

The 'Great Recession'



The global economy is experiencing its worst downturn since the end of World War Two, but most regional sharemarkets have bounced recently. Matthew Sherwood, Perpetual's Senior Manager Investment Market Research, examines the impending 'Great Recession', the Geithner Plan and what it means for the performance of sharemarkets.

Introduction

Sometimes in history events can be so complicated that it is hard to encapsulate everything in a single word, sentence or conversation. During these times, humans can discover, revive, coin and develop words and phrases to help make sense of it all. For example, people term famous phrases such as the 'roaring 20s', the 'swinging 60s', 'Bodyline' and the 'dot.com boom'.

Some of these phrases are assigned years after the events, while others gain immediate notoriety and spread far and wide. Since July 2007, the world has been obsessed with the current financial crisis. In fact, that year the word 'subprime' was awarded the Word of the Year Award by the American Dialect Society and in 2008 'toxic asset' was nominated for the same award, but 'bailout' won and was rated number two in the list of the top ten buzz words of all time.

'The Great Recession'

The current global financial crisis may have been the worst event in 80 years for nations, businesses, households and investors, but it's making our language a bit richer. In mid-March 2009, a new phrase was used for the first time by the Chairman of the International Monetary Fund (IMF) when he described the current economic malaise as the 'Great Recession'. It is not clear whether these words should make us feel better (as at least it is not as bad as the Great Depression) or worse (as this is worse than virtually everything else other than the Great Depression).

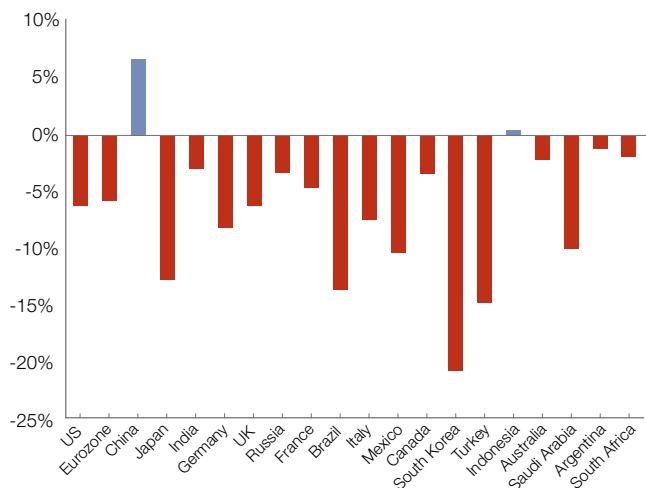
Negative growth in almost all of the G20

The global economy has certainly slowed dramatically given a major slowing in industrial production and trade in the December quarter 2008, with further weakness in early 2009. This meant that only two countries (China and Indonesia) at the G20 conference in London recorded positive growth at the end of 2008 (see Chart 1). The IMF recently forecast that the global economy will shrink by 0.5%-1% in 2009. The basic problem for the global economy is that growth had been strong for a long period of time and households and businesses borrowed too much money to purchase overvalued assets. The subsequent decline in asset prices has prompted households to reduce discretionary spending to reduce debt and businesses and financial institutions to write-down assets and raise equity.

The Geithner Plan – the US government has just become the world's largest hedge fund

Despite the darkening economic clouds, the global and Australian sharemarkets have recently rallied around 15% in the wake of a less dire outlook for the US financial system. In early March 2009, Citigroup and Bank of America announced better-than-expected operating results and this partially eased the risk premiums attached to the financial sector. Sentiment was further enhanced by the scale and detail of the Geithner Plan (the Plan) to address

Chart 1: Only two of the G20 Economies are growing
G20 economic growth (December annualised growth, %pa)



Source: UBS Australia Limited as at 23 March 2009. The number for Turkey and Saudi Arabia are estimates.

illiquid bank assets. The new scheme is a major step to revive bank lending as it creates incentives for the buyer and the seller to meet in the market, which will set a market price for the toxic assets. Without price, there is no market and without a market bank balance sheets will remain clogged. Under the plan, the US government would act as the world's largest hedge fund investor, committing its funds to buy up risky and distressed assets and having them sold later when market conditions normalise at sizable profits. The only problem is that the US government will see most of the profits go to the private sector investor, rather than the taxpayer.

Details of the Plan

The Plan is centered on two parts: one that deal with toxic securities and another that deals with stressed loans. The Plan will use USD75 billion-USD100 billion of funds, coupled with funds from the US Federal Deposit Insurance Corporation (FDIC) and the private sector to purchase between USD500 billion and USD1 trillion of stressed bank assets. Under the scheme, a bank will initially put forward a pool of toxic and illiquid assets with a face value of \$100, for example, to be auctioned by the FDIC and the successful bidder (who say pays \$84 for the assets), would form a Public-Private Investment Fund to purchase the mortgage pool.

The FDIC would provide guarantees on \$72 of financing (with leverage not exceeding a debt-to-equity ratio of 6:1), leaving \$12 of equity. The US Treasury would then provide 50% of the equity financing (\$6), leaving the successful bidder to provide the other \$6. The government's generous financing provisions make it highly attractive for private investors to participate in the scheme as they need to provide minimal equity (around 7% of the total assets purchased), with their losses capped at this initial investment and with unlimited upside.

Several unanswered questions

Although investors responded positively to the Geithner Plan as it has the potential to 'reflate' the U.S. financial system and economy, there are still many unknowns. To what extent will private investors even be interested in stressed assets, especially as the bank decides which ones to sell (most likely to be the worst and most toxic)? How will they value the assets and how much equity will banks need to raise after the auction?

Positive for shares, but a big storm front remains

Generous support for the banks and the prospect of improving credit flows is a substantial positive for shares as things appear less dire than a month ago. Although a global financial system meltdown appears to have been avoided, investors still have to

contend with the worst global economic downturn in 63 years, over-extended household and business sectors and sustained pressure on corporate earnings and balance sheets. Consequently, the Plan is not a call to arms for the sharemarket bulls to return and for investors to re-discover their pre-credit crisis behaviour. The market headwinds are sizable and investors should continue to manage their portfolios for downside risks as the recent reporting season highlighted the stresses that firm's face from a funding and earnings perspective.

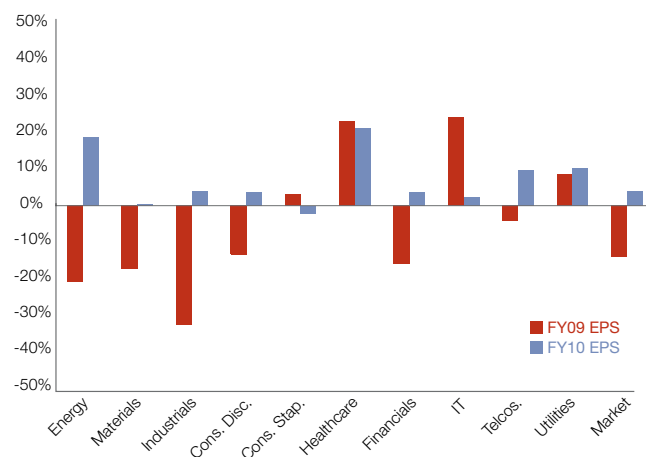
Balance sheet risk remain large

Earnings downgrades were relentless across the Australian market in the two months leading up to the February 2009 reporting season and during the season itself. These earnings declines reflected both weakness in earnings (particularly in cyclical sectors) and dilution of these earnings, given the vast array of capital raisings in response to sustained balance sheet stress. The largest concern in the February 2009 reporting season was the large numbers of companies with weakened financial structures despite substantial equity raisings. With firms undertaking large-scale asset writedowns, overall gearing levels have not improved and considerably more deleveraging is required. The sustained pressure on cashflows and increased tightness in the supply of credit can only mean two things: more dividend cuts and more equity raisings which will further dilute earnings, dividends and share prices.

Either the 'Great Recession' is very short or FY10 earnings will decline

In FY09 the traditional defensive sectors (healthcare, consumer staples and utilities) are expected to deliver positive EPS growth and the more cyclical sectors are expected to struggle. However, at present consensus earnings forecasts have the market earnings per share growth in FY09 (-14.2%) returning to positive territory in FY10 (+4.1% - see Chart 2). Surprisingly, the rebound in EPS growth in FY10 is led by the cyclical sectors (such as materials, industrials and consumer discretionary) even though global and Australian economies are expected to remain subdued in the next financial year. The margins are underpinned by rises in profit margins, even though the Australian market has not experienced margin expansion during an economic downturn. In addition, since the Australian All Ordinaries Index began in December 1979, earnings have always been negative for two years when the economy has become recessed. Consequently, consensus earnings suggests that either the 'Great Recession' proves to be the shortest global downturn in history, or the FY10 forecasts are likely to be adjusted downwards.

Chart 2: Earnings risks remain to the downside
Australian Earnings Per Share Growth: FY09 and FY10 (% pa)



Source: UBS Australia Limited as at 23 March 2009.

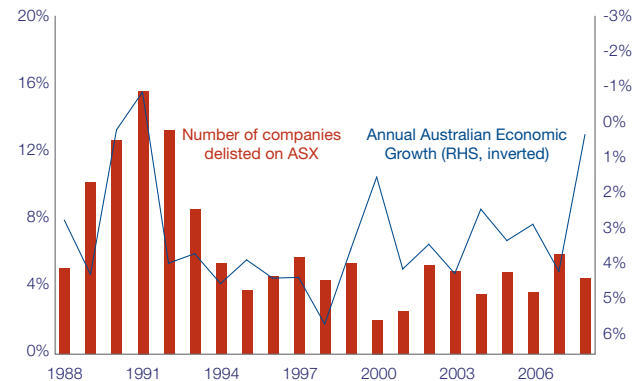
Making sense of the market and the environment

Investors may be asking how to make sense of this environment, given a global financial meltdown has most likely been avoided, but we are in a 'Great Recession', yet markets are rising on the back of Government policy and an optimistic earnings recovery in FY10. With these mixed signals from the markets and the economy, investors need to focus on what they know about the future:

- **The stimulus will eventually work** – even though the global economy appears very weak at present, the amount of stimulus provided by central banks and respective governments is immense and will gain traction through time.
- **De-leveraging will continue** – households and corporations remain over-leveraged and will continue to use low interest rates and record support from the government to reduce debt on their respective balance sheets. To facilitate this, households will need to reduce discretionary spending and boost savings, whereas stressed corporations could either reduce dividends and payout ratios, issue more equity, or both.
- **Asset prices will decline** – in a global economy, characterised by deleveraging, there is little prospect for asset prices to rise in a structural sense. Asset prices are likely to continue declining until debt levels are at a sustainable level and bank lending boosts demand for credit.
- **Many firms will face sustained funding pressure** – at present there remains a global shortage of capital given the tightening of lending standards, which are unlikely to unwind despite the Geithner Plan and the collapse of the US shadow banking system. The cost of debt will continue to be higher relative to recently lowered swap rates and firms will have to fund more of their balance sheet through (weaker) retained earnings.
- **Profit margins will be squeezed** – with firms facing sustained balance sheet pressure, higher funding costs and more revenue pressure in the wake of weaker economic growth, profit margins will be squeezed rather than expanded in the current climate.
- **More companies will fail** – with companies facing more pressure on revenues, costs, competition and balance sheets, it is inevitable that more companies will fail. This certainly occurred during Australia's last downturn in the early 1990s, when the number of listed companies that were removed from the Australian stock exchange rose dramatically and remained high for many years (see Chart 3) during and after the 1990/91 recession.
- **Industry consolidation** – with more companies facing heightened revenue and competitive pressures, some industries will inevitably be forced to consolidate to boost productivity and lower costs, especially those exposed to global competition. This has already been seen in the automakers, airline, insurance and banks, manufacturing and resource sectors and may spread broader and deeper.

- **The strong will get stronger and the weak will fall** – in this environment, firms with high market presence and strong franchises are in a position to either acquire, or witness the destruction of, their competitors. This will enable these types of stocks to build market share at the cheapest point of the cycle, which should eventually reward patient investors as reduced competition enables margin expansion in more normal economic conditions.

Chart 3: Recession leads to more delistings
Australian Economic Growth and Local Sharemarket De-listings



Source: UBS Australia Limited as at 31 December 2008.

What does this mean for investors?

There is tremendous change underway in the global economy and financial markets and while sentiment is not quite as bleak as at the beginning of March, it is not overly positive either. With the global economy forecast to experience its first year of negative growth since 1946, households and corporations continue to de-leverage and earnings outlooks appearing optimistic at best, market risks continue to be tilted to the downside. This outlook is unlikely to change for a considerable period of time and investors should be thinking about investing conservatively and focusing on quality assets more than receiving fast 'recovery-type' returns.

The importance of balance sheet strength in this environment cannot be over-stated. Corporate failures will rise in 2009 and reduced payout ratios and dividends are also likely. Consequently, stock selection will be of critical importance to investors and they should not want any exposure to these companies, whether it is large or small. A diversified portfolio of stocks with strong cashed-up balance sheets, high earnings certainty and sustainable payout ratios, dominant market positions and pricing power should serve investors well in these murky times and position them to benefit from any market upturn, no matter how far away it is.

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**For further information speak with your
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