



Paul Melling Retirement Planning

A Macro-economic Update

including the

2010 European Sovereign Debt Crisis

Whilst this paper may be heavy reading for some clients, it is important that you make an effort to follow this Macroeconomic Update because it is the Global "Macroeconomic" outlook which has driven our recent changes to client portfolios. The changes to client portfolios will be described and explained in the May 2010 Investment Update.

This address focuses on the problems of high levels of Government deficit spending and the resultant high levels of Government debt. A commonly used measure of the "healthiness" of an economy is the ratio of that country's deficit or total debt as a percentage of its "Gross Domestic Product" (GDP).

An easy way of understanding this concept is to think of a family household. If the family spends more than it earns, it goes into "Deficit" and needs to borrow money to make up the difference. This could be measured in dollars or as a percentage of the family's income. Similarly, the total family debt would be the accumulation of many years of deficits.

An annual Deficit for a country is generally considered to be "unhealthy" if it is greater than 3% of the country's income (more than 3% of GDP). Similarly, total debt is considered to be "unhealthy" once it exceeds 60% of a country's income (60% of GDP).

When the European Union (EU) was established, limits were put in place to restrict member countries from running large deficits and from accumulating too much debt. The "Maastricht Treaty" required member countries to have an **annual deficit of less than 3% and total debt of less than 60% of GDP**.

The European Government Debt Crisis - Background to the build-up of debt

To understand the current crisis, we need to look back to the 2007/2008 subprime crisis. The result of the subprime crisis was that Governments around the world came to the rescue of the financial system by guaranteeing banks and in some cases nationalising banks, and as a result a lot of the risk of the banking system was transferred onto the balance sheets of Governments.

Massive levels of debt have been incurred by Governments, not only as part of this risk transfer but also as a result of the very heavy fiscal stimulus enacted afterwards to get their economies out of recession and growing again. Many of these Governments already had quite high levels of debt before this additional spending. At the December 2009 Get Together I discussed the growing issue of Sovereign (Government) default risk. At that presentation I discussed the increasing risk of default of countries such as Greece, Italy and Ireland.

Having barely emerged from recession, the economies of Europe remain in poor shape. Economic growth, where it exists, is weak. Ageing populations in large parts of Europe and high levels of unemployment add to the poor economic outlook.

European Government debt has grown heavily over the past two years. The average debt to GDP of all of the Eurozone countries has grown to 84% (well over the 60% "healthy" limit) and the average current deficit is around 7% of GDP (well above the 3%pa "healthy" limit).

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Some of the countries in the Eurozone (such as Italy and Greece) have total debt in excess of 100% of GDP, and some countries (Ireland, Greece and Spain) have a current deficit in excess of 10% of GDP. Even the strongest economy in the Eurozone, Germany, has a deficit and total debt load in excess of the “healthy” limits.

Clearly the European Governments have been on an unsustainable path, but these growing issues came to a head in the first weeks of May 2010.

2010 European Sovereign Debt Crisis

Act 1 - Greece

The trigger for the current crisis was a series of downgrades of Government debt by Credit Rating agencies. In particular, on the 27th April 2010, the ratings agency Standard and Poors downgraded Greek Government debt from “Investment Grade” to “Non-Investment Grade” (or “Junk”) status. Aside from the negative impact on the perceived quality of these bonds such a downgrade would cause, the major problem with this downgrade is the impact it would have on institutional investors who are only allowed to hold “investment grade” bonds. Such investors would likely be forced to sell Greek Government bonds if the other two ratings agencies followed suit - which seemed very likely. Greek Government bond prices fell heavily.

Greece has around 300 Billion Euros of Government debt, and due to large deficit spending, is expected to borrow a further 50 billion Euros over the next 3 years. This would take Greece’s total debt to 150% of GDP. Greece had 8.5 billion Euro’s worth of debt to refinance on 19th May, and default was looking likely.

It was very important for countries such as Germany and France to prevent a Greek default, because French and German banks had a large exposure to Greek Debt. A default would have weakened the financial position of these banks, possibly necessitating further Government support of these banks.

European leaders and finance officials met over that weekend and put together a bailout for Greece worth 110 billion Euros. This would cover Greece’s funding needs (spending and refinancing) for the next 3 years. In return, Greece agreed to implement “Austerity measures” to quickly reduce its annual deficit to within the 3% limit.

Act 2 – “Contagion”

On 3rd May, Government bond prices of Spain, Portugal, Ireland and Italy started to fall. Investors (and hedge funds) were concerned that whilst Greece would be supported for the next 2-3 years, the same funding issues faced these other countries. Further, the level of debt and the funding requirements of these other countries dwarfed the level of debt and funding requirements of Greece.

The “Domino Effect”

Due to the interlinked nature of the European banking system and bond markets, banks across the Eurozone hold hundreds of billions of Euros worth of European Government debt. In addition, banks across the Eurozone hold hundreds of billions of each others debt. **A default by one country could trigger the collapse of banks which held that country’s bonds.** It was not just the banks of the defaulting country which were at risk – banks in other countries were also at risk because they held bonds of the defaulting country. Furthermore, **the collapse of one or more banks as a result of a sovereign default could trigger collapses of other banks** which held the debt of the collapsed banks. It would be very difficult for Governments to enact a second bailout of their banking systems when their own Government debt was already at risk of default itself.

The situation was extremely serious, and by the evening of Friday 7th May the European financial system (interbank lending and bond markets) had frozen up. It was a situation very similar to that which occurred in September 2008 when banks refused to lend money to each other in fear that the other bank may have had a large exposure to losses.

Over the weekend of 8th and 9th May 2010, European officials again met in Brussels to work out a way to prevent the collapse of the European banking system on Monday morning when the bond markets opened up again. An announcement was intended to be made on Sunday 9th May at 6pm Brussels time. The time of the planned announcement then slipped to 9pm – then to 11pm - and then they stopped publishing an expected announcement time. Finally, at 3:15am on Monday morning, a \$1 Trillion European bailout package was announced.

Under the bailout, EUR 500 billion would be made available by the European Union, with an additional EUR 250 billion from the International Monetary Fund (IMF). In addition, a “line-of-credit” was re-established with the US Federal Reserve. The bailout money would be available to any country which needed money to finance their deficit or refinance existing debt. However, the funding would come with “Austerity conditions” which would require member countries to take steps to reduce their deficits. The result of the package was that the Eurozone countries as a whole effectively guaranteed the debts of each member country. Importantly, the European Central Bank would itself buy the bonds of member countries, to provide price support where needed.

Sharemarkets rallied in relief as the catastrophe had been avoided – for the time being.

Act 3 – A final solution?

As a result of the European bailout, the responsibility for the debts of weaker members has been effectively transferred to the stronger members of the Eurozone (largely Germany). This transfer of risk from the “balance sheets” of weak countries to the “balance sheets” of strong countries has the result of weakening the stronger countries. It remains to be seen how long Germany remains willing to carry responsibility for the heavy debt burden of its less productive neighbours.

The Eurozone has shown its resolve to back the debts of its weaker members, but the problem of large debts, large deficits and weak economic growth has not gone away. Eurozone countries in total have over EUR 7 Trillion in public (Government) debt. In order to reduce the rate of growth of this debt, they need to cut their budget deficits heavily and quickly. This means that they need to immediately stop and reverse the stimulus that they had intended to apply to their economies in order to get their economies growing strongly again. To reduce their deficits significantly, spending will need to be cut, taxes will need to be raised, and further social unrest is likely. Given the already weak state of these economies, these deficit reductions, (if they are even able to be implemented) run the risk of pushing Europe into a second and deeper recession.

Even if these countries are able to reduce their deficits, there is no expectation that they will be able to move to a budget surplus and actually begin to repay their debt.

If the debt cannot be repaid, in my view there are only two solutions to the debt problem;

- 1) default - most likely by a (hopefully orderly) exit of the Euro by some member countries or
- 2) “Debt Monetisation” – Printing money to pay interest and repay the debt.

If the EU takes the option of printing its way out of debt, it runs the risk of creating a high level of inflation. However, if Europe does re-enter recession (and would thus likely face price deflation), it will be increasingly easy for the EU to justify printing money to repay the debt. Both options are likely to result in a further weakening of the Euro, and possibly even a breakup of the Euro.

Global Sovereign Debt risk outside of Europe

The problem of very high Government debt and high deficits is unfortunately not limited to Europe. The UK has Government debt of over 60% of GDP, currently growing at a rate of over 12% of GDP. Even worse, the US now has total Government debt of \$13 Trillion, or over 80% of GDP, and is growing this debt at a current rate of over 9% of GDP. On these numbers, the US is in a worse financial situation than Europe, and it has no expectation of returning to a surplus at anytime in the future, according to official US Government forecasts. In fact, the US Government projects that it's debt will grow by an additional \$8 Trillion over the next 10 years.

What is probably even more important than the \$13 trillion of debt is the fact that the US needs to borrow \$7 Trillion over the next 3 years to fund its deficits and refinance existing debt. As we have seen recently in Europe, it is when existing debt falls due that the problems arise. As I have previously mentioned, the most likely solution to this enormous and growing debt problem is for the US to print money to repay debt – this would lead to a significant devaluation of the US dollar.

It is the prospect of future debt monetization or “money printing” which has driven up the price of gold to new record levels around the world. Gold is considered a possible future currency which cannot be printed, and so as more money is printed around the world, the price of gold rises.

Whilst I would expect this appreciation of gold to continue, I don't think it is necessary for Australian investors to hold gold, as we don't have the same problems as many other countries. Holding Australian dollars, as our clients do, serves the same purpose as holding gold – that is, protection against overseas currency debasement. Australia has no need to print money or debase its currency. For an Australian, holding gold is only really useful as insurance against financial disaster – a little gold may be enough, and you hope that you don't need to use it!

Chinese (and Australian) Economic Outlook

The Chinese economy continues to grow very strongly – nearly 12% growth for the past 12 months! It is possible that the Chinese economy has grown too fast over the past year, possibly creating a property and credit bubble. Personal mortgage loans have doubled over the past 12 months, and the Chinese Government has introduced some measures in an attempt to reduce property speculation. This is a complete reverse from 12 months ago when the Chinese Government encouraged property development as part of its stimulus efforts.

Across China, house prices have risen by an average of over 12% in the past year, whilst in some areas of China prices have risen by over 50% for the same period. The amount of commercial property space under development has risen by 35% over the past year. It is unlikely that all of this space is immediately required, and we may find in the near future that there are a lot of empty properties. The example of the New South China Shopping Mall comes to mind:- This shopping mall, the biggest shopping mall in the world, has been empty since it was completed in 2005. In most places around the world, property developers would secure tenants before building a large shopping mall. In this case, and in the current Chinese property development surge, it appears that building the property is more important than finding tenants. In my view, the Chinese property “bubble” is a symptom of excess Government stimulus on an economy already flush with cash and not in need of stimulus.

If the Chinese Government is unable to slow down the pace of property development and speculation, it may result in a crash. This would have negative implications for demand for basic resources and for Australian exports. As a result, we are cautious on the shorter-term outlook for Australian resources. Over the longer-term, China still has much development to look forward to, so the longer-term outlook for Australian resources is still positive – if the proposed Resources Super Profits Tax is not implemented, anyway. This proposed new tax will be discussed in my May 2010 Investment Update.

Steve Melling, CFA - 17th May 2010



Paul Melling Retirement Planning

Investment Update – May 2010

Australian Sharemarket - Whilst good earnings growth is still expected through the 2011 financial year, companies are clearly becoming more cautious in their outlook. The Australian sharemarket has continued to be volatile, and has made no progress since our last Get Together in December. Positive returns over the past 6 months have only come from dividends and franking credits.

Australian banks have come out of the 2008 crisis in even stronger positions than they went into it. Competition for the banks has reduced and bank margins have increased. However, these positive growth factors are diminishing and bank margins are coming under more pressure, especially as they still need to source significant funding from offshore. I expect banks earnings growth to continue, but at a much slower pace than has been enjoyed over the past year.

Resource Super Profits Tax (RSTP) - The recent Rudd Government announcement of a 40% tax on “super profits” earned on Australian mining operations has certainly cast a pall over the resources sector generally and on Australia more broadly. The proposal is to levy a **tax of up to 40% of the profits** of Australian mining operations (after allowances for a hurdle return, depreciation and state mining royalty rebates), which is **in addition to the proposed 28% company profits tax**. Further, **there will be no franking credits for this additional 40% tax!**

The operation of the proposed tax has the result that the most profitable Australian mining operations will be taxed at a higher rate of tax than less profitable operations. The result of this skew is that mining companies are more likely to look elsewhere in the world to establish operations which have the potential to be very profitable. This is clearly not a positive for Australia, given our heavy economic reliance on mining exports. Over \$100billion worth of mining proposals have now been placed under review and if the tax is not significantly altered or dropped, many of these projects may not go ahead. Australia has been called the lucky country, but increasing taxes on our most important industry so that the Government can increase their spending may simply be pressing our luck too far. Governments find it easy to spend money – taken either from current taxpayers or from future generations (by going into debt). It is not so easy for Governments to reduce spending, especially after parts of society have come to depend on Government money. We have seen overseas the potentially devastating result of high levels of Government spending - Australian needs less Government spending, not more taxes.

There is reason to be hopeful, however, because the tax has not yet been introduced (it is to apply only from 2012) and may in fact never be introduced. There is an increasing likelihood that either the current government will not be in power in 2012, or that they will be forced to rethink the 40% tax as they witness the likely large negative impact such a tax has on the mining industry.

Interest Rates - The current Reserve Bank of Australia cash rate of 4.5% is low by historical standards, but given global uncertainties and a slowing in new home loan growth, it is likely that we will not see significant interest rate rises over the foreseeable future. If global growth turns out strongly positive, we may see a later resumption of increased interest rates, but if the Government debt problems continue to deteriorate, which would impact global growth, we may even see falls in the interest rate again. We hope that this is not what happens.

Global Shares - Companies globally have witnessed strong rebounds in earnings from their lows a year ago, and further growth is expected. However, it remains to be seen if strong earnings growth can be maintained after Government stimulus around the world has been removed and if the efforts of Governments to reduce their deficits end up resulting in lower global growth.

Currency Outlook - Given the uncertain outlook, the Australian dollar is likely to weaken against the US dollar in the short-term, as investors prefer the “safe” (!!) US dollar. However, on a longer-term view I expect the Australian dollar to strengthen against most major currencies – the Australian dollar is one of only a few sound currencies left in the world. We aim to reduce or eliminate client exposure to currency movements.

Managed Portfolio Service Update

Minimum Security Level	1 year return (%)
100% Min Secure	6.5
90% Min Secure	7.3
80% Min Secure	10.5
70% Min Secure	13.8
60% Min Secure	17.2
50% Min Secure	21.4
40% Min Secure	24.9
30% Min Secure	29.1
20% Min Secure	32.8
10% Min Secure	38.1
0% Min Secure	43.1

1 year performance to 31st March 2010
 Figures are for Allocated Pension funds

The one-year performance figures to the end of the March 2010 quarter are shown on the table to the left, and they are very encouraging. These figures are from a low base (April 2009) and so are quite exceptional – we would certainly not expect this level of performance on a long-term basis.

The more aggressive portfolios (lower security levels) have performed particularly well as a result of the strong sharemarket – these were helped by the use of investments such as the Geared Australian Shares fund.

The secure portfolio also did very well, returning 6.5% for the year from a starting point at which cash rates were about 2%-3%pa.

Recent Rebalances - We have recently made two changes to client portfolios in the **Managed Portfolio Service**. The

result of these changes is to **increase the Security Buffer to 20% above the Minimum** level of security and to **reduce the level of risk within the Volatile portfolios**. Whilst it is very unusual for us to conduct two rebalances, the deteriorating situation in Europe and the increased level of fundamental market risk have led us to err on the side of caution and take two sequential steps to reduce client portfolio risk.

The results of these rebalances are described as follows:

Increase in “Secure Buffer” to 20% above Minimum - Excellent profits have been made in the Managed Portfolio Service over the past 12 months - we think it is now a good time to lock in more of these profits and reduce risk in the portfolios by increasing the “Secure Buffer” to 20% above the Minimum level of Security.

Removal of Geared Australian Shares - We have now removed the Geared Australian Share fund from all client portfolios. This fund has performed very well (over 80% return) from the time we introduced it in early 2009, but the borrowing cost is now higher than the dividend yield and the fund can suffer in volatile markets.

Reduced exposure to Global Resources - We have reduced exposure to Global Resources as part of our overall risk reduction and in the face of uncertain global growth.

Reduction in Asian Share volatility - In the same vein of risk-reduction, we have replaced the Firstchoice Asian Shares fund with the Platinum Asian shares fund. The managers of this fund use hedging techniques to reduce the volatility of the fund.

Maintained use of Australian Share Income funds – We have retained our clients exposure to Australian Share Income funds as the primary method of investing in Australian shares. These funds use options to reduce portfolio volatility and increase income yield, as well as focussing on generating a higher level of dividends and franking credits.

Introduction of Australian Fixed Income to the volatile portfolio. This component uses longer-term Australian Government and high-quality corporate bonds to offset the risk of share price volatility in the volatile portfolio. The prices of longer-term bonds are sensitive to interest rate changes, so this component cannot be classified as secure. As we do not expect significant interest rate rises in the foreseeable future, this fund should generate positive returns with low risk.

We may be in for a bit of a “rollercoaster” ride whilst global uncertainties are heightened, so we’ve made sure clients seatbelts are ‘buckled up’. Once we are confident that the significant market risks have been alleviated, we will look to increase portfolio risk again.