

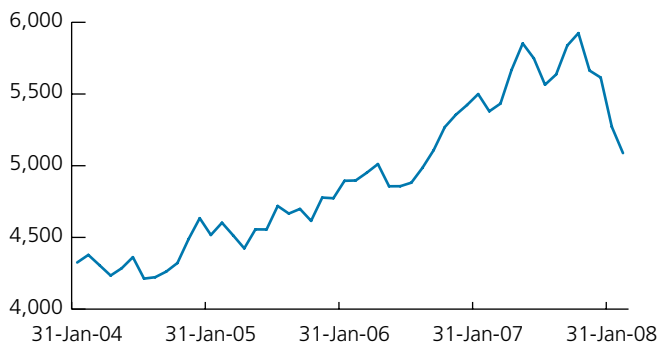
The Ides of March?

Global equity markets remain volatile and the future uncertain. Markets have retreated savagely in the March Quarter with most global equity indices down between 10% and 20%. The key question is when and how to re-enter the markets. In this Five Oceans Thought Piece, we examine this debate and give our thoughts on the current economic environment and some of the flash points.

The future – a binary outcome?

Markets attempt to discount the future in current prices. So how do they function when there are two competing visions of the future, a binary outcome, so to speak? These visions can be characterised as a short versus long cycle reversal. In a short cycle reversal the underlying framework for economic growth remains largely intact, whereas a long cycle reversal would see the current market turbulence presaging fundamental changes to economic structure. The latter scenario we believe would probably see global markets materially lower as certain business models of the *ancien régime* are materially challenged.

Chart 1 – US Stock Market Turmoil
S&P 500 Index (USA) Accumulated total returns



Source: Bloomberg

The fact that it is neither possible, nor useful to reconcile the two views into a single forecast leaves the market having to elect one as a base scenario. Evidence suggests that it leans to the idea that some variation on the status quo can be maintained. It will be as a result of some ultimately effective intervention, most likely by the US Federal Reserve (Fed). It holds this view in part because it is human nature. Father figures should protect loyal acolytes to a system. It has 'always worked before', and

because discounting the other scenario produces outcomes that are confronting and hard to reconcile with a more benign sense of things.

We kept hearing fund managers assert they would 'sell a rally', ironically suggesting being both long and bearish; an uncomfortable place to be. Another common assertion was that fund managers were looking for an entry point in financials, meaning that despite the most serious liquidity crisis in living memory they still had not significantly shifted their expectations of the operating model of the banking system. These are the characteristics of a market that is nervously long, and despite all the talk of structural problems, hopes for the best. The undiscountable worse case scenario fuels high levels of volatility in a range bound market.

The market awaits clarifying events to sort through this dilemma. In February it didn't get them. What such clarification would look like of course probably will not be clear until well after the event. As such, the month was marked by the operation of technical factors keeping the market range bound. It sat in a technical trap. A bearish reading on the economy and credit markets was becoming consensus. In the classic irony that marks the operation of markets, those concerns drove highly defensive positioning by investors. These included large short positions and a strong bear skew in the put/call ratio, suggesting an over sold market. The market sat poised between concern regarding fundamentals and a technically driven risk of a sharp short covering rally.

So whilst the newsflow has been bad, the market is still skirting a serious correction. The question is, has all the bad news been discounted? Or if not, what additional negative will drive it below the current band? Will it be some acceleration in economic decline? A serious challenge to the survival of a 'too big to fail' institution? Question marks over Chinese growth? Or the less obvious,

slow but incessant loss of liquidity through the de-leveraging of the financial system? Alternatively, from its over-sold position, crazy as it sounds, might a serious bear rally be launched by better than expected outcomes against a backdrop of low expectations?

The Greenspan Put revisited

Ben Bernanke has sat at the epicentre of the periods travails. Bernanke and the Fed are essential to the consideration because they sit at the centre of a critical market belief system; don't bet against the Fed, eventually it will put a bottom on the market, it always does. This verging on religious belief, captured in the idea of the Greenspan Put, (see [Thought Piece: Economic Management and Monetary Dilemma – 30 October 2006](#)), sits at the heart of US market dynamics. It is intriguing, because in Western Europe or Japan there is no such belief as to the power of Central Banks. History does not support the view. It is an American phenomenon.

Bernanke's testimony to the US Congress and Senate at the end of February captured the dilemma faced by markets.

His reference to the weakness of the US economy should not have struck anyone as out of order, though it did challenge parts of the community scared to acknowledge the possibility of a recession. Of course, Bernanke, and the Administration, must be careful not to talk down economic confidence. The only judgement here may be that Bernanke and the Fed failed to take warnings as to the ultimate impact of sub prime market on the US sufficiently seriously. There is widely held view that the Fed had been warned at around the time of its Jackson Hole symposium in September last year as to the risks, and failed to take them seriously at that point.

It was the tension in his current policy stance that was striking. Here was a Fed Chairman talking in vague terms about the likelihood of bank failures, the weakness of the US economy, the policy dilemma of the Fed in the face of commodity driven inflationary pressure.

But he also highlighted the benefits of a weak US dollar to economic growth, by way of the stimulus to exports. However, commodity prices are in part being fuelled by the weak US dollar. And a highly leveraged US economy is dependent on foreign funding. A Central Banker who

is talking about the benefits of using the world's reserve currency to stimulate the domestic economy, whilst being concerned about inflation, looks to be committing either an act of desperation or foolishness.

It strikes right at the heart of faith in the capacity of the Fed to underpin the system, embodied in the past in the Greenspan put. Bears jumped at the contradiction. Further to this, rate cuts showed no capacity to re-liquify credit markets, or stimulate consumption in the face of fragile consumer balance sheets. So if the Fed is going to support the value of equities, or the US economy, it will need to be through some collection of policy responses we are yet to see. A fed intervention that holds the banking system together is primarily about survival, not growth. Survival of the system is essential, and will drop credit costs, but the equity markets are not factoring in current credit costs.

Chart 2 below highlights the blow out in borrowing costs as expressed by the spread between the interbank market and government bonds in the US.

**Chart 2 – Credit Crunch
US 2 Year Bond Swap Spread**



Source: Bloomberg

So can the 'bull market' survive the death of one of its key underpinnings, the capacity of monetary policy to support asset prices?

The stagflation dilemma

How should we consider the threat of inflation in the current environment? The dominant narrative in the market regarding inflation focuses on the question of the impact of a weak US dollar and the related phenomenon of high commodity prices as an inflation trigger. A variation on this theme is the idea that inflation can co-exist with low effective demand producing stagflation.

We are more focused on price increases echoing shifts in the bargaining position of various factors of production. The Keynesian view of inflation was built around tension regarding income distribution. That is the crux of the idea of a wage-price spiral. It is unsurprising that the low inflation of the past 15-20 years has been marked by the absence of a wage price spiral, and that this has gone hand in hand with the dramatic increase in profit share in the economy.

Further boosting returns on capital has been a corporate sector which has made a virtue out of low levels of investment, i.e. undercapitalisation, matched by governments that have favoured tax cuts over infrastructure investment.

We now see the end of this phase.

Factor costs are now rising. Labour costs are rising. Not in the developed world, but in China and India. Commodity prices are rising, reflecting both the demand coming from the developing economies, but also the underinvestment in commodity production, agriculture, and ancillary infrastructure. That investment is now proceeding in earnest, but it will take years to impact supply.

The question is to what extent will an economic slowdown mitigate the increase in these prices, holding back demand, versus the impact of supply constraints. Rather than looking for a rise in inflation as measured by traditional measures, we expect to see relative price rises having significant impact. A rise in certain factor input prices will be matched by a decline in asset prices, and rents on property. Margins can be squeezed, emphasised against a backdrop of weak effective demand.

I was interested to hear a fund manager talk on the ubiquitous CNBC about gold. This manager said that he was concerned about investing in gold as the gold price move represented a bubble. He didn't say that the gold price move might reflect US dollar weakness. And that is precisely the point. Gold unlike other commodities is unashamedly a financial asset. Its price has gone up when denominated in US dollars. A question facing the system is the impact of the world's reserve currency now depreciating in part it would seem as a sanctioned element of the strategy to support the US domestic economy.

We are concerned that industrial commodities risk being over-owned as a ubiquitous hedge against US dollar weakness, whilst bearing a risk of a global slowdown, or any disappointment coming out of China. The question remains, will an economic slowdown offset the gains to be had by commodity producers in this environment?

We believe that a portion of these gains will be sustained by commodity producers, whilst being wary of the risk of price pull backs as the sector absorbs the immediate impact of negative economic news.

China – economic flash point

China remains an essential driver of the long-term story, but in the short term the market has understandably become more focused on the risks in China than growth. The more common way of considering the question of Chinese growth is with reference to 'coupling'. To what extent will a US slowdown precipitate a deceleration in China? We think that too much emphasis is placed on this point. We are more concerned to understand the domestic drivers of Chinese activity. To what extent might a Chinese slowdown be a function of local conditions, rather than an export slowdown? Or might an export slowdown which is on the surface marginal instigate more significant risks to the Chinese economy.

The Chinese economy has been driven not just by exports, but also by massive investments in local infrastructure, and property construction echoing a major shift of population towards large cities.

Inflationary pressure has been mounting in China for some time.

That pressure was initially more than offset by productivity enhancements in industry. Moves in commodity prices, an inflationary force, were seen in part as a consequence of the action of speculative interests. This view is no longer sustainable.

The relatively low levels of investment in agricultural production now threaten economic stability. Furthermore the high levels of fixed asset investment are clearly the key driver of many global commodity prices.

Cheap credit creation in China echoes the massive credit creation attributed in part to Alan Greenspan in the US. The Chinese are now clamping down on that credit creation. Major increases in investment in agriculture have been announced. We are now to witness the nature of the deceleration on the Chinese economy. Initial evidence is mixed. China could surprise on the upside here, but commodity markets are in part positioned for continuing Chinese strength.

The Chinese market is now correcting sharply.

But China is also a key piece of the puzzle 'short cycle: long cycle' puzzle. Pivotal in the shift in the global economy is the growing inability of US monetary policy to sustain demand. China, whilst currently reducing monetary stimulus, is not so constrained. It may be China that restimulates global demand, not the Fed, which marks the evolution of the economy to the next cycle. We watch attentively the evolution of the currency peg, Chinese inflation and monetary policy. But we are also aware that this transition may crystallise a shift in global leadership with geo-political consequences which are hard to dimension. All transition phases are difficult to dimension!

Summary

Our current strategy regarding stocks is simply to avoid financials, and find a collection of attractive franchises across a range of sectors at reasonable prices that are reasonably positioned to avoid structural downdrafts. Avoiding the over-owned situation is crucial. The environment remains fraught with danger and we continue to take a very conservative stance with regard to portfolio positioning until we move further through the current global work-out of the ongoing issues related to the credit crisis.

Five Oceans Asset Management

March 2008

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