



# Paul Melling Retirement Planning

## May 2009 - Investment Update

### The effect of the 2009 Budget on the Australian Economy

Headlines of a forecast Budget deficit of \$58 billion for 2009/2010 have filled the newspapers - but who knows how big the Budget deficit really will be? The forecast deficit is based on some pretty rubbery revenue estimates. For an example of how wrong Treasury can be, one need only take a look at last years forecasts. On Budget night 2008, the Government forecast a budget surplus of over \$21 billion for the 2008/2009 financial year. That forecast surplus has turned into a deficit of approx \$32 billion, a turnaround of over \$50 billion in just 12 months. Two of the major reasons for the huge difference are that commodity prices fell heavily in the second half of 2008 and economic stimulus packages of over \$20 billion were deemed necessary. Whilst neither of these could have been forecast, it demonstrates the difficulty of making even short-term economic predictions.

Whilst the Government is forecasting budget deficits for some years, even using quite optimistic growth assumptions, it could also turn out that the expenditure estimates are too high. For example, it has been estimated that a national fibre-to-the-home broadband network could be built on top of Telstra's existing infrastructure for \$19 billion. Yet the Government, under the guise of "economic stimulus", now intends to spend \$43 billion on a "make-work" program by digging up every major residential street in the country to lay down fibre-optic cable - right next to Telstra's existing pipes and cables. It reminds me of part of my studies into Keynesian Economics at university:- Keynes held that economic activity could be stimulated by having the government pay people to dig holes and fill them in again. We are not too far from that here! Hopefully the Government and Telstra will see sense on the way forward, and begin to cooperate to build the broadband network in an efficient manner. This would probably save around \$20 billion alone!

Recessions are a part of a healthy economic cycle - they allow a shedding of the excesses that build up in the boom years. I commend the Government for making an effort to keep our recession as short and shallow as possible, but the high level of expenditure (for expenditure's sake) seems wasteful and unnecessary. Just because the rest of the world is running up enormous budget deficits (and blowing out their public debt in the meantime) doesn't mean we need to follow.

Whilst it is disappointing that our servants in Canberra feel they need to waste so much of our money, it is worth pointing out that the level of deficit in relation to the size of the economy is relatively tame by global standards. The projected deficit is around 5% of Australian GDP. By comparison, the US and UK budget deficits are each projected at around 13% their respective GDP. In any case, by the time the Government gets around to spending the money on infrastructure, we will probably be out of recession.

Ignoring the questionable morality of the package, the \$900 per taxpayer "Rudd Money" stimulus seems to have had a positive impact - partly where it was intended, consumer sentiment, but also on the share prices of Harvey Norman and JB HiFi! Again, I don't think it was necessary - a visit to your local shopping mall will probably tell you that the effects of this recession appear to be largely limited to those unfortunate to have become unemployed. The rest of the economy seems to be in pretty good shape to me - for a recession anyway. Low interest rates and petrol prices have helped to soften the effects for most of the population.

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## The effect on the bond market

In order to fund the projected deficit, the Australian Government needs to borrow money. This will be done by issuing Government bonds - approximately \$80billion worth over the next 12 months alone. This is a massive amount of supply of bonds into a market which may not be able to digest such an issue. The Reserve Bank wishes to keep cash rates low for as long as necessary for the economy to show strong signs of growth, but in my view Treasury will need to offer **significantly higher interest rates** than current bond rates if they are to successfully sell all of these bonds.

The UK Government recently experienced this when it tried to sell 40-year bonds, but was unable to find enough buyers for the bonds. The US has not yet experienced this problem, probably because it is simultaneously buying back long-dated debt as part of its "quantitative easing" program, but with budget deficits running into the Trillions, on top of its existing mountain of debt, US debt issuance is also set to soar. The only solutions to bond-auction failures (aside from not borrowing so much in the first place!) are to either raise the interest rates on (longer-term) newly issued bonds or to immediately buy back the newly issued debt ("printing money" or "debasement of the currency"). I expect the US and UK Governments will probably need to do both.

Australia is in the fortunate position of having low existing debt and relatively high short-term rates, so it has no need to debase its currency. However, in order to keep these short-term rates down, I expect that the Australian Government will need to offer higher interest rates on their long-term bonds. Counter-intuitively, this is NOT good for existing bond holders. As bond yields rise, bond prices fall (many investors may remember negative returns from capital stable funds in 1994 as the bond market fell). I expect the Australian yield curve to steepen over the next 12-24 months.

In my last Investment Update I said that now is not the time to be in cash, given the low yields and relative attractiveness of the Australian Sharemarket. I would suggest that **an even worse place to be than cash would be long-term Government bonds** (Australian or overseas). I will ensure that exposure to long-term Government bonds in the Managed Portfolio Service is minimised.

## Australian Shares

The Australian sharemarket has risen over 20% from its low point in early March. Whilst this is a welcome change from the constant reaching of new lows, the sharemarket is still well down on its peak and it will be a long climb back. Just as markets overreach when greed powers prices to their peaks, they also oversell when fear drives prices to their lows. I don't expect that we will enjoy 20% rallies every two months, but I don't think we will see the ASX200 index lower than we saw in early March.

A notable feature of the past few months has been the large number of capital raisings. Companies have taken advantage of the return of confidence to raise more money from shareholders, usually to retire debt (see section below on interest bearing sector). It appears that the same "consultants" who advised companies to **borrow** piles of money at the top of the cycle (earning huge fees from doing so) now have management's ear again and are earning more huge consulting fees in advising companies to raise equity (**sell shares**) at the bottom of the cycle!

Whilst these capital raisings are taking place, they will continue to hold back share price appreciation, as they have a dilutive effect on the return on equity of the companies. However, our fund managers who take part in the capital raisings are getting more shares issued at a discount, and the company is usually stronger for having raised the money. Once these capital raisings are over, the sharemarket should find further strength.

As mentioned in previous Investment Updates, with short-term interest rates at historically low levels and the sharemarket still quite cheap, it has become very attractive to invest into Geared Share funds. The **borrowing costs are less than 4%pa** inside the CFS Geared Share fund so the cost of borrowing is easily covered by the dividends and franking credits from the shares. We recently introduced Geared Australian shares into the more aggressive portfolios in the Managed Portfolio Service (including both High Volatility Portfolios).

## **Interest Bearing Sector (excluding Government bonds!)**

Whilst the cash rate is at an historically low level, the yields on non-government debt (corporate debt) and hybrid securities are at historically very high levels. This amazing paradox has come about as a result of two related factors:- (a) the introduction of Government Guarantees on bank deposits which caused a massive drain of money out of these securities and (b) fear of a high level of defaults. Because of these factors, debt and hybrid issues are trading at significant discounts to their maturity values. Just as the Australian sharemarket offered (and still offers) a very rare opportunity to buy shares at fire-sale prices, the current state of the interest bearing sector offers a rare opportunity to enjoy much higher yields than cash plus the possibility of capital appreciation.

Whilst we have seen many of the very bad (high financial risk) companies go under in the past 18 months, I think the bulk of these defaults have now passed. Over the past 6 months we have seen very high levels of "capital raisings" - i.e. companies who need money to meet looming debt repayments have issued new shares at very depressed prices. I have previously discussed how this is a great opportunity for share investors (largely fund managers) to buy shares at a discount to an already depressed price. It is also great for investors who hold the debt of these companies. When companies raise money by issuing shares, it reduces the likelihood that the company will have any problem in repaying it's debt - it now has a lot more cash in the bank.

In fact, **many companies are raising cash by selling shares, in order to repay debt holders.**

This is a very important point. Whilst the threat to the global financial system has now been essentially put to bed by the willingness of Governments to guarantee the system, the very easy credit which was available to companies before the financial crisis is not now available, and the cost of issuing new debt is very high. As an example, Tabcorp recently issued 5-year bonds at a yield of 4.25%pa above bank bills, which represents a yield of 7.4%pa.

Furthermore, Hybrid securities have "step-up" provisions. This means that if the company does not redeem (pay-back) the Hybrid security at the "step up" date (essentially a maturity date), the interest rate payable on the security will increase to very high penalty rates. The intention of these "step-up" provisions was to give a very strong incentive to the company to redeem at maturity, which gave Hybrid investors some comfort that their investment had a maturity date.

All of the above offers a very attractive scenario for investors in the debt and hybrid sector. As it's debt matures the company has only two options. It can raise equity to repay the debt or it can accept a very high interest rate on existing or new debt. If the debt is repaid, the investor will enjoy a short-term capital gain and will be able to reinvest the proceeds in the new debt at a high interest rate. If the debt is not repaid the investor will benefit from a higher ongoing yield.

The most likely scenario is that most bond and hybrid issues will be redeemed at maturity (at par) and investors who buy these securities at current prices will enjoy high yields until the securities are redeemed, as most of these maturities will take place over the next 36 months.

These are clearly very attractive investment fundamentals - the only unknown is the level of defaults. Whilst there will continue to be defaults in very weak companies such as Timbercorp, Great Southern and probably some property trusts, it is easy to avoid the weak companies and still access very attractive yields. Debt and Hybrid securities issued by companies such as Macquarie bank, Suncorp Metway and AXA all currently offer double-digit yields to maturity. In fact, Macquarie Bank hasn't missed this opportunity. The bank recently bought back it's own debt in the offshore debt markets for **60c in the dollar!**

As a result of these very attractive investment fundamentals, we expect to introduce some exposure to investment grade corporate bonds and hybrids into the Secure portfolio in the Managed Portfolio Service at the next rebalance. We will also be introducing a High Income portfolio to the Managed Portfolio Service at the next rebalance. This portfolio will have a high level of exposure to this sector and should be suitable to investors who are willing to accept a moderate level of volatility in order to enjoy potentially high returns on their interest bearing funds whilst avoiding exposure to more volatile sharemarket investments.

## Listed Property

International Property markets continue to weaken. The recent bankruptcy of one of the largest property trusts in the world, General Growth, highlights the continuing problem these property trusts have with high level of debt. General Growth was actually able to pay its interest bill with relative ease - it went into bankruptcy simply because it was unable to "refinance" its existing debt as it fell due. The financial crisis has wreaked havoc on financial centres such as New York and London, and office vacancies are rising whilst rents are falling.

As previously discussed, Australian Listed Property trusts are faced with high debt burdens and falling property values. As property values fell, they threatened to breach the banks "Loan to Value" ratio - which could result in technical default on their debt. In order to reduce their debt, the only options are to sell properties or raise equity from shareholders. Whilst there have been some property sales (often to overseas investors), the major action has been in equity raisings.

The outlook for the Listed Property sector is mixed. Some trusts may go under and others may merge. In my view, it is still too risky to allocate investment money into what remains of this "sector". At present we still maintain zero exposure to this sector in the Managed Portfolio Service.

## Global Resources

It has been a frustrating time for Australian resources investors. We have seen falling commodity prices and large debt loads force Australian resource companies into the waiting arms of Chinese companies (with the financial backing by the Chinese Government with its enormous sovereign wealth reserves). I expect that as commodity prices pick up again these assets sales will look particularly cheap and opportunistic.

It has become apparent that China has started to diversify its currency reserves away from paper currencies, and is starting to accumulate "stockpiles" of basic resources, in line with its expected future needs. Chinese imports of base metals and iron ore have increased strongly this year. Base metal volumes have more than doubled this year and iron ore volumes are up 33% on this period last year. Unfortunately for the miners, the prices of base metals and iron ore are much lower than they were than April 2008!

With commodity volumes clearly on the increase, prices have started to follow. The profitability of a mining company is based on price (less cost) times volume. As both price and volumes increase, so should mining profits. We continue to maintain exposure to Global Resources in the Managed Portfolio Service.

## Asia and "Emerging" (not-submerging!) Markets (ex-Japan)

Asia has been the world's "growth engine" for sometime, and this is not going to change because some overleveraged Americans can't repay their mortgages! Whilst I can't see a recovery in US consumer behaviour (ie borrow and spend) in the foreseeable future, China is focusing away from export-focused industries to servicing its own consumers and continuing the build up of its infrastructure. Asia as a whole doesn't have the debt problems of the developed world, and should continue to grow into the foreseeable future.

The Hong Kong, Taiwan, Singapore, Shanghai and Indian sharemarkets have each risen over 20% this year. We will maintain our exposure to Asian Shares in the Managed Portfolio Service, and will look to expand our exposure to Emerging Markets in due course.

## Currency

The Australian dollar has gained strength over the past 6 months (up 26% against the USD). As discussed previously, we expect the Australian dollar to continue to strengthen against most major currencies (those with the highest high foreign debt and most currency-debasing monetary and fiscal policies) such as the US, British Pound and the Euro.

Steve Melling, CFA 21st May 2009