Every success sows the seeds of potential future failure. Every force creates a counter force...

Christopher Selth

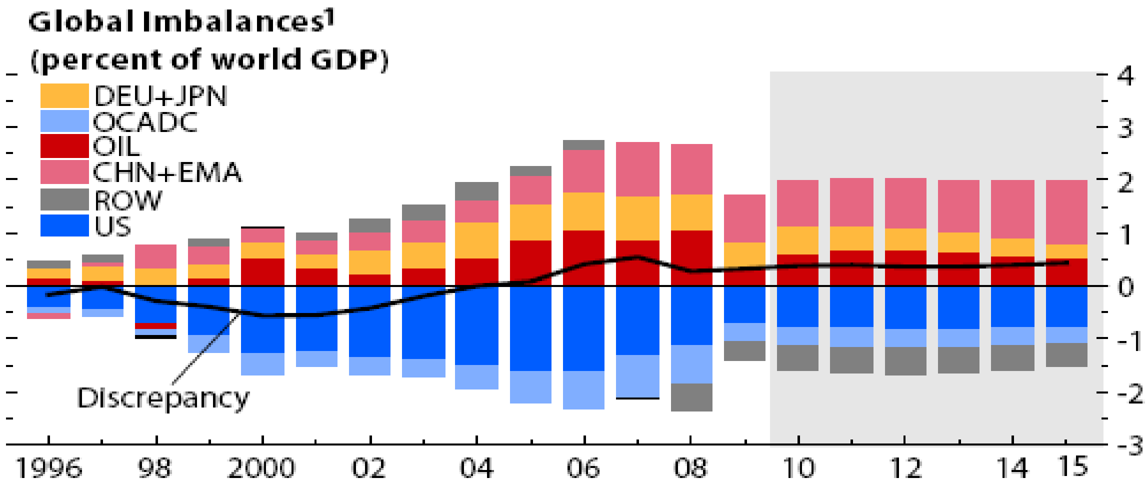
Five Oceans Asset Management, August 2010

- The profound success of Asian industrialisation underwrote the West's debt binge - which in turn created the current crisis in developed economies. The changes set in motion as a consequence suggest not a reversion to the old order after the crisis, but rather moving on to something new. How then does this impact our basic expectations about portfolio construction strategies? Can we simply roll out the old winning formulas? Simple extrapolation of old rules will work... until it doesn't. Then what? Has Australia dodged the bullet, or has our success set us up for our own particular challenges? In fact, the GFC should have been a wake-up call for the need to build shock resistant portfolios.
- Chris Selth will explore the potential nature of that new terrain and look at how you test old truths against new risks.

Background; The Construction of the Present

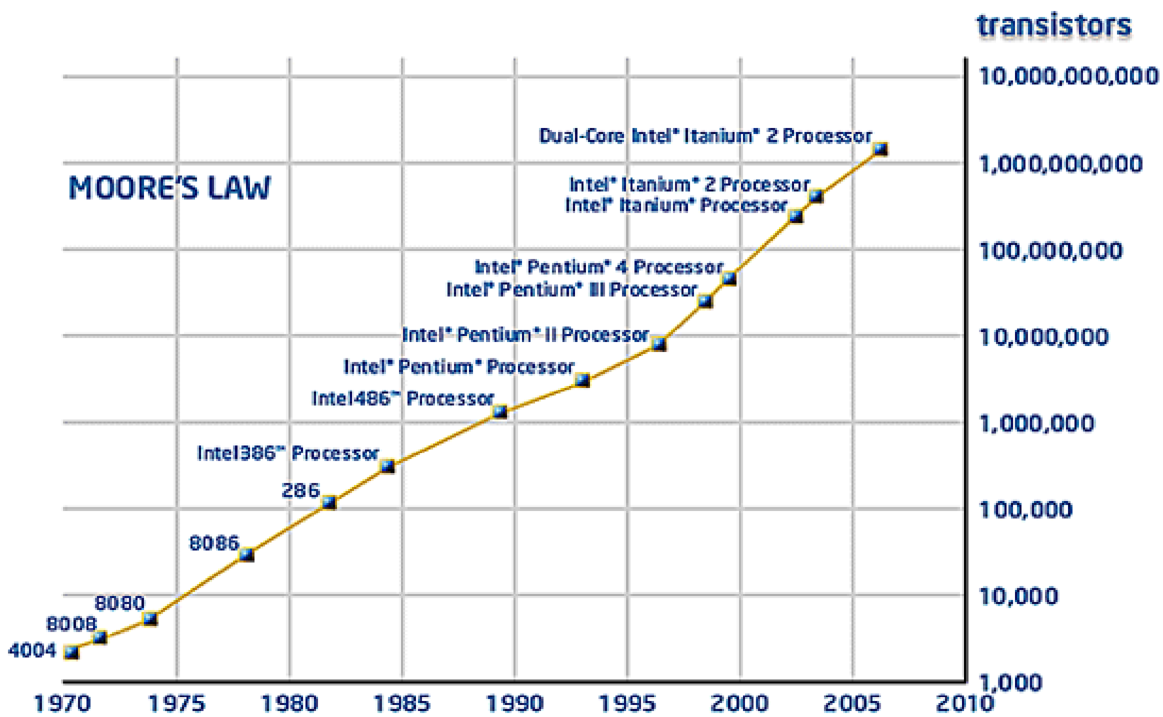
Story One; The Industrial Rebalancing

The industrialisation of China, the revival of India, could be characterised as a truly historic "mean reversion". Its pace has been truly breathtaking. The speed of that change speaks to another important paradigm; our technological prowess is expanding exponentially, challenging old business models and our society's capacity to cope with the implications of such change. Where business models move so rapidly, new business models anchored on cheap production in Asia took hold.

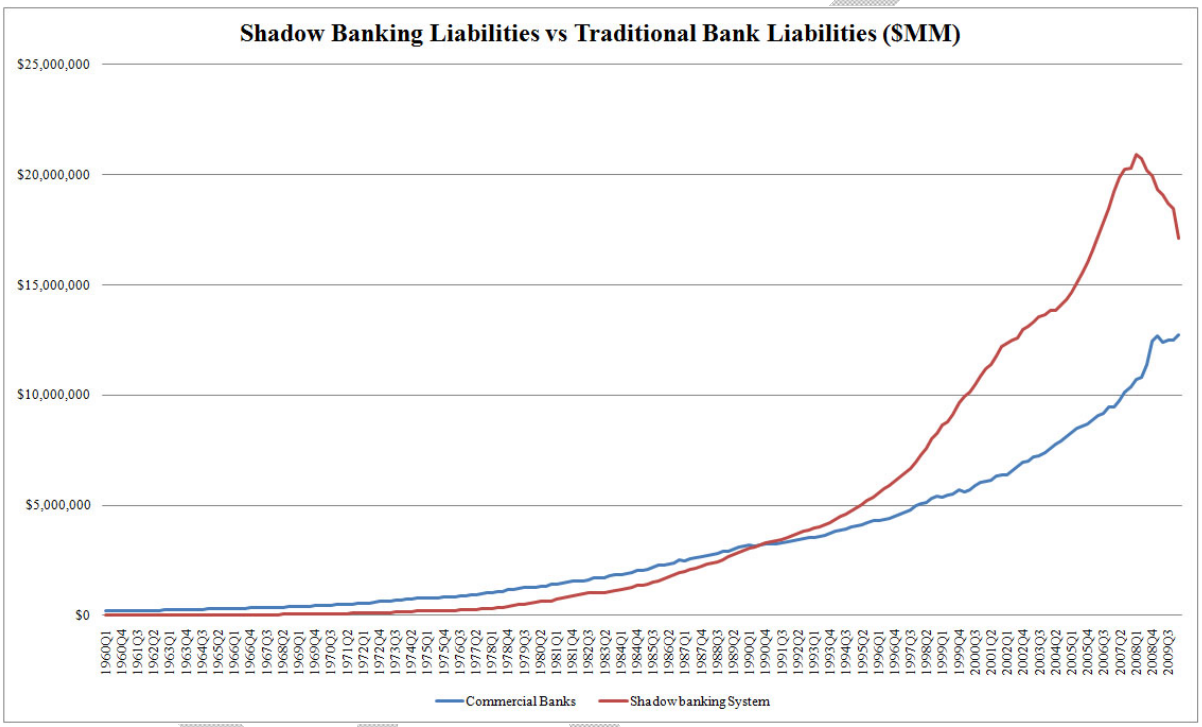


Source IMF

Story Two; Technological Change moving at accelerating pace…



Story Three; The Dominance of Financial Capitalism



Of course this dynamic did not take place in isolation. One of the greatest areas of "innovation" in the developed world was our financial system. Financial markets serve multiple functions; allocating capital to hopefully the most productive investments, facilitating the management of our savings, and helping manage risks associated with savings and investment. But the financial system can also "create money". The supply of money is not some stable finite quantity. For example, money lent by banks against the security of physical assets can be reinvested in building new assets, or buying other existing assets. Amounts of debt in the system can expand as long as bankers are willing to lend, and borrowers can cover interest costs. Even the capacity to pay interest is less clear cut than one might imagine. If interest rates are falling, as happened through much of the past 20 years as the world benefited from cheap product from Asia, the capacity to borrow expands. Furthermore, income generated by trading assets, whose prices are being bid up by the expansion of debt, could be used to cover interest expenses. Economic theory has struggled with the significance of this phenomenon.

Whilst monetarist theory held some power in the 80's period, deregulation of the financial system, the rise of securitisation, and ultimately what is now termed the "shadow banking system" broadened the money creation process, and made measuring money supply more complex. The relationship between money supply and economic activity was previously centred around the operational significance of the Quantity Theory of Money. This argument sits around the equation

$$M \, . \, V = P \, . \, Q$$

M is broadly money supply

V is the velocity of circulation

P is pricing

Q is the quantity of goods of services

P.Q effectively represents nominal income in an economic system

The monetarist reading of this equation might be summarised as follows;

- The source of inflation is fundamentally derived from the growth rate of the money supply.
- The supply of money is exogenous.
- The demand for money, as reflected in its velocity, is a stable function of nominal income, interest rates, and so forth.
- The mechanism for injecting money into the economy is not that important in the long run.
- The real interest rate is determined by non-monetary factors: (productivity of capital, time preference).
- Economic activity, i.e. real income, in a market economy will trend to full employment, adjusted for frictional factors [termed NAIRU]

Keynesians long disputed this reading on multiple fronts including;

There may be no natural equilibrium level of economic activity in an economy around full employment, signifying changes in money supply and credit conditions might materially alter employment outcomes.

Money supply may not be exogenous but rather endogenous to the operation of an economy. I.e. The structural drivers of economic activity go hand in hand with how money is created.

Velocity of circulation may not be stable. Depending on a range of economic factors velocity may vary.

In the Keynesian system monetary conditions are a co-factor in determining the character of economic activity in a complex system. The argument that inflation could be reduced simply and universally to a question of money supply was dismissed as simplistic, though Keynesians did not dispute that excessively easy credit could be a driver of inflation. They tended to focus, rather, on what were the circumstances that produced easy credit, and inflationary outcomes.

The equation put above is always true. It is an identity. The question is “how is it true”? How do the various terms shift to make it true? And over what time periods? Some terms will be stable in the short term, but may structurally shift longer term. And most profoundly, the concept of is there some exogenously given full employment equilibrium, or is the structure of the economy altered by the play of monetary forces, as much as other factors such as the technological nature of the production function, variables the likes of which neo classical economists have classically held exogenous.

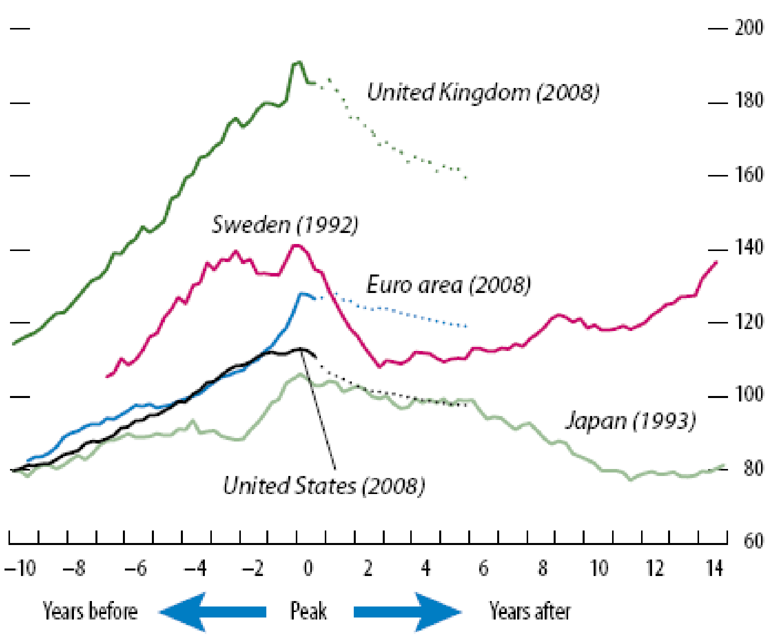
Apologies for this somewhat academic laying out of theory, but it sets an important backdrop to the events leading up to the current economic crisis. The relationship between monetary aggregates and inflation outcomes was seen as increasingly unstable. Central banks, particularly in the Anglo Saxon world focused more explicitly on the inflation target, to bypass the growing practical problems of trying to implement policy around quantitative targeting. This shift was in part supported by “The Great Moderation”, higher levels of growth with lower inflation, also known journalistically as “The Goldilocks Economy”. What was taking place was an expansion in the value of assets rather than goods prices. CPI was tame, whilst wealth was created, particularly for higher income earners, and the owners of existing assets. As characterised by a range of Keynesian and Neo-Keynesian critics of monetarist theory, money supply expansion was produced not exogenously, but endogenously to the functioning of the now dominant paradigm in Anglo-Saxon economies, Financial Capitalism. Of course this critique was increasingly marginalised as wealth was “created”. What had been a debate at the core of academic economics became one between orthodoxy, and more radical elements.

One particular branch of monetarist theory, called the Austrian School, was much more wary of the impact of uncontrolled credit creation, particularly aware of its potential impact of asset prices as much as consumer prices. It is interesting to note that this school retained its greatest influence in some central banking circles, most notably the then Bundesbank of Germany, and now the European Central Bank. Now “dead economist” Hyman Minsky noted that systems inevitably produced excesses as society behaves pro-cyclically, that is success breeds excessive confidence, boosting financial risk taking. As societies exhibit this style of confidence processes will be re-engineered to facilitate credit expansion, because there is money to be made in it, and the understanding of risk declines. This theory is a variant on the Post Keynesian view of the endogenous nature of the creation of money. It is effectively what took place in this decade prior to the Lehman collapse. Alan Greenspan famously argued that bubbles could not effectively be predicted or prevented, and that the risk management techniques offered by new financial instruments offered the best insurance. Of course, reliance on these instruments, and backward looking statistical regressions represented this cycles’ Minsky event, whereby an establishment filled with a hubris that blinds it to the self serving nature of its actions extends a successful operating logic, in this instance the importance of healthy financial markets, beyond its appropriate limits to extract unsustainable advantages to itself.

As a result debt expanded significantly in most Western economies. Ironically in Europe where tighter control was maintained of the so-called shadow banking system, bank leverage expanded. Property assets at the periphery were beneficiaries of this credit creation process. Europe despite its relatively reluctant acceptance of the Financial Capitalist model has exposed another set of problems. Its economic model was built on a foundation of a relatively generous social welfare structure, echoed by a corporatist industrial structure. This has continued to produce successful global enterprises. Labour markets are relatively inflexible within this relatively codified structure. Over and above this sits an ageing population, a significant demographic headwind. The rise of China as a cheap manufacturing base undermined certain elements of the European model, most particularly the smaller businesses in Southern Europe, the Italian textile base for example. But those parts of European industry that have responded to the challenge, making their labour structures more flexible and raising quality standards have done well. Those companies, the winners, are located primarily in Northern Europe. Southern Europe, much as was the case in the Anglo Saxon economies saw there economies become increasingly dependent upon the financial economy, or the sector most classically funded by it, the property sector. Most strikingly wealth was seemingly created in Spain as a property boom driven by low interest rates took hold.

The ultimately unproductive nature of this investment was exposed with the global tightening of financial conditions. Over and above that what stood exposed were inflexible labour markets constraining new business formation, government revenues dependent on the financial sector, and generous social welfare structures challenged by an aging population. The model that seemed so functional in the latter half of the 20th century was shown as fundamentally challenged by the global structural changes. The reliance of Financial Capitalism ultimately could not compensate for underinvestment in the productive renewal of elements of the European economy. That process must start now.

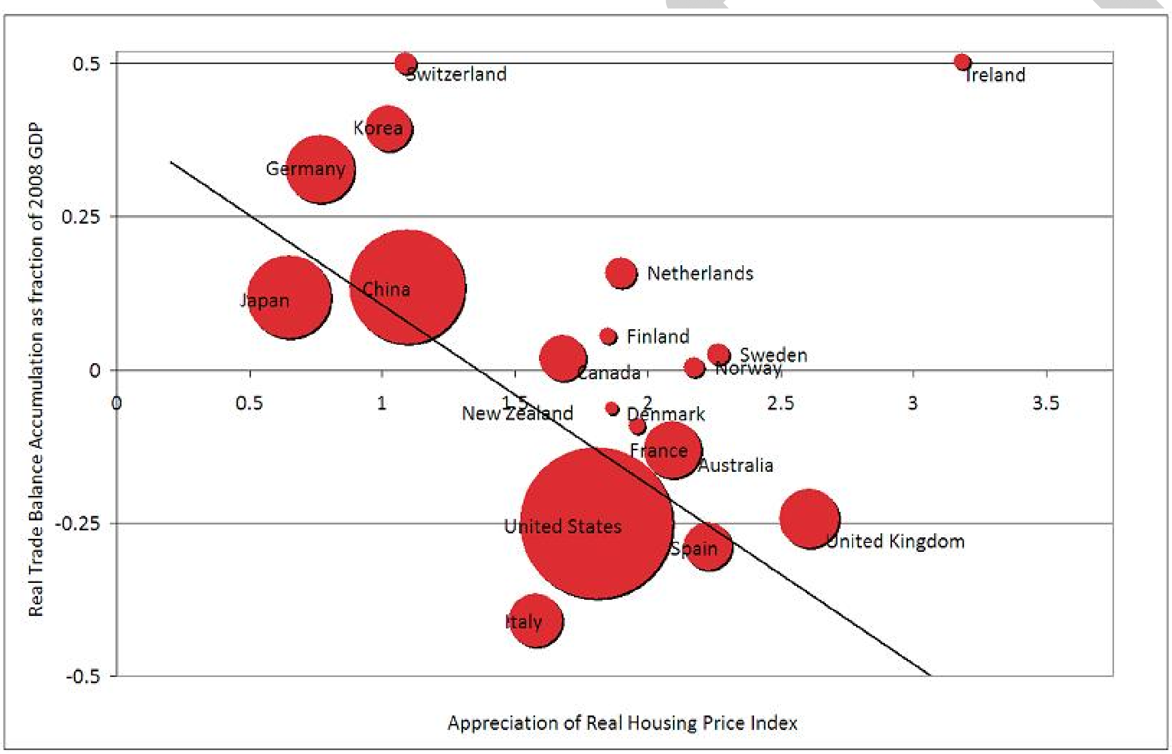
Figure 1.20. Bank Credit to the Private Sector
(In percent of nominal GDP)



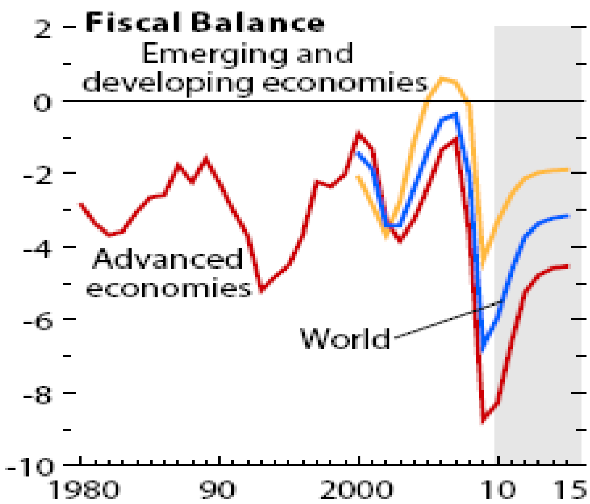
Sources: Haver Analytics; and IMF staff estimates.
Note: Dotted lines are estimates. Year of credit peak in parentheses.

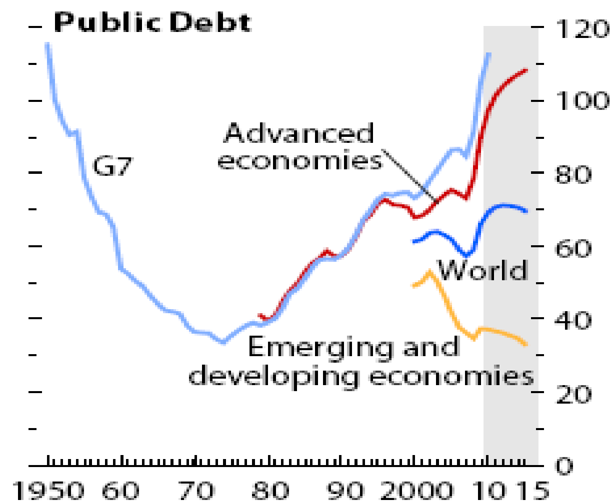
The US has similar fiscal challenges. Whilst current US social welfare structures are not as generous as those of Europe, the ageing of the US population threatens a major blowout in these costs at a time when the US budget is challenged by a similar contraction in income from the Financial and Property Sector, and greater demands on government to support economic activity. The IMF have recently commented that the inability of governments to be fully able to pursue an effective Keynesian response to the current crisis is not so much a flaw in Keynesian thinking, but a result of past accumulated debts resultant from over indulgent social welfare, as well as in the case of the US the expenses of maintaining its military initiatives. The crisis exposes much of this as no longer affordable and demanding major change. The politics is of course complex. The interesting point here is that this challenge is seen by bears as structurally insurmountable, but may in fact prove less of a challenge if retirement ages shift to better reflect the realities of expanded life expectancies, and healthcare systems get reformed to capture the productivity improvements offered by new technologies. There are many parts of these systems that have not yet seen the scale of productivity improvements demanded of the manufacturing sector by competition from low cost production bases.

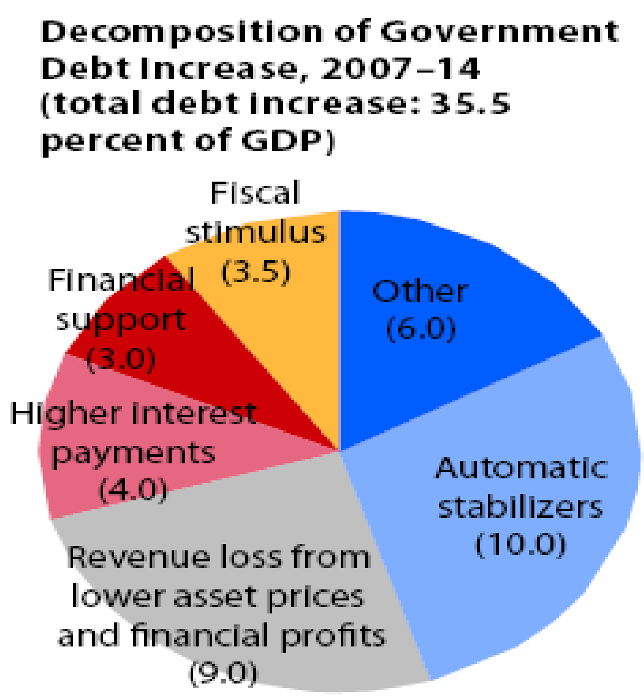
So whilst trade imbalances were a significant aspect of the global distortion, they sit importantly alongside the impact of these credit processes. In a sense the consumption patterns of the US economy, and trade imbalances, were supported by domestic credit and asset inflation, aided and abetted of course by Chinese reliance on an export driven economy, a pegged exchange rate, and a significant preparedness to fund American debt. It is interesting that those nations which exhibited the greatest level of housing price inflation up until recently showed the highest trade imbalances.



The precarious nature of this system was exposed not so much by the trade imbalances, but rather by the sharp loss of confidence in the banking system, driving a liquidity crisis and credit crunch, and the collapse of a range of financial asset prices. This collapse not only drove a very expensive bail out of banking systems whereby private debt was replaced to some extent by public debt, but at the same time government revenues associated with financial assets collapsed exposing the fragility of elements of the system. What was also exposed are imbalances in the governments tax take.


Fiscal Balance
Emerging and developing economies
Advanced economies
World
2
0
-2
-4
-6
-8
-10
1980
90
2000
10
15


Public Debt
G7
Advanced economies
World
Emerging and developing economies
120
100
80
60
40
20
0
1950
60
70
80
90
2000
10
15


Decomposition of Government Debt Increase, 2007–14 (total debt increase: 35.5 percent of GDP)
Fiscal stimulus (3.5)
Other (6.0)
Financial support (3.0)
Higher interest payments (4.0)
Automatic stabilizers (10.0)
Revenue loss from lower asset prices and financial profits (9.0)

The other important element of this system is some of this debt has been taken on by Central Banks. Debt taken on varies from government paper to more problematic private sector debt. Central Bank policy is multi dimensional, both potentially managing the shape of the yield curve, holding down credit spreads in some classes of debt for which there is limited appeal in the market [such as Mortgage Backed Securities in the US, or Spanish and Greek bank paper, where the banks in turn are buying their governments' bonds. Japan showed that if there is deflation even effectively zero rates of interest represent positive real rates of interest, a problem if a Central Bank is trying to stimulate activity and prevent consumer price and asset deflation. It is interesting that the greatest deflationary risk, mirroring the experience of the Great Moderation, is not so much in goods prices but in asset prices. Two decades of asset inflation has been followed by asset deflation. The question is how long this goes on for. The real point here is that assets that cannot command reasonable economic returns, such as speculative residential property, face the greatest risk of price deflation. Assets generating real economic returns should be less exposed. The question is how significant those asset pools are, and whether the fall in their values challenges overall economic activity. The obvious pools of such assets sit in residential property in the US, Europe, China, Australia.

Coming full circle, China has become highly aware that its high level of reliance on an export driven growth model leaves itself at risk. It needs to move towards domestic consumption. US credit expansion combined with the pegged exchange rate is an example of how financial expansions can mobilise underutilised productive potential, and mobilise investment that changes the structure of an economy and the nature of full employment equilibrium. Real productive power has been created by credit. It has been done under the auspices of a contract, a financial contract and a social contract, that borrowers consuming the output of those new production units will repay borrowers at some future point. At that point consumption from borrowers is likely to diminish in relative terms, and a new set of consumers needs to be identified. But the productive potential of the global economy has been expanded, and the question is how to mobilise it. This is both the question facing Central Banks in the West, and the Chinese government. China's fast tracking of development whilst giving itself a significant war chest of accumulated surpluses, has left an economy out of balance. The question is whether it can use its financial surpluses to drive those changes, or has its recent reliance on property inflation to prop up its own economy during the western downturn left it exposed to similar risks as the west.

It is interesting that when you actually look at the statistics of residential construction in China what is striking is not the quantity of housing that has been built, but rather that the growth of the housing stock has been below the level of economic growth in the economy. Excess is primarily located in the upper end within the leading cities. Unlike the US this does not represent a system wide problem, and echoes the relatively low level of domestic demand relative to exports and investments in industrial fixed assets. This speaks to the opportunity for domestic demand in China, as opposed to the restraint on demand in parts of the West posed by excessive debt balances.

The risk in China and Asia is does stimulating domestic demand risk inflation in their domestic economies. It is ironic, that whilst the West fears deflation the risks in the East seem the opposite. Or are we entering into a new form of the Goldilocks economy where weak western demand and deflation allows the East to grow with limited inflation risk. This discussion has suggested that the low inflation of the Great Moderation was in a sense an illusion. Reduced consumer price inflation went hand in hand with asset price inflation. Debate repeatedly comes back to the question inflation versus deflation. This is consistent, interestingly, with how the basic monetarist paradigm operates, with a simple use of the Quantity Equation of Money. We are more comfortable with the idea that inflation/deflation can in certain circumstances be understood as a shift in relative pricing, rather than an increase/decrease in the some measure of aggregate pricing. Our approach to this problem is to consider it as much from the bottom up as the top down, by considering the operating environments of the companies and industries we are investing in. It is by reference to the operating conditions of business that we focus our critical thinking, rather than taking views on what theory best applies to describing current conditions. Many macro economic forecasts seek to predict the future with reference to past conditions, though struggle when past decisions have structurally altered the equilibrium growth path. For example, how has the skills base of the United States been altered by the dominance of the Financial Economy over other sectors? This will materially alter the nature of the US growth path in the near future.

In summary world growth has been driven by the industrialisation of the developing world, and the growth of the financial sector in the West. Western consumption was sustained in part by a complex interplay between borrowing not just to consume, but to drive up asset prices. This “wealth” also masked structural imbalances in the functioning of government, overstating revenues, supporting levels of entitlements not consistent with ageing demographics. Similarly labour market reforms were held back by this wealth illusion in some jurisdictions. Longer term infrastructure investment has also been deferred in the US and Australia. And of course there is the profound challenge of climate change that has been dangerously put on the backburner. Focus on sustainable productivity enhancement has been patchy. But there are areas of strength. Certain sectors have proven themselves very capable in the West; American technology, European industry, the West’s capacity to deliver quality consumer experiences on a global scale, reaching into the burgeoning demand from the East. The world now struggles with what to do with the accumulated debts invested in unproductive assets and immediate consumption, rather than positioning it more effectively to deal with the changes posed by fast changing technological potential, and global rebalancing.

The question is what the burden of that baggage will produce?

The market struggles with the question of the “Double Dip” in the US, as the weight of consumer debt and working off unsold housing stock combines with a pull back in US government stimulus sees the US recovery decelerate. At the same time China is marked by the impact of government policies to take the steam out of the overheated property sector.

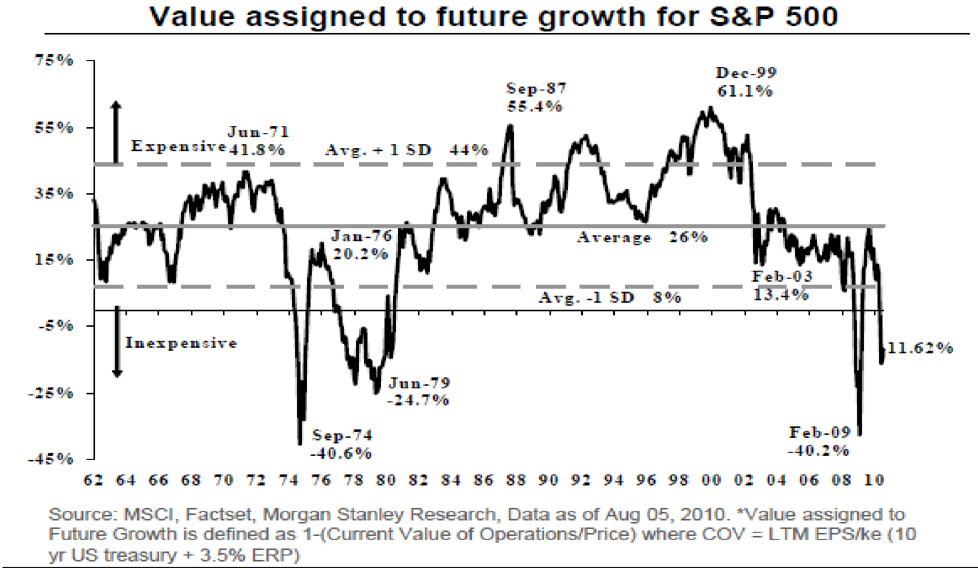
Investing in Equities

These historic changes have produced an equity market struggling to reconcile complex dynamics.

It does not “know” whether what lies ahead is a classical cyclical recovery, as per past cycles, or whether the structural changes mean the recovery takes a different shape. Investors frequently rely on the idea of mean reversion, but what if the past is not a good guide to the future? Post crisis markets have been marked by a sense of binary outcomes, either the west recovers or it doesn’t… risk is “on”, or it is “off”. But of course the reality is much more complex. It is not an all or nothing environment. In the past when credit was cheap you could essentially make money in investing in all financial assets. Really everyone was benefiting from financial asset inflation. Now it’s about distinguishing winners and losers in a two tier market.

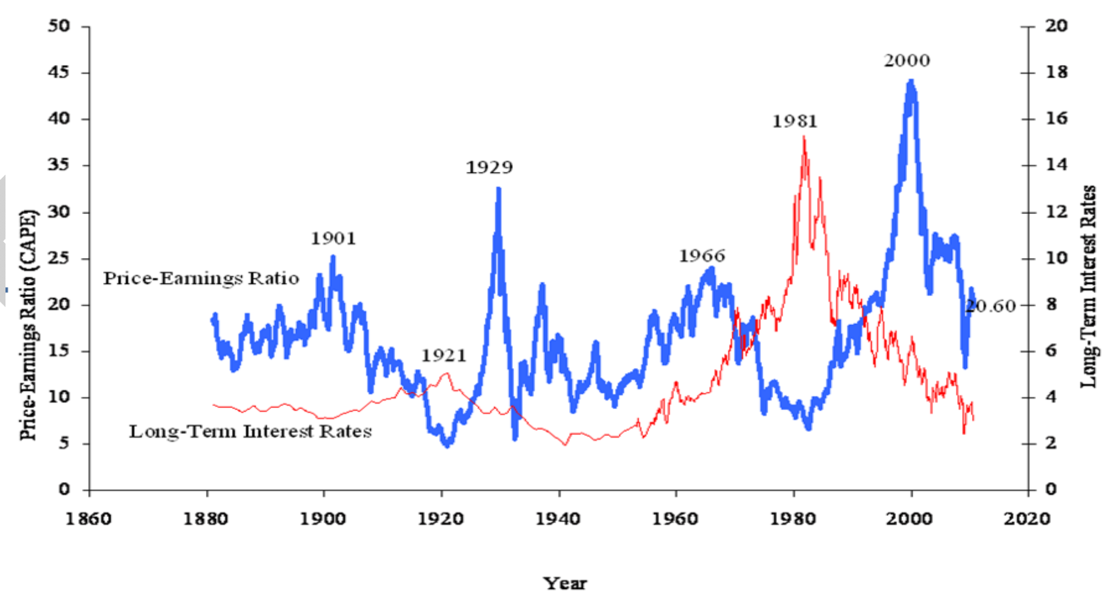
I want to deal with the complex structural environment I have described above with reference to what we see in financial markets.

Valuation

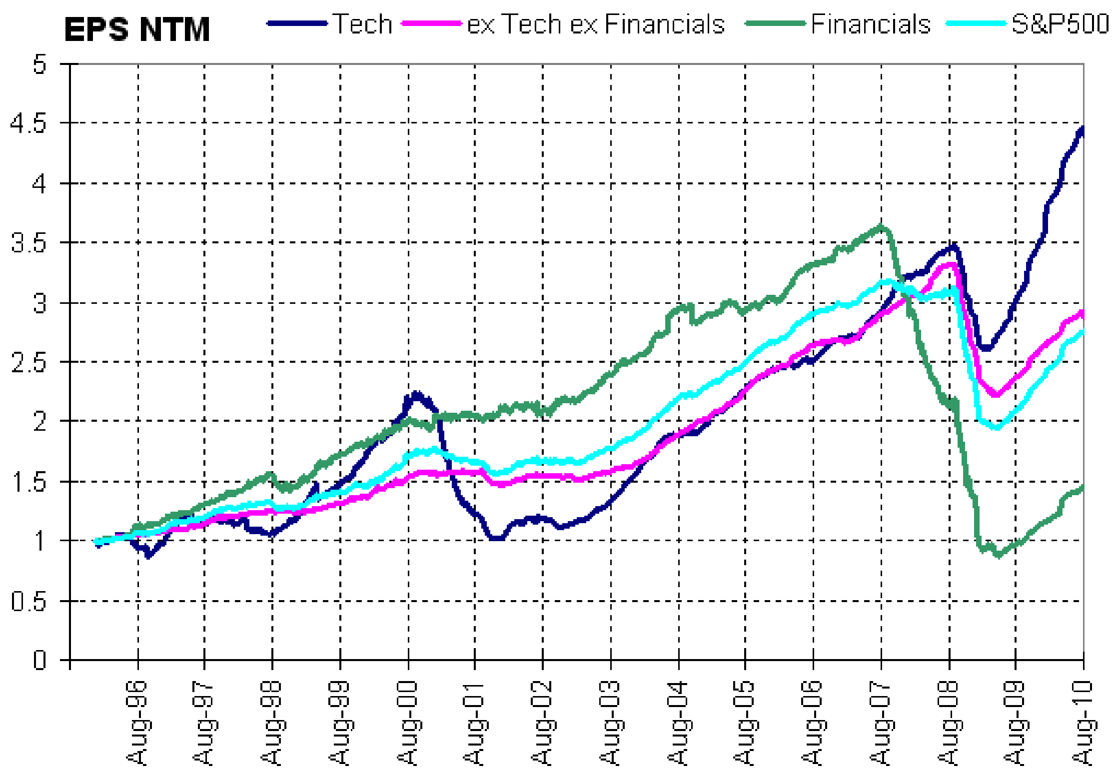


Source: MSCI, Factset, Morgan Stanley Research, Data as of Aug 05, 2010. *Value assigned to Future Growth is defined as 1-(Current Value of Operations/Price) where COV = LTM EPS/ke (10 yr US treasury + 3.5% ERP)

At current valuations, given present earnings power in companies and current bond yields [low] the market is implying future earnings growth of -11.6%. I.e. By this reading the market is pricing in a very negative environment for US companies.

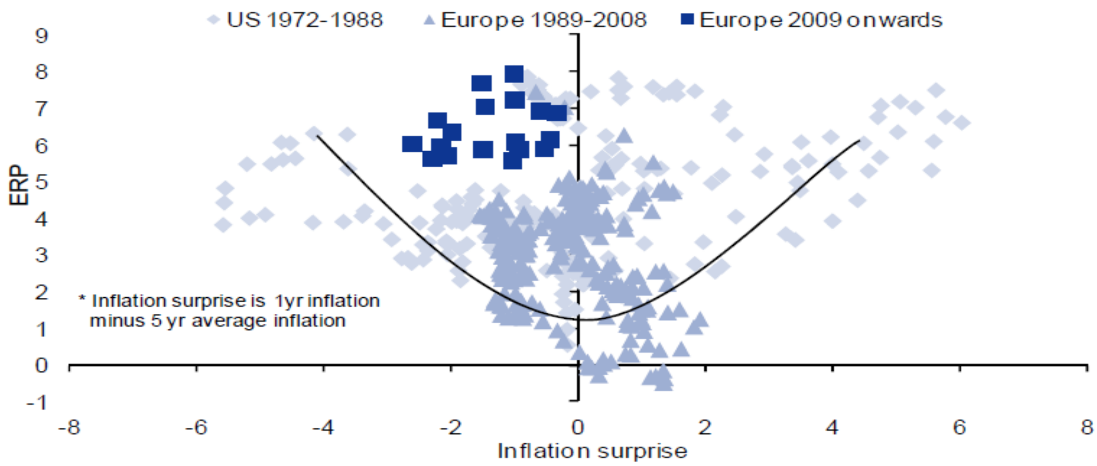


Another reading of valuation is given by what is termed the Shiller PE. This is adjusting corporate profits by applying average profit margins, as opposed to the most recent profit margins. It suggests the market is not nearly as cheap as the former measure. The point is that the profits of American companies are very high, particularly given what is seen as the fragility of the current economic environment. The question is how is it that profits can be so high under the circumstances, and are they sustainable?



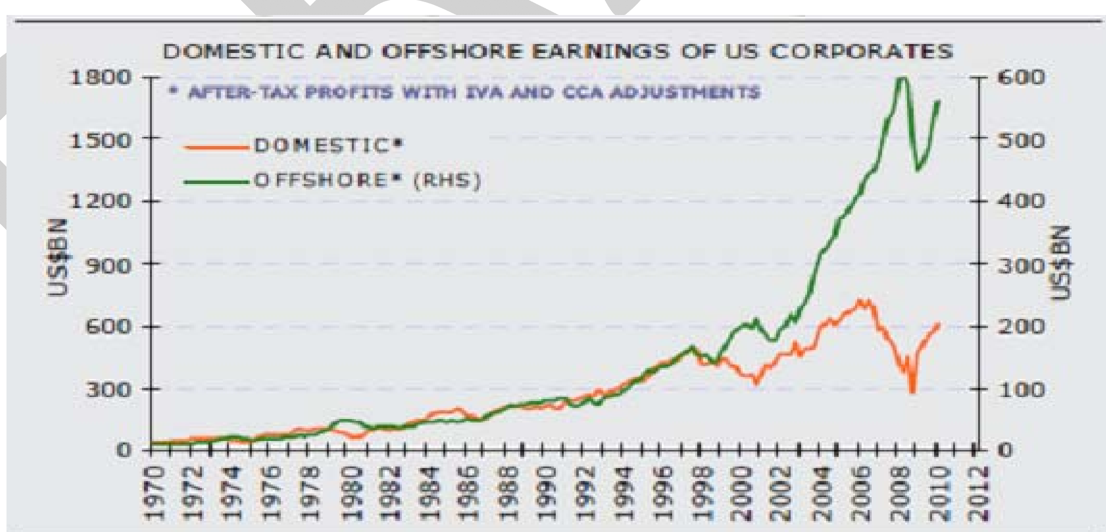
Looking at the earnings composition of the S&P it is telling that core industrial earnings, ex tech and financials have almost reached pre crisis highs even though the economic activity in the United States remains well below pre crisis levels. If you look at the technology sector you see the startling outcome that earnings are actually well above crisis levels. It is telling that at a time when the West struggles with fears of deflation the business sector is doing so well. The question is are these earnings sustainable, or are they a peak? If companies can generate these returns in such weak conditions, what kind of profits might they generate in a stronger economy? In order to understand this we need to consider where they come from.

Exhibit 3: Inflation surprises in either direction have been associated with high ERPs
Using US implied ERP from 1972-1988 and European implied ERP from 1989 onwards



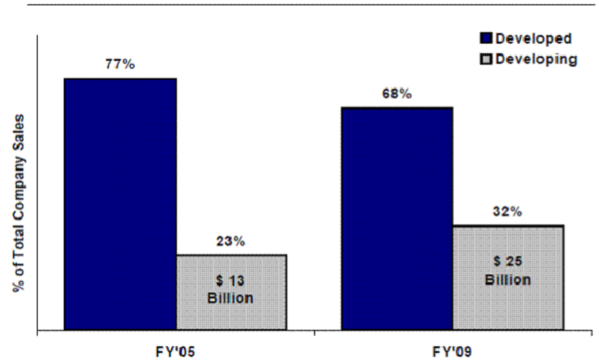
Another way of looking at this problem is by consideration of the nature of the equity risk premium. In this work by Goldman Sachs they suggest equity risk premium expands significantly with inflation surprises in either direction. It is intriguing that the suggestion that the current US market is implying -11.6% growth is based on an equity risk premium of 3.5%. A blow out in that premium, echoing current deflation/inflation fears is as much part of current market valuation dynamics as the question mark re earnings growth.

So how do we explain this discrepancy between corporate profitability against weak western economic conditions?



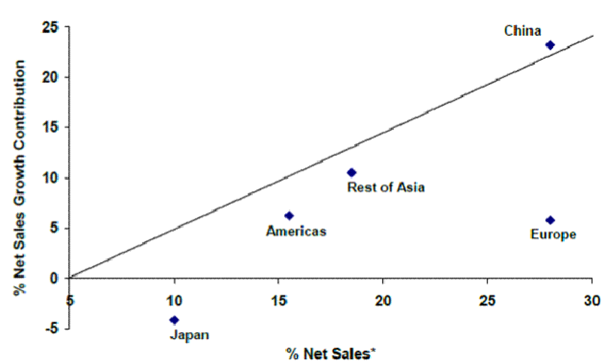
What we have seen is a dramatic alteration in where US and developed world companies have derived there profits. Earnings streams have truly globalised, with significant earnings from the emerging markets. This is one key factor why earnings have regained such high levels. Furthermore profit margins in offshore markets are higher than domestic margins. The emerging world offers in a number of instances very attractive pricing environments. The question re sustainability of profit margins is as much about the situation in developing markets, as it is in weak domestic markets. One factor that is very interesting though is that US interest rates will be set significantly echoing the US domestic employment situation, which remains weak, whilst American companies derive increasing portions of their earnings from offshore.

Procter & Gamble Revenue breakdown



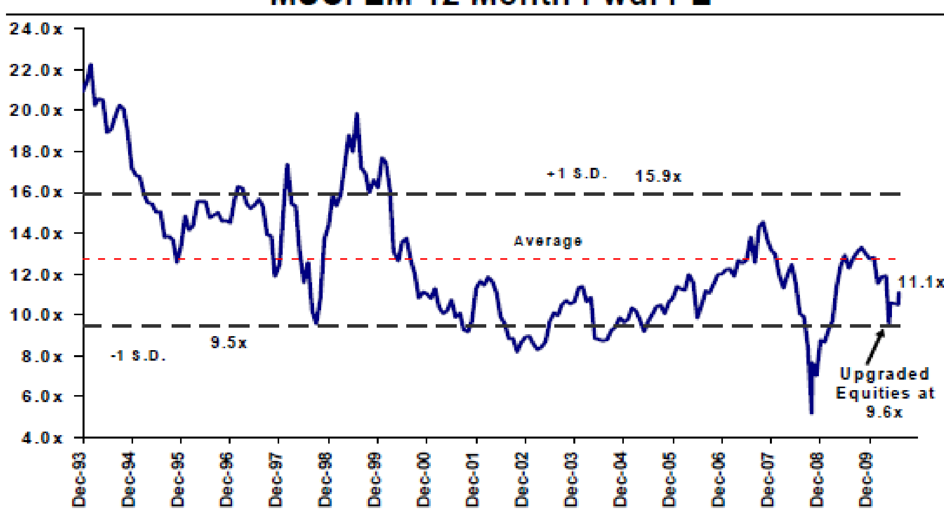
Source: P&G Morgan Stanley Conference Presentation, Nov 20, 2009.

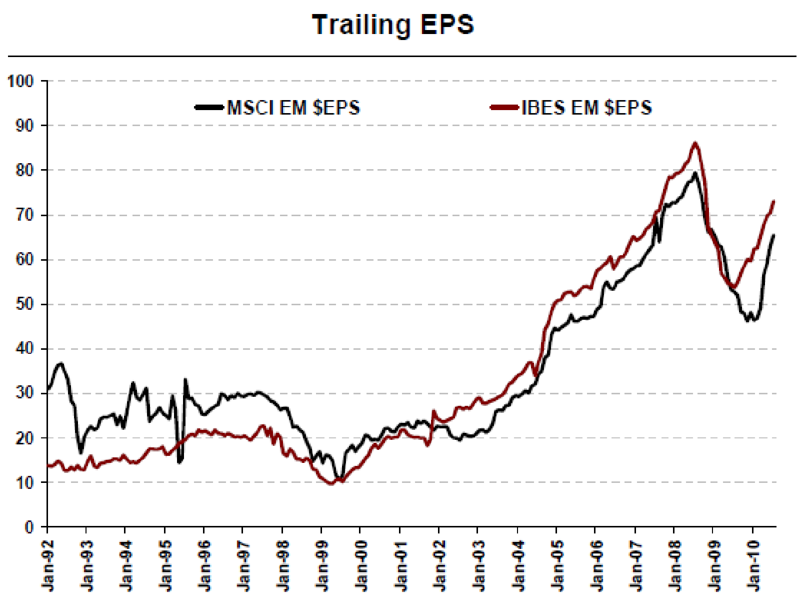
European Luxury Brands Sales share and CAGRs



Source: Company data, Morgan Stanley Research Estimates (FY10-12e).
**Note: Net Sales adjusted to reflect spending by consumer nationality (at home and abroad)*

MSCI EM 12 Month Fwd. PE

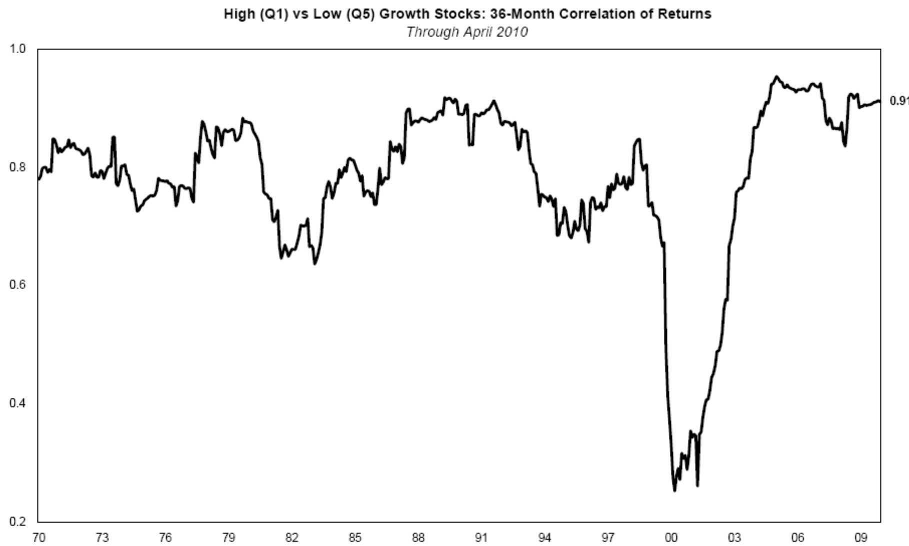




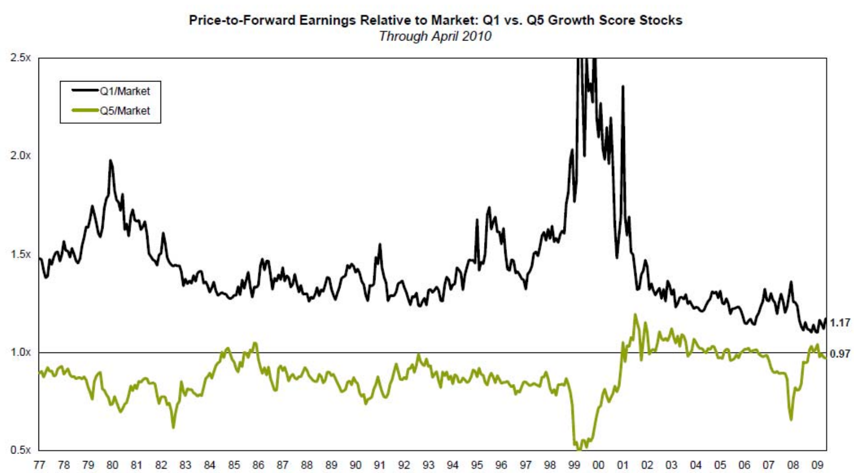
IBES, Factset, Morgan Stanley Research, Data as of July 31, 2010.

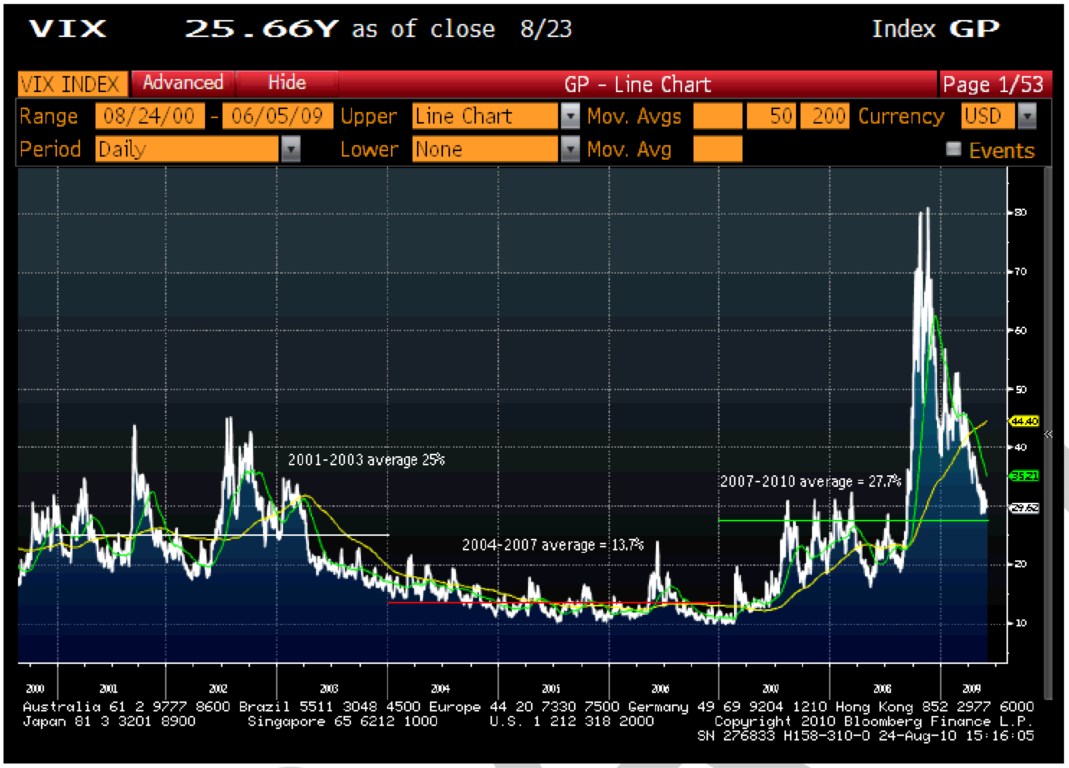
Emerging market valuations are not trading as cheaply as those in the US. Does this mean that US markets are cheaper? In a sense yes. It is priced for deflation risk. Emerging markets are likely to demonstrate structurally more sustainable growth, but they are also priced for it.

A very interesting element to what we have seen in recent equity markets is the high degree of correlation between stocks broadly since the recovery from the internet bubble crash, with the exception of the heart of the financial crisis. But correlation has increased not just between stocks, but between a large range of assets. As such diversification offered such limited benefits in recent crises, one of the reasons why many portfolio strategies failed to protect investors. This can be explained a number of ways. When the taps re liquidity are on it is the availability of liquidity that dominates returns over individual characteristics. A rising tide raises all boats. When the market is struggling with the success or failure of nations, rather than companies, outcomes for companies again are dominated by the sovereign question. Interestingly this has also seen some other interesting effects, performance and valuation differentials between higher and lower quality companies have narrowed significantly.



Q1 growth stocks are now only at a 15% premium to the market while Q5 stocks are trading just below parity

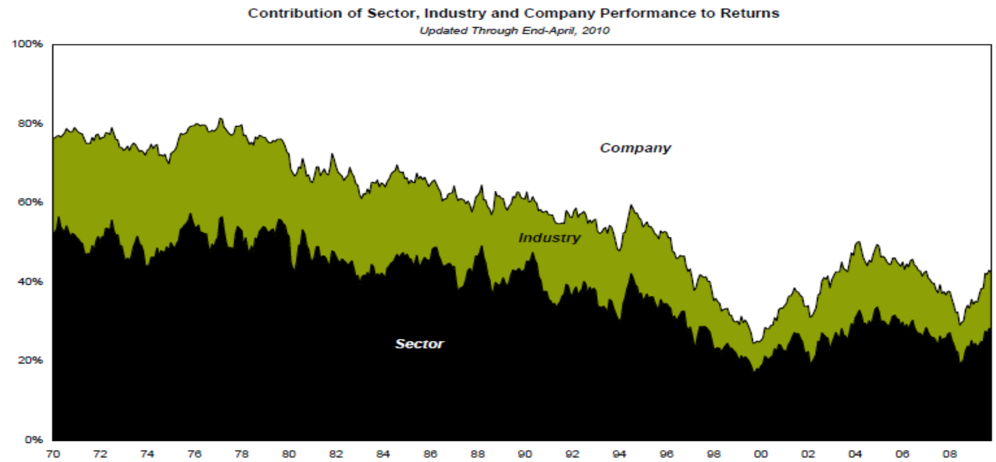




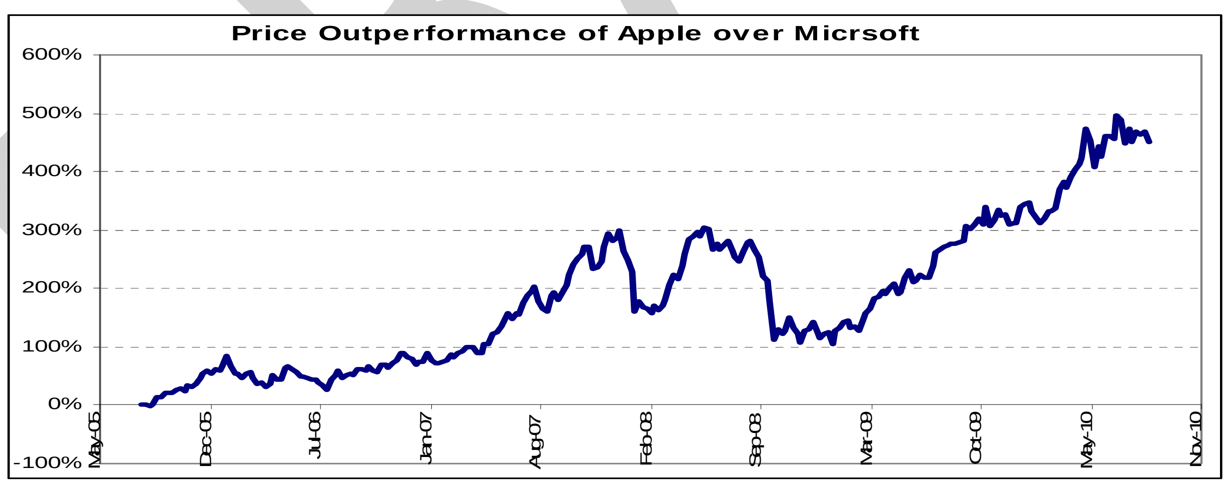
Also interesting is looking at the question of risk from the point of view of volatility as measured by the VIX. In the mid part of the decade when rates were low and the benefits of leverage easy for all to access equity market volatility actually fell. This is a powerful point. It happened as balance sheet risk was increasing. The power of leverage dominated stock returns. Remember the Private Equity boom. After the crisis, volatility has increased for the entire market, showing the danger of system wide leverage which is now on the balance sheet of the state.

But what is as also interesting is that picking winning stocks is still very important. This seems counter intuitive given what I have said above, but it speaks to a very important point. The first point is that dramatic macro economic reversals and market reversals can dominate market returns. BUT against that backdrop of broad based risk, business conditions at the franchise level are being dramatically altered by the two drivers of structural change referred to at the beginning of this discussion, globalisation and technological change. The difference between winning companies and losing companies in this environment is dramatic, and vital to investment returns.

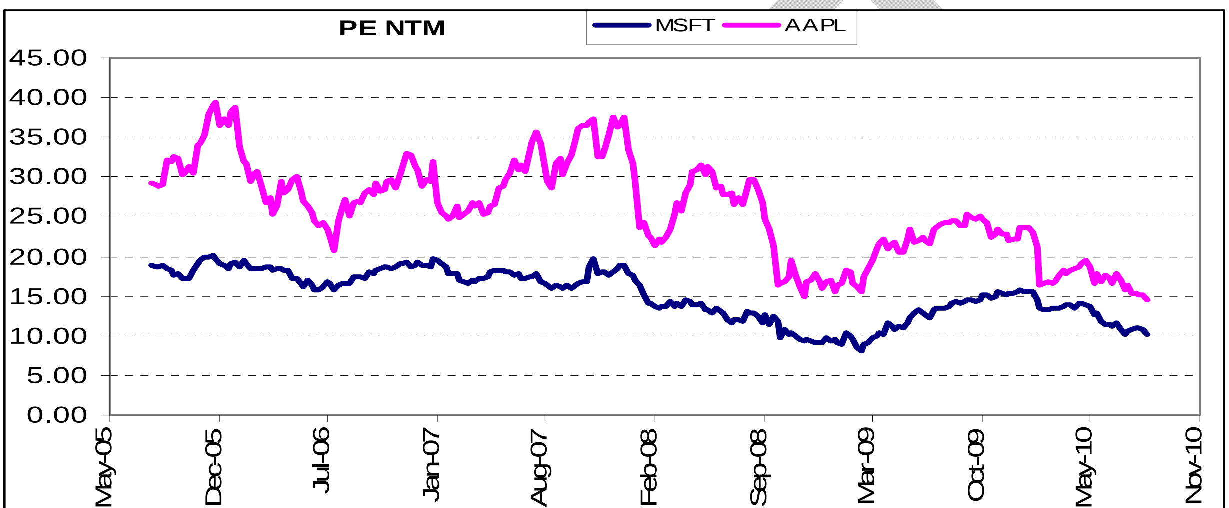
Sector betting remains far less important than getting the companies right - you have to do more than get energy or financials right



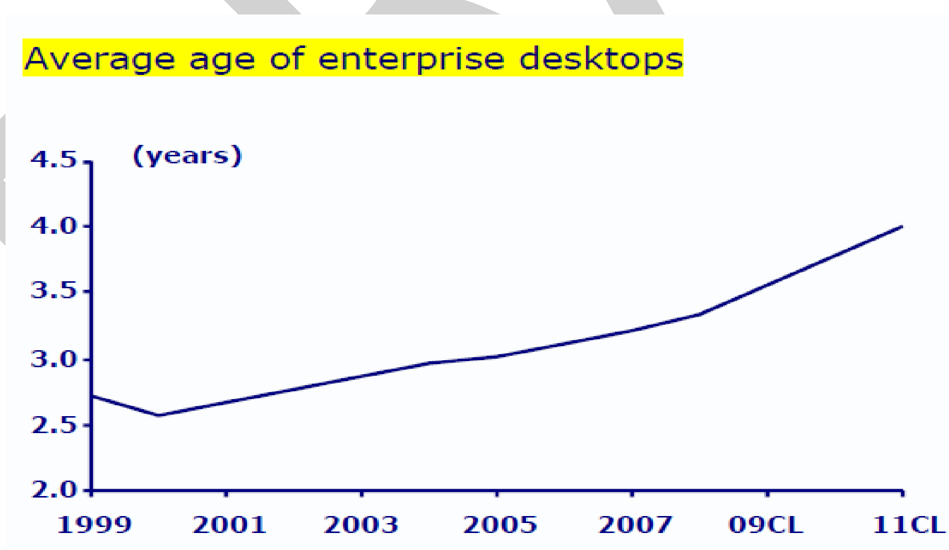
There are many stark examples of this phenomenon. Possibly the most obvious is Apple versus Microsoft. How the underdog moved to overtake what was once the world's largest company is already the stuff of legend. There are many important elements to the Apple story. As an investor owning one versus the other was of major significance. Apple also is spear heading a major reworking of multiple industries. It is not just a device maker. The music industry was irreversibly changed by the iPod, the telecom industry by the iPhone, and prospectively print media by the iPad. iTV, the reworked Apple TV is rumoured to be launched in September. Apple wins, but many have lost in the process.



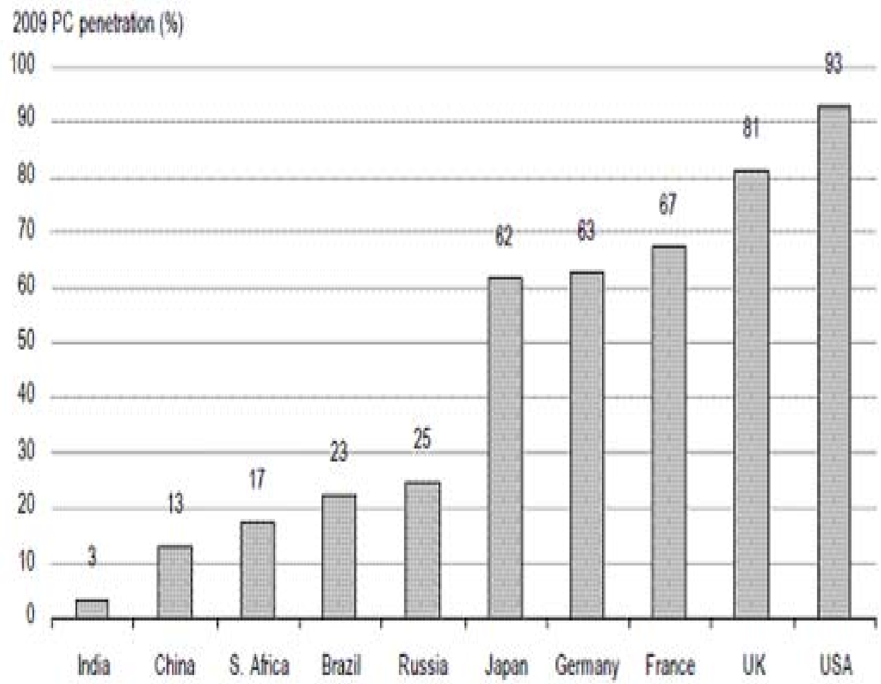
As interesting is that these stocks are getting cheaper as they grow. This is an example of how higher growth stocks have been derated versus the market. It is in part appropriate, because it says that these growth rates may not be sustainable. This is in stark distinction to what was seen before the tech boom. But unlike then these stocks are not operating in industry environments where they or there customers have debt. And bond rates may remain low because of low employment opportunities in the US economy. So are there earnings at risk, or may they be rerated in a low interest rate environment given the quality of their cash flows?



Technology is both a developed and developing world phenomenon. In the west companies have held back due to the financial crisis on upgrading IT. The installed base of PC's is now reaching scrapping age.

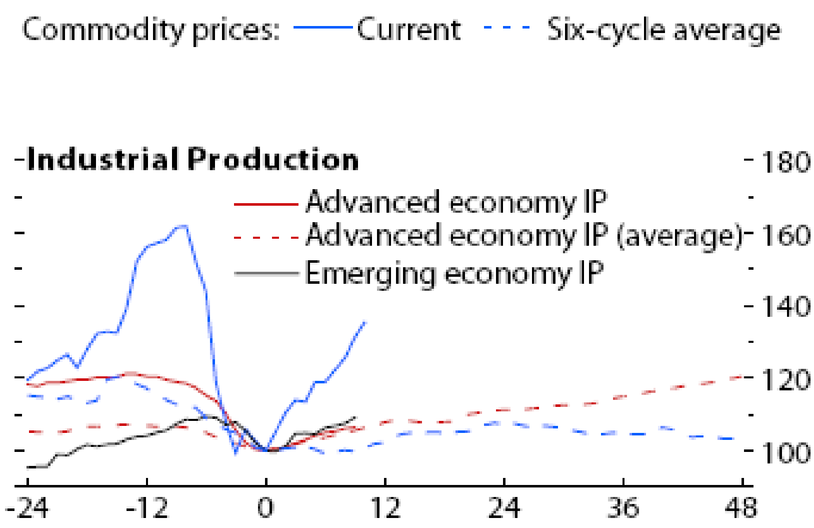


At the same time PC penetration in Asia remains low. The growth opportunity in technology remains. But it is a difficult sector, where winners win big, which operates in an environment of perpetual price deflation due to the impact of Moore's Law on ever increasing productive efficiency.

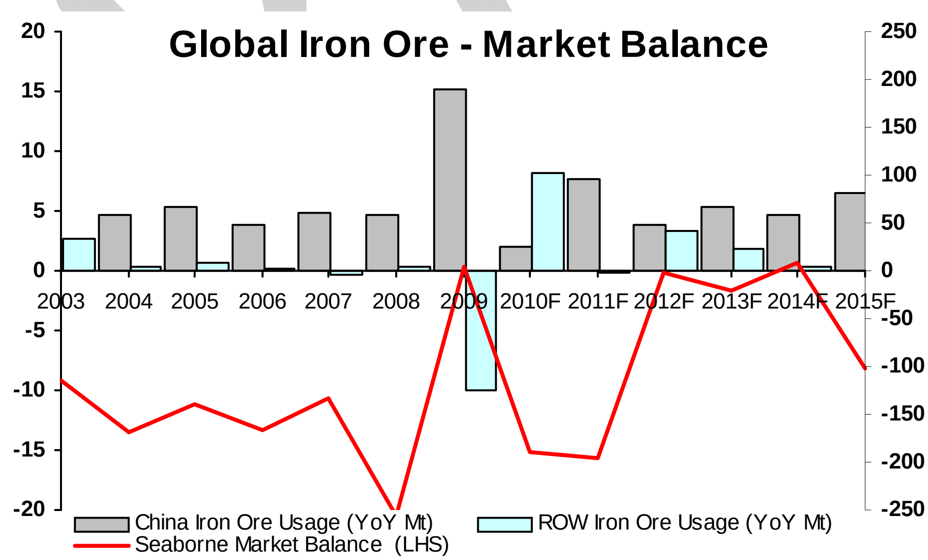


Another element of the rebound in tech earnings has been the reduced investment in semiconductor capacity in the industry. So whilst we are seeing excess housing inventory in parts of the world, there is a relative shortage of manufacturing capacity in this structural growth sector. Little wonder profits to the semiconductor industry have reached extraordinary levels despite the weakness in parts of the global economy. The market is now marking down semiconductor companies on the basis that earnings have peaked. The question is why have they peaked? Is it because we are about to see a double dip recession, or is it because we are about to get excessive capex in the industry. If that were true the world economy must be in better shape than the more fearful out there contend.

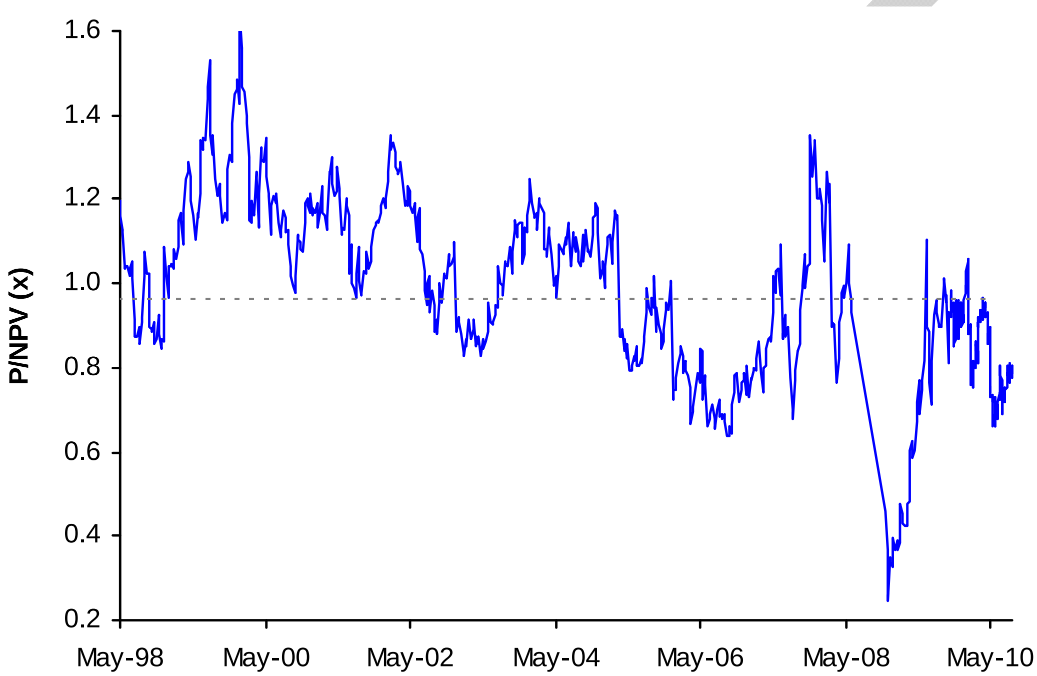
Let's examine this phenomenon from another sector… commodities.



Another telling element of the current cycle is that commodity prices have rebounded far faster than the bounce in industrial production would suggest. Why is this so? We can look at a range of commodities to consider this point, but as we can see with Iron Ore there remains no spare capacity in the industry. The crisis brought the market briefly into equilibrium. Additional supply coming on in the next few years may bring it back to equilibrium, but there is little sign of excess capacity in the industry.



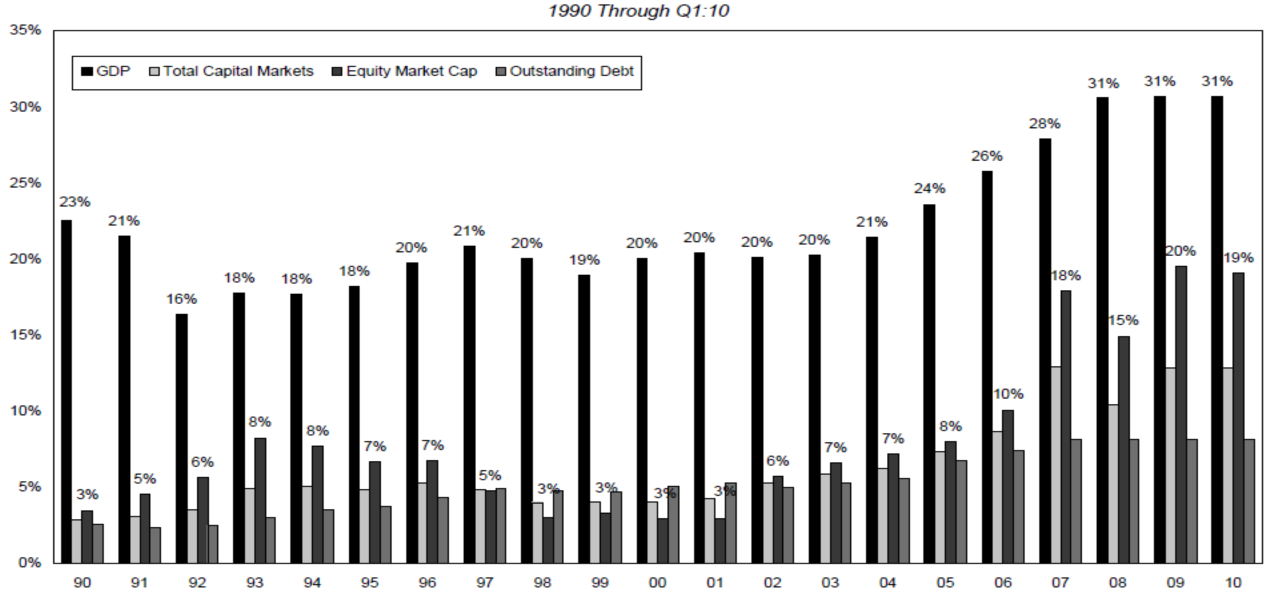
Rio Tinto – P/NPV – LT History



As per the technology companies, Rio Tinto and the mining companies are trading below historical averages relative to NPV. The question is are mineral prices sustainable in the new world order? The market is sceptical.

Let us look at another of the growth drivers of the world… the rise of Financial Capitalism so to speak, in Asia.

Emerging Market Share of Total Nominal GDP, Equity Market Cap and Debt Outstanding
1990 Through Q1:10



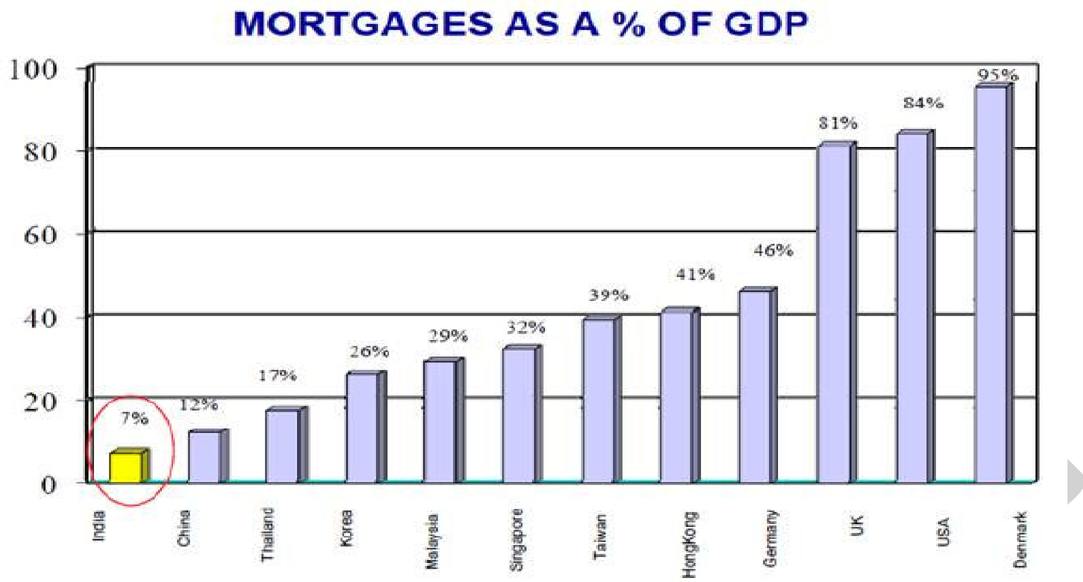
The massive increase in market value in emerging markets has been achieved, unlike in the west, without an increase in debt. This was in part a consequence of the discipline imposed after the 97-98 crisis by the IMF, a situation Asia was not wanting to repeat.

Over and above this Asia has a number of markets showing low banking penetration. We note the markets of India and Indonesia.

Loans as a Percentage of GDP (December 2009)

	China	India#	Indonesia	Thailand	Korea	Malaysia	Taiwan	HK	Singapore
Total Loans	127%	50%	26%	86%	86%	116%	140%	201%	127%
Business Loans	103%	39%	18%	67%	48%	56%	75%	145%	60%
Retail Loans	24%	11%	8%	19%	38%	60%	65%	56%	68%
--Mortgage Loans	14%	5%	2%	11%	25%	31%	48%	43%	54%
--Non-mortgage Loans	10%	6%	6%	8%	14%	29%	18%	13%	14%

Source: Morgan Stanley Research; # Data corresponds to Scheduled Commercial Banks only. For the whole banking system in India, loan to GDP ratio stood at 52% as of December 2009.



Source: European Mortgage Federation, 2008 & Asian Development Bank, 2007

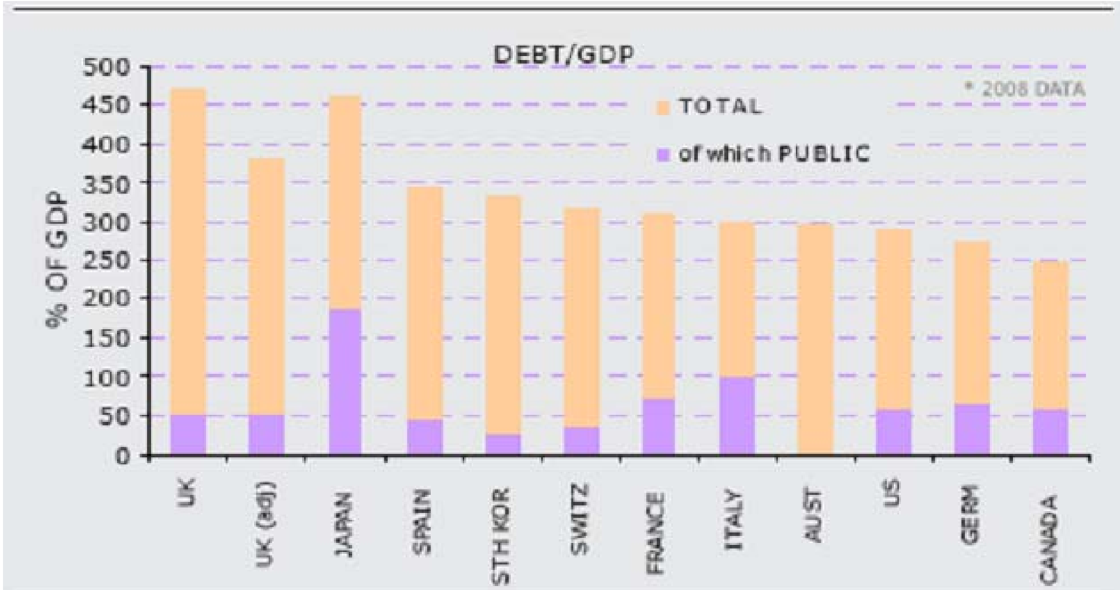
In these markets there is clearly high structural growth potential. Let us think now about what we are paying for banks across the globe.

Based on 2012 estimates

	CBA ($AUD)	Wells Fargo ($USD)	ICICI Bank (Rp)
Current Share Price	50.3	25.38	1000
P/TE	2.60x	1.45x	1.80x
Return on Assets	1.03%	1.50%	1.50%
Leverage	18.2x	10.7x	7.3x
Loan to Deposits	127%	104%	99%
2012 Earnings	4.62	3.82	68.43
2012 PE	10.89x	6.64x	14.61x

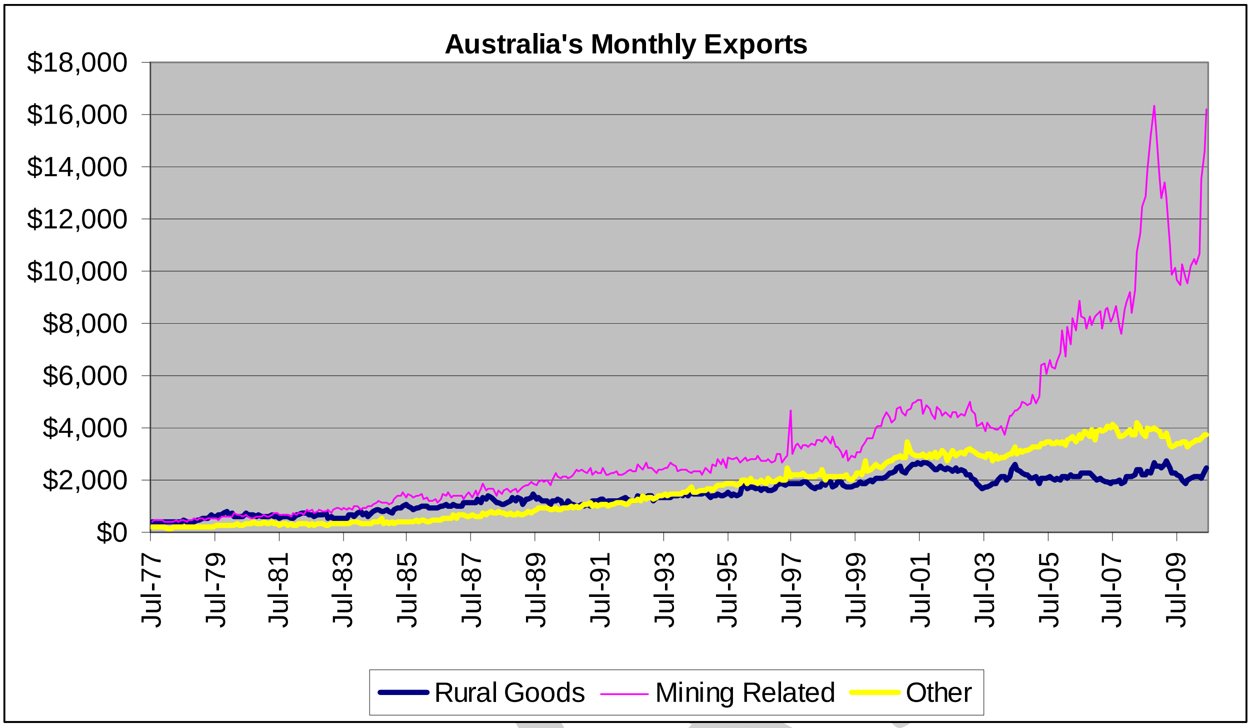
Comparing ICICI, the largest bank in India not controlled by the government with the Commonwealth Bank, and Wells Fargo in the United States we make the following observations. ICICI as very little leverage on its balance sheet, meaning it can increase loans without raising capital, in an environment which is under banked, with significant loan growth potential. It is currently totally self funded from deposits. It trades at a cheaper valuation to book relative to the Commonwealth Bank. Whilst PE is higher it has significantly higher growth potential with little risk to its capital base. Wells on the other hand is significantly cheaper than the

Commonwealth Bank on all metrics, in an environment which has already seen massive capital write-offs. Where does that leave the Commonwealth Bank and what does it say about the Australian market?



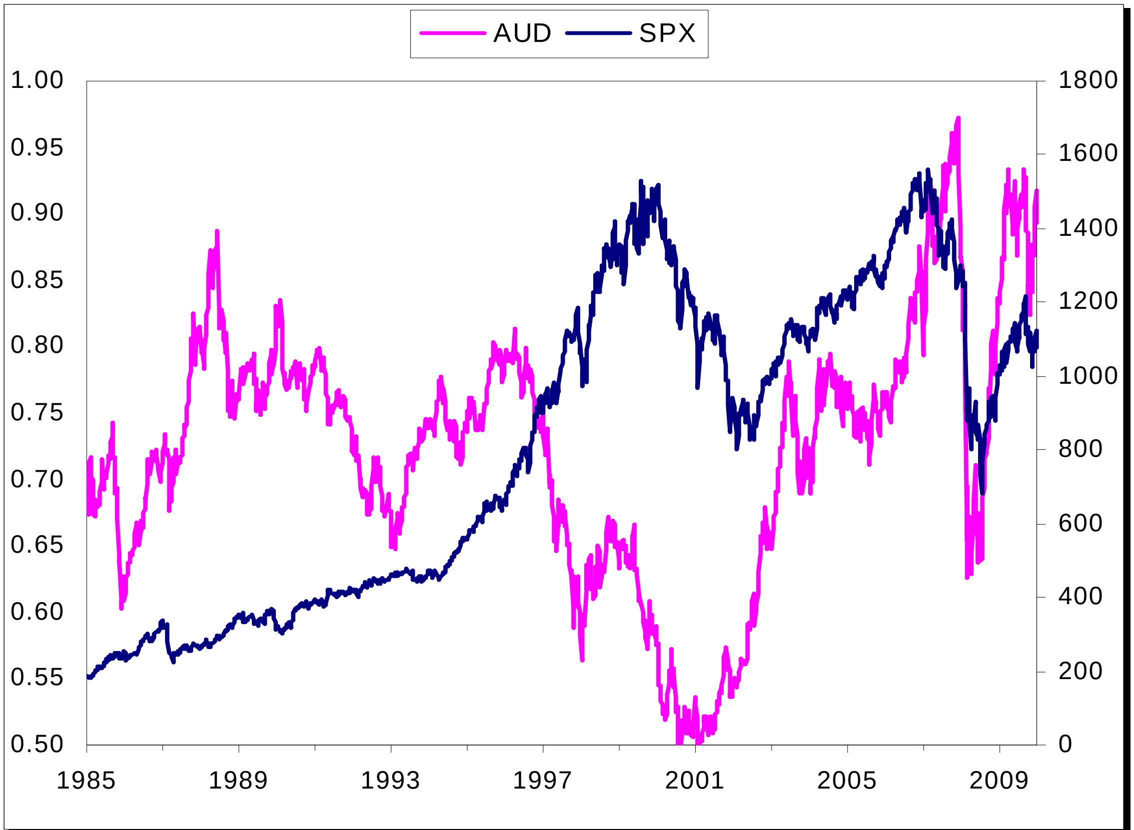
Note: The 'adjusted' UK total removes debt associated with UK's role as a global financial centre. Swiss data are for end-2007; Australian data as at June 2008.
Source: McKinsey Global Institute, http://www.mckinsey.com/mgi/publications/debt_and_deleveraging/index.asp, ABS; Morgan Stanley Research

It is interesting that there is much discussion of Australia's low public sector debt. But when we look at private sector debt the situation is nowhere near as favourable. Consumer debt in Australia is very high. So whilst we have benefitted from the mining boom, that success has underwritten also an extraordinary increase in private sector debt. High gearing puts even the safest assets at risk.



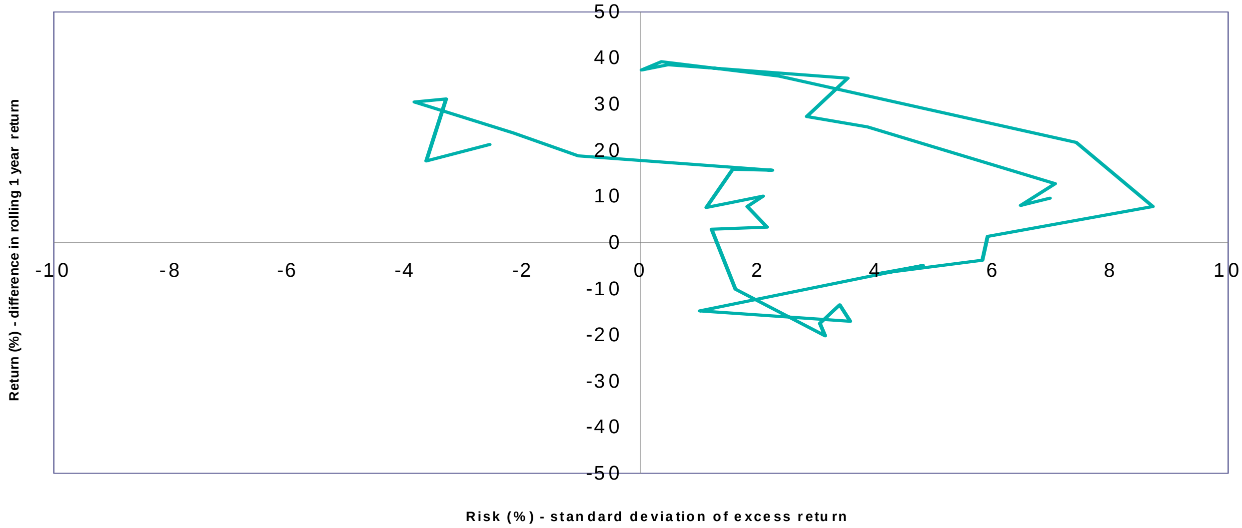
We have discussed two speed economies in other parts of the world. Australia also has a two speed economy. Residents of the South East risk being the equivalent of Spain, or sub-prime in our economy. Ex mining the question is what supports Australia? How secure are we carrying this much debt with a one legged stool?

And even if housing doesn't roll over in Australia, how much more can Australian banks lend to the household sector? So without forecasting a rollover in the Australian economy, the capacity of all sectors to keep firing simultaneously in a world where excess credit is being rationed is a risk. Will all Australian companies rise going forward as Asia grows? And if Asia doesn't grow where are we?

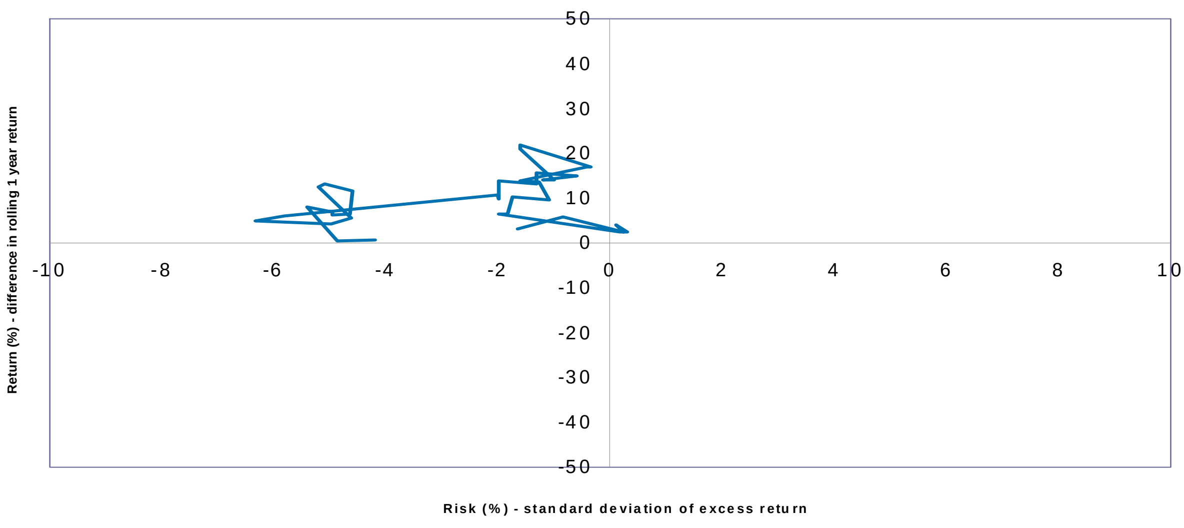


The Australian Dollar has changed its dynamics in a very interesting way. In the 90's it had limited correlation to global equity markets, but in the new millennium it became a "beta proxy", following global equity markets. This corresponds to our charts showing increasing correlation of equities, and is an example of the broader correlation of risk assets. This took away from returns from International Equities for Australian investors, in the absence of hedging. With variable hedges on the Australian Dollar, high when confidence in growth was high, and low when equity risk increased the returns from international equities could be captured to an extent, with volatility reduced. The Australian dollar performs a useful function in this regard. But it is as interesting a question to ask if it will continue to behave like this in future as the limits to our economy posed by high debt levels might become an issue.

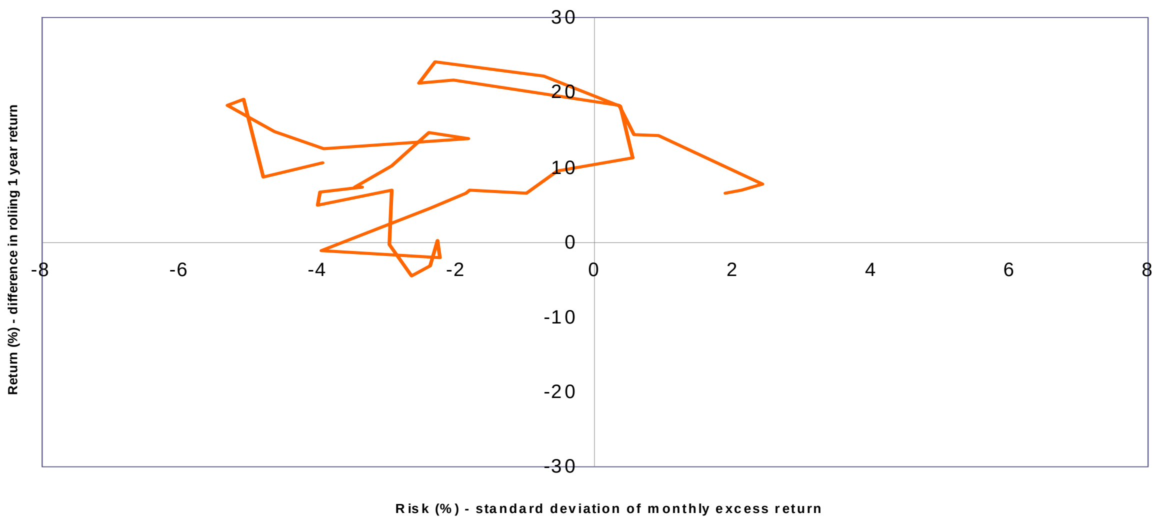
So this raises the final point. The behaviour of Australian equities relative to international equities. It goes without saying that unhedged international equities have underperformed the Australian market over recent periods, though Australia proved very volatile during the crisis.



What is not so obvious is that global equities with hedging strategies actually delivered positive returns with low volatility over the period.



It is interesting that this relative performance took place when everything was working for Australia. It is interesting that when you combine the two you find that a diversified portfolio gives very good returns with significantly less volatility. The question then remains? What is the best strategy moving into the future world? Australia is stark in its lack of diversification. It has outperformed international equities starkly. Equities have considerably underperformed bonds. We would suggest that increased diversification is now essential. Old winning formulas run serious risks. Past success breeds complacency. It is the reason, as Hyman Minsky captured, that excessive debt is built up. Time to challenge conventional thinking.



Christopher Selth
Five Oceans Asset Management, August 2010

Disclaimer

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