FINANCIAL REVIEW

SE Perspective

HD **Investors in denial**

BY Karen Maley

WC 1,585 words

PD 12 July 2014

SN The Australian Financial Review

SC AFNR

ED First

PG 21

LA English

CY Copyright 2014. Fairfax Media Management Pty Limited.

LP

Global economy Markets may be underestimating the impact of the end of quantitative easing, writes Karen Maley.

It's a dangerous time in global financial markets as investors wait to see whether rampaging animal spirits will wilt under the pressure of rising United States interest rates. Some fret that with soaring prices for virtually every asset – from US shares to Spanish government bonds, from Manhattan apartments to contemporary art – the mood is eerily reminiscent of the heady days of 2007, just before the onset of the global financial markets. Meanwhile, the Vix index of US share price volatility – the "fear index" – is plumbing seven-year lows, while volatility in foreign exchange and bond markets has also evaporated.

TD

A fortnight ago the Bank for International Settlements – the banker for central banks – sounded a major alarm, warning that exuberant financial markets have been dancing "mainly to the tune of central bank decisions". BIS warned of a "puzzling disconnect between the markets' buoyancy and underlying economic developments".

Dom Giuliano, a portfolio manager at leading fund manager Magellan Financial **Group**, which has delivered an impressive annual return of 9.4 per cent since inception, agrees that investors could be underestimating the risks. "There does seem to be a fair degree of complacency. When you look at volatility and valuation levels, it suggests that some of the significant risks that exist in the world today are being ignored."

Even though BIS cautioned central banks not to fall into the trap of raising rates "too slowly and too late", Janet Yellen, the powerful head of the US Federal Reserve, has signalled she intends to keep short-term US interest rates low to avoid choking off the US economic recovery.

All the same, the US central bank has decided to end its controversial bond-buying program, known as quantitative easing or QE, in October. The bond **purchases** were supposed to push long-term bond yields lower, driving investors to **buy** riskier assets such as stocks and junk bonds.'The big money has been made'

Kerr Neilson, the highly regarded founder of Platinum Asset Management, which has delivered investors an astounding annual return of 13 per cent over 19 years, points out that the end of QE has important implications for financial markets.

"It means people will be able to earn the yield they need without taking so much risk. Printing money is just a tax on people who own cash deposits and government bonds.

"The fact that people don't have to chase so enthusiastically after risk to get some return on their money really does suggest to me that the big money has been made in these Western markets."

Neilson argues that in the US "valuations on small caps – the Russell 2000 index – look very expensive". The S&P's valuation, he says, "is probably justifiable" but this depends on US companies boosting their earnings. "The earnings are key because everyone has built in an acceleration in earnings in the second half."

As for Europe, he says, the latest problem with the Portuguese bank "just draws attention to the fact that Europe is still much earlier in the recovery cycle and there are tensions with countries such as France that need to make changes.

"So I see the Western hemisphere as being fairly fully priced."

But Neilson is enthusiastic about investment opportunities in Asia.

"What we're seeing in Asia is that countries are growing again. And even if China has slowed somewhat, the stimulus measures introduced by Beijing are allowing the country to grow. Asian markets are all pretty much out of favour. But the Chinese, South Korean and Japanese markets strike me as being ready to go to the next level. All these three big Asian markets are under-owned and look very good value."

By contrast, Giuliano says Magellan feels the US is on track for a sustainable economic recovery and is significantly overweight the US market. The aim is to capture some of the tailwinds from rising interest rates, improve consumer activity and increase e-commerce and more investment in technology by corporates.

He says the outlook for all sectors of the US economy is improving.

"Households have deleveraged over the last five years, the unemployment rate is continuing to decline to almost 6 per cent, the participation rate is improving and the rate of under-employment is also improving."

In addition, he says, "households are benefiting from improving house prices which have risen 10 to 12 per cent over the last year. This helps the economy because as house prices rise, people feel wealthier and tend to spend more. Also the number of people with negative equity in their mortgages is falling."A boost from construction

The US economy is also getting a boost from a pick-up in residential construction. "There were around 400,000 new houses built in 2010-11 but this has now increased to about a million new houses per annum, which represents a lot of extra economic activity. But there's still a way to run because underlying demand is running at about 1.4 million new houses a year."

At the same time, he says, "The corporate sector is healthy, balance sheets are in good shape and companies have a lot of cash which they're looking to invest. The US banks are among the best capitalised in the world and are ready to lend.

"And the US government sector is on an improving trend. The US deficit has shrunk from around 9 per cent of GDP to below 3 per cent at present."

As Giuliano sees it: "The risks are all around the end of quantitative easing. The US Federal Reserve has signalled that it will stop buying government and mortgage-backed securities by around October and so the question then becomes how does the balance sheet of the Fed unwind and will there be a residual inflationary impact?"

So far, he says, the US bond market has appeared to take in its stride the imminent end of QE. But he says there is still a major unknown: "Will we see a steady normalisation of interest rates or is there a potential for a jolt in interest rates as the US economy strengthens and QE finishes?"

If US rates rise, he says, "arguably the rest of the world will suffer more than the United States, particularly the emerging markets".

Higher US interest rates, he says, "will expose the vulnerable emerging markets even more, particularly those that have borrowed heavily, have large current account deficits and government deficits – such as Turkey, India and Indonesia".

As for China, Giuliano says Magellan sees rising risks from the excess supply of residential construction in China and from the strong growth in credit over the past six years.

"If you think about China's building and construction over the last couple of years, there is a need for 1.25 billion square metres of new housing space each year as around 20 million people a year move into urban areas. For the last few years, the amount of space built is closer to 2 billion square metres. As a result, there's an estimated three years of excess housing supply in China."

 © 2018 Factiva, Inc. All rights reserved.

Given that construction makes up a significant slice of **China**'s GDP, he argues a sharp decline in construction activity could cut several percentage points off **China**'s 7 to 7.5 per cent GDP growth rate.

"That could have significant impact on resource exporters such as Australia. But it could also affect emerging markets such as Brazil that are already vulnerable as a result of rising interest rates."**Chinese** credit another risk

Giuliano says the sharp growth in **China**'s credit could also result in instability.

"Credit outstanding has gone from about 140 per cent of GDP in 2008 to around 200 per cent of GDP at the end of last year. It's a huge jump. The increase in the dollar value of credit outstanding in **China** in that period is equal to the entire US banking system." But he notes that "**China**'s government does have some levers to deal with these risks".

Platinum's Neilson agrees there are some concerns over **Chinese** economy.

"The **Chinese residential property** market is in a severe downturn and prices are dropping fast. The desire of people to clamber into the market is reduced and there's not the same enthusiasm to load up on **property**.

"There are an estimated 10 to 12 million apartments that are not **sold** – so that's a good chunk of real **estate**. And that will have an impact on developers as they think about starting new projects."

But, he says, "the issue in **China** is that they need to find other avenues of growth and they'll do that as the economy transitions from being an investment-led economy to a consumption-led economy".

Neilson points out that **China**'s President Xi Jinping's clampdown on corruption is aimed at "bringing radical change to **China**'s state-owned enterprises which have concentrated economic power and where senior management has been using their privileged position to strip assets and money from the companies".

Xi, he says, "is trying to get rid of opposition to the whole notion of reform". "The clampdown is not just about rectitude, it's about political determination."

Neilson is "quite optimistic" he can make good money in the Asian region and less money in the Western hemisphere.

NS e1202 : Interest Rates | mntdbt : National Government Debt/Bond Markets | nedc : Commentaries/Opinions | e12 : Economic/Monetary Policy | ecat : Economic News | m12 : Debt/Bond Markets | mcat : Commodity/Financial Market News | mgvdbt : Government Debt/Bond Markets | ncat : Content Types | nfact : Factiva Filters | nfce : FC&E Exclusion Filter | nfcpex : FC&E Executive News Filter

RE usa : United States | austr : Australia | apacz : Asia Pacific | ausnz : Australia/Oceania | namz : North America

PUB Fairfax Media Management Pty Limited

AN Document AFNR000020140711ea7c00020

 © 2018 Factiva, Inc. All rights reserved.