

# thebigpicture

guideposts for the private investor

Week Commencing 18 April 2005

## **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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## MANAGING THE TRANSITION

**Investors will have to decide how they manage the transition from near record profits and stable, low interest rates to slower growth and the risk of higher interest rates.**

As a general rule, markets will be most likely to rise when earnings growth is accelerating and interest rates are falling or stable. Markets are least fond of rising interest rates and declining earnings, a combination highly likely to cause equity prices to fall.

Unfortunately, market outcomes are least clear-cut in the interim cases such as those likely to prevail in 2005 when profit growth is moderating but still positive and there is a possibility of another interest rate rise but no dramatic change in monetary conditions.

Complicating the decision is evidence that the market remains undervalued. While the ASX 200, for example, had risen by as much as 25% over the past year, underlying profit growth was strong and returns on funds employed have been rising, validating a significant appreciation in the market.

Moreover, beyond 2005, with the momentum of Asian growth intact, there are good grounds for expecting global output growth in excess of 4%, comfortably ahead of the 3½% average over the past three decades. Profit growth rates could accelerate in 2006 creating more favourable conditions for equity markets.

Through the second and third quarters of 2005, uncertainty about the macro-economic environment might give rise to market weakness. Stocks most obviously sensitive to global and local growth conditions might be most affected. Investors will have to decide whether they adjust their portfolios tactically in response or whether longer-term value considerations are given more weight.

How investors react will depend on their investment time horizons. Some will decide to look to the longer term and the value to be had from riding through the cycle, treating the short-term volatility as a risk to performance. Others, however, might consider tactically altering their stock selection to a more defensive posture to take account of the market risks which typically appear as the transition to lower growth is occurring. ■

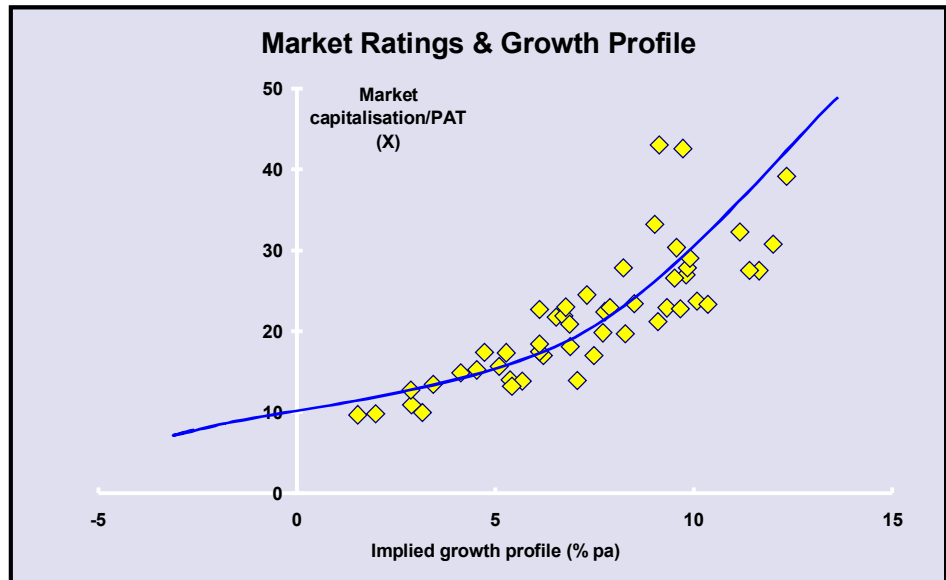
### Worrying About Growth

Equity markets have become more preoccupied with the trajectory of growth. This is understandable.

- Growth in 2005 looks set to be slower than in 2004.
- Markets nearly always get nervous around turning points because forecasters are likely to get them wrong – underestimating the momentum of the turn in either direction.
- Even apparently attractive global growth rates are concealing an important change in the geographic mix. For example, the above average global growth rate forecast for 2004 reflects the growing importance of developing Asia. The older world order of the USA, Canada, Europe, Japan and the western hemisphere would be growing at a disappointing 2½%.
- There has been some acceleration in the rate of price increase as the US cycle has matured creating some anxiety about possible further interest rate rises although inflation remains within bounds generally acceptable to policymakers.
- High oil prices are eating away at growth by reducing the amount of expenditure on more discretionary items.

## THE WEEKLY CHART SPOT

*“...high growth is not necessarily preferable to low growth. Both come at prices which need to be compared.”*



Source: Company sources and *thebigpicture* Economics

As the macroeconomic growth outlook is reappraised, investors should be looking for any signs that individual stock prices are reflecting growth rates which are becoming harder to achieve. Of course, this is a test which can be applied at any point in the cycle.

Analytically, one way of doing this is to think of a company's market value as having two components:

- the value of the existing profit stream; and,
- the value of future profit growth.

For practical analytical purposes, the value of the existing profit stream can be viewed as the capitalised value of the last reported profit adjusted for any abnormal or unsustainable elements. The company's weighted average cost of capital could be used as the capitalisation rate.

The value of future profit growth could be looked at simply as a residual: the difference between the value of the existing profit stream and the market value of the company.

The table uses Coles Myer data for 2003/04 to illustrate the approach. Its existing profit stream valued at \$6.2 billion accounts for 53% of the \$11.7 billion market value of the company.

Example of Company Value Components		
2003/04 operating profit (\$m)	610.7	Net operating profit after tax but before interest charges
Cost of funding (%)	9.9	Weighted average cost of capital
Current value (\$m)	6,168.7	Capitalized value of current profit
Enterprise value (\$m)	11,721.2	Net debt + market capitalization
Value attributed to growth (\$m)	5,552.5	Difference between current value and enterprise value
Implied growth (% pa)	7.7	Growth rate required to vali-

Implicit in the company's pricing is also a rate at which its existing profit would have to expand to validate the current market value. This implied growth rate provides a perspective on the sustainability of a share price. In the example, operating profit would have to grow at 7.7% a year (for the indefinite future). A benchmark test of how reasonable this might be is to compare it to the performance of the Australian economy which might be growing by as little as 5% or 6% a year in the longer term.

This alone might not be cause for concern. A company might be able to deliver above average growth for a period if, for example, it is undergoing a restructuring which is designed to enhance its profitability. This might translate into an average rate of growth

## Turning Point Risk cont'd

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imminent crisis, the impact on growth is unavoidable. Real consumer spending power will be cut, business costs will be raised and ongoing uncertainty, especially if there are fears of shortages, will affect investment commitments.

- Interest rates are facing some upward pressure. This might seem odd given the growth trajectory outside Asia. However, rising raw material prices are tending to produce additional inflationary pressures. Even if there is little or no further adjustment, interest rate uncertainty might persist for most of 2005.
- Structural problems continue to sap the growth potential of Europe and Japan. Brief glimmers of hope have given way to more realistic views of their potential. This is another source of uncertainty and downside risk.

Whatever the global growth outcome happens to be, the geographical mix is also tending to conceal some headwinds for many national equity markets.

The world is increasingly dependent on developing Asia as the primary driver of global economic performance. China, in particular, will contribute more than one percentage point or 25% of this year's global expansion in output.

From some perspectives, China's role is a

positive feature of the world outlook. For example, the strength of its investment spending is creating additional demand for raw materials which is fostering growth in countries like Australia. Australia's improved terms of trade, driven by higher prices for natural resources, have further boosted domestic spending power.

Countries in the region and, to a lesser extent, beyond are also benefiting from China's new self-sustaining momentum. China has become more of an engine for world growth in its own right rather than being dependent for its momentum on growth elsewhere, as it once would have been.

However, China's growing economic power risks concealing that the rest of the world is not doing so well. The combination of the USA, Canada, Europe, Japan and the western hemisphere – accounting for nearly two-thirds of the world's output – will be growing at an unspectacular and disappointing 2½% in 2005 based on the likely 4¼% expansion rate for the world as a whole.

Since the volatility of growth in the developing Asian economies is greater than the volatility of growth in the more developed economies outside Asia, the overall risk attaching to global economic growth (and, consequently, business profitability and equity market values) also increases as its dependency on Asia rises. ■

*“...markets usually become doubly nervous around macroeconomic turning points because of a tendency for forecasters to get the magnitude of the turn wrong.”*

## THE WEEKLY CHART SPOT CONT'D

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above that of its macroeconomic environment. On the other hand, if there are no special factors, investors could become justifiably nervous about the sustainability of the share price.

The chart summarizes the outcome of this analysis for some fifty of the largest listed Australian industrial companies. The implied growth rates calculated by **thebigpicture** are shown on the horizontal axis. The vertical axis contains a measure of the premium being paid by the market for different growth outcomes.

Generally speaking, and unsurprisingly, the market pays more for more quickly growing companies than for less fast growing businesses. However, since it is done on a consistent basis across many companies, the value of this analysis is that it provides

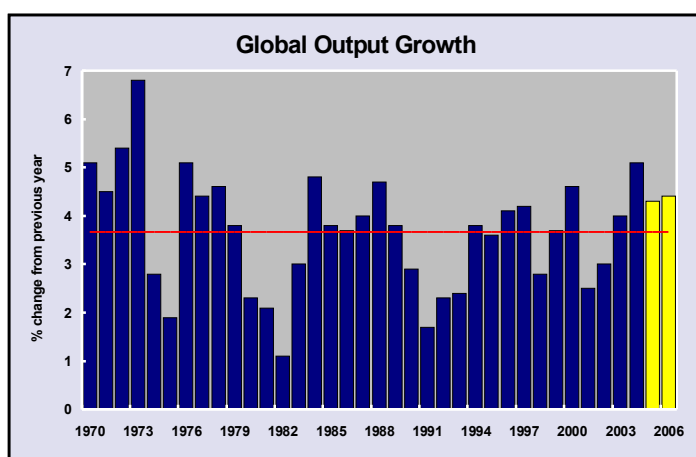
a 'sanity check' at three levels.

- It prompts a question about whether there are any special factors in the short term to boost underlying growth sufficiently to validate the existing share price if implied growth rates are above what the macroeconomic environment alone can sustain.
- It confirms that high growth is not necessarily preferable to low growth. Both come at prices which need to be compared. The model provides a perspective on this.
- It shows that for companies with similar implied growth rates, the market treatment might vary reflecting other less tangible concerns (if the market rating is below average) or attributes (if the rating is above average). ■

## TURNING POINT RISK

Global output growth of 5.1% in 2004 - the strongest in three decades - is widely expected to decline to around 4¼% in 2005. For investors, 'turning point risk' is probably more important than the level of growth itself.

Although global output growth in 2005 and 2006 is expected to be weaker than in 2004, according to the International Monetary Fund (IMF) it will still be ahead of the 3.7% annual average growth of the world economy over the past 35 years (shown in the red line).



However, markets usually react to momentum changes. An acceleration or a slowing in growth will usually have a greater impact on equity market values, for example, than the absolute level particularly if it flags a change in direction.

Usually accelerations in activity are accompanied by progressively more positive reappraisals of conditions as macroeconomic forecasters have to raise their estimates of the eventual growth outcome and company profit forecasters revise upward their earnings estimates.

Few complain about this forecasting risk when it benefits market values as it has done for most of the past two years.

However, the same risks loom more ominously when the change is in the other direction. Even if forecasts prove accurate, there will be some anxiety as markets wait for confirmation of where growth

will settle when it is moving lower. That is a destabilising influence for markets.

However, markets usually become doubly nervous around macroeconomic turning points because of a tendency for forecasters to get the magnitude of the turn wrong.

One study of this tendency toward turning point inaccuracy by the IMF itself concluded that "like outside forecasters, IMF forecasters have not been particularly successful in capturing major turning points and the ensuing impact on activity".

This tendency toward underestimation is also apparent in forecasts for the current cycle. Global output growth has accelerated over the past three years rising from 2.5% in 2001 to 5.1% in 2004. However, as late as September 2003, the IMF was forecasting calendar 2004 growth would be only 4.1% subsequently raising the forecast to 4.6% in April 2004 before confirming a 5.1% out-

come.

Similarly, in April 2004, the initial 2005 forecast was for growth of 4.4% which has since been revised down as more information about the forecast risks have become evident.

Against this background, the nagging thought is whether further downward adjustments are likely.

In the current cycle, despite a consensus that growth will remain at historically high levels, there are three reasons why growth could be weaker than currently expected weighing on markets.

- The rise in oil prices is taking away expenditure from other goods and services. While the global economy is better equipped to cope with high oil prices than it was in the 1970s and 1980s, removing any sense of

*"...China's growing economic power risks concealing that the rest of the world is not doing so well."*

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