



Investment Briefing

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Paths to stability – what history tells us

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Asset market volatility spiked as the Eurozone debt crisis escalated and policy makers prevaricated through the September quarter. There remains no clear path to stability, let alone normality. The difficulty is not so much that the right actions are not getting clearer, but more that they are politically very difficult to make. There is no easy fix. A review of past financial crises quickly reveals that they can be solved either the hard way or the exceptionally hard way.

The early 1990s crisis in Sweden provides perhaps a close to best case example. There was what seems to be an inevitable period of denial and attempts at muddle through solutions. The Swedish finally bit the bullet and forced banks to write down losses before recapitalising (and, importantly in terms of future behaviour, they imposed most of the cost on shareholders). Once there was clarity that a sound plan was being put in place, international confidence rapidly returned. In contrast, Japan provides an unfortunate example of how to get a worst case outcome by continuing to duck and weave and avoiding really sorting out the mess (particularly non-performing loans). In Japan, the power of interest groups representing uncompetitive sectors weakened political will. Politicians focused on staying in power and failed to make the required structural reforms. Resulting policy errors caused persistence of the liquidity trap and prolonged the slump across two decades.

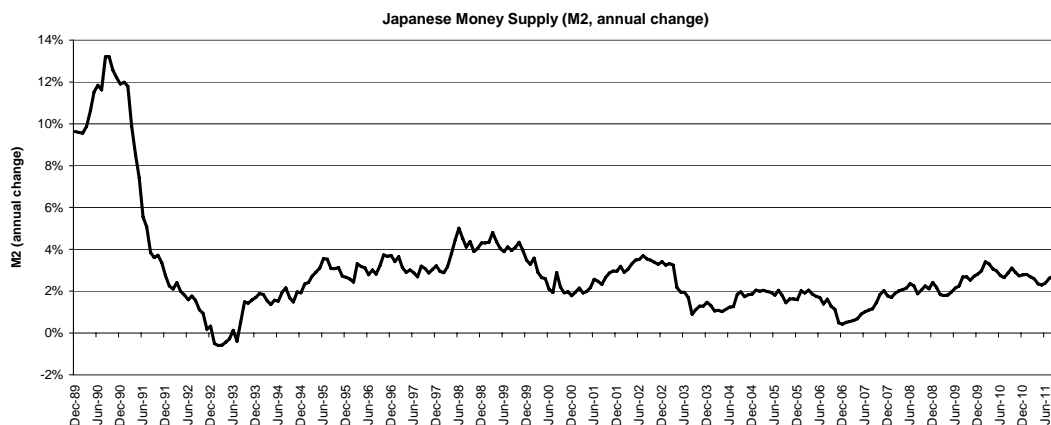
The policy response to the current crisis is absolutely critical. The Eurozone political morass makes it seemingly impossible to get it right. Persuading 27 countries to agree on anything is neither a quick nor easy process, particularly when there is so much confusion about the right course of action. The debt problem can't be solved simply by dealing with Greek debt, but it will be an important step. While bond holders are set to have a haircut of 21%, analysts suggest something close to 50% is required. This will exacerbate the crisis unless banks are strengthened to withstand a write-down of this magnitude. Importantly there are reports that Germany has a rescue plan for its banks...but much remains uncertain. While this uncertainty remains, markets are vulnerable to further bouts of risk aversion; but expect markets to celebrate when we get enough clarity. Unfortunately policy makers, many of whom are in weak positions politically, may still require further messages in the form of markets taking fright to force the necessary measures through. The risk is that this could push interest rates high enough to make other Eurozone members (Spain and Italy) insolvent. ...the EFSF is not yet large enough to control this risk. The solution is at hand – increase the EFSF or make the ECB the lender of last resort – but although political will is firming, we are doubtful it is yet strong enough.

The recent market volatility is an additional negative for already faltering economic growth. This is not a V or a U shaped recovery but more of an L. There's worry about a double dip recession, but that misses the main point that there is no sustainable recovery in sight. The world economy is slowing as fiscal stimulus reverses and unemployment rises again. The uncertainty, shock and risk aversion of the past quarter add to this downside risk.

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The developed world is in a slump and fading hopes for a sustained recovery have led to comparisons with 1937. In that year the US economy experienced one of the worst recessions of the century. Tighter monetary and fiscal policy is generally seen as the cause. However this doesn't really account for the severity of the contraction. Recent research suggests the key factor was the absence of any growth in money supply (caused by sterilisation of gold inflows)¹. There were specific issues that caused this which were particular to the 1930s, but the 1937 experience reminds us that money supply used to be a widely used indicator. Money supply became less useful in the era of financial deregulation (when the demand for money lost its stability). In a slump it arguably regains some usefulness as an indicator – declines in money supply are associated with depression conditions and normalisation of money supply and demand growth with growth recovery.

The first chart shows the collapse of growth in broad money supply post the bursting of the Japanese asset price bubble...and subsequent absence of recovery. The second chart shows post crisis declines in growth in monetary aggregates for a number of countries. While in the US there was some post crisis pick up, the Eurozone and the UK are currently looking decidedly like Japan (to get this in perspective this is not as dire as the 1937 experience). The ECB has mistakenly raised interest rates; the US, Europe and the UK have all tightened fiscal policy. These countries are in a liquidity trap which means that traditional monetary policy is ineffective. Policy needs to remove structural impediments to growth and boost spending...to do the latter, money needs to get into the hands of consumers. Martin Wolf of the Financial Times has recently proposed that a new round of QE in the UK take the form of cheques to households. Although growth in money supply in a slump is useful as an indicator, the challenge is to get sustainable economic activity through whatever means... stimulate now and commit to fiscal and monetary austerity later.

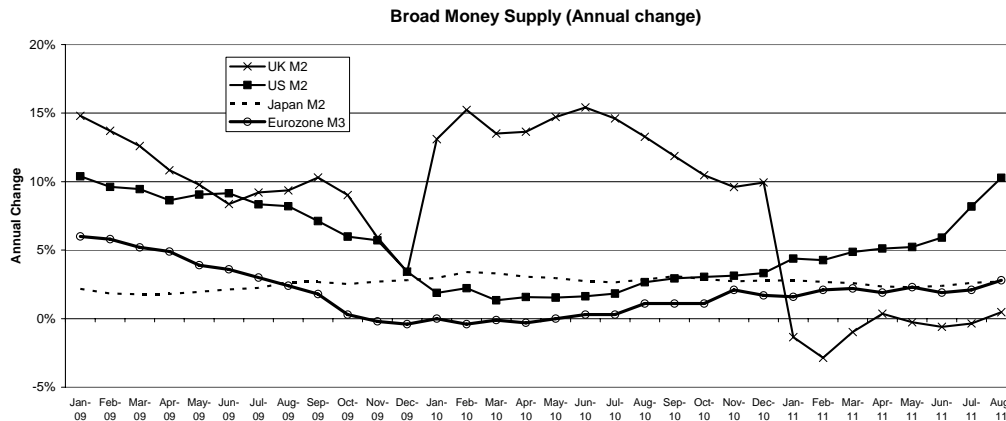


Source: Global Financial Data

¹ Douglas A Irwin (Dartmouth College and NBER), 'What caused the recession of 1937-38?', 11 September 2011, VOX, <http://www.voxeu.org>



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Source: Global Financial Data and European Central Bank

It seems undeniable that developed world de-leveraging will constrain growth for a prolonged period of time. The path back to stability is still not clear because of political prevarication, and we continue to envisage a wide range of potential paths forward. It is critical today to understand both the potential risks and the opportunities, in order to be able to judge whether equity markets are attractive or not (following recent falls). Debt problems can be solved by growing out of the problem (difficult given much of the developed world is stuck in the mire and policy inaction); inflation (difficult for most in the near term but aggressive monetary policy may ultimately result in inflation), and/or default. Growing out of the problem is the most desirable – it does not penalise savers like inflation, or generate systemic risk like default. Growth in the developed world will continue to be limited by the rebuilding of balance sheets, but there is a glimmer of hope about economic growth in the longer term.

Things have got so bad that the US and Europe are being pushed by sheer desperation to consider structural reforms – notably of healthcare in the US and social security and pensions in Europe and the UK. The Euro periphery is starting to cut through regulations and shrink bloated public sectors. Were this to gather pace it would auger extremely well for the future. Of course there are pitfalls. For example, growing inequality of income and wealth is an insidious issue fuelling unrest in developed economies, and it is being exacerbated by a divergence between demands for skilled versus unskilled labour. Also of concern, particularly with regard to the fallout for Australia, would be an unanticipated slowdown in China ...the importance of trade links with the developed world and the uncertainties involved in engineering a soft landing may mean this risk is being underestimated. More generally, the risk of policy mistakes is high and while equity markets are now discounting more of this risk, we regard equities as attractive on a selective rather than a general basis.

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