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SPECIAL EDITION

The storm *before the calm*

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For the month, the ASX 200 fell by 6.7%, its sixth successive monthly fall. The US share market, as measured by the S&P 500 index, fell by 7.2%. Further weakness in the first few days of October now means that the US market is down by more than 20% from its mid-April high, a threshold commonly taken to indicate that the index is in 'bear market' territory.

The reasons haven't changed: fear of 'double dip' recession in the United States and continued concerns about debt issues, and the state of the economy in Europe. I continue to think that concerns about a return to recession in the United States are overstated; what we have is an economy caught in a 'slow growth' trap, but that is a long way from recession. Incidentally, in recent days, forecasters have been marking up their near-term forecasts for economic growth in the US.

In the past month, by contrast, many forecasters have become much more pessimistic about the state of the European economy. I think return to recession will be avoided there also, but with far less confidence.

The issue in Europe is, of course, the continued overhang of the Greek debt crisis. I have made the points before that the Greek economy is very small (and getting smaller!), and that an eventual default on its debt was inevitable. I have also thought all along that financial-market volatility would continue until the resolution of the situation is clearer. That said, I did not expect markets to behave anywhere near as poorly as they have.

There are two main reasons why the Greek situation drags on. First, it is not clear that there is any 'magic bullet' – a policy that Europe can adopt that will alleviate the problem significantly. Second, even if such a magic bullet exists, it is difficult to believe that the seventeen separate entities that make up the European Union, with their disparate agendas, strengths and weaknesses, will find it. The British author, Gilbert Chesterton, once said that he had searched all the parks in all the cities and he had not found one statue of a committee.

Just this week, Greece has announced that it will not meet its short-term deficit reduction targets, and European leaders have postponed their decision on the next tranche of aid to Greece until 13 October. What is clear is that the finance ministers in Europe are looking to increase the size of the contribution (loss!) that investors will have to make – from about 50 billion Euros to about 160 billion Euros. This constitutes at least a partial default.

What is old is new again?

The current situation has been compared with the GFC in 2008. I have resisted such comparisons, mainly on the grounds that the current situation is in fact smaller than the sub-prime debt problem was, and that it is far more transparent. But I am starting to think that there are some useful parallels to be drawn. In both cases, driven by fear and uncertainty, markets around the world were pushed down to very cheap levels.

That is to say price/earnings ratios declined to very low levels; markets were fundamentally dirt-cheap when assessed according to the earnings – current and prospective – of the listed companies.

In late 2008, a circuit breaker eventually came along, primarily in the form of TARP (the Troubled Assets Relief Program) in the United States. This policy was much disparaged at the time, but it ‘was the beginning of the end of the nightmare’, to quote Jim Cramer, the US market analyst.

I am not denying that the current situation is dire. I am making the point that current market levels have a lot of bad news priced in; probably too much.

Somewhat ironically, I spent September in Europe, with 10 days in Greece. This doesn’t mean I found out very much about the situation. In holiday mode, and cut off from one’s usual sources of information, what one sees is not the true picture. I can report that tour guides are very poor sources of economic analysis, obsessed with the belief that taxes in Greece are far too high! One also scratches one’s head about the thinking behind calling a taxi strike on a day when 15,000 cruise passengers are at the port, with no other feasible way of getting to Athens to spend some money! But I observed two examples of commendable business ingenuity; the man who charged passers-by for weighing themselves on his bathroom scales, and the young boy selling dental floss by the strand in restaurants.

Domestic concerns

My overseas visit also provides one answer to the question as to why the Australian dollar fell so much in the month (by more than 9%)! It’s just what would happen. I have made the point for some time that the

currency was too strong; at 94.6 cents it is still above ‘fair value’, which I estimate at 85 cents, so it may have further to fall yet. The fall in the currency has at least provided some cushion for Australian investors with money offshore.

There were some significant developments in the Australian economy in the month. First, the labour market news continued to be quite soft. Employment is now shown as essentially unchanged in the first eight months of the year, with the unemployment rate now at 5.3%, up from 4.9% in April. I said last month that if this rate were to hit 5.5%, the RBA would be able to justify lower rates on domestic grounds alone.

Second, there was a remarkable revision to recent estimates of underlying inflation in Australia. The Australian Bureau of Statistics now says, essentially, that the previous estimate of underlying inflation, of 0.9%, in the June quarter, was artificially inflated by seasonal factors. Adjusting for those factors suggests that underlying inflation was only about 0.6%. This puts the year-to underlying inflation rate at 2.55%, which is very close to the middle of the RBA’s target range, and considerably reduces the likelihood that inflation will be a cause of concern for the RBA in the foreseeable future.

So, with less inflation to worry about, and more concern about the labour market and contagion from global weakness, the stage is now set for a cut in interest rates. The RBA has shown a predilection for rate moves on Melbourne Cup Day – it has made a move in every one of the past five years, at a time when there have been just 20 changes in total – so a cut next month now appears highly likely. My esteemed Westpac colleague, Bill Evans, can take pride in his midyear call that a rate cut was likely before year’s end.

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