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Investment Strategy | Australia

Why US policy decisions matter for Australian investors

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Hope is not a strategy

This entirely unoriginal phrase has been aptly used to debate the very significant policy decision facing the US. In light of softening economic momentum, a recovery cannot be assumed. The questions remain: Should there be further stimulus and if so, what form should it take? Then, what are the investment consequences?

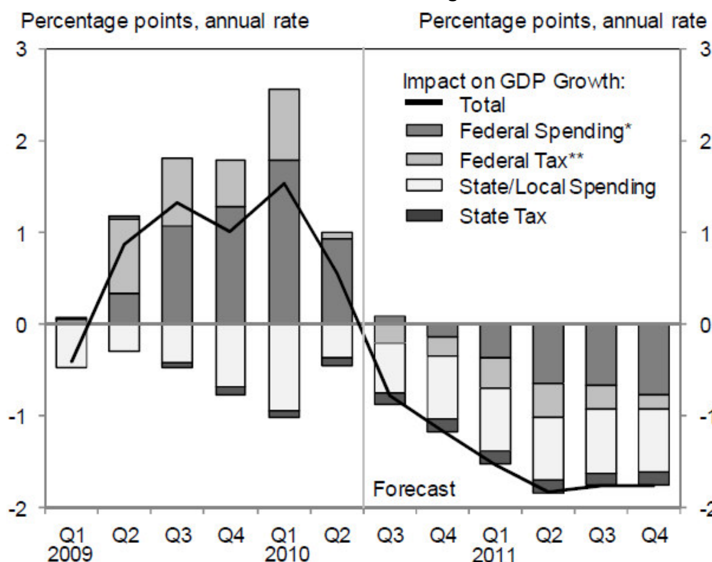
Relevance of the US

Australian investors may well ask why we have to be so considerate of US circumstances while our own economic outlook and the region that matters to us, appears to be very different. The US still remains, by a good margin, the largest economy in the globe (circa 25% of global GDP), has the highest proportionate weighting in global equity markets, the most active treasury sector and the US$ is still the fiat currency of the world. There is no way to entirely avoid the consequences of actions from the US. US growth is likely to filter into the developing world as a net importer from this region. The US$ value itself is of important as most commodities are still priced in US$ and most of the rest of the world holds various forms of US$ denominated debt.

Growth concerns and the policy quandary

The premise of US GDP growth slow enough to require action is based on recent data showing moderating consumption spending and little improvement in employment. During late 2009 and early 2010 fiscal support in the form of tax cuts and federal spending was complemented by the improvement in industrial activity. However with the potential for tax cuts to be reversed and unemployment benefits curtailed, the consumer spending lift seen earlier this year appears to have faded away to a trickle. Without some trigger, GDP growth may well ease off to 1.0 - 2.0% by year end, and show little sign of emerging onto a better platform over 2011.

Fiscal boom to fiscal drag?



Source: Goldman Sachs ECS Research estimates

The danger is then that the US economy enters a stalemate, with inflation at around zero and no break in unemployment. Traditional monetary policy is rendered ineffective as official interest rates cannot go lower and fiscal policy is handicapped by the already high deficit with low revenue from taxes due to the slow economic growth. The key is to find ways to get the private sector ball rolling. That is, from elements of investment spending, sustained consumption momentum, housing activity and export growth. Each, or some, of these segments has to regain sufficient confidence to change behaviour.

Gloomy predictions are made that the US could enter a "Japan like' era, where even with persistent debt based spending for some decades, which took Japan into the highest debt/GDP of any developed nation, saw the growth line remain flat. Then there is the question of what the US should wish for: excess credit and consumption caused much of the financial downturn, why would one aim to revive that?

The debate on the next step for the US economy has flared up in the financial press as well as from the US Federal Reserve itself. The views put forward below are a summary of this discussion.

The next move

The purpose of monetary and fiscal measures has been two fold. Firstly to put a floor to economic activity and support to households left with little or no alternative cash flow. The second is to stabilise financial systems, through the recovery in credit markets and reduction in credit spreads. At face value this has been successful. The nature of setting policy in distress is that it invariably is driven by short term considerations rather than long term goals. We are now at that 'longer term' point where the next decision will need to demonstrate that post recovery growth can be imbedded.

Each choice has downside: the question is which is the least damaging and potentially most rewarding longer term.

Fiscal measures include another round of incentives to spend (e.g. 'cash for clunkers' and house buying subsidies) or cheques in the mail. These have inherent problems as they can add significantly to the budget deficit and service costs at a time when 'bond vigilantes' are waiting to see if policy mistakes result in unsustainable budgetary outcomes. Further, to date they have proven to be temporal and done little to shift the key employment data. While some supportive measures are appropriate for disadvantaged groups, a full scale household stimulus would be unlikely. Running into a difficult mid term election, both sides of politics in the US are likely to want to be seen taking a strong stance which may prove unhelpful in achieving a rationale outcome.

A potentially more rewarding set of measures would aim at industry. Suggestions include investment in clean energy, upgraded power grid, infrastructure and education at all levels to improve job skills. Of course this makes sense, but whether it is sufficient to move the dial on GDP at a sufficient speed is debatable.

The more likely outcome is monetary policy. In July the Federal Reserve Bank member, James Bullard, published a paper on the theory and practical application of potential policy settings in the current situation. This has lead to suggestions that the US Fed will shortly be undertaking another round of easing. Of course, easing in the US is no longer about reducing interest rates as they can't go down any further.

The policy conclusion Bullard comes to is for the Fed to renew its strategy of buying assets off the financial system adding to liquidity – quantitative easing. Over the past year the Fed has bought a large amount of mortgage backed securities which are maturing. It could elect to use these proceeds to continue buying assets (likely to be Treasuries), even though many are concerned about the significant expansion of the Fed's balance sheet. The question is whether this will have an impact on economic growth?

As Bullard points out, the US is closer to a Japanese-style low growth ineffective policy than any other time in history. The low interest rates and language on keeping interest rates low for an 'extended period' may not be helpful. Rather than encourage action due to the low cost of capital, it appears to have resulted in a delay in credit growth as there is no urgency and the Fed is effectively signalling that underlying economic trends are worrying, hardly an inducement to credit demand.

Private sector credit growth is critical

Achieving credit flow to the business sector is the core of the issue. Corporate profit growth has been stronger than expected, with companies beating guidance. The corporate credit market has been solid especially for large companies. Yet there has been little investment activity by corporations in general and cash accumulation seems to be the ethos of the day.

Chairman of the Fed, Ben Bernanke addressed the question of credit to small business in a recent presentation. He mentioned that small business employs roughly half of all Americans and accounts for 60% of all job creation. Yet over the past 18 months loans to small business has dropped. The question is how much is due to weaker demand versus restricted supply. While the authorities can influence supply and the price of supply through monetary policy, they struggle to create demand, which is essentially driven by business confidence In that context, the policy setting and language on direction of the economy is something the Fed has to undertake with care.

Credit supply depends on the health of the financial system. To a significant extent that has recovered, with recapitalisations stress tests. Another aspect is the assessment of the creditworthiness of borrowers and the security they can provide. In line with comments we hear from within the Australian business community, borrowers are struggling to convince banks to lend without

onerous collateral. As businesses, in general, shift from asset based to service based, the problems in assessing creditworthiness increase as the important metrics are cash flow track record and forecast

Investment consequences
Global investment markets have become highly sensitive to these broader themes. The European sovereign debt problems quickly translated into weak global equity performance and increased the funding problems for our local banks. Similarly the potential for uncertain policy while the US economic momentum fades could again dampen confidence in the emerging recovery.

It highlights the problem that we remain in untested waters and that the relatively stable domestic outlook may not result in stable investment returns. The recovery profile of global economies and investment markets to date has not been vastly different from the past but in inescapable fact is that the structural issues which caused the meltdown are still around and in some cases even more imbalanced.

There is also a possibility these issues may pass us by without major pain. For investors expecting guidance on outcomes, our views may present as fence sitting, loaded with possibilities rather than concise direction, but to continue using quotes: Voltaire said that "while doubt is not a pleasant condition, certainty is absurd". We believe it is important to present these debates as part of the decision making on portfolios.

Our specific advice is therefore to continue treating investment markets with caution. In broad terms we have focused on a solid low risk fixed income portfolio based across a combination of term deposits, hybrids, Australian fixed interest and global corporate credit. The purpose of this part of the portfolio is twofold: stable income and low volatility and secondly to allow investors to tolerate the higher risk in equity portfolios. Equities appear to be the most undervalued compared to expected and historic returns, but they are also the asset class that has the greatest instability, as they represent the riskiest part of an organisation's capital structure.

At a more direct level, the decisions in the US are likely to impact on the value of the US$. In turn this can have implications on Australian equity holdings, hedging on global investments and well as the flow of investment funds globally.

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