

Markets Summit 2011 Communique



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by BlueChip Communication Group

"Bubble": any asset group that becomes so significantly overpriced compared to fair value that it must certainly eventually fail, and suffer a dramatic reduction in price for a long period of time." Professor Niall Ferguson, in his video address to the Markets Summit 2011.

The panel of investment market experts at the Markets Summit 2011 paid particular attention to some of the big questions we're asking as we seek to build robust, resilient and sustainable portfolios – questions such as what are the signposts, the headwinds, the key risks and opportunities. And the really big question: 'Any sign of a bubble, anyone?'

Because, as Graham Rich pointed out in his introduction, human nature persists, distorting and defying those neat economists' models, with the irrational and the unexpected. The definition of insanity is to repeat the same actions over and over again, and every time expect a different result, noted PortfolioConstruction Forum publisher, Graham Rich, as he opened Markets Summit 2011. But what happens when this kind of insanity becomes so widespread that it's endemic - like a cancer? Because, here we were, not even out of the global financial crisis 'woods' yet, and already dealing with the question of potential investment bubbles.

As Graham said, the toil is ours – but so too the trouble...



The big picture

Offering some scene-setting perspectives of the global scene were two video presentations.

Bubbles

Professor Niall Ferguson, Harvard Business School

Key message – Stimulus does't always stimulate the right thing.

Niall pointed out that stimulus is prone to leakage and, when the biggest fiscal stimulus in world has just taken place, that leakage is likely to be vast. In his view, the huge unprecedented monetary stimulus of the past two years has not stimulated the right things, such as employment. Rather, it has leaked off and stimulated commodities and the emerging markets. As a consequence, he flagged both of these areas as susceptible to bubbles.

View Niall's update >

The big risk

Hon Dr Pippa Malmgren, President, Cannonbury Group (in association with Ironbark Asset Management)

Key message – Beware inflation in emerging markets and its consequent effects on global markets.

Pippa sounded a warning on emerging markets. But, she said, the single most important issue globally right now is inflation risk. Inflation figures are lifting all over the developing world and beginning to cause civil unrest where rising food and energy prices — which form half the expenditure of an emerging market worker — are compressing standards of living dramatically. She urged delegates not to be deceived by top line growth in cases where the rate of bottom line inflation is going up even faster.

View Pippa's update >

The global economy

Dr Bob Baur, MD & Chief Economist, Principal Global Investors

Key message – The world's economies have embarked on an economic expansion that has the potential to be better and last longer than the consensus expectation. The biggest risk is inflation, now in emerging markets and, within a couple of years, in developed countries.

Bob's presentation was loosely based Isaac Newton's law of motion as it applies to the global economy. And that is (loosely, and with apologies to physicists everywhere), that it will stay in motion until some other force stops, slows or diverts it. The trick is to anticipate and plan for that something which could be economic or



human factors or, more likely, both. As Bob took us through the broad economic trends of the past 12 months, he was swift to highlight the role of human emotion in shaping the motion of the economy. Fear, in particular, following the recent global financial crisis, is swift to rear its head and pull back growth as markets and investors remain gun shy and scurry into retreat at the merest hint of things awry (of which there are still plenty).

Stop (a lot of your) worrying!

This was Bob's challenge, and he made three broad points in support of it.

- Firstly, that recovery is over and we have moved into the expansion phase, a phase which has momentum and will continue to move forward a la Newton's theory;
- Secondly, that despite the positive picture we do need to worry about forces that may disturb that motion

 again, a la Newton's theory.
- Thirdly, that once you have assessed those disturbances, we must adjust portfolios accordingly.

Expansion: it's all about the fundamentals

Bob pointed to the strength of various fundamentals in support of his contention that expansion is not only underway, but may well be better and last longer than anticipated:

- In the US, Bob pointed to spectacular profit growth, with S&P reported earnings at all time record highs, record cash on balance sheets, along with increasing dividends, continued M&A activity, and continued capital spending. On the consumer side, he listed positive indicators such as deleveraging and savings rates moving from zero to almost 6%, with spending cuts on appliances, cars and other consumer durables likely to lead to pent up demand. Broad economic signals are strengthening too, he noted, with excellent export figures, a shrinking trade deficit, and improved job market. While other indicators and activities such residential and commercial construction continue to drag, in Bob's view, these are stabilising.
- Europe continues to confound the sceptics with the economy more resilient than many fear, Bob argued. Germany (the region's biggest economy) is booming, with growth at 3.6%, its highest level since reunification, along with similar highs in employment and consumer confidence. As France and Germany are the region's strongest trading partners, France is poised for improved growth with purchasing manager indices also at record highs. Bob argued that the numerous austerity programs in place throughout Europe are a positive, with shrinking governments leaving more room for private sector growth, providing people with a better outlook and the belief that taxes will be down.
- The growth story continues in emerging markets, with EM now accounting for some 37% of global GDP. And
 that's not all China, with its 9% per annum growth India is growing at 7% per annum. These economies
 continue to build new infrastructure, demand commodities and show increases in consumer spending.



Although wages might be up and inflation and interest rates on the rise, at this stage, these issues are being managed and there's still a lot of room to grow, Bob said.

• World monetary policy remains accommodating which supports the overall global expansion. Most major contributors to world GDP still have interest rates hovering around 1% or even negative, with a spirit of pessimism still prevailing. The upside of pessimism? That there is still plenty of room for growth and improvement. According to Bob, there are no signs of maturity, hence its companion, decline (signs such as too much debt or excessively high wages). On the contrary, the US economy is poised for growth, with the US Fed actively trying to create inflation to give it a kick-along.

Don't mess with my motion

Having looked at the overall forward momentum of the post recovery expansion, Bob turned his attention to some of risks that may derail it. And, despite his broadly positive view, he acknowledged there are a few.

- Problems in the Middle East in economic terms at least, revolutions often end badly for the country concerned and their trading and geographical partners. Continued disruption across the region augurs ill for economic wellbeing.
- A double dip in housing in the US the big concerning measure here is household formations, which are stuck at record lows of 500,000 a year, compared to a 15 year prior average of 1.3 million per year. However, this trend is beginning to turn around.
- The European debt crisis while on everyone's radar, in Bob's view, the contagion will be limited and ultimately, the distressed debt will be purchased and restructured with lower interest rates and longer maturity dates.
- A Chinese real estate bubble this is also, in Bob's view, an unfounded concern. While certainly some
 pockets of Beijing and Shanghai may be overheating, on the other hand, most people pay cash for houses so
 with no leverage, there is no bubble.
- China will tighten too much Yes, Bob conceded, rates have risen several times recently and inflation is at 6.5% to 7%. However, he said, in practical terms, this level of inflation is offset by real interest rates.
- Uncertainty about US tax and regulation back to the developed world, in Washington DC, there have concerns about transparency of government intentions and, in particular, more taxation. However, the power shift brought about by November's Congressional elections has provided economic clarity for business, which is now expanding.
- US debt The problem here, Bob said, is government spending which is up 25% in last two years. However, he argued, if this is brought under control, the long term problem can be fixed. So, will it be brought under



control? On the positive side, some States and authorities are now acting, New Jersey and Indiana being cases in point. If this kind of leadership spreads, the debt situation may yet be resolved, Bob said.

A brief 'how and why' on inflation and why it is a risk now

Inflation was a flagged as a key risk throughout the day by numerous presenters, Bob included. In his view, inflationary risk comes about as a result of the global currency system, which he described as "an enormous engine of liquidity". To illustrate, he took delegates through the inflation story, highlighting the forces that have kept it down over recent decades and why he believes that, with those forces now in abeyance, inflation risk is once again the rise:

- The practice of emerging nations linking their currency to the US dollar means that they have to buy currency, then print more, and so on, creating a cycle of inflation. In a sense, emerging market inflation is a natural part of the global rebalancing that has to take place.
- However, there are two immediate problems with this. One is that buying such vast numbers of US dollars in effect constitutes an investment in US Treasuries on a huge scale. This has the effect of putting prices up, at the same time distorting yields on low the side.
- Secondly, because Treasury yields are the reference point, other markets and asset classes also become distorted and voila! there you have it – a bubble in the making.
- The reason inflation has remained low over the past decades is because these inflationary forces have been matched by deflationary ones. These include the incredible dynamism in emerging markets which, due to various geopolitical events such as the opening up of the USSR, the fall of communism elsewhere and the opening up of China, have in the past decade or more effectively added some 3 billion more consumers to world market. This has had a net disinflationary effect. In addition, the Asian currency crisis helped keep a lid on inflation, as did the seemingly limitless pool of Chinese labour, in an age group not yet hit by the impact of the one child policy. However, as that key labour demographic ages and is not replaced with a pool of commensurate size, the days of limitless labour and its deflationary impact on wages will be over - albeit not overnight.
- These deflationary global forces are now waning and it is likely that inflation will once again become a major risk for world markets.

The second mouse gets the cheese – or, how to adjust your portfolio

In Bob's view, three key investment themes fall out of the current world economic picture and need to be factored into portfolio construction:

Reflation in the US, Europe and Japan – Bob recommended taking advantage of this by investing in stocks



which, when in the early stages of inflation, tend to benefit investors. In particular, look at US and German shares and possibly even Japanese stocks, he said. This is especially the case for large cap, growth and dividend paying stocks in sectors such as technology, basic materials and industrials.

- The impact of inflation in emerging markets with inflation high, P/Es and valuations higher and rising interest rates likely to continue, it is going to be harder for EM valuations to expand. For that reason, Bob argued that the major emerging markets outperformance of the past two years or so is over.
- Rising interest rates in developed countries against this rising rate backdrop, bonds are not so attractive, Bob said, adding that he is steering away from US, UK or German sovereign bonds. Some investment grade corporate bonds, however, may offer more appeal.

Finally, and certainly while not advocating fear, the big 'exit' trigger Bob recommended being on the look out for – among others that remain less certain at this stage – is a sudden move in US rates. This would require a significant rethink of allocations and a reassessment of likely risks and opportunities.

The Australian economy

Dr Steve Keen, Associate Professor, University of Western Sydney

Key message – The dominant economic force in OECD nations is deleveraging of excessive private debt. Australia, however, avoided a serious downturn by delaying the deleveraging process. Renewed deleveraging now that the housing bubble is ending will counter the stimulus from China.

Economists being what they are, it was inevitable that, following the broadly upbeat nature of Bob Baur's presentation, we for in for something completely different with Steve Keen. In a neat counterpoint he laid out the economic events of the last 25 or 30 years and used them to highlight the truth of the old saying – you could lie every economist in the world end to end and they still wouldn't reach a conclusion.

We all know Australia did not suffer as badly as the US in the downturn. So does this mean we will escape unscathed? Yes and no, Steve said.

Although Australia has similar debt issues, our debt was lower and a different type, so when it burst it resulted in a different outcome from that in the US. The Australian stimulus was also different and, in Steve's view, more effective, targeting consumers directly to boost spending rather than targeting banks as is the case in the US.

Then there is the effect in Australia of variants of the First Home Owner's Grant, both since its inception and its recent doubling in its big 2008/2009 stimulus boost (which Steve preferred to describe as the First Home Vendor's Boost). These schemes have had the net effect of building a massive housing bubble that Steve argued



(later in the morning) will be bursting sooner rather than later.

Then there's the much-vaunted China factor. While certainly it does and has benefitted Australia, it will come to an end, Steve warned – in which case we are in real danger of finding that all our eggs are in one basket.

In short, all of the cited factors have had a delaying, rather than negating, effect on Australia's rather bleak longterm economic outlook, Steve contented.

Turning Japanese

Among other things, an iceberg lies ahead, according to Steve. Because we avoided the GFC by releveraging – in other words, by using same conditions that caused it - we have delayed our deleveraging. Our Credit Impulse did go down, but it is now once again positive and the cycle of debt continues.

So the big questions are – can we continue avoiding the plunge? And is it a good idea?

No – based on the levels of mortgage debt in Australia and its growing proportion of GDP, Steve argued. In his view, the First Home Vendor's Boost is doing for Australia's economy and outlook the same thing as the subprime mortgage did for the US. And we are likely to experience similar results, he warned. Steve's analogy is that of a taking a drive from debt to GDP. Drive from Sydney to Canberra and it's easy to do in

one day – driving back is a breeze. But drive from Sydney to Perth and it's a hell of a long way back – and this is

the level of debt Australia is dealing with.

So, broadly, Steve's less-than-cheering expectation for Australia was that we are going to turn Japanese – that is, continue falling back into low or negative GDP growth, with occasional growth spurts courtesy of government spending and quantitative easing.

Specifically, in 12 months' time, Steve predicts a negative Credit Impulse in the housing sector that will cause a rise in unemployment. This may, however, be countered by the China boom – and Steve had more confidence in China's economic management than that of the US or Australia.

His caveat was the timing. As he noted, Australia is not an engine of industrial development, therefore doesn't leverage to the point of a nation such as the US. As a consequence, debt does not lead GDP as it does, say, in the US. Also on the plus(ish) side is the strong direct role that the Reserve Bank of Australia can play – unlike its US counterpart - with rate cuts able to improve the mortgage outlook and boost the economy, even if only for short bursts.



Base-case asset allocation

Joe Bracken, Head of Macro Strategies, BT Investment Management

Key message - Classic mean variance optimisation may not protect you during bubbles since it tends to put you into assets with higher expected returns – typically the inflating ones. Adding alternatives to your portfolio should help with performance stability. Overweight equities and alternatives and underweight bonds seems to be a sensible starting point.

Joe's brief was to give and explain a base-case asset allocation for a medium risk tolerance, capital accumulation investor – and then to stay on for the rest of the day to pose questions of the other presenters, before presenting his portfolio construction key takeouts at the end of the day (including flagging any changes to his initial allocation had changed following the day's proceedings).

The problem with bubbles

Markets are all about processing information, Joe noted. So if that information is distorted or we want to believe something that is not true, the trouble starts. And the bubble only bursts when someone finally decides it's not true.

Which brings us to Joe's problems with bubbles: that they significantly distort the way we construct portfolios. This can be seen, for example, from the Harry Markowitz-style mean variance optimisation model which became the norm for many managers in the past 25 years (and understandably so, Joe said - it's simple to punch in the numbers, sounds scientific, generates nice charts – all very professional, objective and sound). However, because bubbles inflate expected returns, and a mean variance optimiser methodology means that the investor will buy the asset with higher expected returns, the problems start – only to be compounded by the fact that price runs ahead of risk. So, while the risk is increasing as a tradeoff for the expected high return, the mean variance model still reports the risk as being lower. The end result? A portfolio that puts an investor into very overpriced assets. And, as we have seen, when these assets deflate it really, really hurts.

So, when it comes to bubbles, says Joe, it takes a brave man indeed to step back and be the lone voice saying "Hang on, I will get out".

What to do about bubbles: the lazy man's portfolio

Joe went on to suggest a three-step approach to asset allocation so that bubbles don't blow you up. He stressed that this is a starting point for a conservative, capital accumulation investor.

• Step one is to include bonds, equities and absolute returns – A good mix of betas and absolute returns should ensure some diversification benefits. Joe said he was mindful of the dangers of correlation that caught so many out during the recent GFC. And, because it is very difficult to figure out which classes are



genuinely different and avoid doubling up on your allocation, he recommended focusing on those three classes that offer the best chance of real diversification.

- Step two is, in the first instance, to allocate equally between the asset classes Joe termed this the 'forecast free' allocation which, in his view, protects against over inflation because it avoids excessive weighting of any single class.
- Step three is to add some short tem views into this within the broader confines of steps 1 and 2, to give the overlaid portfolio allocation.

On an analysis of the current market, Joe said he would adjust the original equal portfolio weightings to make it slightly underweight bonds, at around 25%; look at around 40% for equities and about 35% absolute returns, for the following reasons:

- Bonds, while they may no longer be the safe haven they were and may be negatively affected by fears about rises in interest rates, inflation and sovereign default, still represent true diversification and limits on potential drawdowns in a downturn.
- Equities, while not the 'screaming buy' they used to be, may still continue to appreciate as growth continues, Joe argued. Further, in some European markets where valuations are very depressed, they may offer genuine opportunities for investors who are willing to take the risk.
- Absolute returns at least the non-directional ones fared well during the GFC and tend to offer better returns during high volatility periods such as the one we are currently experiencing. Judging these is a bit tricky, in that you don't want to be in them all the time, Joe warned. The success of absolute return investments relies on all having active managers to generate value, something they can only do where there is value to be had.

In summary, Joe's lazy man's view is that keeping allocations simple can lower drawdowns and smooth returns over time, while adjusting the portfolio in the short term can exploit immediate opportunities. And, to achieve true diversification and avoid correlation, taking a sweeping view of the asset classes rather than trying to drill down into the niceties and subtleties will work best, he contended.



The outlook for global debt markets

The global debt markets

Kumar Palghat, Founder & Managing Director, Kapstream Capital

Key message – The US economy is turning the corner. Its housing backlog will be cleared and employment data is improving. The Fed will continue to maintain easy monetary policy. Risk assets (equities, commodities, hedge funds, high yield, etc) should continue to do well but bond markets are starting to sell off as the safety of bonds is no longer required. Solutions for European debt problems are in the works, and the US recovery continues to be very bullish for Asia, which already has overheating economies.

To highlight the difficulty of predicting markets, Kumar took delegates through a broad summary of the past year's market performance, in particular, where it did and did not fall in line with his (and many others') predictions. On the plus, 'we got it right', side of the ledger, rates did remain unchanged; the stimulus continued; high unemployment continued; as did weak growth in the US and developed countries, countered by very strong growth in Asia. But, there were also surprises, he said. Equities outperformed bonds and the European debt crisis deepened to unprecedented levels. And, in perhaps one of the biggest surprises close to home, Australian equities underperformed their US counterparts to the tune of more than 10%.

Facing up to the problems

Problems in the markets persist and their flow-on effect must be considered, Kumar said.

- US debt load is almost at capacity Government debt is at 100% of GDP and corporate debt levels are also soaring. The big question here is, Kumar said, how are these debt levels to be brought back once the US economy moves beyond recovery? And, on the corporate side, debts are falling due which is sounding alarm bells for the future in a nation that, unlike Japan, cannot fund its own debt.
- Housing is under water The US housing situation continues to be dire, Kumar argued, citing stalled
 construction levels, values having plunged relative to purchase price, and banks stuck with bad debts that
 they can't clear by foreclosure because, during the height of the subprime madness those notes were sold
 off to other companies around the world whereupon the rest, as they say, is history.
- The European problem This is not helped by the fact that we are looking at many countries with one monetary policy, Kumar said. One consequence has been a massive increase in the cost of insuring European debt due to high probability of default. Not so long ago, the prospect of buying European government debt at 13% would have been unthinkable, Kumar noted.



So ... to the solutions

According to Kumar, while the light at the end of the tunnel may not yet be dazzling, we are at least some way along the track of addressing these problems.

Repaying debt – One way to assist with debt reduction is to promote inflation, Kumar pointed out, while
at the same time deflating the currency, thus reducing the total real value to be repaid. This, he said, is
happening now. The potential downside is the proliferation of cheap money flowing into hot markets where
it is likely to fund both constructive and some speculative – that is, bubble forming – ventures, including
affecting, for example, commodity demand in China and India.

Fundamentally, Kumar said, the hope of the US in taking this approach is that, by the time the resulting Asian bubble blows up, its own economy will be back on a sufficiently strong footing to withstand it.

And, despite the risks, Kumar, like Bob Baur, remained convinced that the Fed will keep the foot firmly enough on the pedal to avoid deflation.

- Clearing the housing backlog This is getting closer, Kumar said, as banks and authorities work together to organise schemes to clear their books of the bad debts and enable valid foreclosures.
- European debt This will be resolved with help from the collective political will and economic power of all the European nations, Kumar believes.

However, despite being a self-confessed Fixed Income Guy, Kumar said he is a bond bear. Given the universal concern about the impact of interest rates (and inflation) on the outlook for the debt markets, if you are going to include them in portfolios, he recommended:

- in general, avoiding long-dated sovereign debt and instead focusing on investment grade corporate debt;
- buying floating rate assets, because the consensus is that rates are going up
- choosing fixed income assets in countries with positive growth (such as Australia).

Equally, bear in mind the risks, he said, which include the Asian bubble bursting, and the potential dangers of being short on the US dollar.

Australia's debt markets

Anthony Kirkham, Head of Investment Management, Western Asset Management

Key message – Don't make the mistake of putting Aussie bonds into the global bonds basket. Many of the underlying factors that make bonds a problematic buy in other markets do not apply in Australia. The market may be small but there is value to be had for the discerning investor.

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Anthony kicked off his presentation by highlighting the Australian fixed income investable universe and its rapid expansion from around \$200 billion in 2005 to around \$500 billion at the end of 2010. The corporate bond sector had attracted the most favourable comments within debt discussions at the Markets Summit 2011 so far and, broadly, Anthony concurred. But, he pointed out, the local market is crowded – although a new wave of issuance does present some welcome opportunities. This is due to the desire of corporates to diversify and lengthen funding and avoid being caught short as they were in the GFC, he said. And, he urged delegates not to forget that, despite these constraints, bonds did give us double digits in the hard times.

Aussie bonds are 'more equal' than others

As to the question of a bond bubble – it's just not happening, according to Anthony. He did note, however, that hte market is still jumping at shadows, not a characteristic that makes for good investing and which can lead to bubbles if unchecked. So, he stressed, while bonds may look less than appealing in some markets, especially given the unnatural influence of massive developed world debt on the market, we should differentiate bewteen what's going on elsewhere – especially the US – from what's going on in Australia.

All the signs are that what's going on here in Australia is just fine, he said. The cash rate is relatively normal, as are mortgage levels. Plus, the RBA has the big stick of monetary policy and is not afraid to use it to keep things under control. Further, having variable rate mortgages means that, when the levers are pulled, the effect is felt quickly. The Australian economy has remained AAA rated, and the cost of insuring bonds – a concern elsewhere as Kumar pointed out – is still a mere 30 basis points. He expressed some concerns about the RBA's "excessive" focus on Australia's terms of trade perhaps leading to too much tightening, but while we may be looking at rate rises here, according to Anthony, these are already factored into bond pricing. On balance, there is still great value to be had in the Australian bond market, he argued, warning that bonds have stronger active defensive characteristics than term deposits – including the prospect, as we have seen so recently, of delivering strong double digit returns.

Anthony recommended a strategy of active duration management to help manage the inevitable speed bumps and uncertainties. Within that, he suggested an bond allocation that is:

- overweight corporate securities, and concentrated in financials, property trusts and utilities;
- underweight to Commonwealth government securities and selected supranationals; and,
- overweight to government guaranteed debt, which is still offering a greater return for less risk.



The outlook for Australian residential property

Australian residential property IS a bubble

Dr Steve Keen, Associate Professor, University of Western Sydney

Key message – Australia's house price bubble dwarfs that of the US, and Australian households are now more debt-encumbered with much higher interest rates. Government policy helped light the fuse and Ponzi lending by the financial sector provided the fuel. Prices will deflate as the rate of growth of mortgage debt slows, with negative impacts on aggregate demand and employment.

Steve addressed a whole host of factors in support of his view that Australia is in the midst of a housing bubble. Essentially, his view was that there is a residential housing bubble because there is no other rational explanation for the dramatic rise in house prices since 1997. This fact, coupled with the huge rate of debt that goes hand-in-hand with such price rises should be sounding massive alarm bells, he said.

Why a bubble?

Steve took delegates through all of the conventional explanations used to justify the heady increase in Australian house prices since 1997:

- Prices are rising due to rises in disposable income The facts do not bear this out, Steve said. In fact, his
 detailed examination of the historical data and a factoring in of predictions relating to mean reversion shows
 that house prices have been far outstripping this measure since 1997, to the extreme point that we are now
 in 'black swan' territory.
- Prices are rising due to rises in income and GDP Again looking at the figures, this is a myth, Steve said. On the contrary, current price values are at least 50% above sustainable levels, according to his calculations.
- Prices are rising due to population growing faster than dwelling construction Again, close examination
 of the numerous figures used to support this argument does not, in Steve's view, hold water. He pointed,
 for example, to other periods in history where population has spiked with no corresponding house price
 increase; and also to an overall long term trend of 'persons per dwelling' actually falling except for more
 recent years. He also noted that, for the most part, dwelling construction has actually exceeded population
 growth. Therefore, he asserted, any seeming correlation between population growth and rising house prices
 in response to dwelling shortages is in fact spurious.
- Prices are rising due to an increase in underlying demand (i.e. shortage of housing relative to projected demand) – A gap between underlying demand and supply (for example, the need to house the homeless



and marginalised) may explain the need for housing, but does not explain the monetary demand for it.

• Prices are rising due to a boom in exports to China – If that is the case, we should have seen a recovery in employment in the mining states first following the GFC, he argued. But we did not. What actually happened is that the Victorian government gave the biggest incentives, which led to the biggest house price rises – and that's how, in Steve's view, we got out of trouble.

So, if none of these factors can explain the house price rise in Australia – now 6-fold since 1986 compared to the US increase which is 2.5-fold, what can?

The Hand of Gov?

Steve's explanation is the 'Hand of Gov'... that is, government policy favouring housing as exemplified by the First Home Owner's Grant in its various iterations since inception in 1983, and especially, its more recent doubling in the Rudd Government's 2008 stimulus boost. As he wryly terms it, the First Home Vendor's Boost has dramatically distorted the market, as vendors selling at boost-factored higher prices in response to the heightened demand created by the scheme then pay commensurately over-inflated prices for their next home, and so on and on in a strong upward spiral.

Essentially, in Steve's view, this amounts to using house price inflation as a form of macro economic policy management and has played a major role in causing a residential housing bubble in Australia. Quarterly increases in house prices before the scheme were, for example, 0.10%; after the scheme, more like 1.0%.

Removing the savings requirement for eligibility to the scheme, and the role of banks and their willingness to provide excessive credit are also factors, he said.

Nothing more clearly supported his argument that Australian residential property IS a bubble than his final compare-now-with-then example.

Not so long ago, you could go to the bank with your 30,000 deposit and the bank would lend you \$70,000 – so you could bid 100,000 on a house. Now, for the same 30,000, the banks might lend you \$970,000 – lifting your bid to a cool \$1 million. Is it any wonder then, Steve asked, that house prices are in a bubble?

Australian residential property IS NOT a bubble

Chris Joye, Managing Director, Rismark International

Key message – It is absurd to suggest that Australian house prices will fall by 40%, or that house price declines will accelerate. While the next year or so will be relatively weak, Australia's housing market will yield investors solid, through-the-cycle returns as it has done over the last 30 years.



Chris put the contrary case to Steve's – which was that Australian residential housing is not in a bubble, that the rises in prices can be rationally explained and that it continues to be a positive part of Australia's overall economic outlook. In support of his case, Chris presented extensive information addressing Aussie housing's risk return characteristics, fundamentals, valuation benchmarks, international comparisons, and more.

A strong and steady performer

According to Chris, on a risk-adjusted returns basis, Australian residential outperformed global equities, Australian equities, 10-year government bonds, and listed property trusts for the vast majority of the time between June 1982 and June 2010. Further, he maintained, as an asset class it remained genuinely uncorrelated, demonstrating resilience throughout numerous crises, including the stock market crash of 1987, the Tech Wreck in 2001, the Asian crisis and the GFC.

Unlike Steve, Chris accepts a number of the arguments for house price increases, taking a different slant on similar figures.

- Population growth Chris looked at projections of massive price rises, in the order of 60% by 2050 (and that is on conservative figures based on a halving of current growth rates and slashing of immigration). This would lead to continued sustained housing demand and strong steady performance, he noted.
- An underlying housing shortage In Chris's view, there most definitely is a shortage, as rental vacancy rates attest. The usual vacancy rate average of 3% is down to 1% to 1.5% in Sydney and Melbourne, for example. (Steve accepted this as one reliable signal of a shortage but not one significant enough in itself to justify or explain housing prices.)
- Valuations in relation to incomes Chris maintained that incomes and house prices have broadly tracked each other. Again in contrast to Steve, he pointed to a steady income-to-dwelling price ratio in the region of 3x. With this currently at 4.4 and falling slightly, he saw no cause for alarm.

Then why the rise? And can it last?

The sharp rise in the price of houses over the relatively recent past is due to inflationary policy which has kept interest rates relatively low, leading in turn to a one-off surge in housing activity, Chris argued. Other factors that he cited which mitigate against a bubble (and any corresponding burst), included:

- Australian housing relative to international An examination of Australian housing performance in the international context, far from indicating a bubble, shows that, from 2000 to 2006, it in fact underperformed other countries.
- Critical differences between Australian and US housing markets The Australian situation and that of, say, the US, are different in critical aspects. For a start, Australian default rates are lower despite higher rates,



with mortgages never approaching the US subprime leverage levels. Our gearing levels average around 29% compared to 60% in the US, and we have only 3.5% of borrowers in low equity, high return style loans, while 83% of borrowers pay less than 40% of their income in mortgage repayments.

- Higher urban concentration This provides some protection against the dramatic rural and remote regional property slumps experienced in the US and UK, where the populations are less concentrated.
- Australian residential property is low risk Australia's banks apply a low risk rating to residential loans because they demonstrably are low risk. In the 1991 recession, for example, the bank losses were not in residential mortgages, they were in other impaired loans, such as those to business.
- Japan in the 1980s, US in the 2000s and Ireland today is Australia any different? Is a collapse in housing here any more unthinkable than in it was just prior to the bust in those other economies? According to Chris, if the same variables applied here as in those situations, he would be more worried. But, they don't, he argued. For example, for a big bust to happen there would need to be an associated banking crisis, something that was evident in each of those other cases. And there is no sign of that. Wholesale funding is our key banking vulnerability, but the government would step in to address this if push came to shove, Chris argued. In fact, he considers that to trigger such a bust would require a sovereign debt crisis – highly unlikely.
- A China bust Chris had an interesting take on this, which is that housing may even be a potential hedge for a China collapse, because such a collapse would cause rates to tumble.

Nontheless, look ahead to the next 12 months we should expect low, single digit capital growth - or, if we experience three rate rises, we may see property levelling off for a short period, Chris warned.



The outlook for global equities and commodities markets

Global equities markets

Jacob Mitchell, Portfolio Manager, Platinum Asset Management

Key message – Asian central banks are behind the curve in terms of inflation policies and that is building macro risks. Despite the fact that the global economic recovery looks self sustaining, we won't know for sure until fiscal issues are solved. There are still interesting investment opportunities.

Jacob echoed the inflationary concerns of others, especially in relation to China and what he sees as its sanguine attitude to inflation and mistaken belief that they can control it using price measures. As he pointed out, these tools are the ones that the West experimented with in the 1970s – and we all know what happened then.

Time for a bubble alert?

In Jacob's view, it is hard to argue that market conditions are currently extreme enough to cause concerns about bubbles. Price to book ratios in Asia, for example, are still hovering at 2.5, a long way from the bubble-alert levels seen prior to the tech wreck, he noted (where in too many cases there was no book!). Jacob argued that while it may be fashionable to describe Asia as a bubble, or a bubble in the making, this view does not stack up when you look at the valuation to premium levels which are still relatively small, although he conceded that some signs of extremes can be found – for example, in very high US corporate profits due to a low tax environment and unit labour cost appreciation lagging general economic growth.

The one area he said is arguably a bubble in the making is commodities. However, the related underlying equities – the price of BHP, for example – are at single digit P/Es and showing no immediate signs of blowing out, so these fears should, for now at least, be allayed, Jacob believes.

• China and emerging markets – In Jacob's view, the idea that Chinese demand is in its infancy is naïve. While its infrastructure capability is enormous, we should be aware that the transition to a consumption driven economy – which is urgently needed, in Jacob's and others' view – is slow and, with the market ahead of reality, it remains very much an investment driven economy. There are strong moves in China to maintain the status quo, and the power of provincial governments and other localised political forces which do not want to see the model change should not be underestimated, he warned.

Further, China's imposed 1970s-style income policy will have a negative effect on both commodity and wage inflation. Inflation degrades equities so it's tough to justify big spends on consumer goods in China when you know you can get better value in the West, Jacob said. Instead, the best opportunities in China are in areas of neglect – that is, of need that it cannot fulfil itself, such as oil, polymers and electronic equipment. While



per capita demand of this type of product is low compared to the West right now, it may rise, and a move away from iron ore and coal and toward energy and consumer goods may pay off.

• In the West – Bearing in mind that the West is the mirror opposite of China, infrastructure for example is desperately in need of an upgrade. The size of fiscal deficits is also a concern – a risk without an opportunity, in Jacob's view. Although the bond markets seem to be sanguine on this score, Jacob asked: how long can this last? Because growing real rates could kill the consumption rebound.

In Jacob's view, rather than raising questions about bubbles, we should be asking a broader question: whether there is an emerging long duration bull equity market. His answer? No, we should expect a stop-start global equity market rather than a 1983 to 2000 scenario.

Asian equities markets

Ahn Lu, Portfolio Manager, T Rowe Price

Key message – Despite a number of concerns, there is a strong list of positives for the Asian growth story – but again, with the proviso that commodities are an issue.

What happened in 2010 largely set the stage for 2011 and beyond, she said. And 2010 was very much a year of three quarters and one quarter, characterised by a huge dispersion of returns both between and within markets. The first three quarters of 2010 brought great growth and performance. In India and even China, despite its easing, there was still strength in various pockets. Q4 2010, however, gave a huge reversal due to a surge in commodity prices. Overall, domestically oriented Asian equity markets did better for most of year but there was a cyclical rotation to developed markets in its latter stages. In general, valuations still remain in the safety zone, she said, but there are pockets of over valuation emerging.

A strong list of positives for the Asian growth story

- Domestic consumption Although agreeing with Jacob that moving to a consumption driven economy is a very slow process, Anh argued there is still strength in the domestic consumption story in Asia. Even despite this slow progress, some companies are still posting very healthy top and bottom line performance, she said. Prime examples include industries in which there has been a lot of consolidation, such as beer in China. Only four to six years ago, this was very competitive, however now the top three companies control up to 60% of the market. In other words, there is much more pricing power in some categories than in the past.
- Favourable demographics Demographics remain strong throughout the region, despite the fact that the labour pool in China is filling, albeit very slowly. This includes in India despite its highly inflationary tendencies where, for example, the working to non-working ratio is entering the 50:50 range, recognised as the highly



productive total dependency ratio.

- Financial leverage remains low, helping absorb economic shocks.
- Chinese property Anh conceded there are pockets of bubbles in the very high and luxury property markets in China, and it might take one or two years to absorb them. However, there is no sign of an overall price bubble, she said, especially with mass market demand strong and continued high affordability.
- Chinese current account surplus The rebalancing of the world's financial systems and China's domestic economy are interrelated, and Anh said she expects China's current account surplus to continue falling.
- India While it is the inflation leader in the region, its stock market is large. Currently, India has the opposite problem of China, that is, lack of capacity. Although investment spending is on the rise, unlike China, India is still effectively a net importer of capital. For this reason, a lot of projects were put on hold during the GFC. But, longer term, domestic savings are rising and, over time, it will fund its own spending, lessening the volatility of imported inflation. It is, however, going through a dire period now due to surging commodity prices, Anh warned.
- ASEAN nations It took 10 years for these economies to climb out of the Asian crisis, but Ahn argued that
 we will soon be seeing an increase in their demand for credit, which is currently low. We can see this in
 corporate capital expenditure starting to pick up again, albeit from a low base and slowly, she observed.
 Korea and Taiwan are better positioned to weather inflation some of the world's best companies are in
 Korea and are gaining market share globally and doing so profitably.

But risks are there, too

As she indicated at the outset of her presentation, the Asian story is not all positive. Risks include:

- Inflation Looking at China and India, the key to success is finding companies that can manage volatility through pricing power (as in the Chinese beer example);
- Rising food and commodity prices across the region;
- Policy risks, which vary from nation to nation;
- Geopolitical risks
- Current accounts for example, in India where surging inflation is putting pressure on the currency at a time when India needs a depreciating currency;
- Export dependency although this is now lower than historically, a meaningful economic slowdown in the West remains a risk to many Asian economies;
- Reversal of hot fund flows (especially in response to inflation scares).



Commodities markets

Ric Deverell, Director - Commodities, Credit Suisse

Key message – The rise in global commodity prices amounts to a structural change that will have a major effect in Australian markets, where we can expect to see sectors affected by higher interest rates and a strong Australian dollar struggle.

Commodities emerged as a prime suspect in the Markets Summit 2011 bubblehunt. However, according to Ric Deverell, they were innocent of the charge. Yes, he said, commodity prices are high and climbing, but this is due to the force of valid, strong demand and surges in worldwide industrial growth and production. We must not mistake the US for the world, he warned, and should look instead to the strong growth elsewhere and the very V-shaped recovery that's occurred – or occurring – in so many other global regions.

Not a commodities bubble

It was Ric's contention that, when thinking about demand for commodities, we need to move out of the box and consider macro factors. First, there is global industrial production, in his view, a good proxy for demand for commodities used to make goods and, in many ways, a better measure than GDP. And global industrial production, unlike GDP, is above trend, he noted – in fact, extraordinarily strong and much stronger than in the 1970s. The second macro indicator he pointed to was global fixed asset investment which after a big fall in 2008 and 2009 has shown a very sharp rebound above trend. Only then did he cite global demand, again well above trend, particularly for basic materials.

Ergo, Rick argued, there is no commodities bubble, because the surge in price is related to real value, driven by real demand. There is no artificial inflation of price with no relation to real demand, hence value as occurs with a bubble.

Growth that's here to stay

Ric went on to say that these global levels of industrial production, investment and demand lead to a consideration of what's driving that demand and whether or not it can last. And, of course, the big word on everyone's lips in relation to growth in general and commodities in particular, is China.

While China is tightening, it is thus doing exactly what it should be, Ric argued, and doing it pre-emptively to address food price inflation and so on. On balance, he would be a lot more worried if China was not tightening, he said. And Chinese tightening will have a slowdown effect that's needed. But the very rapid rebound that's occurring in the G7 will more than offset the slackening of China, Ric said.

In addition, there's the momentum factor, as exemplified by the current situation in the US. With commodities, what really matters is not just growth rate, Ric said, but also how growth compares to expectations. So, when



people booked their commodity orders it was with the expectation that the US would continue to put in a terrible performance. But this was not so. Already, suppliers have been caught short with not enough metal, for example.

What does all this mean for Australia?

A lot, according to Ric. Australian terms of trade are at historic highs (excluding "about five minutes in 1955") with mind-boggling yields that have had a profound impact on recovery – and, Ric argued, the future shape of Australia's economy.

Mining investment as a share of GDP is already a full percentage point higher than ever before, according to the RBA. And it's about to get even bigger, Ric warned, led by massive investments in LNG across Western Australia, Queensland and the Northern Territory. In a conservative scenario, this would put mining investment at around 2.5% of GDP by 2013. And, even if iron and coal don't get bigger, we're looking at continued growth figures of up to 6% (or even 7% or 8%).

Sounds like boom times?

It might be, Ric said, if Australia could actually hold all of that investment. The problem is that there is very little spare capacity in the economy, so the problem is there is nothing to do with the enormous wave of investment. Fiven that the RBA will not allow Australia to go down the inflationary path, this means higher interest rates, higher exchange rates, and the prospect of sectors that are exposed to those factors, such as retail, having to struggle, Ric warned.

For portfolios, Ric recommended looking at sectors directly leveraged to mining investment and commodities, and avoiding sectors that will be hurt by higher rates (such as retail) and currency volatility.

Australian equities

Sean Fenton, Portfolio Manager, Tribeca Investment Partners

Key message – The outlook for the Australian equity market is positive with all of the key drivers remaining supportive. Valuations are attractive, liquidity is abundant, and economic growth around the world is either stable or improving. The growth recovery favours cyclicals, but mainly those with global exposure. The tightening moves in China do raise the risk of a near-term correction on commodities. The commodity boom is a boost for the Australian economy, but comes with higher rates and acts as a brake on a highly geared consumer.

Sean presented a reasonably upbeat view of the Australian equities market in which valuations remain attractive, with liquidity strong and the earnings outlook improving. In his view, these positives are helping to offset the



strong currency, which is capping some upside, making Australian equities a bit less attractive to international investors and crimping some earnings.

- Global cyclicals (offshore industrials, transport, steel) The accelerating growth in developed markets has been an upside surprise, and one we can capitalise on locally by going overweight in related stocks, Sean said. His preferred stocks were Newscorp, Incitec Pivot, Brambles, Amcor, and Sims Group.
- Resources (bulk commodities, metals, energy) As with other presenters, Sean acknowledged that you can't assess Australian equities without talking about China and asking whether its growth and corresponding impact on the Australian economy is sustainable. In the medium term, at least, he said the answer is yes, pointing to drivers for long-term growth in China such as urban migration, development of tier two cities and the increased consumption that should follow. Nonetheless, as others also had pointed out, there are risks. In Sean's view, many of these may play out in the near term, even if over the medium-term the outlook is steadier. Accordingly, he is neutral on resources. His preferred stocks included Equinox, PanAust, Gloucester Coal and BHP Billiton
- Domestic cyclicals (building materials, industrial services, retail, media) In general, this is a mixed bag, Sean's warned. Housing remains highly geared, with interest payments as a proportion of income high, he noted. Savings are rising, albeit forced saving, as GFC trepidation causes us to come back from the increase in debt that followed the home equity withdrawal bonanza and growth of personal credit of the early 2000s. Now, however, Australia is looking at more austerity and the squeeze on household discretionary income due to the increase in principal repayments of loans and in utility bills, along with rising inflation and interest rates, for example. As a consequence, Sean suggested going underweight in retail and building materials, however, going overweight mining services. His preferred stocks included Boart Longyear, Bradken, and Graincorp.
- Financials (banks, insurance, diversified financials) Credit growth is structurally lower and now closer
 to nominal GDP, and new capital and liquidity standards, which previously caused uncertainty, are nearly
 resolved, Sean noted. The level of market leverage also delivers an upside so, in his view, value exists
 in Australian financials, and he suggested going overweight. Preferred stocks included ANZ, NAB and
 Challenger.
- Growth stocks Higher yields have in general been pressuring valuations and QE2 didn't bring down the yield curve, Sean noted. As a result, we should expect longer duration and higher rates, which equates to less value. Even in healthcare, for example, although there are strong long-term demographics supporting an overall growth story, government funding pressures in the short term suggest an underweight call for this sector. Seans' preferred stocks include ResMed, and Flight Centre.
- Defensives (telcos, healthcare, REITs, infrastructure) A stronger equity market and higher short rates is not a good combination for traditional defensives, so go underweight, Sean recommended. His preferred stocks were ResMed and Transurban Group.



Portfolio construction key takeouts

The final session of the Markets Summit 2011 saw our investment and markets specialists return to stage for a vigorous debate about the prospects for their competing asset classes, and the implications for constructing portfolios, before Tim Farrelly summed up the day's key takeouts.

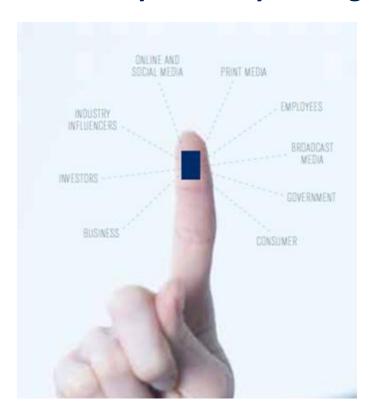
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Tim's key takeouts >



This communiqué was written by Kaitlin Walsh, Director of Media and Content, BlueChip Communication. BlueChip supports PortfolioConstruction Forum to help give Australian audiences access to high quality local and global investment expertise.

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