Market Update

August 2011

Capitulation

...or Sins of the father, grandfather and various other people over the last 60 years in the US.

I remember studying excessive military spending and the US debt issue (not a crisis at that stage) when I was at uni. To put that in perspective for the IT savvy amongst you, people were still running around with punch cards and there was talk of phasing out cobalt as a computer language.

Of course everyone needs a scapegoat and the US President makes a big target. The reality is, this is a problem that has been building since the post WWII period. Defence spending, the cold war, the space race, the welfare state - none of this stuff is cheap. Or sustainable.

Point is the US debt crisis is not particularly new. It was just that no one knew when the ticking time bomb would explode.

Boom!

One thing that did surprise me was the trigger. It wasn't that S&P downgraded US government debt, it was that it occurred so soon following the resolution to raise the debt ceiling. I guess the US Government needs a new lobbyist, because ideally this would have been delayed for as long as possible to give markets a chance to digest the "good news" of a political solution to the debt ceiling.

End of an empire

This is a recurring theme of mine, but I think we can safely say we have taken the first step towards a brave new world for the US over the weekend. The long march has begun, and not to a good place. While the US economy may be on the wane, remember this is a far cry from saying investing in strong US companies is a bad idea, particularly if much of their earnings are based globally.

Crisis of confidence

To have confidence in markets going forward it is necessary to climb the wall of worry. What will authorities do now? How do you deal with the massive debt issues in Europe and the US?

Lets take a step back for a minute. The market reaction in the last few weeks is assuming the world is heading into another GFC event, but the evidence for this is simply not there.

During the GFC the US posted a full year of negative GDP growth, while most of the rest of the world experienced a recession. This is not the case now. Manufacturing, particularly in the US, was in a hole. Now the weak USD has helped it recover somewhat. US unemployment is not great, but at least it has stabilised at around 9 per cent. Chinese growth and industrial production is still relatively strong, despite the attempts of authorities there to slow activity.

Layer on top of this the fact that company balance sheets, especially in the US, are very strong and cash balances are at record highs. Governments aren't having to bail out banks and liquidity in the bond market seems pretty good. All in all, not such a bad story.

So what's next

Well for starters a relief rally like we saw in the Australian market on Tuesday afternoon.

Because the global debt problem appears so intractable, central banks around the world (with a few minor exceptions) will have to recant on inflation targeting and crank up the printing presses. Already done that you say? You ain't seen nothing yet. No, it is time for a tried and true wimpy way out - inflate the debt away.

And as I have said before, one of the unintended by-products of excess liquidity in the past has been a bull market in equities and a bear market in bonds. This is unlikely to happen overnight, or be a smooth ride with such an indebted consumer sector, so caution remains the key. But in my view having minimal equity exposure right now may turn out to be costly down the track.

One more thought. As an Australian investor, the recent retracement in the AUD means the value of any global portfolio of shares you hold just went up significantly. This helps protect against the recent market fall. At around one to one with the USD, historically this still represents a good buying opportunity.

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Dated August 2011