Around the bend

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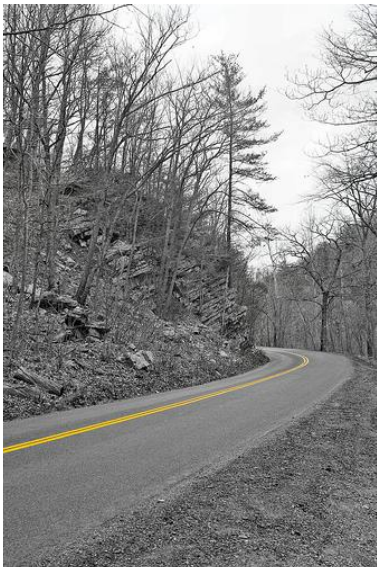


You would be crazy to forecast what is around the investment corner given the turbulent year we have had. Instead a structured scenario analysis can help identify possible destinations for where we may be headed and actions for you to consider.

The two big uncertainties which have the most consequence for your personal finances are how long will this downturn last and will deflation or inflation rule? It is still possible we may enjoy a quick snap-back recovery in the share market and avoid a recession in Australia. However many suggest we are in for a long period of economic malaise. While all the talk is deflation at the moment, inflation could break out after all the planned economic stimulus works its way through the system. Inflationary extremes play havoc with personal finances in different ways. With these uncertainties in mind, there are three possible destinations for the near future to describe:

- Happy Valley – where a "V" shaped recovery is enjoyed
- Deflation Flats – where deflation drives asset prices down further
- Runaway Heights – where excess stimulation reprices everything

What different investment strategies perform in each one of these? What are the signposts to look for that indicate which direction we are headed? What "no regret" and "regret" moves should you consider in all cases?

Happy Valley

Happy Valley is a nice place to live. Everyone there breathes a low carbon sigh of relief knowing the crazy events in the markets were caused simply by forced selling by institutional investors. People look back at 2008 as an episode of mid-air turbulence when the cruising economy simply hit some dead air, fell hard, but got back quickly to a smooth, albeit slightly lower cruise altitude. The rapid decline in Australian share prices and the dollar, alongside the rapid rise of the Yen were explainable for instance by highly geared hedge funds being forced to quickly repatriate monies borrowed in low interest rate Japan. At the time, the media said retail investors were panic selling, when in fact most stayed the course and were rewarded once the selling stopped and prices recovered.

Those who kept regularly investing superannuation contributions and the few who courageously invested other monies, found they bought assets at discounts better than those offered in the 2008 post-Christmas sales. Investors who sought the safety of cash, including a fair proportion who sold at the bottom of the market when their nerves finally shattered, are still unsure about getting back into the market. However several did reluctantly when the All Ordinaries index rocketed through 5,000 and the Dow 10,000 by mid 2009 marking out a "V" shaped recovery. Over time more sensible regulations were introduced to curtail the speculators and markets returned to a place where investors could reliably buy dividend, rent and interest income streams without asset values jumping wildly. Inflation in Happy Valley is moderate allowing central banks to keep interest rates in normal ranges. World leaders Obama, Brown and Rudd are heralded for their stewardship of the crisis.

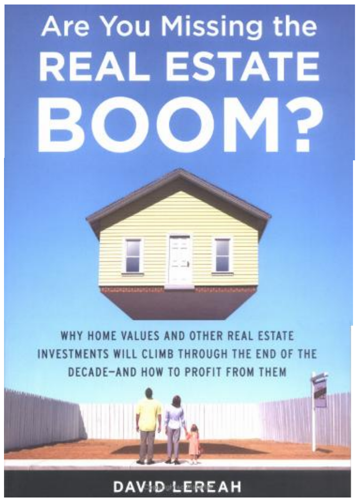
Happy Valley feels a little bit like life in the 50s. Many are bruised and a few have given up on investing in shares. The new decade of 2010 commenced with the All Ordinaries testing 6,000 and the Dow 12,000. The All Ordinaries officially bottomed on 20 November 2008 at 3,332.

Some of the signposts to Happy Valley are around us now, particularly those that point to the share market being good value – such as low price/earnings ratios and share market yields that exceed cash rates. A sign not yet seen is confidence that events are stabilizing which normally signals a rebound is near. In past downturns, firming, not falling commodity prices and a recovery in auto sales signaled good times ahead. Given the origins of this crisis, reassurance that more bank failures will be managed through a functioning recovery program should be looked for. If the market gets bored of and stops falling every time there is bad news, then that could be a sign you're at the exit ramp to Happy Valley. One thing is clear, if you look for a recession to be over you will have missed the rebound by several months.

Happy Valley is the best case scenario, however, the longer it takes to eventuate, the less likely it ever will.

Deflation Flats

In Deflation Flats everyone feels deflated and some even depressed**.** People don't brag any more about how much more their house, investment property or share portfolio is worth. Instead many are cocooned at home watching Foxtel. Thrift is the new black. First and hardest hit in the downturn were white collar professionals such as bankers, executives, middle managers, lawyers and consultants. The exceptions were insolvency specialists, forensic accountants, and litigation and divorce lawyers. Hit next were blue collar workers after their pipeline of project work evaporated, including building lavish homes for the former groups. Those light blue collar workers in recession proof industries like health care fared better than those in hospitality and personal and business services.



The housing affordability crisis disappeared, as did many borrowers' home equity as residential property prices fell by over 30%. This made people realize housing was simply over priced. Interest rates of 2% meant servicing debt was more affordable provided you weren't part of the 13% unemployed (a figure which some think is under reported and doesn't count the self-employed who struggle to meet expenses). Everything is worth less and people are afraid of spending as they suspect next month things will get cheaper, again. People have recalibrated their expectations and don't use credit anymore –some used to think it was different than debt having been told it was *priceless*. Early on Baby Boomers were devastated by the collapse in their retirement savings especially after many illiquid assets including unlisted property, infrastructure, hedge funds and private equity were reluctantly priced down. Many alternatives funds closed and new ones emerged once it became clear they would never recover enough to earn future performance fees. Generation Y scream from their MySpace sites about how their future has been stolen. Co-prime minister Gillard is focused domestically on managing the part nationalized early child hood learning, banking and manufacturing industries. Co-prime-minister Rudd seems to be forever embarking on foreign trips to fight protectionism and negotiate concessions with now dominant China. The cover of *Time* magazine in June 2009 read "*All hope lost*" which became the buy signal for contrarians.

Just like in the 1930s a multi-year bull market in stocks began once the yield on the All Ordinaries rose above 10%. It didn't take long for it to rise to 4,500 for the start of 2010. This provided a 50% return off the bottom which was a little below 3,000. There was a suspicion it stopped falling further due to intervention by the Future Fund and others.

The large signpost to Deflation Flats is rapidly rising unemployment. It's the trigger that pricks the local housing bubble and sends the local economy into a second deflationary spiral (the first being the deflation in listed company and property prices). Large job losses in banking are to be expected but if substantial losses extend into other industries, then that is a warning sign we're having the recession we didn't need to have. Be careful when listening to the nightly news as they could use the same language to describe modest job losses as they would massive ones. Failure of stimulation and bank recovery programs, as well as the persistence of ultra-low interest rates, is another sign to look for. It is not clear a declining CPI is a necessary guide post as prices could still rise while asset prices deflate, however if it falls that's strongly supportive.

Deflated Flats is a more likely scenario than Happy Valley the longer the economy softens.

Runaway Heights

Everything keeps rising in Runaway Heights including people's tempers. Inflation is rampant. Those on fixed income screamed for more taking their shirts off in public on routine. Employees used new IR rules to secure increases in pay pointing out how everything has gone up in price. Conspiracy theorists claim the CPI at 7% is under reported so as to reduce the government's indexed payment obligations. The US dollar fell once it became obvious it was printing its way out of debt rather than choosing to raise taxes (other than through tax "bracket creep"). Oil became priced in Euros and the Chinese revalued their currency upwards. After a short time appreciating against the US dollar, the Australian dollar fell in response to both home grown and imported inflation. Every where you look prices are rising including through carbon taxes, water levies, gas, electricity and food price rises. Yes, even private school fees went up after subsidies were reduced earlier. Oil scarcity re-emerged and another luxury island started to be built in Dubai. Local and state governments hit rate payers to shore up failing pension plans and even the Future Fund needed topping up. Government coffers held up as inflating income, and later rising land prices met tax thresholds which stubbornly didn't move. The Medicare levy was raised to 2%.

In Runaway Heights, the heavily indebted feel better as their borrowings seem more manageable now with everything else having gone up in value around them – that is except for those who didn't lock into lower interest rates and are now paying over 10%. Gold bugs are having their year and energy and resource stocks snapped back. Residential property owners breathed a sigh of relief as their much anticipated fall in value was cushioned by rising prices. Other illiquid assets including those in a well known super fund held up surprisingly also. Listed property rocketed up in value as people sought their rising CPI linked rental income. Infrastructure and utilities did well for similar reasons. "If it's too heavy to carry, it's worth investing in" became the catch cry for investors. Banks and bond holders aren't doing so well. Heavily hit are those retiree investors who fled into cash at the bottom of the 2008 stock market collapse then didn't see the real value of that being eroded by inflation. Newly elected President and Treasurer Turnbull is working hard to show he isn't full of hot air fighting the many wage outbreaks fed by the fiery winds of inflation.

Life in Runaway Heights does feel a bit like the 1970s. The All Ordinaries finished 2009 at 5,500 however on an inflation adjusted basis this was more like 5,000.

Signs on the road to Runaway Heights include increases in various money supply measures, gold, oil and other commodity prices. Continuing rises in the consumer price index (CPI) is a sure sign to look for. A falling US dollar would be expected. Recovering commodity prices might support our currency in the short-term; however it could fall like it did in the 1970s. Don't rely on interest rates as they might point elsewhere in the short term and indeed be part of the problem. However if they rise above 10% that will certainly confirm you've been in Runaway Heights for awhile.

It is important to know that according to some maps, you can get to Runaway Heights by first driving through Happy Valley and Deflated Flats.

No regret and regret moves

A "no regret move" which should benefit you in all scenarios is to maintain a diversified exposure to both Australian and International equities. In Happy Valley shares recover quickly. Equities, particularly those with a commodity bias which we have in Australia, give you a chance of keeping up with inflation in Runaway Heights. In Deflated Flats just like in the 1930s, share prices can recover before the economy once yields on cash become unattractive. Investing offshore is especially important in Deflated Flats when commodities and financial stocks (which constitute most of the Australian market) might not perform. Given the many directions currencies can move, hedging some but not all of your overseas investments' currency exposure makes sense. Spreading over time the investment of any new monies in the market avoids mistiming. Of course if the market recovers quickly, you may regret not putting in more – but that would be a tough call.

Holding too much of your wealth in cash is a regret move in all scenarios. In Runaway Heights cash erodes in value and in Happy Value it comes at great opportunity cost. In Deflated Flats it offers only temporary respite before stock prices recover. Of course there you run the risk of prices falling further, but there is a greater risk of missing out an eventual rebound. Rebalancing your portfolio now to its target asset allocation helps you manage this.

Listed and unlisted/residential property is priced differently in the current market. In my opinion, now is not the time to get into residential and unlisted property in all scenarios. In Deflated Flats it could fall hard as many will be forced to sell after losing their income. In the other scenarios past excesses need time to work through. Later on in Runaway Heights direct property should keep up with wage inflation, but not necessarily right away. Listed property is by no means clear of trouble in Deflated Flats, but having fallen about 60% it is better placed for a recovery in all scenarios.

Locking into a long term bond or term deposit is probably also an unwise move. While doing so may be beneficial in Deflated Flats, the market may be pricing in most of the decline in interest rates. Rising interest rates in Runaway Heights can make you *cash poor* unless those bonds are inflation linked. Higher yielding, lower credit quality bonds will rebound in Happy Valley but fail in Deflated Flats.

Borrowing now to invest in equities would benefit those who live in Happy Value. It may even work in Deflated Flats provided asset prices don't fall too much further, you don't borrow on margin and you don't lose your job. At current yields, new gearing may be cash flow positive. Borrowing in Runaway Heights works only if you fix your interest rate before it rises and you get in early.

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Of course the future will not be exactly like these purposeful extremes. However uncertainty doesn't mean you can't consider some steps to take now and others later as signs emerge.

Doug Turek is the Managing Director of independently owned wealth advisory and money management firm Professional Wealth (www.professionalwealth.com.au), corporate authorized representative of Money Managers Partner Solutions.

Predicting the future of investment markets is fraught with difficulty. Like Warren Buffett, we don't claim any special insight about movements in the market and especially the future level of the All Ordinaries index. Instead the above may help you understand possible future states and how various factors can interrelate. This is not advice and you should seek expert input before making any investment decisions.