically demanding and lower paid service jobs.

Australia has more aggressively pursued

market opening opportunities than many countries. Its unilateral initiatives to lower tariffs on manufactured goods mean that today's negotiations will have less impact on its domestic economy.

The flip side of this advantage is that Australian negotiators will have less to use as bargaining chips with which to buy off US negotiating positions.

Of course, needing negotiations to establish free trade is a sure sign that free trade is actually under pressure. Genuine free trade would mean that all trade barriers are to be removed and there would be nothing to negotiate. In the event that anyone found impediments to trade, the infringement could be brought to the attention of a relevant authority and financial sanctions imposed. It would be easy.

The reason for negotiations is that both countries are seeking to gain market access where it is currently denied but prevent market access where national interests might be affected detrimentally.

FREE TRADE: WHAT'S IN IT FOR INVESTORS?

With the Australian economy having been opened to more competition over the last two decades and Australia's corporate regulatory regime progressively harmonised with that of the USA, the impact here of a trade agreement is likely to be quite limited.

There will be few clear-cut winners and losers from which Australian investors will be able to pick. Moreover, many of the sectors likely to benefit most such as agriculture are not related directly to investment market performance.

The argument for a free trade agreement is that it helps raise the efficiency of the industries within the region by promoting competition and specialisation.

Larger markets contribute to economies of scale. Overall growth is boosted as those operating within the boundaries of the free trade area are presented with new cross border investment opportunities. Since technology transfer is also made easier, industries are modernised and rejuvenated.

From a performance standpoint, free trade is supposed to deliver higher productivity and output growth which trans-

lates into higher personal incomes and higher rates of profit growth.

These restructuring benefits are likely to take some time to filter through - more likely years than months. They will be hard to discern because they will typically be diffused widely throughout the economy.

Nonetheless, longer-term investment returns should improve. Being able to boost national productivity performance by enough to sustainably push economic growth from 3½% a year to 4%, for example, would imply profit levels around 10% higher after 20 years. Other things being the same, the value of Australian equity investments could be up to 10% higher.

With annual national profit growth set to contract from 10% to under 7% over the coming two decades as population growth slows, the marginal compensation available through widened market access should be attractive for the local investor.

The argument is not confined to market access agreements. Any initiative which helps the Australian economy achieve higher rates of productivity growth will produce higher income growth and better investment returns.

"Once concessions are made to the US negotiators under the pressure of a looming election and long term arrangements are agreed, the chance to revisit agricultural trade barriers with the USA might be lost for the foreseeable future."

USA-AUSTRALIA TRADE: DECISION TIME

This month marks the tenth anniversary of the North American Free Trade Agreement which has brought together Canada, Mexico and the USA in one of the world's most important regional markets. It is also likely to be the month Australia is admitted to the club – or decides the sacrifice is too great.

Australia's attempt to become a part of the expanding north American regional market through a free trade pact with the USA was originally set to be completed by the end of 2003. The negotiating timetable is now overlapping ominously with the US presidential election campaign.

Amid clear signs of rising political influences in the past week, US Trade representative Robert Zoellick stated flatly in the key sugar producing state of North Dakota that "Our position is not to have any increase in sugar from Australia."

Regional dairy interests in the USA have also signalled their hostility to liberalised agricultural trade between Australia and the USA with a rising tempo of opposition.

Gaining access for agricultural products was the incentive for the Australian government to invest the effort in an agreement and risk the embarrassment of failure.

Without agriculture, a free trade agreement will be little more than window dressing since market access between the two countries suffers from relatively few barriers. Across the investment and service sectors, other potential stum-

bling blocks in negotiations, there is considerable convergence in standards and an increasingly common regulatory base.

If the US side holds fast on agriculture, the Australian government will shortly have to consider admitting failure. It might have to walk away from any potential agreement that excludes agriculture or a substantial part of it.

Once concessions are made to the US ne-

Bilateral v Multilateral

In many ways, bilateral agreements are a poor substitute for global free trade arrangements under the auspices of the World Trade Organisation.

Recourse to bilateral agreements is being forced on national governments as trade liberalisation talks have stalled especially over agricultural products with Europe holding out to preserve its domestic arrangements. Other countries such as Japan and China have also sought to protect their own interests with constraints on investment flows, intellectual property ownership and access to government procurement contracts.

For Australia, expanded agricultural markets are one of the most attractive aspects of greater US market access. For the USA, ensuring that its companies have freer access to investment opportunities, services contracts and copyright protection remain some of the motivating factors.

While a bilateral free trade agreement creates some trade opportunities, it is also by its nature exclusionary since some countries are not parties to the agreement and do not participate in the benefits. For this reason, market access agreements are not necessarily popular with international policy makers.

Free trade regions create the risk of trade diversion and require local content rules to be agreed and enforced. For example, what is an Australian car? If its components are manufactured throughout Asia but the vehicle is assembled in Australia, should that qualify it as an export to the USA under a free trade agreement? Sometimes arbitrary benchmarks are established to make these judgements. If it is accepted as Australian, an incentive is created to divert components from non-member countries to be assembled in Australia.

Might Australia simply be drawing activity away from other countries as trade is diverted to take advantage of the privileged market access? Australia might be better off but is the world better off for having the market access agreement? These are some of the broader issues which should be addressed but which are being neglected as multilateral talks stall and countries pursue their national interests.

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