

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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US GOVERNMENT DEBT: HOW SCARY?

The US budget deficit is pushing toward record levels. There are more frequently expressed fears that this will force the US dollar lower. This has implications for global economic conditions as well as the competitiveness of Australian companies.

Governments are ultimately dissuaded from running large spending deficits because they have to be funded by borrowings. Unless there is a high level of domestic savings from which to draw, this usually means governments tapping offshore debt markets to raise foreign currency loans. In moderation, this may be no matter for concern especially if funds are used to enhance the productive capacity of the economy. However, international borrowing raises the national risk profile.

In the event of currency devaluation, the government would have to make larger repayments in the local currency than had been borrowed in the first instance exacerbating the shortage of domestic savings which forced recourse to international funds in the first place.

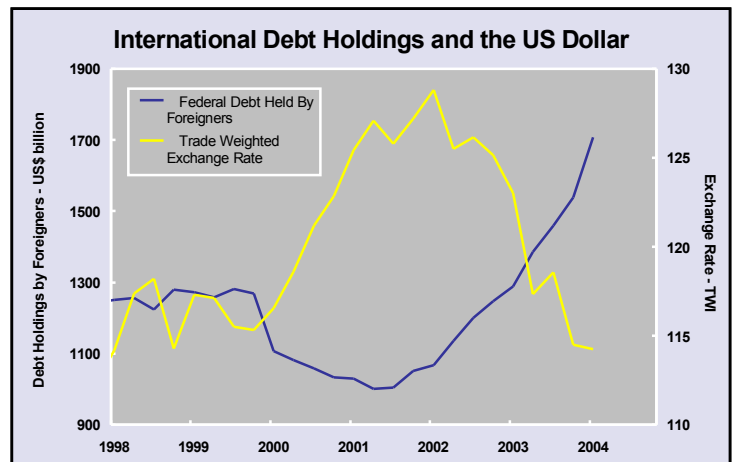
Sometimes this leads to economic and political crisis with a loss of sovereignty as the IMF takes over policy making, the ultimate sanction to be imposed on the borrowing nation. There are many Latin American examples. Australia in the 1980s was a less dramatic and more easily solved manifestation of the genre.

The US is the one country that does not face this risk since it is able to fund its deficit by issuing securities denominated in its own currency to both domestic investors and foreign investors. Devaluation does not increase its international liabilities. For the US government this is one less reason to feel constrained about borrowing.

Since the US economy is large and growing with liquid, reliable capital markets neither its ability to repay its debt nor the attraction of its markets to offshore investors have limited its borrowing, at least within the limits it has imposed on itself.

Whether a US budget deficit of any level can be sustained depends on whether there is adequate demand for the government securities used to fund it. The adequacy of demand will be affected by international investors as well as the demand from US residents.

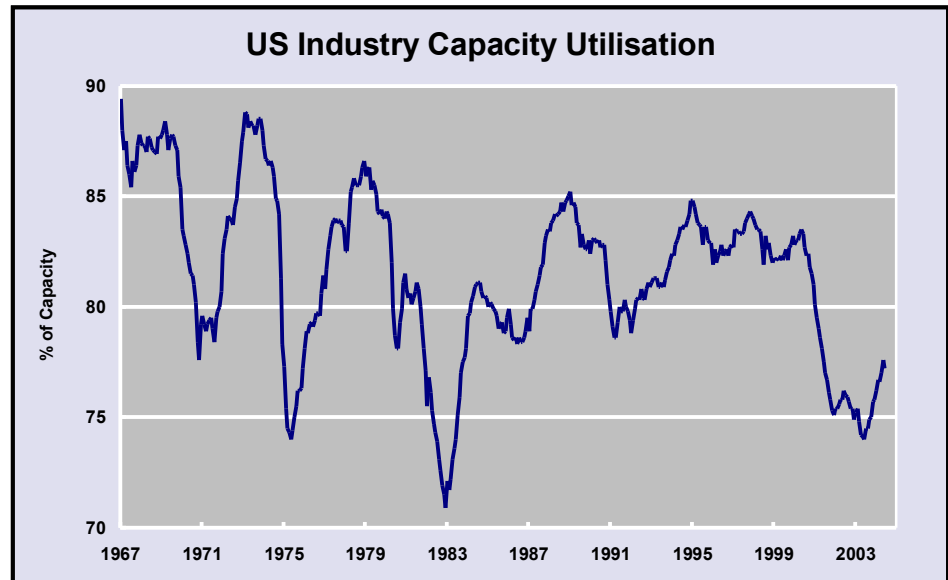
If international demand is inadequate, the US dollar must fall to make US debt cheaper or interest rates must be raised to make it more attractive with the adverse implications that would normally have on company profitability and domestic growth. In reality, there would be some combination of both outcomes.



(Continued on page 2)

THE WEEKLY CHART SPOT

US capacity utilization rates have been edging upward as the economic recovery there has taken hold. However, there is still some way to go before the economy starts hitting the utilization rates typical of the top of an economic cycle. This is good for US inflation prospects (and interest rates) since capacity constraints are usually a sign of more inflation pressures emerging. It also suggests why US business investment has been so weak - the pressure to expand capacity is not there yet.



Source: US Federal Reserve Board

US GOVERNMENT DEBT: HOW SCARY? CONT'D

(Continued from page 1)

This is the focus for those now highlighting the budget deficit risk. They would also be looking at the first chart which shows how the US dollar appreciated between 2000 and 2002 while the claim on foreigners was relatively subdued and how, subsequently, the currency weakened as foreign holdings of federal debt began to rise while the budget moved from surplus to growing deficit.

The second chart makes the prospects for the US dollar a little scarier still because it shows that the government deficit is expected to rise to US\$520 billion in the current year after having been in surplus as recently as 2001. And, while it will decline subsequently according to the most recently published projections by the Office of Management and Budget, the average annual deficit is still expected to be over US\$200 billion over the five year projection period. And there is a worry that this might itself be underestimating the potential due to the unknown costs of the US having to lead continuing anti-terrorist campaigns around the world.

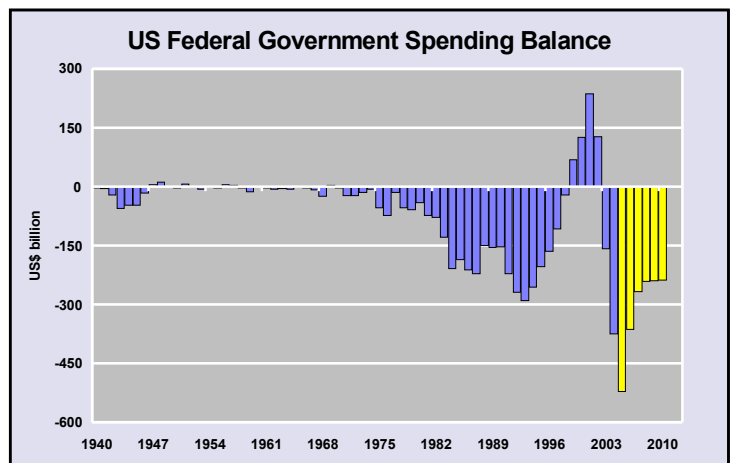
And, just to add further to the scary side of the

argument, the continuing deficits are expected to require a 49 percent increase in the quantity of US federal debt held by the public between 2003 and 2009 (shown in red in the third chart on the following page) after its holdings had remained relatively stable for some five years.

In essence, this is the argument which says that the US dollar is likely to face on-going downward pressure for the foreseeable future. It is not an argument to be ignored.

Like a lot in economics, however, there is the scary and the not so scary view of the world.

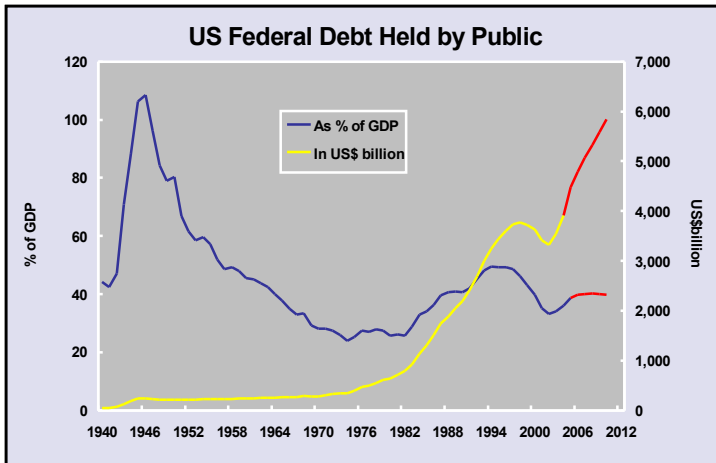
The not so scary perspective sees the debt funding task relative to the size of the US economy. In that context, the peak reading was in the mid-1990s. Supported by rela-



US GOVERNMENT DEBT: HOW SCARY? CONT'D

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tively strong economic growth, the quantity of federal debt relative to the size of the economy then declined. Importantly, now, the prospects are for some increase but for the anticipated outcomes to be held well within the limits of the past 15 years (again shown in red in the chart below).



The last chart shows the longer term connection between the US dollar and foreign held US federal debt. Again, the recent inverse relationship (i.e. lower debt/stronger dollar) is evident. However, the longer period of history shows that the US dollar appreciated all the while foreigners were taking up larger quantities of federal debt.

These two seemingly contradictory aspects of the relationship highlight the dual role of US government debt - as a means to fund US government activities but also as a store of value for the world's investors. In other words, the rest of the world places some value on the US running deficits so as to maintain a supply of government securities into which it can place its savings.

The ebb and flow of debt supply can cause some nervousness from time-to-time when there are concerns about the supply of bonds exceeding the global appetite. As an international store of value, however, the US dollar has few if any counterparts. The key issue is not so much the size of the deficit

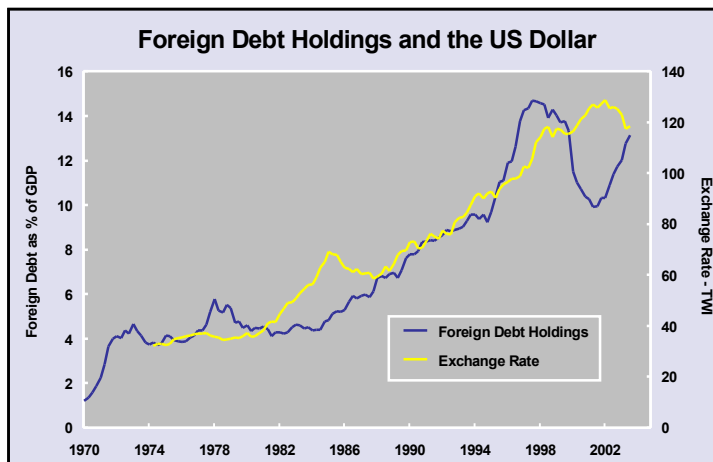
itself but whether the world's need for US dollar securities will be growing faster or slower than the supply emanating from the US government.

There is some argument that during the 1990s as more economies were liberalised, demand for US securities would have been growing above trend. With that structural change having occurred,

demand from the rest of the world is now likely to grow less strongly - more in line with underlying rates of economic growth outside the USA.

Even so, the US relative position in the long term will be a strong one with:

- relatively high sustainable growth when compared with the performances of other developed nations;
- the largest, most cohesive market for sophisticated manufactured goods and services in the world;
- a more highly developed capital market than can be found in any faster growing part of the world;
- wealth accumulation outside the USA occurring at an unprecedented rate as Asian economies mature; and,
- global inflation outcomes reflecting the integration of international markets so that US inflation is unlikely to run ahead of inflation in other countries causing its store of value position to be eroded.



“The US is the one country that does not face this risk since it is able to fund its deficit by issuing securities denominated in its own currency to both domestic investors and foreign investors. Devaluation does not increase its international liabilities.”

IT'S MY VALUE CHAIN

Control of the value chain is an important indicator of business sustainability.

Product value can be generated anywhere from the point of processing initial raw material inputs through manufacturing, transport, wholesaling, marketing and retailing.

The battle for the value chain determines the fate of many companies as they attempt to maximise the credit for their own contribution.

One of the most recent examples of the value chain tug-o-war has been the bid by Woolworths for Australian Leisure and Hospitality (ALH), the pubs and gaming business floated late last year by Foster's Group, the leading beer and wine producer.

The ALH business is concentrated in Victoria and Queensland. In Queensland, there are regulations which limit liquor retailing to hotel owners. Unless it also owns hotels, Woolworths is unable to set up shop in the state in the same way it can (with the appropriate licenses) elsewhere in Australia.

When Foster's was selling the ALH business it apparently did not invite bids from any of the large retailing groups with an interest in the liquor trade because it did not want them to strengthen their economic power over its beer and wine business. More power for the retailers means less brand power for the producers.

For the likes of Foster's, Lion Nathan and Southcorp, in the case of alcoholic beverages, this is important because their customers (the retailers) are not their consumers (the drinkers). While they build their brands by communicating with their consumers, they depend on their customers to get the product into the hands of the people who choose to drink their product.

By standing between the producer and consumer, retailers can modify the relationship in their favour. A classic example of what can happen is in the milk trade where the large retailers maintain a substantial business in house branded product which typically sells at a lower margin despite being produced by the major dis-

tributors of branded products such as National Foods and Parmalat. This is the greatest fear of the brewers.

In the extreme, Woolworths would like to be able to sell a high-volume house branded beer on which it can get acceptable retail margins rather than support the 20%+ margins typically obtained by the brand managers.

Another example of the importance of value chain positioning is Amcor, a leading Australian company with an international position as a supplier of packaging to brand managers. The quality of the packaging helps to define the nature of the product in many instances.

Amcor sits down the pecking order from Foster's or Lion Nathan. Without any brand positioning it must rely on the efficiency of its operations and its ability to be continually innovative in its production processes to have any chance of making an economic return on its investments. Its customers will continually be forcing it to reinvest to deliver more sophisticated products at lower costs. Signs of rising profitability will attract more aggressive negotiating tactics so that more of the product value can accrue to the downstream parts of the value chain.

The company has admitted that its returns in the USA have been eroded by one prominent brand manager using its economic power to capture a larger share of the soft drink value chain.

Further upstream are the raw material producers which sell generic products such as aluminium or copper and which are at an even greater disadvantage with virtually no capacity to innovate at the product level and using production processes common across the industry. While these companies are able to generate extraordinary returns from time to time through the commodity cycle, they face an uphill battle to sustain competitive rates of return for their shareholders.

A company's economic power within the value chain plays a critical role in the long term economic performance of the business and, importantly, the sustainability of returns above its cost of capital.

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