

# The recovery recovers

**Doug McTaggart**  
**November 2010**



QIC ABN 95 942 373 762 is a statutory government owned corporation regulated by State Government legislation pertaining to government owned corporations. The Corporations Act 2001 does not apply to QIC and, therefore, QIC does not hold an Australian financial services licence and the financial product disclosure provisions in the Corporations Act 2001 do not apply to QIC. However, the Corporations Act 2001 does apply to QIC's wholly-owned subsidiaries. Where required, QIC's subsidiaries have obtained an Australian financial services licence. QIC and its subsidiaries and associated entities, and their directors, employees and representatives ("the QIC Parties") do not warrant the accuracy or completeness of the information contained in this document ("the Information"). To the extent permitted by law, the QIC Parties disclaim all responsibility and liability for any loss or damage of any nature whatsoever which may be suffered by any person directly or indirectly through relying on the Information, whether that loss or damage is caused by any fault or negligence of the QIC Parties or otherwise. The Information is not intended to constitute advice and persons should seek professional advice before relying on the Information.

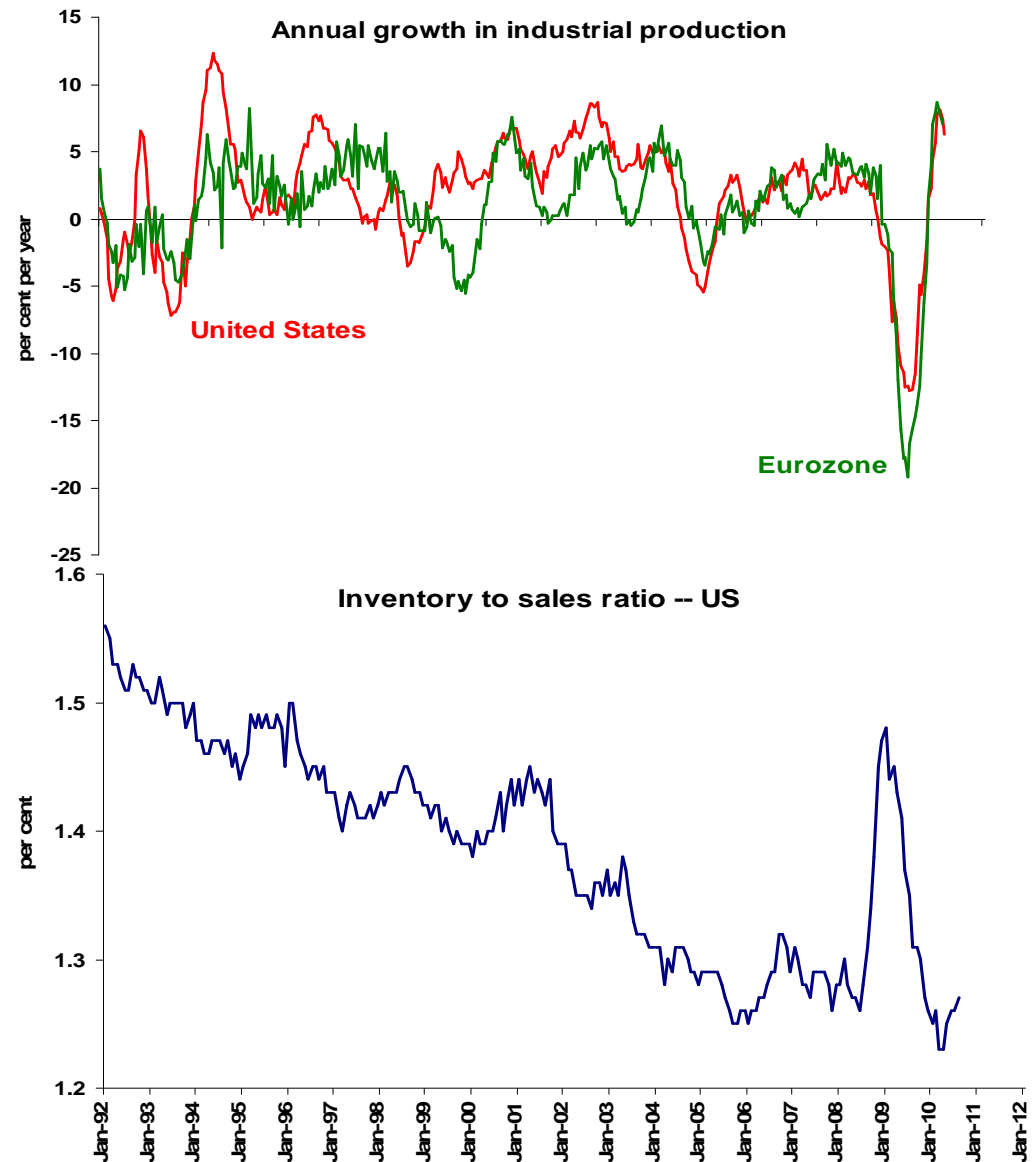
- The global economy was dragged into recession because households prudently stopped spending, and the paradox of thrift ensued, following the GFC
- “Green shoots” of recovery abound – V shaped!
- Interest rates are under upward pressure because of renewed growth, government borrowing and potential future inflation
- Future inflation is an issue
- The nexus between government debt and inflation poses problems
- Population growth will underpin housing in Anglo-economies for many years
- International equities still appear cheap

- Collapse of financial sector leverage led to a collapse of world growth in the fourth quarter 2008
  
- Order of proceedings was
  - Household confidence folded September 2008
  - Retail sales and broader consumption fell
  - Inventories/sales ratio soared
  - Business confidence collapsed
  - Manufacturing collapsed
  - Business investment contracted
  - Unemployment up
  
- End result
  - Collapse in inventories and world trade
  - Slowest global growth in over 50 years

# A recession in US and Euro manufacturing

Because discretionary consumer spending collapsed, inventories accumulated in a totally unexpected way. This led to a collapse in manufacturing

Industrial production fell at the rate of 12 per cent per year in the US, 20 per year on Europe, and 40 per cent per year in Japan



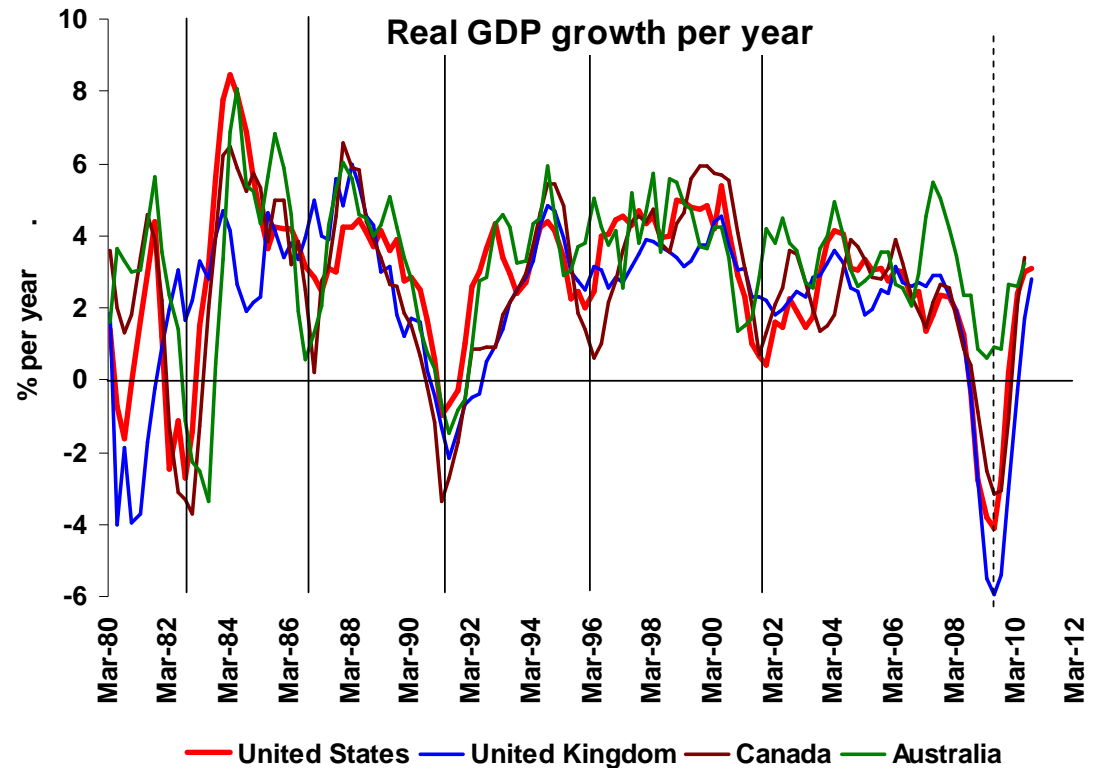
# The V-shaped global recession

Measured real GDP growth fell in nearly all economies

September 2007 shaped as the trough in a “normal” business cycle, until the GFC hit

A V-shaped deep trough occurred

Australia fared better than most, though now the pack is catching up

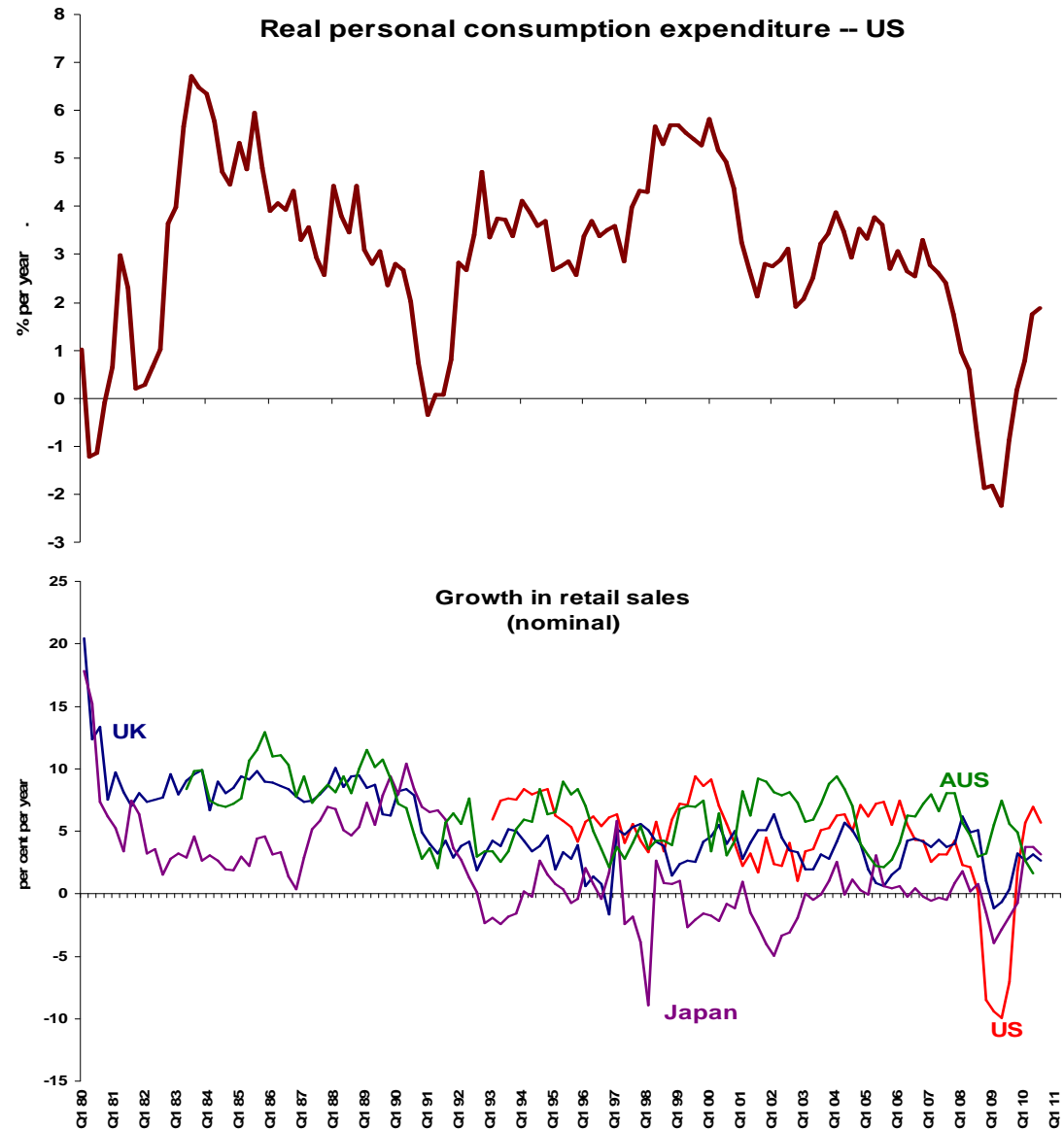


# Consumers return



Consumers who cut spending on discretionary items have returned relatively quickly

However, caution will prevail while the constant stream of gloomy news continues



# This US recovery is par for the course



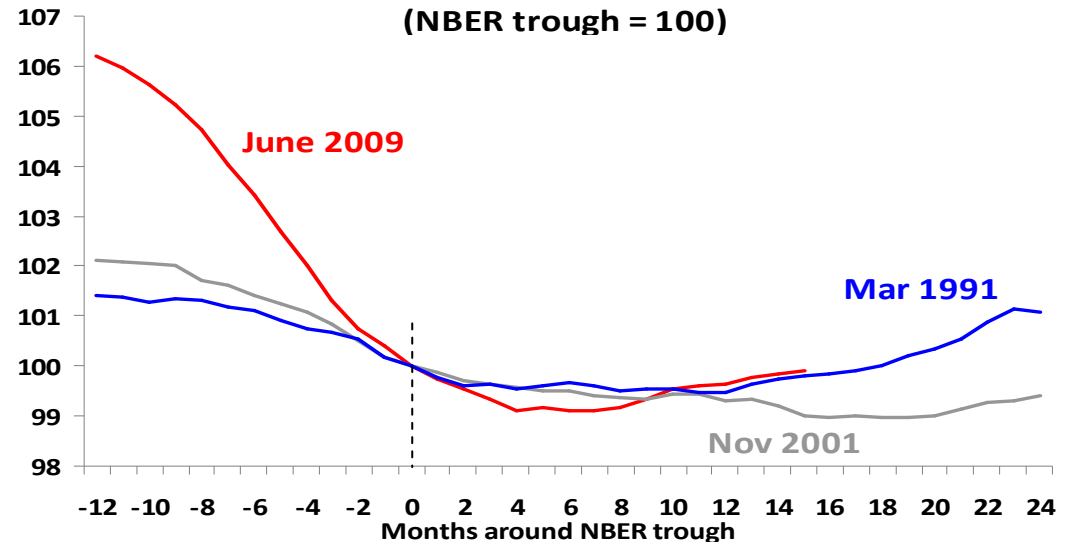
The US economy has recovered from the deep recession about as fast as it could have, and at least as fast as in past recessions

Why the current paranoia regarding double dips and so?

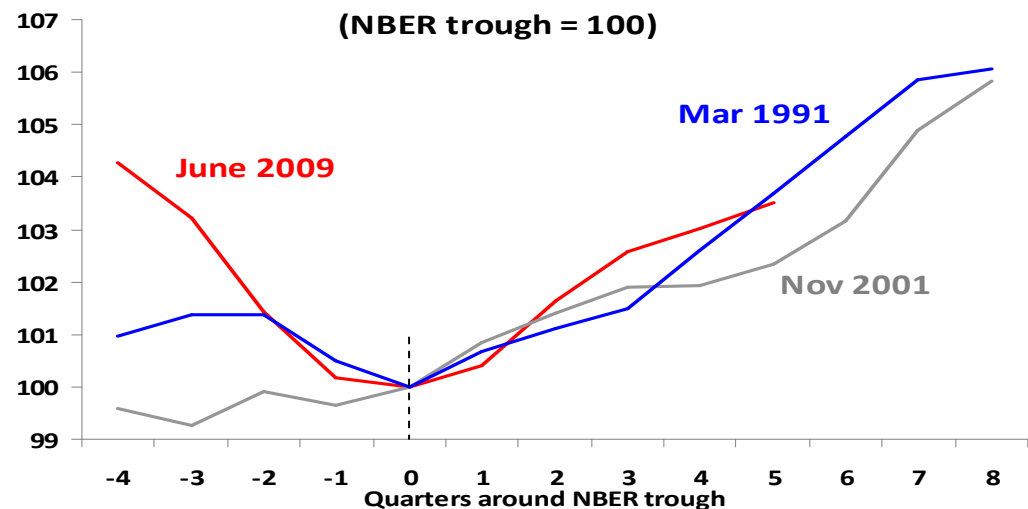
Because attitudes to risk have changed dramatically over the last two years

Equity risk premium at around 8%!

US private non-farm payroll employment  
(NBER trough = 100)



US Real GDP  
(NBER trough = 100)



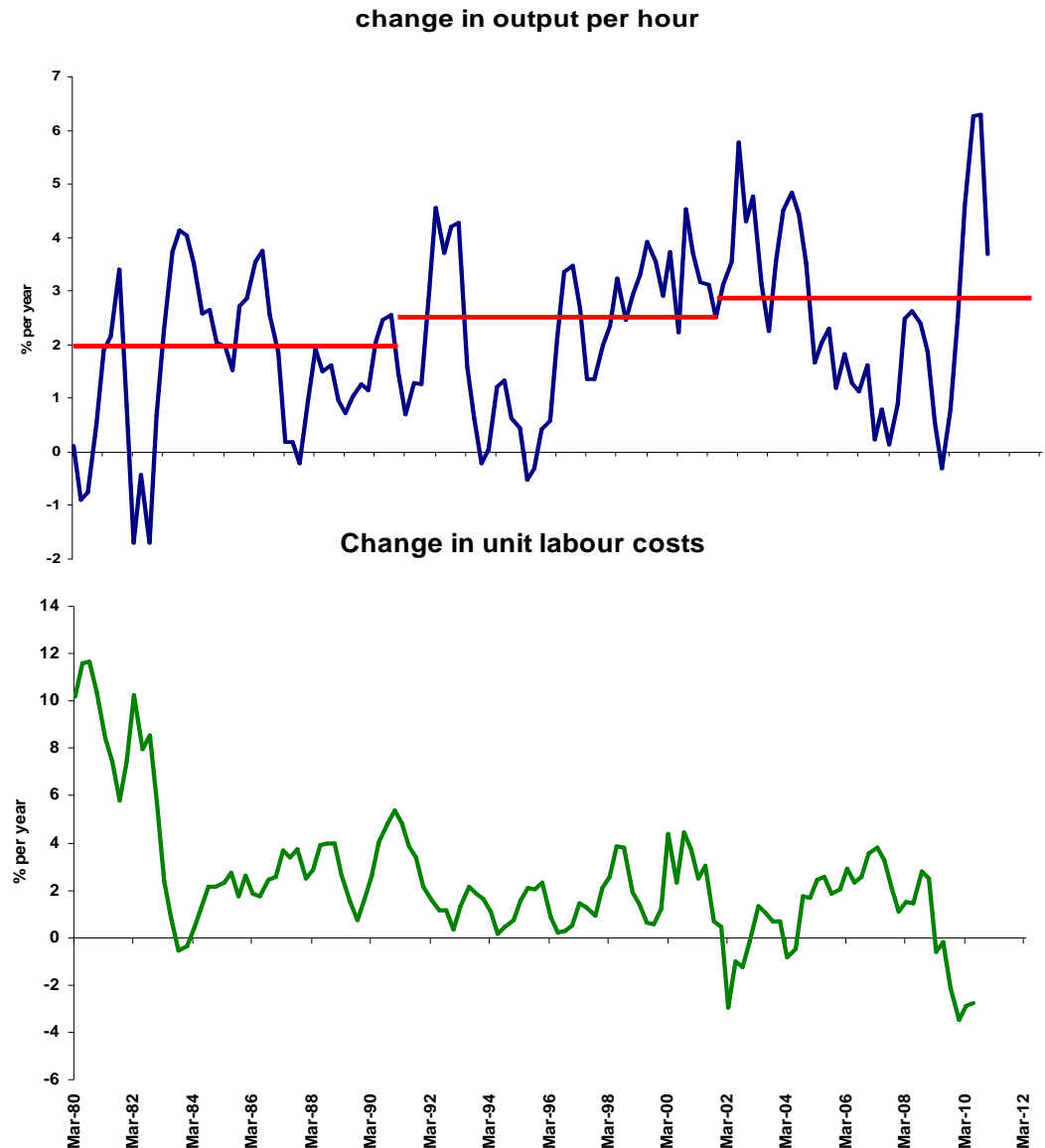
# The US economy reinvents itself .... again



By allowing the unemployment rate to reach double figures the US economy again goes through a process of “creative destruction”

The process of reinventing itself every decade or so ensures that the US remains the most efficient economy on the globe, with the best prospects for future growth

To paraphrase George Friedman from Stratfor: This is the beginning of the American Century



- The recent recession was one delivered by rational consumer behaviour as they took steps to guard against a financial market meltdown – the recession we chose to have
- Even as global financial markets are de-leveraging by about 50%, there is no evidence that households (US and other) are de-leveraging or are having to de-leverage going forward
- US economic growth is quickly returning to trend
- The US economy again reinvents itself – the “US century”?
- Why the current angst? Attitudes to risk have changed dramatically. Look at equity risk premiums.

# How has Australia done through the GFC?



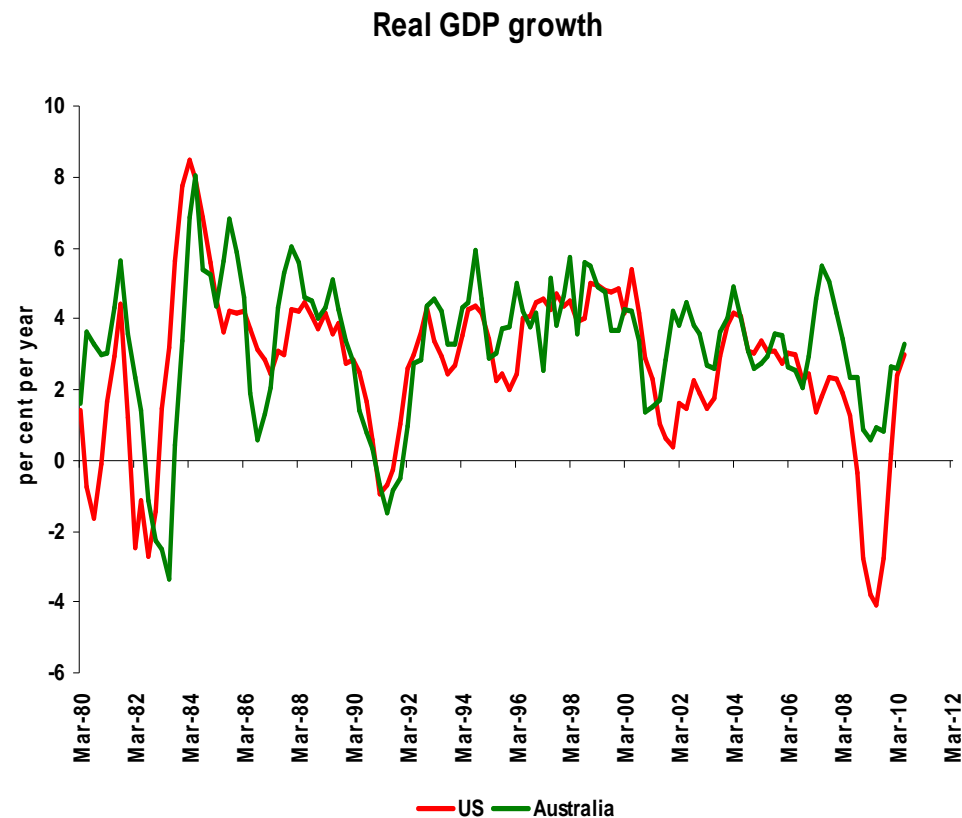
The Australian business cycle is still highly correlated with the US business cycle, albeit we have done somewhat better in recent times

It is clear the US drives the Australian business cycle

And note that average GDP growth was higher before the commodities boom than it was after:

3.3% 1990-2004

3.0% 2004-10



## Why Australia did relatively well

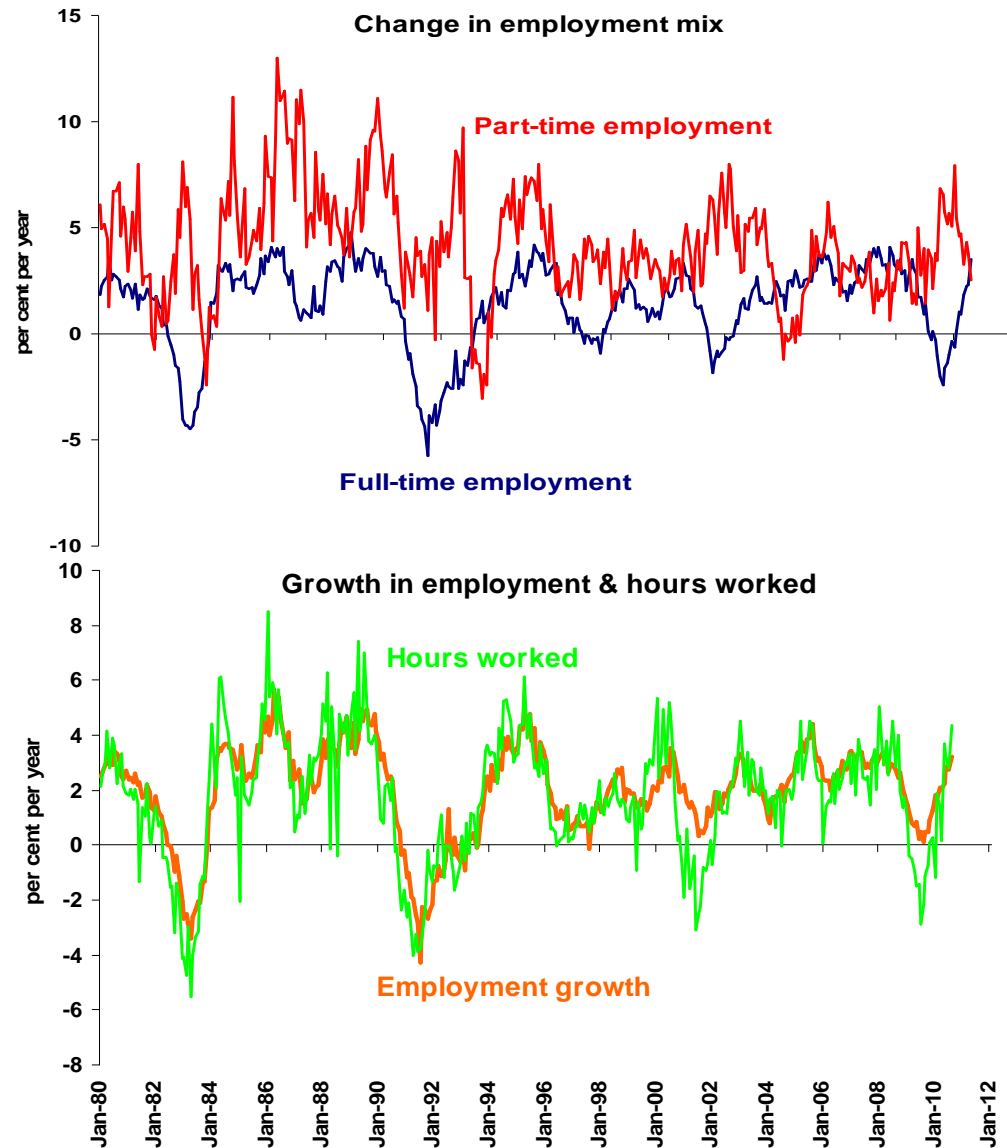


- Robust economy following years of broad-based reform
- Robust financial sector – even though relatively large
- National, uniform prudential legislation
- High immigration rates
- High initial interest rates and variable rate mortgages
- Falling oil/petrol prices
- Recent experience with skilled labour shortages, labour hoarding
- Relatively small manufacturing sector
- Predominance of bulk commodity exports
- Stimulus packages

# Labour hoarding in Australia

With recent skills shortages still in their memory, employers protected their interests by finding ways to keep employees on, but reducing their hours worked, increasing unpaid holidays and converting jobs to part-time work

These activities put a floor underneath the employment market

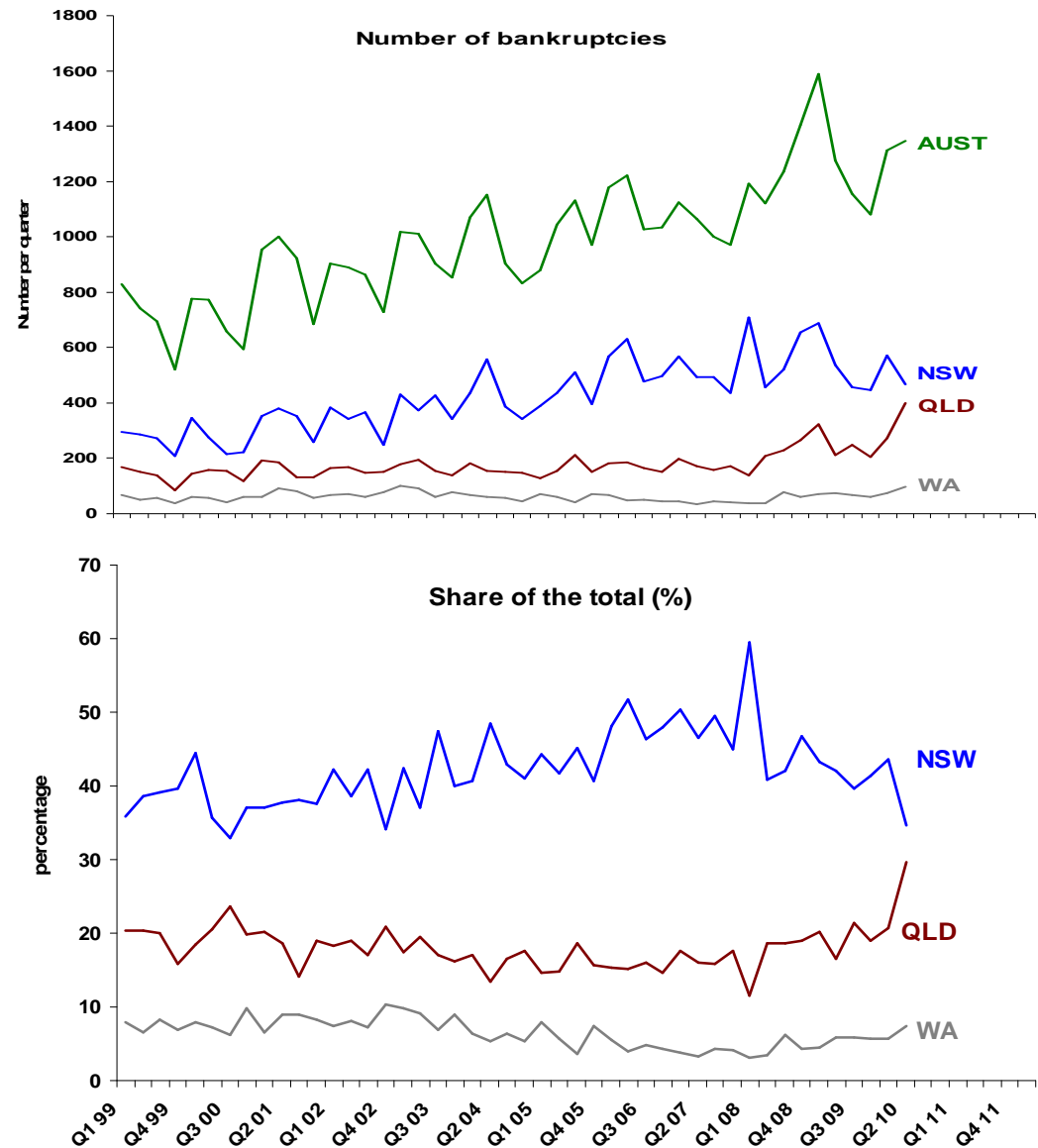


# Bankruptcies stabilising, but divergent

The raw bankruptcy data are very seasonal, but overall show signs of stabilising:

-- except in QLD

The impact of the commodities boom can be seen in the divergent behaviour of the resource state compared with NSW and Vic



## What are the risks?



- Household de-leveraging
- Credit squeeze
- Inflation
- Rising interest rates
- Commodities boom and two speed economy
- Housing bubble
- Foreign defaults

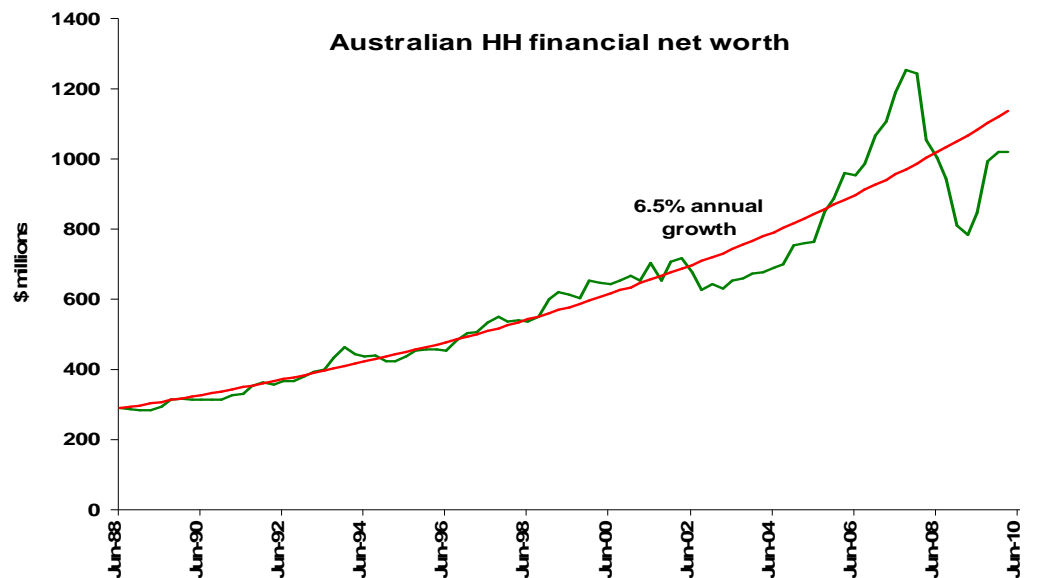
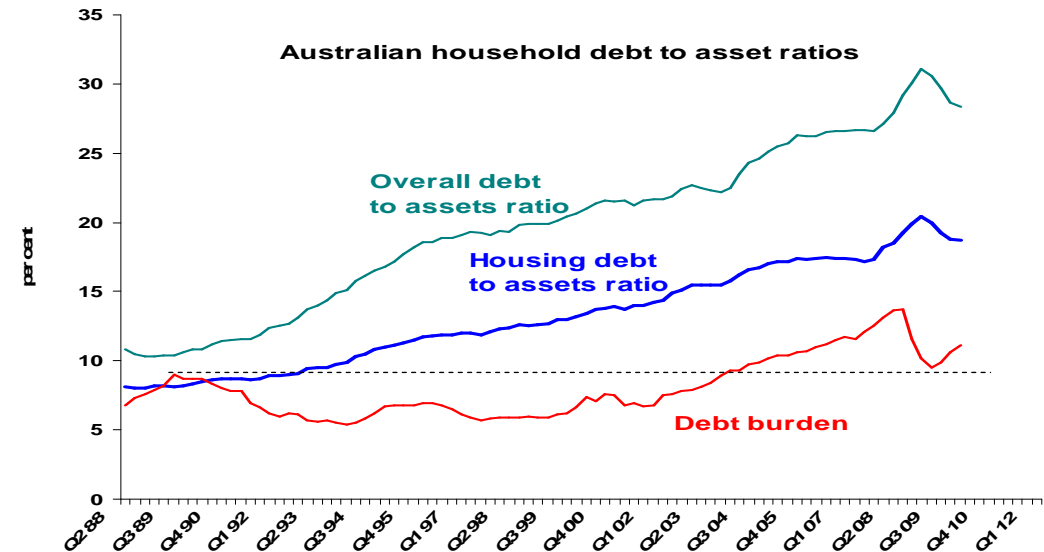
# Australian HH balance sheets strong



There have been significant mark-to-market hits to the HH balance sheet. However, balance sheets remain strong and growing as one would expect

US household balance sheets look very similar

Financial services sector is de-leveraging, as it should, but households are not

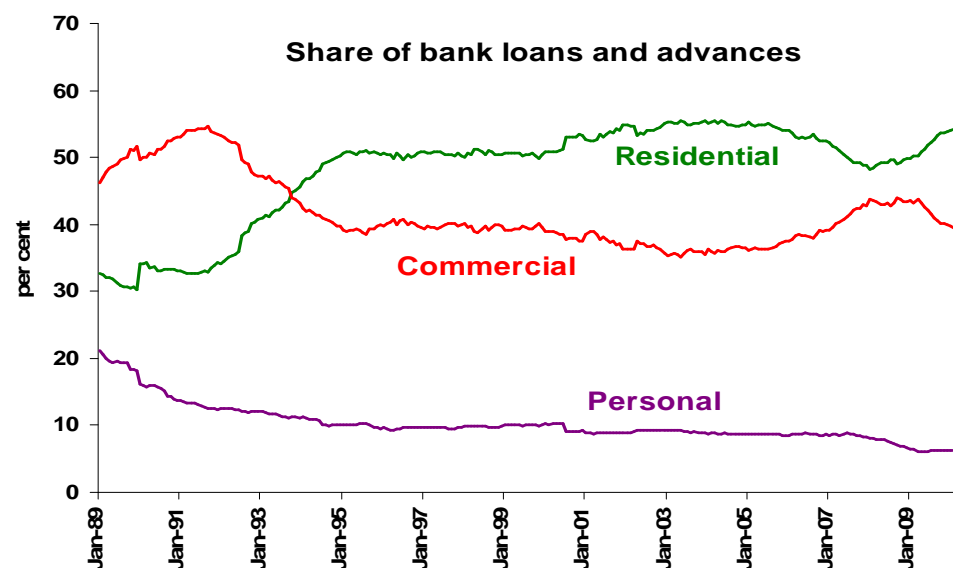
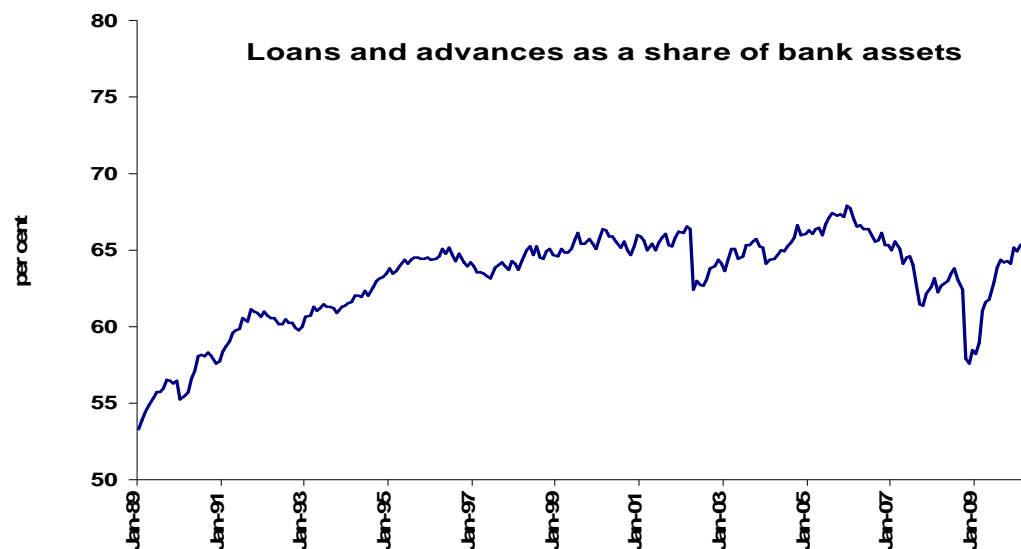


# A credit squeeze is on

The ratio of loans to assets reflects banks' willingness to lend. This varies with the cycle and collapsed during the GFC

Growth in loans and advances was 3% Jun to Dec and 0% since to Jun

Who banks lend to is also important and there would currently appear to be a squeeze on commercial loans as banks move back into the residential space as non-bank lenders have left the market



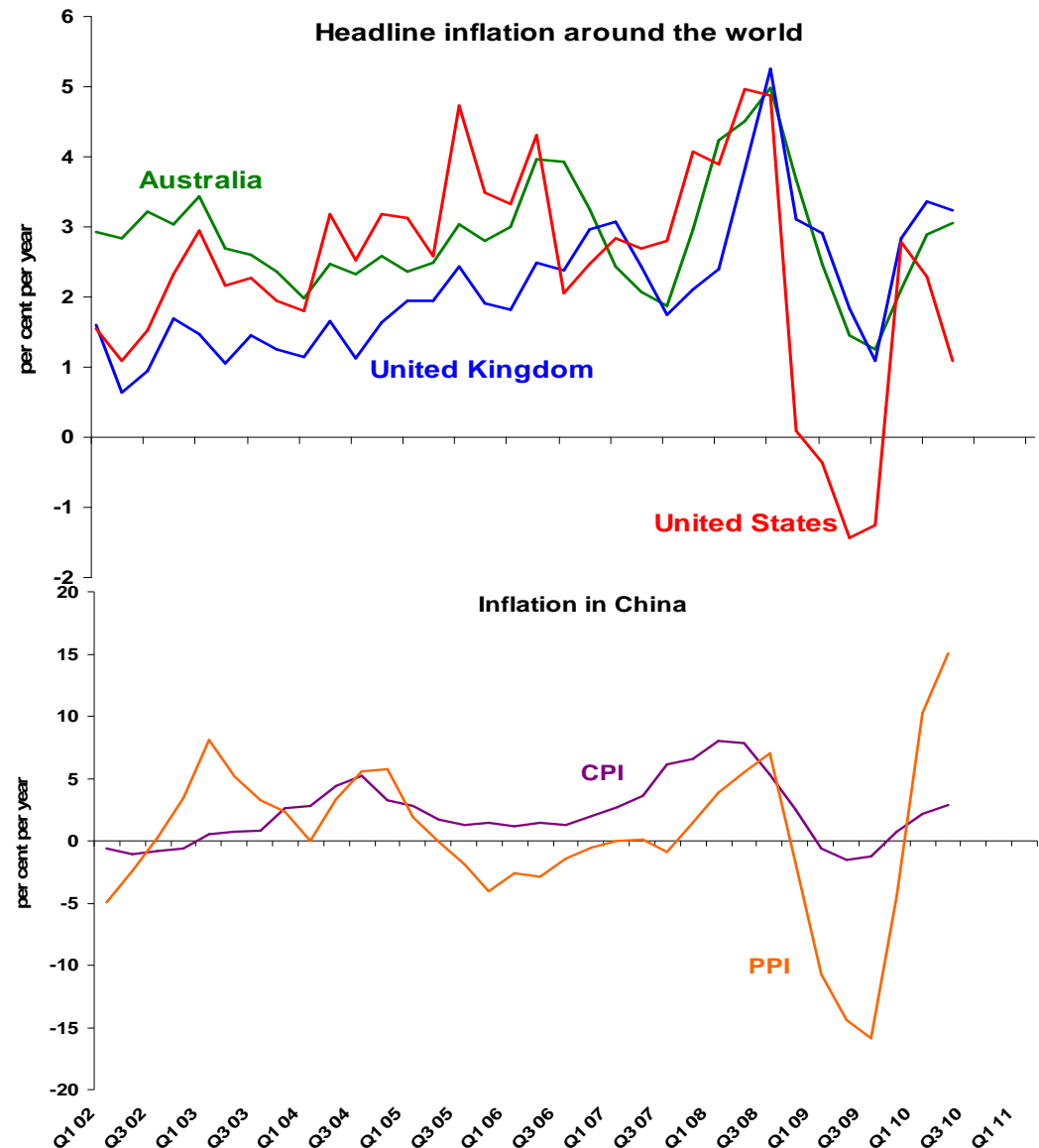
# Inflation – where from?

Only 24 months ago inflation was a global problem

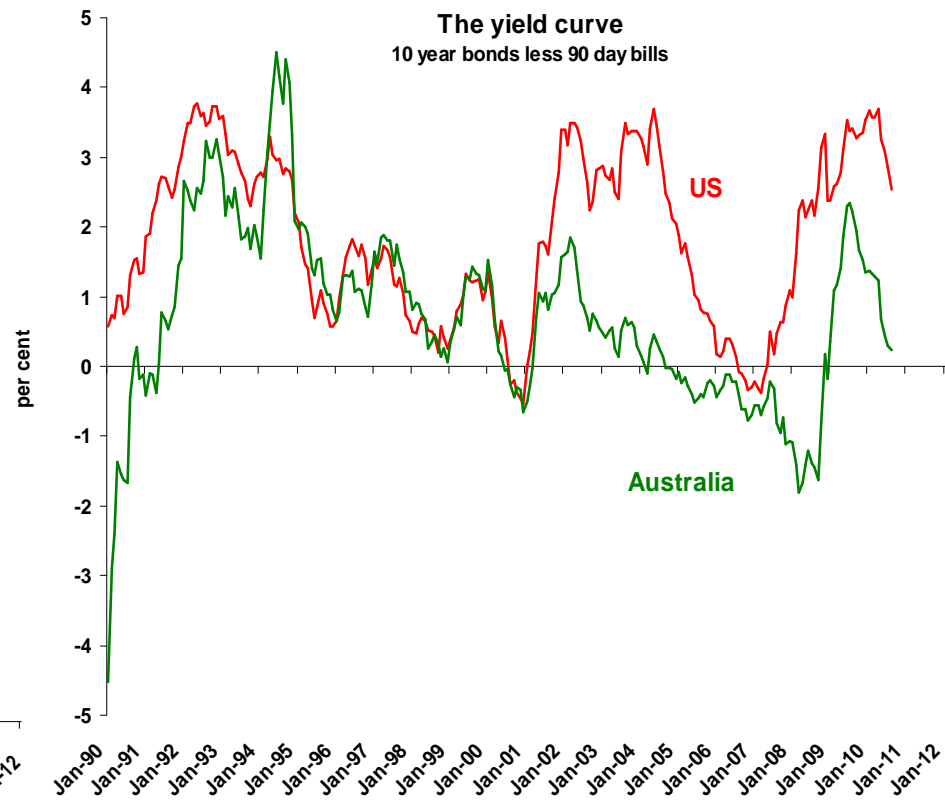
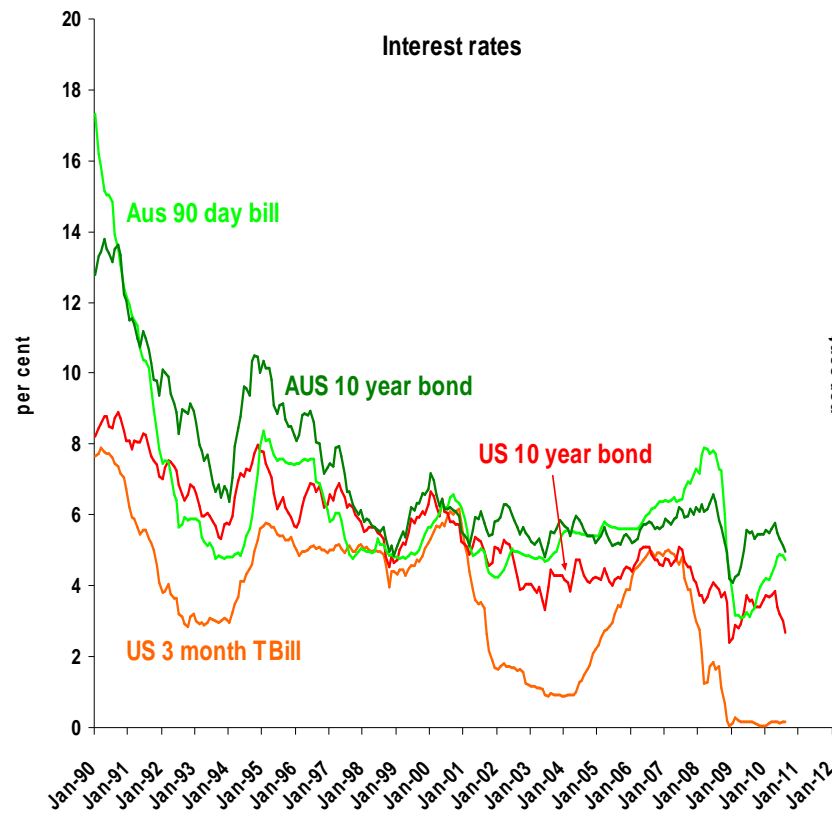
The GFC and subsequent global recession ended this discussion by providing a massive deflationary shock. Inflation will not originate at home

Will Asia begin exporting inflation again, soon?

Note the current level of wage inflation in the eastern part of China



# Interest rates – only way is up



# The commodity price boom

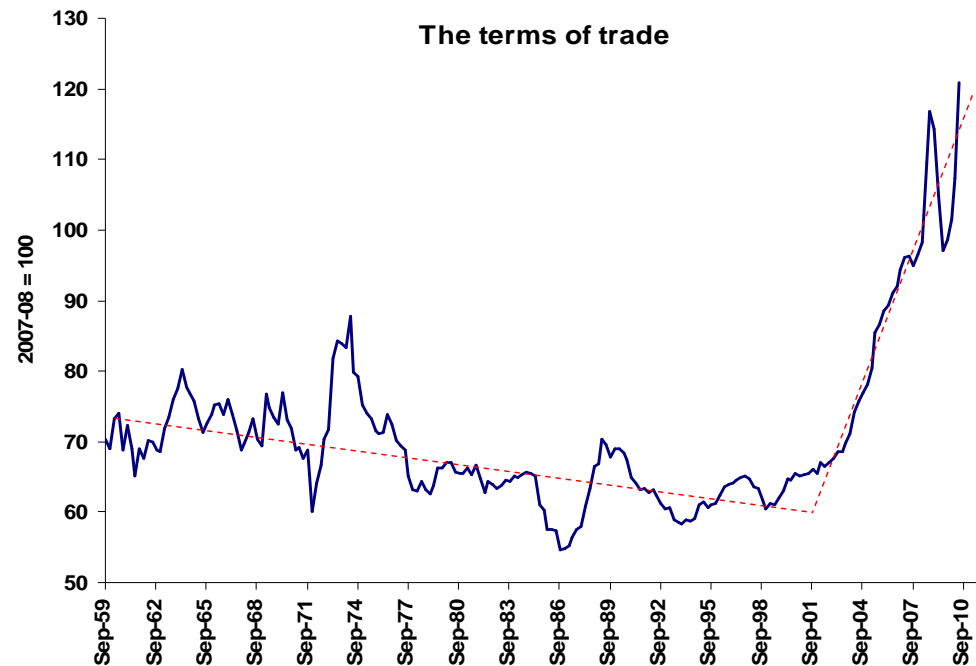


The commodities boom, beginning in the early 2000s, but accelerating in 2004, has been very much a price boom.

It has both supply and demand elements.

Global stocks of commodities, especially base metals, reached record lows in 2004, fuelling price rises

This coincided with increasing demand for Australian coal and iron ore from China, which between 2004 and 2008 went from being the world's largest importer of steel to the world's largest exporter



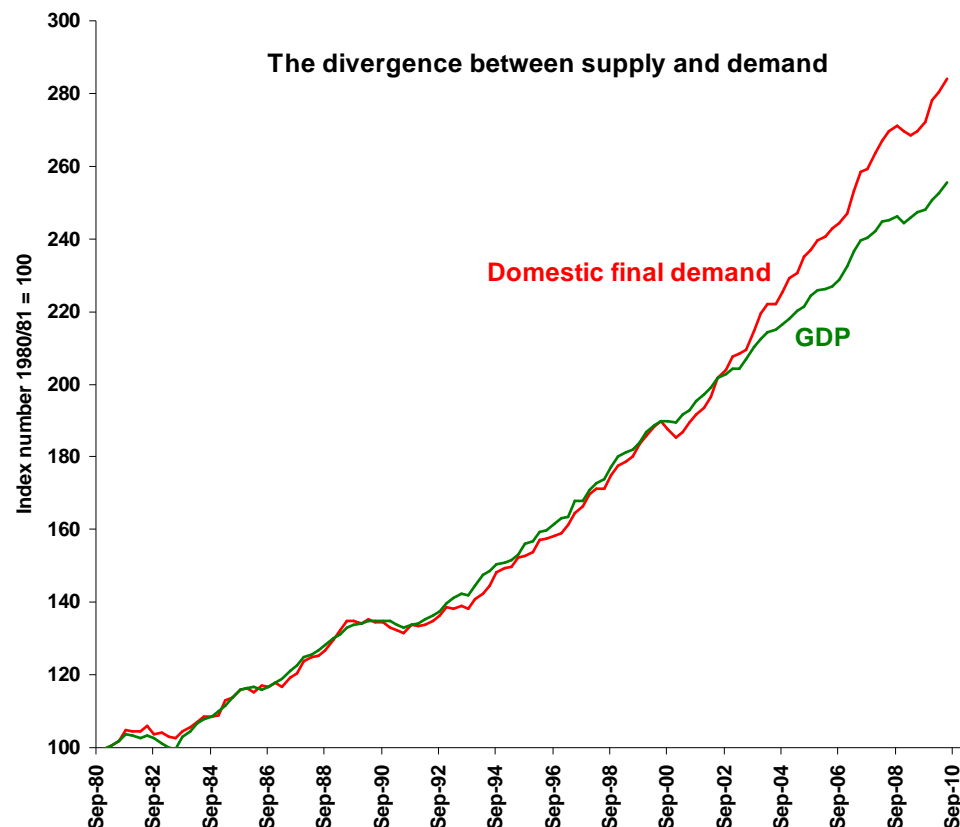
# And it has distorted the Australian economy



Since the resources boom has been primarily a price boom, not an export boom, demand has grown faster than supply

The difference is accounted for by a collapse in net exports

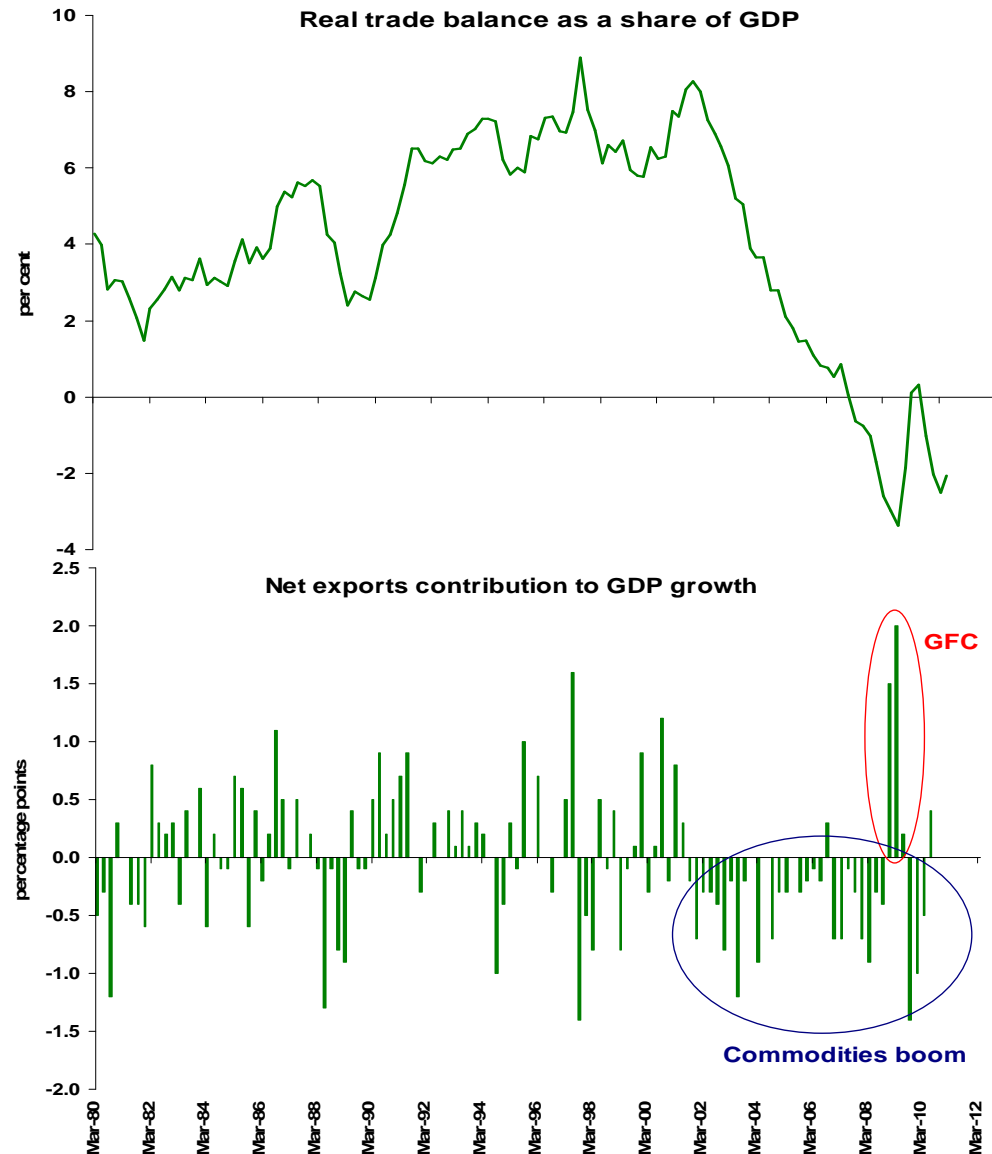
This is not sustainable in the long run



# And trade impacts?

For the entire period of the commodities boom, Australia's trade balance has deteriorated, except when imports crashed during the GFC as households curtailed consumption

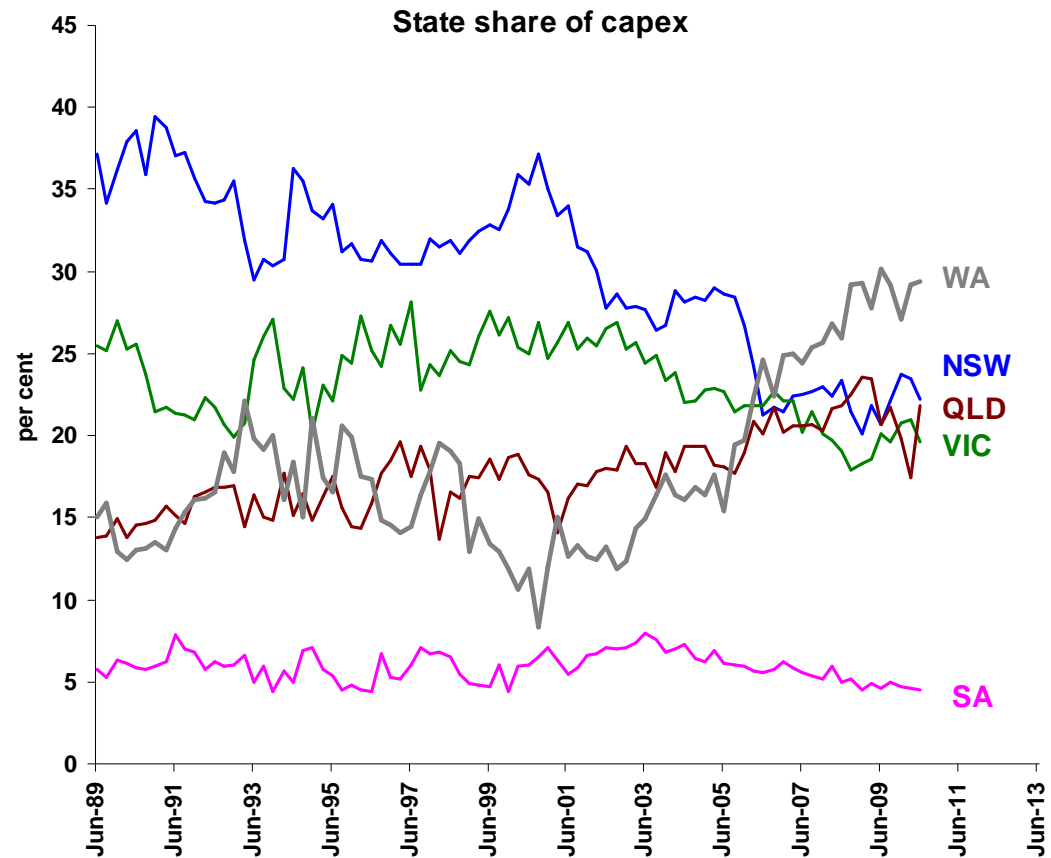
But isn't the commodities boom, for Australia, an export led boom?



# Uneven state impacts

The impacts have not been uniformly positive across Australia

- WA has dramatically increased its capex share, largely at the expense of NSW, with less significant impacts on VIC and SA
- QLD has done moderately well



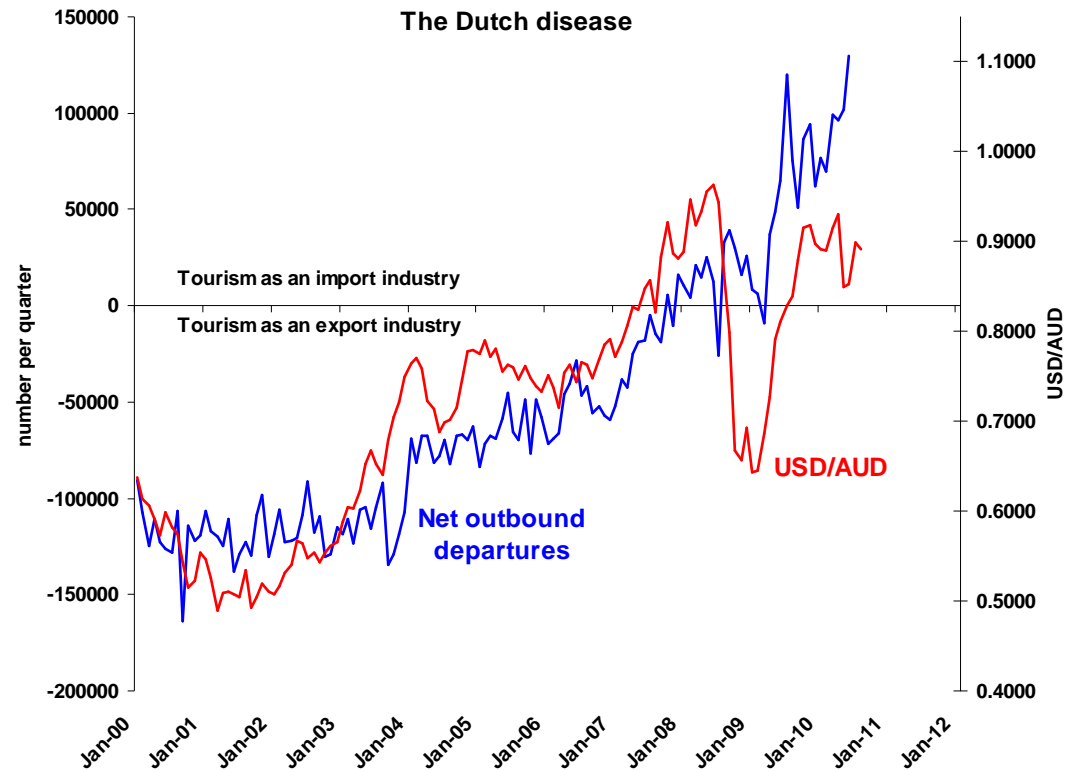
# Currency valuation effects



As the AUD appreciated, tourism changed from a large export industry to a large import industry

This is a dramatic example of the Dutch Disease (Gregory Thesis), and it applies across the board to all Australia export sectors outside of the resources sector

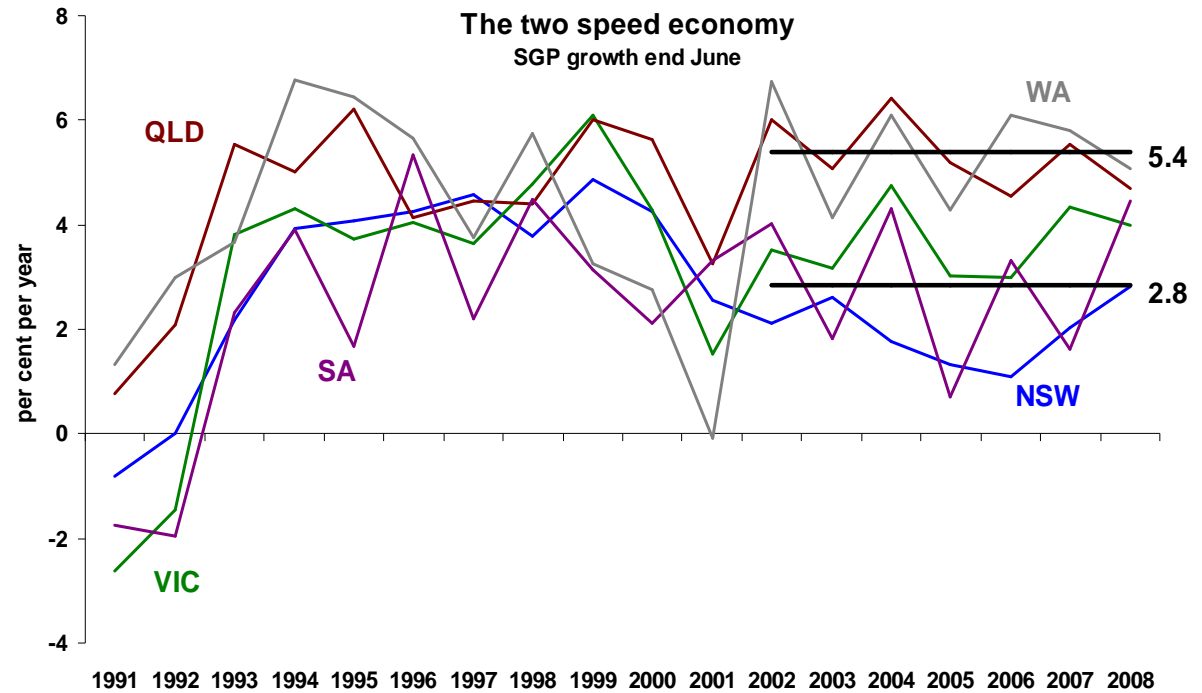
We haven't managed this very well.



# There was and will be again a two-speed economy



The resource rich states have done better than the other states as their traditional exports have been squeezed by the over valued exchange rate

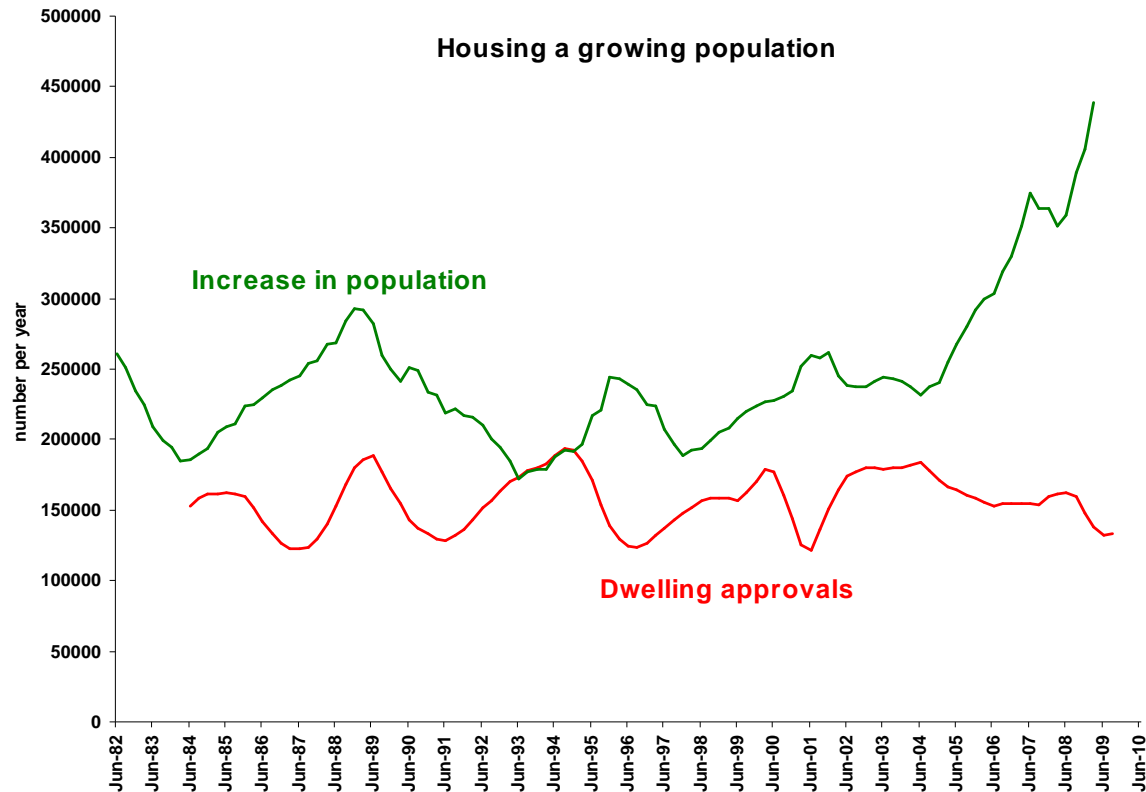


# Where will all Australians live?



We appear to be growing faster than our ability to provide housing

In fact, there is evidence that dwelling approvals are negatively correlated with population growth!



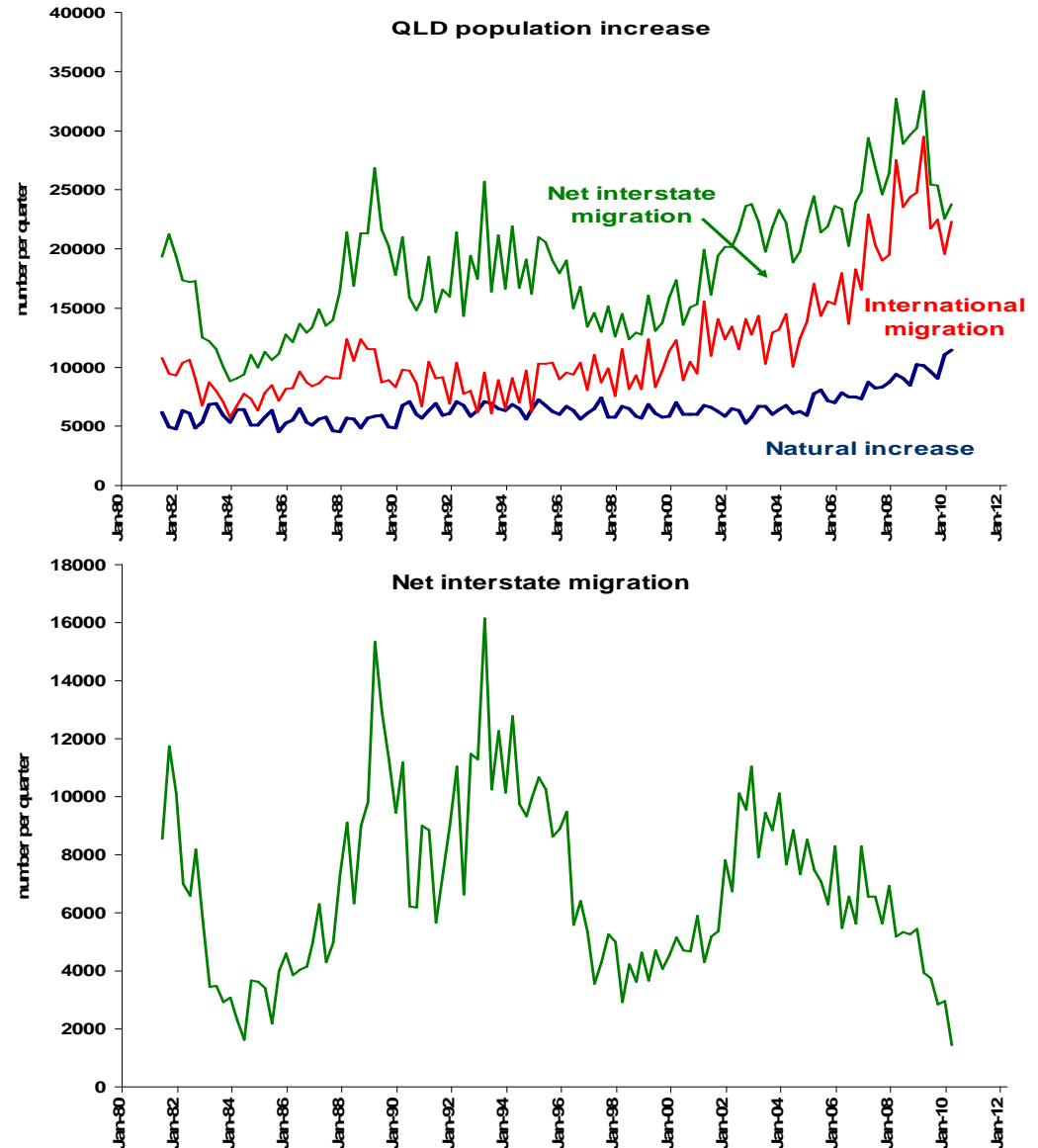
# QLD population growth suffering



The Queensland population growth rate is high because of the high natural growth rate and high international migration.

But both these sources of growth add less to the household formation growth rate

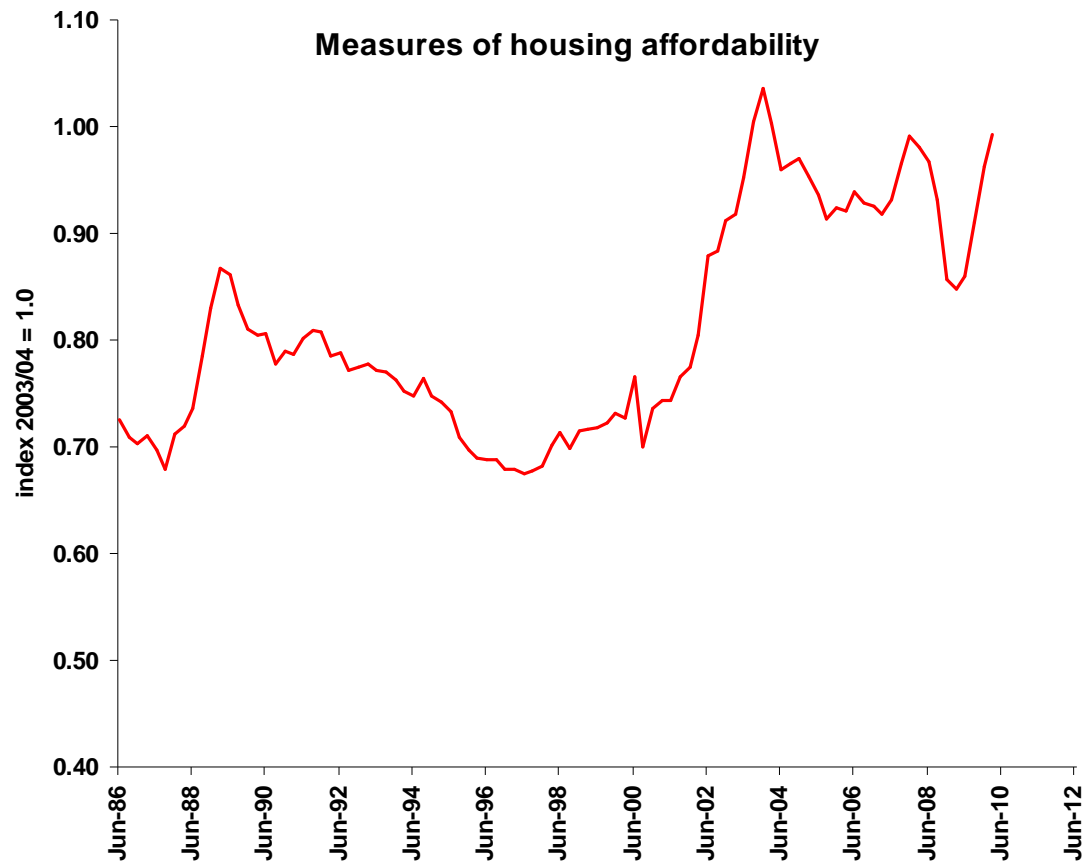
The past source of strong growth – net interstate migration – is at a very low level



# What about housing bubbles and affordability



Taking an index measure of average house prices divided by household disposable income shows that it takes more income to buy an average house today

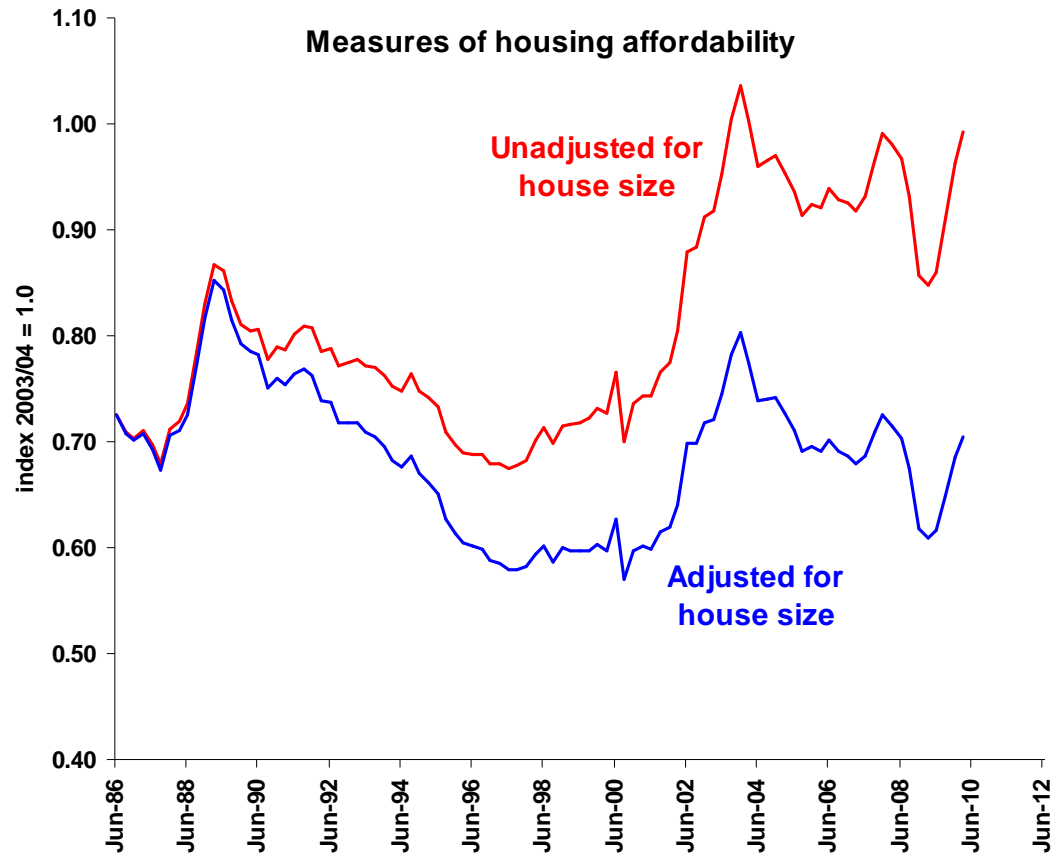


# What about housing bubbles and affordability



Taking an index measure of average house prices divided by household disposable income shows that it takes more income to buy an average house today

But, deflating house prices by house size gives a different picture!



# House and share prices

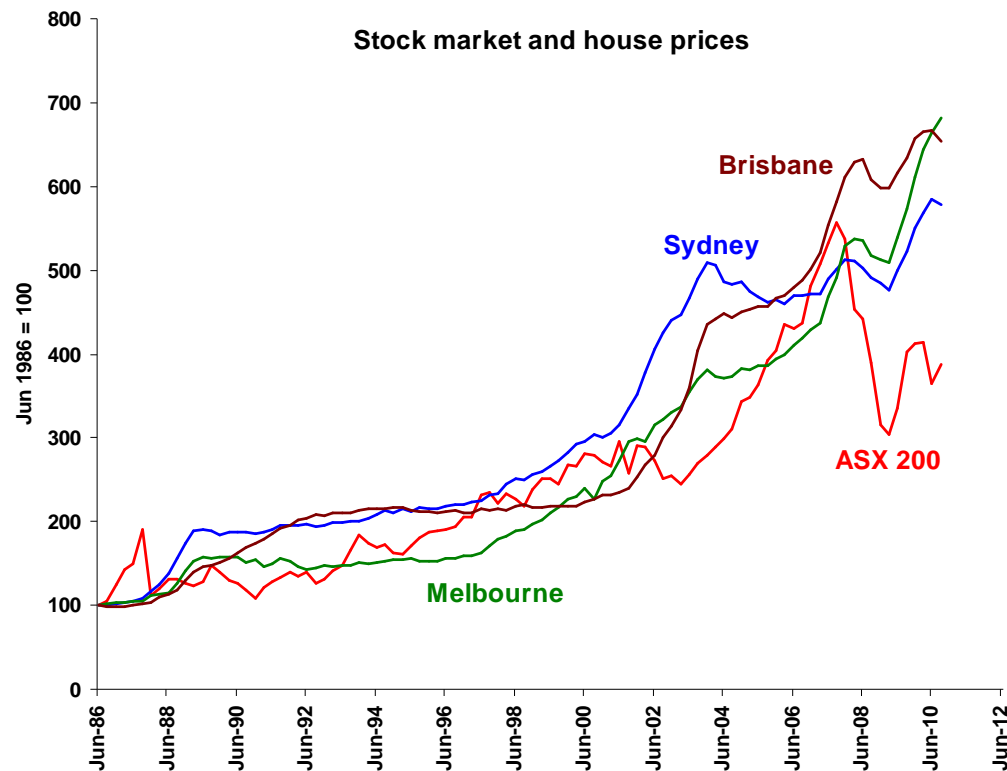


Established house prices have shown strong growth over the last two decades – but that growth has been “lumpy”

And we get long-run arbitrage with other growth assets

House prices are not in bubble territory

But equity risk is probably overpriced

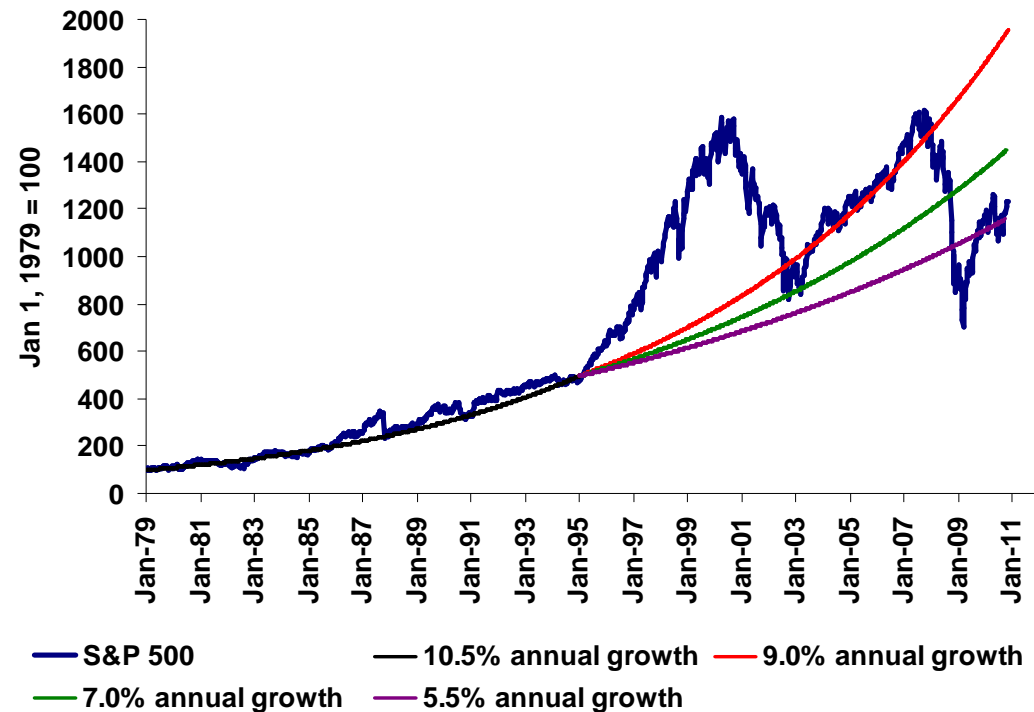


# US risk assets underpriced



The US stock market is trading at levels seen in 1998

### US stockmarket growth



- Global recession was caused by a justifiable collapse in household confidence – the recession we chose to have
- But as labour markets stabilised household confidence returned and resulted in V-shaped recession, with the resumption of normal growth
- To get a “W”, what would precipitate a second collapse in confidence?
- There are risks, of course
- Household de-leveraging is not one
- Rising interest rates will emerge with stronger growth
- Two significant medium terms risks are
  - Inflation is a significant medium term risk
  - Falling commodity prices
- Risk is over-priced and, therefore, risk assets are underpriced