

# coming to grips with the new age

by Arun Abey, ipac Executive Chairman

**After a fact-finding trip to the United States (US) which included meetings with some of the world's leading fund managers and economists, Arun Abey, Executive Chairman, shares his views on prospects for recovery now and financial success in the coming years.**

In the early 1990s, Nobel Laureate Paul Krugman wrote extensively about what he called 'The Age of Diminished Expectations'. From about 1973, he said, economic growth in America slowed significantly, after a period of relatively strong growth. While the reasons for this were not completely clear, Krugman believed that slow growth would continue and that Americans would have to adjust to this new era of diminished expectations.

Clearly he did not anticipate the decade-long boom in household spending that began in the mid 1990s, stimulated by Americans 'consuming' the equity in their houses. He could not imagine how this would be enabled by lax bank lending standards leading to an extraordinary degree of leverage, while monetary authorities were asleep at the wheel.

Now that the party is over, it seems clear from my recent discussions in the US with various fund managers and economists that Krugman's scenario is reasserting itself. The answers below to some key questions our clients are asking draw from meetings with Jeremy Grantham of GMO, Seth Masters of Alliance Bernstein, economic adviser David Hale, Joseph Lakonishok of LSV, government economists, financial strategists and academics.

## is the worst of the financial crisis over?

Yes, in the sense that the financial system is not going to collapse. Prominent economist David Hale estimates that US banks still have another \$600 billion of asset write-downs likely in the coming year or so. But the government's bank stress tests suggest that a combination of asset sales, other restructuring moves and the improved profitability of the banks could mean they only need to raise \$75 billion of new capital.

The US banks have around \$14 trillion in assets and net earnings of around 1.3 per cent per annum, which will help them to cover further losses within a few years. In turn high interest margins should help to underpin earnings.

While the system as a whole is restoring itself, there will inevitably be collapses of individual financial institutions and ongoing consolidation of the industry.

## is the worst of the economic crisis over?

Not yet. The US economy continues to decline and unemployment continues to rise. For the economy to stabilise, the housing market needs to stabilise too. But house prices are still falling, albeit at a slowing pace.

For those under the illusion that bricks and mortar are safer than equities, the numbers are startling. From the latest peak to current levels, major cities such as San Francisco, Los Angeles, San Diego and Miami have all seen house price declines of over 40 per cent, roughly the same fall we have seen in major share markets.

This has resulted in around 20 per cent of households having negative equity in their homes. By the time this cycle is finished, the average price decline across the USA is likely to approach 50%, plunging more than one in four households into a situation of negative equity, where their house is worth less than they owe to the bank.



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The situation in Europe and the UK is even worse, with the slowness of the European Central Bank to reduce interest rates as aggressively as elsewhere likely to leave the region in the doldrums for a long time.

### will the Asian markets save the world?

On a more optimistic front, the Chinese and other Asian economies are showing signs of stabilising sooner rather than later. In fact, Asia is likely to lead the world out of recession towards the end of the year, followed by the US, with Europe lagging.

More balanced, and therefore sustainable global growth requires Asia, especially China, to rely a bit more on domestic consumption and less on exports, while the US needs to reduce consumption and increase exports. Economic policies in both regions seem to be fostering such an outcome.

The peculiarities of economic statistics are likely to result in some volatile growth numbers, but overall economic recovery in the US and Europe is likely at best to be moderate.

The need to rebuild both bank and household balance sheets (known as

'deleveraging'), the resulting increase in household savings, combined with negative house equity and high unemployment will restrain consumption for quite some time. A combination of higher taxes, interest rates and inflation will be a medium-term cost of the current massive stimulatory policies, and this will act as a further drag.

For Australia, the positive Asian outlook, a relatively sound financial system and stronger fiscal situation should all help to produce a softer landing than in the US or Europe. But housing prices remain overvalued, savings need to increase and hence sustained recovery back to the levels which prevailed prior to the recession is unlikely any time soon.

### what does this mean for investment markets?

There has been the usual vacuous speculation of whether the recent recovery in share markets is a 'dead cat bounce', that is a temporary rise that will only lead to further losses, or a genuine recovery.

The trough which equity and corporate bond markets hit in November 2008 reflected pessimism that the financial system itself could collapse. Such extreme

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pessimism was unwarranted and the sharp rise in markets since early March has provided a deserved reward for those with the ability to treat 'Mr Market's' depressive mood with disdain.

For the moment, markets will remain highly nervous and therefore volatile. Nevertheless, the undervaluation of a number of good quality companies, combined with the potential for company profits to jump as recovery starts to emerge in the coming six to nine months, should underpin solid returns in the medium term. Longer term returns are likely to be moderate, reflecting the constraints on longer term growth described above.

### **what does this mean for personal financial planning?**

Rising asset prices and the ability to 'eat our houses' for too long have allowed us as a society to be complacent about planning our finances. We now need to go back to basics.

We need to recognise that long-term (not short-term) interest rates are on the rise, expecting higher inflation a few years from now. To be on the safe side, particularly those with limited cashflow should consider the option of fixing mortgage rates for five years or so. To do so, they will need to pay a bit more interest today and it may be more expensive to do this than stay with variable rates over the five years. But it will protect their core household asset should inflation and interest rates soar as they did in the late 1980s. Remember, from current levels there is a lot more upside risk than downside gains in interest rates.

People entering the home loan market for the first time also need to meticulously stress test their finances, making sure they can easily absorb rises in interest rates back to significantly higher levels. We need to invest a significant part of our longer term savings in a sensible portfolio of equities, remembering that this provides a greater likelihood of inflation-proofing our long term savings. We need to recognise that a move to cash and government bonds is not currently an attractive option, given the very low yields they now pay and the medium term prospects for inflation.

But equally we need to be moderate in our long term expectations of equities. A portfolio of good quality companies, sensibly diversified, is not going to produce spectacular returns in a more restrained economic environment.

Advisory groups who promote high returns will be exposing their clients to much higher risks. We need to recognise that success in equities requires a modest amount of investment skill and a great deal of emotional fortitude. But not to develop this fortitude will condemn our savings to be eaten by inflation. And there is no greater risk than guaranteed failure.

### **what can we do on the home front?**

Speaking of savings, in a world of moderate investment returns we need to recognise the need to increase our savings, which in turn involves reducing our spending. This is a good time to understand the idea of hedonic arbitrage, introduced in the second edition

of How Much is Enough? That is, how do we increase our happiness, without any increase in spending?

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For starters, we need to embrace the idea of the 'family economy' – to make money visible to our kids and involve them in an understanding of what it takes to run a household.

Explain and show them the bills like electricity, mortgages, fuel and groceries. Tell them that times are getting harder. Ask them for their suggestions. You may be surprised at their ideas and their willingness to go back to basics. Initiatives like saving water in the shower, turning off lights and texting rather than phoning don't reduce happiness at all but can make worthwhile savings if everyone commits to the cause. And by waging the war on the economic front in this way, you can bring the family together.

One of the ways to get kids smart fast is to present a situation in which real consequences exist, by placing them in charge of their discretionary spending. If they receive an allowance, then parents should require their kids to map out the money they have coming and also where it goes. Seeing it on paper, or in a computer chart, will give them a sense of reality about their money, and also build healthy financial habits for life.