

## MAY RESEARCH

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### Current Themes

- The last 6 weeks has certainly been “risk on” as sharemarkets around the world increased sharply and higher yielding bonds continue to be in strong demand. This is unsurprising given that the “money printing” by the biggest central banks of the world continues and may do so for a few more months yet. Valuations continue to be stretched but price momentum is dominating financial market behaviour.
- The Reserve Bank’s slightly earlier than expected cash rate decrease shows its determination to decrease the value in the Australian dollar. At the time of writing the dollar is down to parity with the US Dollar, but whilst money printing in the US, Japan, and Europe continues, and with local interest rates higher than overseas, the Aussie is unlikely to maintain this downward momentum and will most likely stabilise near current levels.

### Interest Rates

- The latest Reserve Bank action has confirmed recent bond market movements that there may be even further cash rate decreases this year. A 2 year Australian government bond yielding 2.52% (13 May 2013) strongly suggests that cash rates are heading lower.

### Credit Spreads

- Whilst lower interest rates in recent years have coincided with higher credit spreads, given this is the norm for a slowing economy, it does not appear the case in the short term. Credit spreads in Australia are still relatively wide and the “chase for yield” will ensure they continue to narrow.

### Australian Dollar

- Despite the Australian dollar decreasing since the Reserve Bank reduced its cash rate, it is expected to stabilise. As already alluded to, the overwhelming factor influencing the value or strength of the Australian dollar is more the ongoing weakness of the biggest currencies of the world...US Dollar, Euro, and Japanese Yen.

### Volatility

- Global imbalances from the artificial nature of financial markets are simply getting worse. Financial market volatility around the world has been high since 2007 and whilst it has artificially settled somewhat over the last 12 months, the fact that valuations are looking stretched in a low growth environment suggests volatility will continue to sporadically spike.

## Macroeconomic Risks

- From an Australian perspective, the biggest risks will continue to come from Europe and China. Europe's impact is more of a global impact that could unsettle local markets whilst a poor economic result from China is more likely to have a direct impact on the success of our resources-driven economy.
- The Euro zone still has the possibility of a break up despite looking more unlikely compared to a year ago...current talk is of a move away from the fiscal policy of austerity (or reduced government spending). The result of the current Japanese experiment whereby this highly indebted nation is spending even more will be influential...so far the signs are good for Japan, hence putting another nail in the coffin of European austerity which has done nothing but produce terrible economic outcomes.
- Whilst China is expected to grow, its economy is currently transitioning from an export and investment led economy to one whose growth needs to come from consumption. Transition is unlikely to be smooth.

## Reserve Bank decreases cash rate by 25bps

As we all know by now, on May 7 Glenn Stevens announced the Reserve Bank is lowering its cash rate by 25 basis points to a record low 2.75%...lower than during the GFC which was 3%. This is obviously a sign that all is not well with the Australian economy and it appears one of the primary goals of this reduction is to help reduce the value of the Australian dollar. During April, the Australian dollar hit a record high in trade weighted terms and this high level does not help our exports, tourism, or manufacturing sectors, to name a few. As has been well documented, economic growth is unlikely to be driven by the resources sector in the future and there is no obvious driver of future growth. So with inflation lower than the Reserve Bank's expectation a rate reduction makes sense.

Despite this action, there was very little difference in the Reserve Bank's May Statement compared to the April statement, when rates were kept on hold. The key differences included...

- Employment is growing slower than the labour force...so whilst more jobs are being created, the unemployment level is still creeping up. This is likely to impact negatively on inflation and also economic growth
- "Savers have been changing their portfolios towards assets with higher expected returns"...so we're still saving at high levels, which is a continued dampener on inflation, but now we're investing more in shares and higher yielding bonds and property securities.

These key statement differences are really strong confirmation that inflation continues to be of little concern to the Reserve Bank and the focus needs to be on the economy and unemployment. Whilst many believe the Reserve Bank's role is to keep inflation between 2% and 3%, its primary role is to contribute to...

- The stability of the currency
- The maintenance of full employment, and
- The economic prosperity and welfare of the people of Australia.

...and all three of these goals are a focus at this point in time and are of concern.

## What did the Reserve Bank say? continued...

So whilst the outlook is one of weakness and not strength, we still shouldn't forget some of the positives mentioned by Glenn Stevens. Some of which include...

### International Economy

The two biggest economies in the world appear fine...

- "The US continues on a path of moderate expansion", and
- "China's growth is running at a more sustainable level"

### Global Financial Conditions

Quite simply confirming that sharemarkets and credit markets have been performing well and that capital raising conditions for companies appear strong...

- "Risk spreads reduced", and
- "Borrowing costs for well-rated institutions and sovereigns are exceptionally low"

### Unemployment

It is low. When you compare Australia to the US (7.5%) and Europe (14%), our unemployment level (currently 5.5%) is definitely enviable.

### Australian Economy

- "There has been a strengthening in consumption and a modest firming of dwelling investment"
- "Exports for raw materials are increasing"
- "Productivity growth appears to be improving"

Similar to last month's conclusion to the Reserve Bank's statement, it is very difficult to see interest rates significantly increasing in the coming months and the same goes for the lower rated bonds. So from the perspective of having a diversified investment portfolio, there is still a good case to include a fixed income component. Fixed income investments are still paying a good premium above the current level of inflation, which is expected to remain low. The biggest risk to fixed income investments would be a spike in the inflation outlook or very strong Australian economic data but these are increasingly looking unlikely for now.

## China...another property bubble?

We've already mentioned that the Australian economy is relatively reliant upon the strength of the Chinese economy because they are the primary purchaser of our resources. Also, the Chinese economy is transitioning from an investment and export led economy to one that is to be more consumption driven...this is the natural transition as China moves from a developing economy to a developed economy like the US, Japan, and Australia.

On face value, the Chinese economy appears great. Particularly when you consider that China's current GDP growth rate is 7.7% and far and away higher than any other nation in the G20. Whilst the outlook is no longer 10% GDP growth and the slower 7%+, surely things can't be too bad. China has some very enviable economic statistics...

- GDP Growth is 7.7%
- Latest Inflation rate of 2.4%

## China...another property bubble? continued...

- Unemployment of 4.1%
- Debt to GDP of 23%
- Budget deficit of 1.5%

However, there are numerous concerns regarding the Chinese economy. One which has not hit the headlines yet and also relatively unknown in terms of potential impact, relates to their property boom. Like the US property boom that resulted in the GFC, there are bubble characteristics in the Chinese property market, which includes...

- Sharply rising prices
- Cheap money and high debt levels
- Significant reduction in earnings expectations

Land prices have doubled in China since 2007 and are now higher than average prices in England, which is a reasonable comparison given England is a small, heavily populated country with clearly limited land supply. Eastern Chinese land prices are almost double that of the peak of London's land prices in 2010 and not far short of London's prices during its peak in 2008...a result that would surprise many.

Interest rates in China have been relatively low, with lending rates averaging around 6% and with little fluctuation over the last 10 years. The amount of credit in the Chinese economy has also expanded from around 100% of GDP in 2000 to around 180% towards the end of 2012....satisfying relatively cheap funds and high debt.

The financing of much of the property build has come from "Local Government Financing Vehicles" (LGFV). LGFVs were formed in the mid-1990s in order to fund their local area economic growth. Local governments sell land to LGFVs who use the land as collateral to then borrow funds to invest in their local economy and this model can work so long as property prices keep going up. In 2007, there was an estimated 360 LGFVs and that number has increased massively such that by 2010 there was an estimated 6,000 to 10,000 LGFVs formed. The debt in these vehicles is estimated to be potentially 40% of GDP...another very high number.

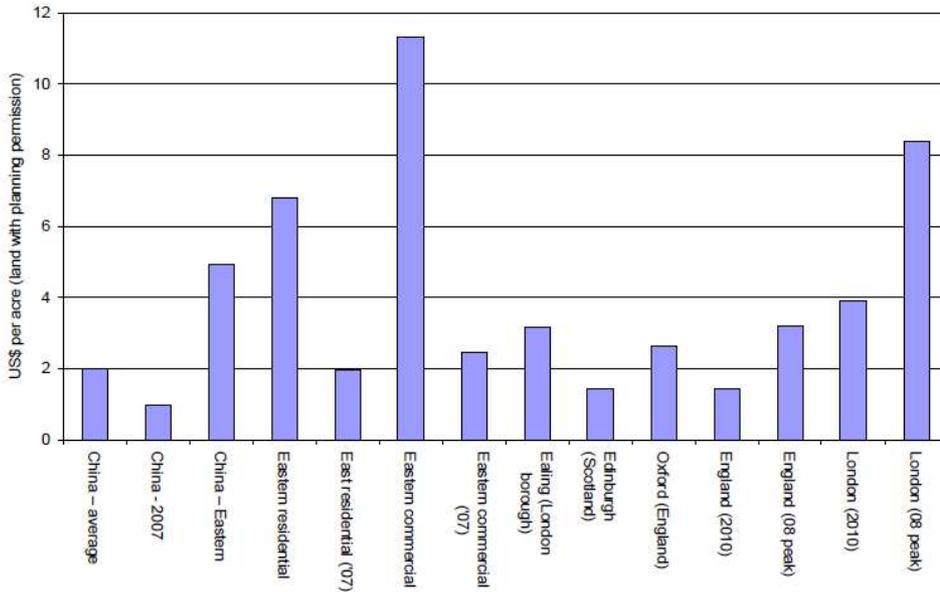
According to Longview Economics, "assuming the average living space per person in China is 30 square metres, there has been enough housing built in the last 16 years to accommodate 930 million people", or 70% of the population. This property has been built in urban areas and there are many buildings that currently lie dormant. Longview Economics estimates that potentially "23% of the population could be housed in this excess housing". An oversupply suggests the only return potential for much of this housing investment will therefore be in capital appreciation only as an empty house cannot produce rental income.

So, whilst the numbers suggest there may be strong potential of a Chinese property bubble that could burst, there is no guarantee that this will happen and it is always possible that if overvalued a slow depreciation and shift to other parts of the economy could soften any blow. Either way, whilst there are numerous question marks around data that comes out of China (e.g. how does China produce GDP growth figures 4 weeks after the quarter whilst Australia and the US take many months), there is no denying that significant risks in the Chinese economy exist and the current property situation is certainly one of them.

The main message is that Australia has been a lucky beneficiary of China's growth but it should not be taken for granted. From an investment perspective, a close eye on the ongoing success of China is essential and the only free lunch in investing, diversification, must be a strong part of every investment portfolio.

### The growth in Chinese and Eastern China Land Prices

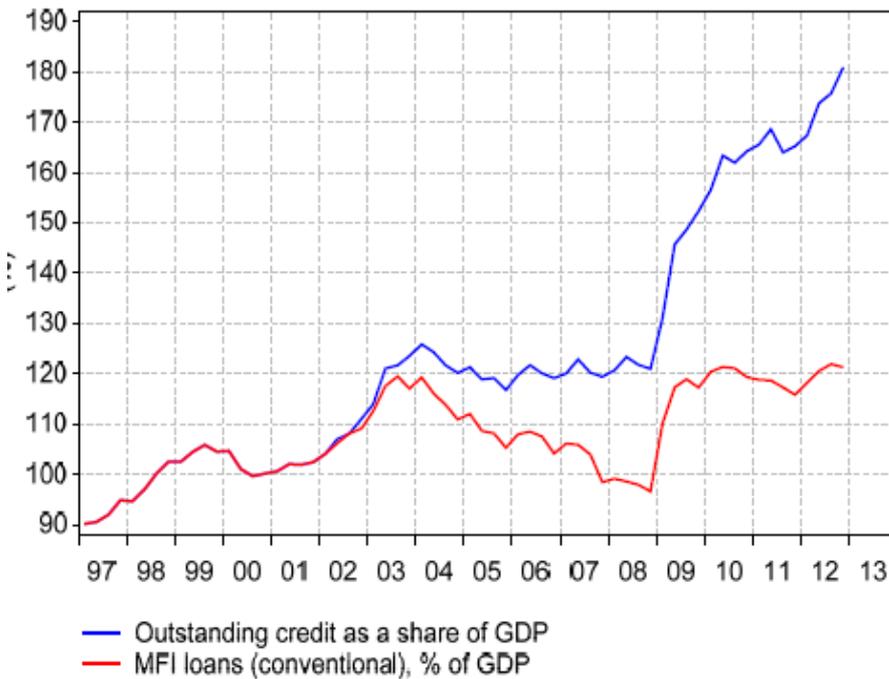
Average Land Prices: China vs. England/London (various dates) – all US\$ per acre\*



Source: Longview Economic, WIND

### The growth in Chinese credit

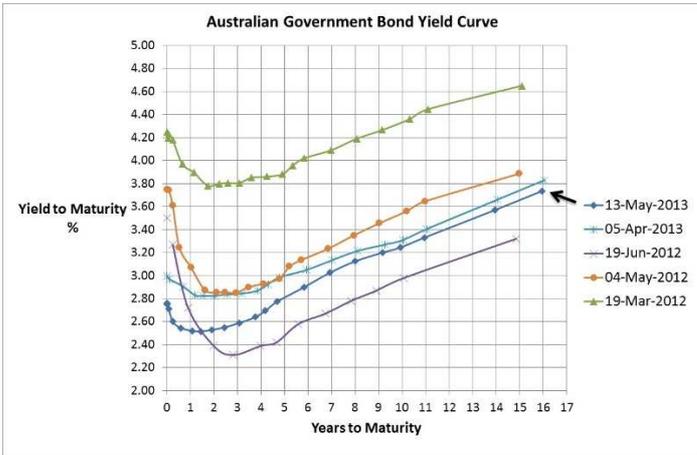
Chinese Debt to GDP (system wide lending & traditional bank lending)



Source: Reuters EcoWin

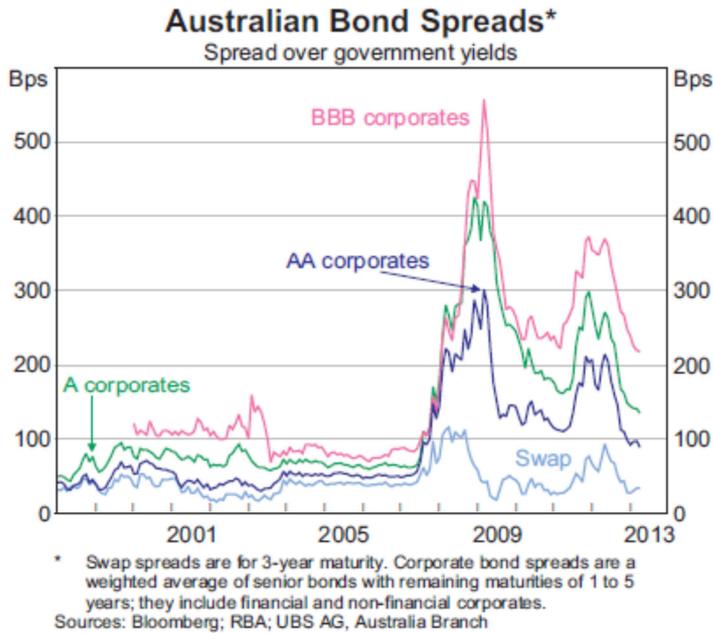
Source: Longview Economics

**Interest rates near 2012 lows**



Source: Reserve Bank, Delta Research & Advisory

**Credit spreads continuing decline**



Source: Reserve Bank

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