



THE PAIN REPORT

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The Great Decoupling

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Australia's economic performance through the 'Born in the USA' global economic crisis has been particularly impressive. The October labour force report showed that Australian employment rose 24,500 and the unemployment rate was 5.8%. In America, we saw the unemployment rate in October rise to 10.2%. In an earlier Pain Report I suggested that the conduct of Australian companies had been both notable and commendable in that Australian employers have reduced working hours rather than engage in mass layoffs. American employers, in contrast have reduced their workforce by 7.3 million since December 2007.

Does this suggest that Australia has decided to forge its own corporate model and adopt a more European and Asian model? Over the last decade or more, financial markets have demanded that chief executives focus pretty much exclusively on 'shareholder value'. The Japanese model, much derided by Wall Street, has been staff first, customers second and shareholders third. It is still too early to tell, but perhaps Australia has elected to forge its

own approach and create its own corporate model. One that is neither Western nor Eastern, but simply Australian, or one, perhaps, that is a fusion of the best of both. Only time will tell, but I very much hope that we choose our own approach rather than the one taught at Harvard, and demanded on Wall Street. It is interesting to note that Richard Branson has always said that staff should come first rather than shareholders.

In the last Pain Report, I quoted the response from an equity analyst, to the news that International Paper Co. would fire 1,600 workers etc. The analyst said, 'This is highly positive for the company and the industry.' This quote painfully illuminates the great divide between Wall Street and Main Street and the obsessive reliance and emphasis on the shareholder value model. All of this brings me, albeit in a rather circuitous route, to the views I have been boring you all with for many years now, and possibly best described in various speeches and articles such as my 2003 speech, 'The Sleeping Giant Awakes', 'The Mother of all Crossroads', 2005 and,

'Consumed by Asia', January 2006. **Ultimately, it is the story of the great decoupling.**

Perhaps, now is a good time, particularly as we begin to look at 2010, for me to attempt to perform a reality check on where we are and where we might be going. Let us start at home. Australian house prices rose sharply in the third quarter and have now surpassed the previous peak recorded in the first quarter of 2008, according to the Australian Bureau of Statistics (ABS). As you are aware, in Q2 2008 I forecast a decline in Australian house prices of between 20-25% from their peak in Q1, over the next several years. Prices initially declined by approximately 6.7% but have now climbed above their previous high. We all know the reasons why, First Home Owners Grant (FHOG), 3% interest rates etc. I know I sound like a stuck record on this one, but I still believe house prices are way too high when compared to incomes and still see lower prices in the years ahead. Contrary to some sources, I did not say, in 2008, that house prices would fall 40% in the next year. My forecast was for house prices to decline 20—25% over the next several years and this forecast was first made in the second quarter of 2008. I hope I am wrong.

As stated above, Australia's economic performance since 2007 has been nothing short of miraculous and follows in the footsteps of two similarly significant escapes, notably our performance through the 1997/98 Asian crisis and the Tech bubble in 2000-2003. In all of these episodes the Australian economy performed, in relative terms, rather well. Now I know it is all too tempting to declare 'mission accomplished', as have many policy makers, and I do need to stress that our housing market is dreadfully expensive and we have got a horrible amount of household debt. So with these

two very important caveats we need to understand that as interest rates rise, as they appear destined to do, and given about 80% of our mortgage debt is variable in nature, that rising rates will pose a threat to consumer spending in 2010. But, having got that out of the way, I remain optimistic about Australia's long term future as it is now firmly underwritten by nations in developing Asia, particularly my two long term favourites, China and India. In early January 2006, in a Pain Report, 'Consumed by Asia', I wrote 'BHP is an Asia/China play, full stop. If you believe in Asia, you believe in BHP.' At the time BHP was priced at about A\$23 and then rose nearly 117% to a high of A\$50.0 on 16 May 2008. It then plunged to a level of A\$20 on 21 November 2008, although it traded at A\$20 for literally seconds. Since then it has worked its way back to A\$39.

As most of you know, I am not a stock picker, but when I find a company that is aligned with my macro view, I do get excited. Recently, I suggested that we are likely to see a rotation out of the banks into the resources sector, and I continue to hold that view. I have also been positive on gold, for some time now. However, I hasten to add, I am not a 'gold bug'. Gold bugs, of which there are an increasing number, have an almost religious devotion to gold, in an almost 'fundamentalist' fashion. I do, however, hear what this constituency is saying at the moment and whilst I don't subscribe to the more apocalyptic views, some have, I do see, the 'value' in gold as an insurance policy; a view I stated in March 2009. However, one problem I do see when getting an exposure to gold equities, is too often the company management get between the gold price and the share price. Namely, they mess up the hedging and quite often sell their gold production forward and the shareholder then sees little benefit as the gold price rises. So, do your homework or simply buy the physical gold. Please note, I am not a 'gold bug' and

I do not want lots of emails from you on why gold is going to \$5,000, as I get them already.

In an environment of free money, excess liquidity, soaring budget deficits and the debasement of the world's reserve currency and with virtually every developing world central bank increasing their gold reserves – yes, I can see the case for gold and, yes, I know India and China would buy every gold bar on the planet if they could. Slight exaggeration, of course, but you get my point.

Staying on the commodity theme for a moment, I have, as have many others, made the point that India and China have, and will continue to have, an insatiable appetite for raw materials. In recent weeks we have seen Chinese oil imports, once again rising sharply. Chinese net oil imports rose to 18.98 million metric tons, or 4.47 million barrels per day (bpd) in October. Yes, the fastest growing automobile market in the world is now the second largest oil consumer, devouring 8.2 million bpd. China and America together now account for 33% of global oil consumption. Now, as you know, even despite the fact that about a million cars are being sold every month, less than 5% of the population own a private car. The 'Financial Times' recently stated that China only has 38 million passenger vehicles, versus 230 million in the USA. In the same article, 'Rule of the iron rooster', published in August, they had the following to say regarding the railway network and high speed roads,

'... over the next three years, the railways ministry plans to add 20,000 km of track to the existing 80,000 km, with a total investment of more than Rmb2,000bn. At this rate, China's rail network will this year overtake that of India to become the second-longest in the world, just behind the US. As for roads, construction began in the first

half on 111 expressways totalling 12,000 km with an investment of Rmb700bn, according to the ministry of transport. By the end of last year China had just over 60,000km of high-speed roads, compared with 75,000km in the US. But if plans by local governments are included, China's high-speed road network would expand to 180,000km in the next few years, an astounding figure considering China has only 38m passenger vehicles against 230m in the US."

This is truly remarkable stuff. And, whilst on the subject of China it looks like China has engaged in the 21st century equivalent of the 19th century European 'scramble for Africa'. Over the last several years China has been investing billions and billions in minerals and energy in Africa so as to secure its long term supply of raw materials. These numbers speak for themselves. Since 2006, China's energy companies have announced plans to spend at least \$16 billion on oil and gas fields in Africa. In 2008, China-Africa trade amounted to \$107 billion, an increase of 45% since 2007. At the recent Forum on China African Cooperation (FOCAC), Premier Wen Jiabao offered Africa \$10 billion in preferential loans, over the next 3 years to develop infrastructure and social programs. Yes, China has arrived in Africa!

The remarkable rise of China continues to dominate the headlines around the world. The very latest economic statistics showed retail sales rising 16.2%, industrial production up 16.1% and fixed asset investment up by a staggering 33.1% (all figures are year on year). The caveat to this extraordinary growth is the question of sustainability and similarly excess capacity. It is interesting to note that according to Fortune magazine, China has enough spare production capacity in the cement industry to meet annual cement demand from India, Japan and America.

That is enough on China, so let us shoot briefly across to Ireland where the news could not be more different. The headlines in Ireland are depressing indeed. The Irish Parliament, last week, voted to allow the National Asset Management Agency (NAMA) to purchase 54 billion Euros worth of property loans from Irish banks, this is equivalent to about a third of Irish GDP. Real estate prices have fallen about 50% since the crisis began and the banks are basically bust. The contrasting news between Ireland and China serves to illuminate the growing divide between the **submerging nations and the emerging**. Britain, Ireland, Iceland and Spain probably lead the list of submerging countries with America following close behind. Most of continental Europe is somewhere in the middle and China and India lead the emerging world. Australia has both fortunately and fortuitously been swept along in the emerging Asian slipstream. China is now our largest export destination, having replaced Japan this year. We now export more to India than we do to America and studies have shown that between 60 to 80% of our exports to China are used for domestic investment and consumption rather than for exports. Hence, Australian exports to China are highly leveraged to Chinese domestic demand rather than external demand.

The news of late from America has turned somewhat mixed with unemployment at a 26 year high and consumer confidence remaining in the doldrums. Manufacturing surveys have exhibited a V shaped recovery; however, the consumer faces a torrid period of de-leveraging. Consumer credit declined for an eighth month in a row in September, the longest such period since records began in 1943. Given consumer spending comprises 70% of the economy, I just cannot see how final demand will exhibit anything close to a V shaped trajec-

tory. So everything I said from 2005 on is still both valid and relevant. We simply cannot rely on the American consumer, as an engine of global growth, for the next several years at least; but you knew that already. I stumbled upon an interesting story in The Financial Times which I think really captures the seismic shift taking place in America, "The decline in credit available to US shoppers has been starkly demonstrated by the latest figures on the volume and quality of credit card offers that once used to pour through creditworthy US mail boxes on an almost daily basis ... credit card issuers sent 391 million direct mail offers during the third quarter ... at the peak of the credit boom in 2005 and 2006, the industry was sending out more than 2 billion card offers a quarter."

Now, if I didn't have such a high regard for the FT I would not believe such numbers and hence would not quote them. I just have to repeat that final sentence again, " At the peak of the credit boom in 2005 and 2006, the industry was sending out more than 2 billion card offers a quarter".

I would take issue with the word 'creditworthy' as we all know that the money lenders did not care too much about the credit worthiness of the borrower and would lend to anyone with a birth certificate, NINJA mortgages etc. But, in a perverse and paradoxical fashion all of this makes me feel better, because at long last we all agree that, that whole era is behind us. Some of you may remember me talking about people 'day trading' apartments in Florida in 2005 and how I saw this as the ultimate sign that the bubble was about to burst. Well, that it has and we should all be extremely grateful that a majority of the world never went 'debt crazy'. As a footnote to this discussion it is worth mentioning that the majority of new cars bought in China are paid for with 100% cash.

Financial markets waited nervously for the wording of the last Federal Open Market Committee (FOMC) meeting on November 4 and Bernanke dutifully delivered the words everyone wanted to hear, namely, 'are likely to warrant exceptionally low levels of the federal funds rate for an extended period.' These are, without doubt, the most valuable, some might say, expensive, words in the history of finance. Indeed, one could even say, and with profound apologies to Winston Churchill, 'Never in the history of finance have so few words meant so much money to so many.'

So, the mother of all stimulations continues and the financial markets celebrated accordingly. My more cautious approach to markets remains intact and as I said in my last report a number of key US indices, such as the transports, Russell 2000 and the KBW bank index have not made new highs, whereas the Dow Jones clearly has. Longer term, I think the US dollar is in serious, serious trouble but, as I mentioned in my last reports, the short dollar trade is very crowded. A sudden short term reversal is inevitable when you get such an overwhelming consensus. Some commentators, such as Roubini, are talking of the mother of all carry trades in reference to people now borrowing in US dollars for virtually free and buying pretty much everything and anything.

In the months and years ahead we are going to see some extraordinary events. My advice is simple; stay very well diversified and seek sound financial advice. The universe of potential investment opportunity is enormous as the world sees seismic and unprecedented changes. The American locomotive needs a rest after a prolonged age of heavy lifting and locomotion. The Asian train has arrived and just in time. Which train do you want to be on? It is your choice but I know my train and my destination.

All the very best,

Jonathan Pain



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