Goldman Sachs JBWere
Asset Management

Food For Thought

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Failing Memory

'Fundamentally, the Australian economy is in much better shape than previous recessionary episodes. Whilst time can dim our memories, the environment and financial strains that existed in the early 1990s were a greater risk to the Australian economy than the current global slowdown.'

As investors fret over the uncertainty in both the global and local economy I was reminded by an experienced central banker that it always feels worse in the present. His words were to the effect – the current episode always feels worse because we know how past episodes finished whilst the current script is still not complete. In sporting parlance we are watching the game live rather than reliving old memories, a recipe that increases the stress and tension of the moment.

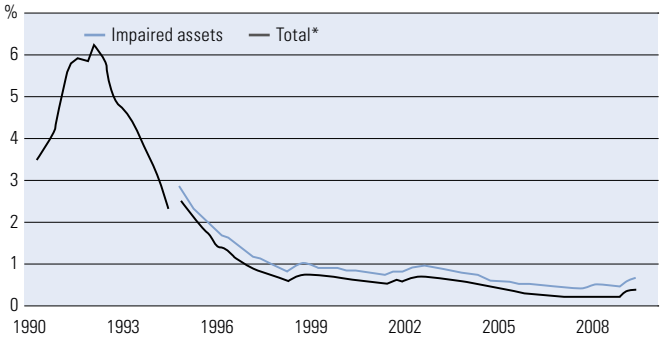
With the weakness seen in the Australian economy since March 2008 there have been some comparisons raised with previous periods of hardship in Australia – namely the 1993 and 1982 recessions. Talking to market participants who did work the tough markets of the early nineties, most (including myself) would conclude that the current episode certainly feels more serious. We need to be reminded, however, that time heals old wounds and a side by side comparison is needed to make a more objective conclusion.

Looking at the statistics of the time, the Australian economy entered the nineties with a full head of steam, recording annualised growth rates of over 5% and unemployment was historically low (just below 6%). Growth was fuelled by a commercial property boom that saw new construction of office space triple, driven by price rises of over 150% in Sydney commercial property over the period 1985–2000. Inflation was a problem, however, with the inflation rate increasing over the period, topping out over 8%. This necessitated a tightening campaign by the Reserve Bank of Australia (RBA) which pushed home loan interest rates over 17%, resulting in extensive stress in the consumer sector. Clearly there are a number of significant differences today. Most notably, on the inflation front where inflation, whilst high, remains below 5% and home loan interest rates, which peaked recently at 9.5%.

Whilst there remains considerable uncertainty regarding the global financial crisis today, the situation was much closer to home in the early nineties. Two state banks failed or were rescued (State Bank of South Australia and State Bank of Victoria) and extensive lending to the commercial property sector severely impaired the balance sheets of the listed banks in Australia. Two of the largest Australian banks suffered significant losses due to commercial property exposures and the listed banking sector was loss-making in 1992. In many ways Australia had its very own credit crisis. As Chart 1 below shows, impaired assets were running at 6% versus the current modest level below 1%.

Chart 1 – Banks' Non-performing Assets

Consolidated, per cent of on-balance sheet assets



* Includes 90+ days past-due items that are well secured
Source: APRA

Scanning newspaper articles of the day, the economy was also going through structural change and geopolitical uncertainty. In an effort to expose industries to competition, an extensive tariff reform program was in place exposing Australian manufacturing to global competition, whilst the Mabo court decision cast some doubt on the question of ownership of mining rights. On the stock market, listed companies had geared extensively through the latter half of the cycle and there were many high profile failures including Bond Corporation, IEL and Bell Resources. Globally, Iraq had recently invaded Kuwait and the oil price spiked.

The brief recount of history serves to make two important points. Firstly, that the passage of time dulls the memory on past episodes of uncertainty and secondly, that no two episodes are the same.

Structural reforms implemented over the last twenty years leave the local economy much better positioned to withstand the current downturn, and strength in our emerging market trading partners provide a degree of insulation that has not been present during past consumer retrenchments. In Table 1 below we look at a number of simple metrics contrasting the Australian economy to the US and Europe.

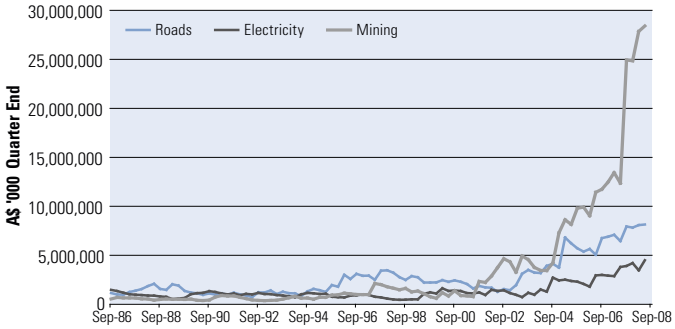
Table 1 – Key Macro Positions

		Australia		United States		Europe	
		2007	2008	2007	2008	2007	2008
Consumption	(YoY %)	4.3	2.9	2.9	1.4	1.8	0.4
Investment	(YoY %)	10.5	7.0	3.0	-2.5	3.5	2.4
Fiscal Balance	(% GDP)	0.8	0.9	-2.6	-3.8	-0.6	-1.1
Interest Rates	(%)	6.5	7.0	4.8	2.0	4.0	4.3
Employment	(%)	4.3	4.1	4.7	6.1	7.4	7.3

Source: Bloomberg, RBA, IMF

At a consumer level Australia has seen a slowdown of similar magnitude to those experienced internationally. Consumption has fallen by 1.5% in response to high oil prices and interest rates. Both Europe and the US have experienced similar falls in consumption, both for similar (energy prices, interest rates) and more unique reasons (house price falls). Where the outlooks differ, however is in the investment outlook, government fiscal position and monetary flexibility.

Chart 2 –Australian Investment Pipeline



Source: RBA, ABS

Unlike the US and Europe where capital spending intentions are weakening, Australia is experiencing a strong investment phase especially in the resources and energy industry, as shown in Chart 2. These are long-dated projects that are likely to continue despite the short term volatility in developed markets economies.

The structural changes in Australia's public sector balance sheet over the last thirty years also provide a degree of policy flexibility that is not accessible elsewhere. With a fiscal surplus and no outstanding debt the Australian government is in a strong position to support segments of the economy that are feeling pain from the current slowdown. Lastly, the RBA retains strong policy flexibility given the tight monetary policy settings in the economy. As we have seen already the RBA is embarking on a path of lower interest rates that will ease the burden on home-owners.

Fundamentally, the Australian economy is in much better shape than previous recessionary episodes. Whilst time can dim our memories, the environment and financial strains that existed in the early 1990s were a greater risk to the Australian economy than the current global slowdown. Given the All Ordinaries is down 27% compared to a fall of 26% in 1990, and the market is trading on similar inflation adjusted multiples to 1990, one would hope that rationality will prevail once confidence returns to the global financial system.

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Andrew joined Goldman Sachs JBWere Asset Management (GSJBWAM) in 2004. As Chief Investment Officer, Andrew has overall responsibility for managing the research and portfolio management activities of the domestic investment teams, covering fundamental and quantitative equities, real estate, cash and fixed interest and multi-sector portfolios. Andrew is also Chairman of the Asset Allocation Committee and is the Portfolio Manager of GSJBWAM's multi-asset strategies – Income Plus and Diversified Growth.

Before joining GSJBWAM, Andrew held the position of Head of Global Equity Research at Citigroup Asset Management in the US for three years, before which he was head of Australian Equity Research and Portfolio Manager at Citigroup Asset Management/JP Morgan in Australia.

Andrew is a Chartered Financial Analyst (CFA) and holds a Master of Business Administration from the Australian Graduate School of Management. He also holds a Bachelor of Engineering (Ceramics) with First Class Honours from the University of New South Wales, at which he won the University Medal.

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Angus joined Goldman Sachs JBWere Asset Management (GSJBWAM) in 2005. He is responsible for analysing macro-economic activity in Australia and internationally. He is engaged with the portfolio management and ongoing research of GSJBWAM's multi-asset strategies – Income Plus and Diversified Growth. Angus is also a member of the Asset Allocation Committee and assists in the management of GSJBWAM's cash and fixed income portfolios. Before his current role, Angus worked as an Analyst in the Adviser Service team.

Angus holds a Graduate Diploma of Applied Finance from the Financial Services Institute of Australasia and a Bachelor of Science (Physiotherapy). Angus is accredited by the Securities and Derivatives Industry Association (SDIA).

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Investment strategy – multi-sector funds

October 2008

Our current strategy for our multi-sector funds is as follows:

Mild overweight in Australian equities

Valuation – after an extremely volatile month, our local equity market finished September down -9.8%. With markets now pricing worst-case scenarios, valuations remain very supportive across a number of metrics. In the current environment of extreme risk aversion, we have built a mild overweight as we envisage some stabilisation to macro-economic risks following recent global government intervention, and proactive initiations by our own policy makers.

Earnings growth – results from the recent earnings season fell generally inline with market expectations, however company guidance and outlooks have become increasingly cautious, causing longer term downgrades. The impact of tight credit conditions and slowing global growth combined with declining consumer spending on recessionary fears is likely to have an ongoing impact on earnings estimates. 2009 forecasts remain elevated in the financials, consumer and general industrials area, whilst global cyclical earnings are looming in 2010.

Economy – the evidence our domestic economy is slowing is increasing, causing the RBA to drop rates by 0.25% at its September meeting which was then followed by a huge 1.0% drop in October. Continuous interest rate increases in conjunction with higher fuel costs and lower asset values have lead to a large fall in consumer confidence and slowing demand. The economy is likely to slow to sub-trend levels as we move closer to 2009. Despite unemployment levels remaining low, leading indicators and anecdotal evidence suggests this demand may be diminishing.

Corporate health – corporate gearing remains conservative outside of a number of stock specific situations.

Neutral in global equities (Neutral in global small companies)

Valuation – the global PE ratio is currently around 11 times, substantially below its long-term historical average of 18 times. The ongoing effects of the credit crisis look unlikely to resolve in the immediate future. With recent data now suggesting the US is now most likely in recession, and the rupturing global financial crisis impacting Europe heavily, co-ordinated responses from central banks and governments have been necessary to support markets. The response to these measures in improving the outlook for growth across the G7 economies remain critical to the future outlook.

Earnings growth – the slowdown in the US and the impacts of the credit crisis now being felt more globally, has seen global earnings momentum slow significantly over recent months. We would expect earnings growth to slide further as a result of softer global consumption as the likelihood of the developed economies entering a period of significant subtrend growth now looks increasingly likely. Bottoms up earnings estimates for global markets remain aggressive and downgrades are likely.

Corporate health – corporate balance sheets are un-stretched (ex-financials) preparing corporates to weather the slow-down in a better fashion than has historically been the case.

Underweight in property securities

Valuation – the sector faces a number of headwinds; increasing cost of credit, higher cap rates and reduced liquidity for managed fund products. Earnings have been amplified by increased use of leverage, along with companies using accretive acquisitions and more diverse business models to fuel growth. Valuations are attractive on historical comparisons, however, with an extended period of fundamental adjustment likely, and after the recent relief rally, we are remaining underweight the sector.

Yield – the LPT sector yield has increased recently and is now above 9%, well above the 10-year Government bond yield, after a sustained period of being at a discount. Historically the premium for the sector has been 1.1%.

Neutral in domestic fixed income

Economy – our domestic economy continues to slow as the impacts of the global financial crisis on confidence materialise. The RBA has abruptly reversed course since the first half of 2008, and since commencing an easing path in September has recently cut rates substantially by 1.25%.

Interest rates – domestically, the RBA will continue to monitor growth and activity levels to determine the appropriate policy setting after aggressively cutting rates at its October meeting. Following this move, we now expect a more rapid easing cycle and with the extended rally in the yield curve believe that the balance of risks remains tilted to a neutral duration position. The likelihood the US is in recession has increased due to the delayed impacts of the housing downturn beginning to bite, the recent boil-over in global credit markets and evidence of deterioration in labour markets increasing in severity.

Build underweight to neutral in global high yield

Credit spreads – the ructions seen across the world's financial markets in September and October have seen forecast default rates rise and liquidity in secondary markets effectively frozen, causing spreads to spike, as the implications of the worsening global macro backdrop start to take hold. Valuation models indicate that high yield spreads now capture extreme levels of corporate distress and at these elevated levels reflect a dire default scenario. Strong corporate interest cover ratios and modest gearing levels give us comfort in shifting our risk position back closer to neutral.

Yield – the dramatic reduction in corporate yields seen over the past several years has underpinned the heightened levels of corporate activity, evident in the M&A and LBO markets. Problems in the US sub-prime market and the subsequent evaporation of liquidity have resulted in 'risk' being repriced, with yields rapidly increasing as a result.

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