vanEyk

9TH ANNUAL CONFERENCE

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NO HARD LANDING FOR CHINA

Direct polling of Chinese households points to a rebound in consumer sentiment and a continued strong performance from the Chinese economy, a visiting US expert on emerging markets told the van Eyk conference in Sydney on March 21.

David Riedel, founder of emerging markets specialist Riedel Research said that after a sharp drop last year his firm's Chinese Consumer Sentiment Index, which directly polls 1000 households in 30 cities, had rebounded sharply and added to other signs the economy was on a better heading.

He said over the five year history of the survey it had a strong positive correlation to growth in Chinese industrial production as well as retail and auto sales growth.

"This is predicting strong growth in the next few months," he told delegates.

Amid all the talk of a possible hard landing in the Chinese economy, Mr Riedel said he would like to challenge the believers in a hard landing to define exactly what they meant by the term.

He noted that the Chinese economy was 28 times larger than it was in 1990 and given such huge growth a slowdown in annual GDP growth from 8 per cent to 6 per cent was not dramatic.

"A true hard landing would involve some failure of the banks. We don't think that would be allowed to happen," he said. "I think China is heading towards a managed slowdown."

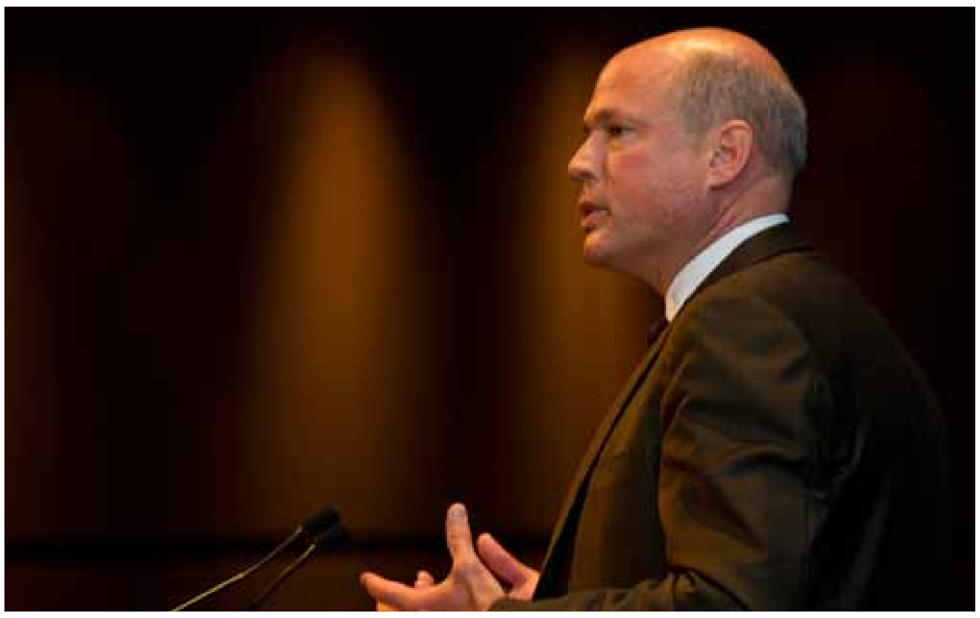
Mr Riedel said although the rebound in confidence set the stage for a strong performance from the Chinese economy in the first half of 2012, investors should watch for signs of a breakout in inflation in the second half of the year. Food and fuel inflation was particularly important in emerging markets because of the large slice of the family budget consumed by these two inputs.

Mr Riedel said emerging markets were entering a "third phase" of growth, marked by strong consumer demand and healthier demographics. The first phase was the manufacturing boom of the 1980s and 1990s and the second phase was the commodities boom of the past decade.

"Policy makers in emerging markets want to boost domestic demand and activity," he said. "A lower reliance on exports and external financing is seen as a good thing post the 2008 financial crisis."

> "POLICY MAKERS IN EMERGING MARKETS WANT TO BOOST DOMESTIC DEMAND AND ACTIVITY"

This third phase would present new opportunities for investors. He said that telecommunications companies offered some of the most promising investments.


DAVID RIEDEL

Mr Riedel nominated specific telecommunications companies with good fundamentals in markets such as Indonesia and Turkey as promising investments. The qualities that made them good prospects included relatively low market penetration and strong projected growth in the consumer market for their services. Indonesia, for example, had one of the lowest penetrations of mobile handsets among the population in the region despite already having 180 million mobile subscribers.

But the hottest emerging market investments at present were in the midcap sector on the Hong Kong stock exchange. A number of these stocks were trading on PEs of only eight to ten times and dividend yields between four and six per cent. "These are good, well run companies where you can get an exposure to China," Mr Riedel said.

Mr Riedel advised investors to be careful about which countries they had exposure to and concentrate on particular companies and sectors rather than markets as a whole, noting the uncertain relationship between economic growth in emerging countries and the performance of their equity markets.

However, he noted developed market investors were still underweight emerging markets as a whole, with only 6 per cent allocated to the sector. ■

GOOD POLICY CAN EASE THE BELT-TIGHTENING BURDEN

World economies are deleveraging with gusto, running down debt mountains as fast as they dare to while steering to avoid inflation and political instability.


DAMIEN HENNESSY

Success will depend on the exact mix of strategy according to Damien Hennessy, a principal of Heuristics Investment Systems: "Too much reliance on austerity or reflation could place any recovery at risk".

Australia is making its way steadily in this world, yet progress is not without its perils, according to Hennessy. "For us, the process of deleveraging has barely begun," he told the conference. "Households have boosted savings rates but debt levels are still relatively high. Our vulnerability would seem to lie in high level of house prices, substantial bank offshore funding needs and at least until recently, rising mortgage rates and debt servicing costs."

On the positive side, Australia's overall debt position is relatively sound and the government balance sheet is strong.

Elsewhere in the world the outcome of high debt on inflated asset prices has got the global economy into a predicament that we are sure to feel the effects for some time to come as the excesses are unwound, Mr Hennessy said.

In the US since 1990 private sector debt grew at an average 8 per cent a year compared to nominal GDP growth of closer to five per cent. Much of this was in the household sector where the household debt to GDP ratio climbed from 60 per cent in 1990 to in excess of 100 per cent by early 2008.

In Australia, household sector debt expanded at more than 15 per cent a year between 2000 and 2008, taking the household debt to disposable income ratio from 92 per cent to more than 155 per cent as higher house prices drove higher mortgages and vice-versa.

The US has made some progress, Hennessy said. "The US household debt-servicing burden is down, while the debt to income ratios are lessening. "Much is due to growing incomes, which is good, and defaults in housing and commercial credit," Mr Hennessy said. "Net of defaults, consumers have actually been increasing borrowing, albeit at a very subdued pace."

More deleveraging can occur via defaults, anti-inflationary policies, growth and productivity gains, or austerity. Europe has tended towards austerity while the US has spread the load and so far not embarked on austerity measures.

Mr Hennessy said increased savings and "belt-tightening" might be least painful but entail slower growth and ongoing fragility. "The US is also trying to keep real interest rates low to make it easier to fund outstanding debt. Peripheral Europe does not have this ability."

Other central banks appear to be going down this track, he said.

Increasing nominal growth via inflation is one avenue being considered. With higher inflation, incomes tend to grow more rapidly and the real value of debt reduces. But Mr Hennessy expects growth would eventually weaken in that environment as market- >>

KEEP YOUR EYE ON THE CAPITAL FLOWS

Here is a tip for fund managers and currency strategists: keep a steady eye on money flows out of China – it will be a sure sign of internal opinion that the currency is about to be devalued, as part of government policy to manage the economy.
"Hot money was showing signs of leaving China in increasing sums, according to reputable news reports in January," futurist John Trudgian, Managing Partner International of Williams Inference told the van Eyk Annual Conference. "If that flow starts to flood – as it might in a hurry – then it will be a signal that at least the wealthiest sector of the economy will be trying to move capital out of the country in the search for international investments."
Mr Trudgian said there were other signs that capital was moving out of China, among them a dip of $US100 billion in reserves in November and December last year, as rich investors grew frustrated over a lack of investment opportunities at home, an unsustainable cost structure, a 58 per cent fall in railway investment and higher rentals in Beijing than New York.
"Any investor needs to watch China, as we have set so much store in its future growth," he said. Yet there were various measures to suggest that the retail environment in China was contracting. Fuel prices went up 7 per cent this month after a rise in February of 3.5 per cent, food prices are up ten per cent, three out of four big banks have contracting deposit flows and even Mercedes car dealers were offering 25 per cent price discounts.
In words of caution, Mr Trudgian said any flow on of the retail economic shrinkage into larger sectors could be concerning. "China consumes more than 60 per cent of the world's iron ore, is an equally-big player in soya bean consumption and takes nearly 30 per cent of the world's copper," he said, so all sorts of companies could be affected by an economic slowdown.

"HOT MONEY WAS SHOWING SIGNS OF LEAVING CHINA IN INCREASING SUMS"

Balancing the global growth equation is the realisation that peak oil is delayed – the idea that world production must fall as supplies are consumed. "It's true that gasoline is taking its highest share of the median family budget – 8.4 per cent – since 1981, but energy supplies seem to be appearing in abundance," he said.
Natural gas is the saviour, arising from shale fracturing, improved directional drilling methods and better seismic discovery. "Gas is substituting for oil and coal, in transport, domestic heating and even steel making," he said. "It could initiate a price collapse in some grades of oil."
Mr Trudgian said oil produced from new fields in Dakota in the US and parts of Canada already had sales at a $US30 a barrel discount to world prices at inland US centres. "It is possible to say that North America will enjoy oil independence quite soon,"
Casting an eye around other world economic developments, Mr Trudgian noted that a North Asia savings pool was "on the march", away from places of weak growth - Japan, China, Korea and Taiwan.
Where the money might go was not clear: India stood to inherit the mantle of cheap producer but was suffering from a lack of infrastructure.
So how can fund managers position their asset allocations in such a climate? Labelled as winners by Mr Trudgian will be those who get the call right on US dollar movements against the yen and European markets. "That's the big call," he said.
Big banks will be happy recipients of world capital flows – the Citibanks and JP Morgans of this world – as investors seek safe havens, channelled through the conduits of Singapore, Hong Kong, London and Switzerland.
Standing to lose ground could be investors in gold and commodities in general, dollar borrowers and US multinational brands, such as McDonalds and Coca Cola. "I have no doubt the latter companies have good business models, but great sales they have achieved in an era of a weak US dollar will come under pressure as the dollar strengthens." ■

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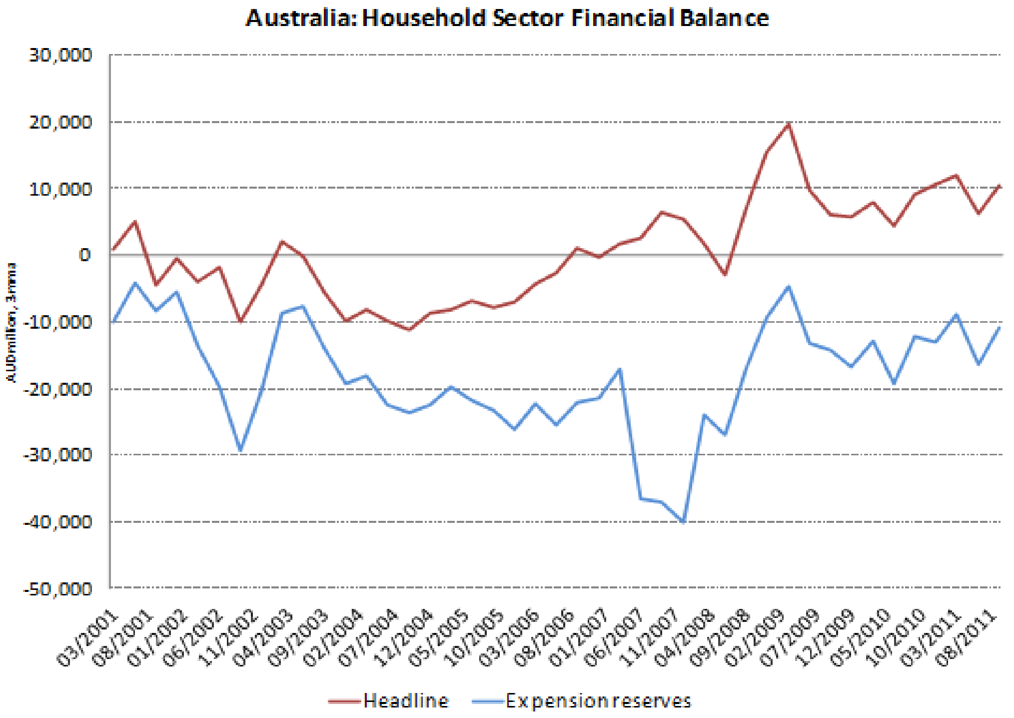
determined interest rates rise.
"To date stimulatory monetary policy and quantitative easing have done little to foster growth, though they may have reduced credit stress," he said.
Another way to boost growth is to engineer a competitive exchange rate and that supports growth in exports. "This appears to be US policy at present but not all countries can pursue it at once as it is a zero-sum game."
According to Mr Hennessy, fiscal austerity on its own is no panacea. "The inflation route has significant downside and the export route raises the risk of protectionism. In truth all six channels are required to some degree but perhaps the key at present is policy leadership with a focus on employment growth in the near term through fiscal and monetary support. Policies that improve education, flexibility, entrepreneurship and productivity alongside a credible medium term deficit reduction program would provide for a more "risk-loving" environment. ■

AUSSIE HOUSEHOLDS ON A "KNIFE EDGE"

Australian households are cashflow negative if the portion locked up in superannuation is removed from the equation, economist Andrew Hunt told the van Eyk conference in Sydney.
Mr Hunt, head of the UK-based Hunt Economics and a consultant to van Eyk, said there was a $60 billion shortfall in Australian household income that was only being filled by household borrowing.
"Australian households are on a knife edge," he said.
Mr Hunt said Australian incomes had not benefited a great deal from the commodities boom considering its size and length. According to the Australian Bureau of Statistics, real household disposable income actually fell between 2007-08 and 2009-10, the first fall in 14 years. "The commodity boom hasn't really lifted incomes that much," he said.
He said household finances were currently the weakest in ten years and with borrowing by households currently falling he expected that within six months households would be obliged to increase their savings.
"There could be a consumer recession in six months' time which would force the Reserve Bank to start cutting interest rates later this year," he said.
This could also lead to a sharp fall in the Australian dollar. "I wouldn't be surprised to see the Australian dollar down to around US75c in 12 months' time," he said.
There was evidence that hedge funds were beginning to show an interest in shorting the Australian dollar, he added.
Mr Hunt said the world was in a fragile state. Asset prices had been bid higher in the past few months and company inventories had grown, but this appeared to be based more on the expectation of an economic recovery than the reality. If evidence of that growth did not appear in coming months, asset prices could fall back sharply.
However, on the positive side, Mr Hunt said he believed China was at the beginning of a capital export boom as the country dismantled its internal capital controls and wealthy Chinese sought to diversify their funds offshore.
He said Australia would benefit from some of this funds flow.
Net foreign assets held privately in China more than doubled between 2008 and 2010 to almost $US1.2 trillion but is still low by international standards. He said he expected that figure to grow to several trillion US dollars in the next few years.
"I think they are creating a tidal wave of capital out of China," he said. ■



WESTWARD HO, SAYS SYDNEY PROPERTY EXPERT

Some of the best investment yields are available in Sydney's western suburbs, where low building rates and high immigration levels have generated a classic squeeze. "Many postcodes have vacancy rates of less than one per cent," Louis Christopher, the head of SQM Research told the conference.
"Sydney's west has a definite shortage of residential property."
Ignore negative "Westie" stereotypes, Christopher urged delegates to the van Eyk Investment Conference, and look at the strong fundamentals for the region.
"It is unusual, but it's true, that the outer ring of Sydney suburbs is a better place for property investors than the inner suburbs."
SQM Research is forecasting dwelling>>

VOLATILITY IS YOUR FRIEND, SAYS OPTIONS EXPERT

The traditional means of protecting equity portfolios from the risk of sudden falls in markets is fundamentally flawed and will cost the investor more than they are worth, Triple 3 Partners director Simon Ho told delegates at the van Eyk conference.

Mr Ho, an expert in options strategies and market volatility, said the way fund managers typically tried to counter the "fat tail" risk of large declines in equity prices, using derivatives, had serious shortcomings.

"The losses made on this strategy over time are not compensated for when markets fall," Mr Ho said.

Investors have become increasingly concerned about volatile markets, with the European debt crisis, turmoil in the Middle East and money printing by governments swinging markets between the extremes of fear and greed.

Volatility has the potential to rob investors of returns as it reduces the power of compounding.

Mr Ho said it was possible to use options in a new way so that their performance was negatively correlated with shares over time, thereby reducing volatility and risk in an investment portfolio at reasonable cost.

"VOLATILITY ALWAYS REVERTS TO THE MEAN"

"Volatility is your friend," Mr Ho said. "Options give you a way of accessing volatility."

Triple 3's strategy uses options over the well-known VIX index of market volatility, which has spawned a highly liquid market with up to one million contracts traded daily.

Mr Ho told delegates that the strength of investing in volatility was, ironically, that its behavior was much more predictable than the behavior of traditional assets like shares. Volatility, for example, always reverts to the mean and it is negatively correlated with other assets.

"The VIX is over 85 per cent negatively correlated to the S&P500 and the correlation for big moves (in the S&P500) is 100 per cent," he said.

But a long only position in the VIX was not the way to go, Mr Ho warned, noting that investors in a popular VIX ETF would have lost 90 per cent of their money since 2009 if they had held it the entire time.

Mr Ho said that during the latter part of last year, at the height of the Greek debt crisis, Triple 3's investment strategy made 15 per cent while the S&P500 lost 20 per cent. ■

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prices in Western Sydney to grow between 2.6 per cent and 6.6 per cent in 2012. This compares to the Sydney forecast of between 2 per cent and 6.4 per cent over the same period. Over a five-year period, the price growth in Western Sydney should be between 4.2 per cent and 8.1 per cent a year compared to the Sydney forecast of 2.3 per cent to 5.6 per cent a year.

In part the gain is a bounce from falls experienced over the previous few years, though the fall was less than in the greater Sydney and the more affluent regions of the eastern suburbs and the upper north shore.

Capital growth for houses has generally outperformed or tracked that of greater Sydney. Capital growth for units on the other hand has underperformed. SQM Research believes there is particular value in investing in houses in Western Sydney, with rental yields in the region being offered at over 100 basis points over greater Sydney. In addition to the region's strong returns, prices have been less volatile than greater Sydney.

It is also important to add houses and units in Western Sydney are still being offered at a strong discount to greater Sydney. At September 2011, discounts were being offered at 20 per cent and 29.6 per cent for houses and units respectively.

Mr Christopher said many commentators had suggested that as baby-boomers moved into retirement and down-sized, that free-standing housing prices would come under selling pressure, "but that's not happening."

Western Sydney has long been heralded as the geographic centre of the state capital. Big employers, particularly the banks, have steadily repositioned staff-dependent functions such as data processing, clearance centres and other administrative functions away from the central city to places further west.

It has all added to total demand for residential property, to support the growing commercial districts that have grown at Auburn, Bankstown, Blacktown, Fairfield, the Hills Shire, Liverpool, Parramatta and Penrith. All are backed by good public transport, with trains running through the major commercial districts, and regular bus services. More is promised by the O'Farrell state government.

Commenting on the broader Australian housing market at the conference, Mr Christopher said house prices were still falling at the moment. "Auction clearance rates are weaker than this time last year even though interest rates are lower," Mr Christopher said.

However, he said there were some "great opportunities" in Australian real estate investment trusts, with some still heavily discounted even though their gearing levels had heavily reduced since 2008. ■

DR JAMIL BAZ

GLOBAL EQUITIES NOT CHEAP SAYS TOP HEDGE FUND

Global equities are not cheap, despite the claims by many market analysts, because earnings forecasts are much too high, visiting UK hedge fund manager Jamil Baz told delegates.

"Profits are heading only one way and that is south," said Dr Baz, chief investment strategist at GLG Partners, one of the world's largest hedge funds.

He said the painful process of deleveraging that economies would have to go through had barely started, particularly in Europe, noting the total debt to GDP ratio in Europe had not changed since the onset of the global financial crisis.

Governments had few of the traditional weapons to offset the effects of debt reduction such as lower interest rates because these were already at near zero or zero.

"The crisis hasn't even started and will take 15 years to resolve," he said.

He noted that the sick economies of Europe would have to cut their wages by 25 per cent just to be competitive with Germany, something their populations would not tolerate.

"Even Mussolini couldn't force such a wage decline in Italy," he said.

The fact that European governments and Brussels were trying to impose this level of austerity on their populations showed the biggest deficit in Europe >>

INVESTMENT PANEL

ANDREW HUNT

ADRIAN WHITTINGHAM, IAN MACRITCHIE, AIDEN KELLEHER, RONAN ZILLE

CHRIS TERZIS, CHRISTIAN NOSSITER, BEN WILLIAMS, MATTHEW OLSEN, JULIAN MORRISON, JOHAN DE LANGE

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MATTHEW OLSEN, MARK THOMAS, SIMON HO

POST-CONFERENCE EVENT

BEWARE THE BLACK HOLES IN THE WORLD'S FINANCIAL SYSTEM

Investors need to be cautious of possible black holes in the world's financial system, van Eyk's Head of Research John O'Brien told the van Eyk annual conference in Sydney.

"Like the universe, there are at least three black holes in the world's financial system whose nature and impact is not fully understood and have the potential to severely affect financial markets," he told delegates.

O'Brien nominated three black holes: computer-based high speed trading, inter-bank asset pledges and unfathomable valuations on developed market and emerging market banks.

High speed trading already forms a substantial share of all turnover on the Australian Securities Exchange. The ASX's annual report for the 2010-11 financial year reported there were 144 million trades that year, far higher than the number of human traders in the Australian market would suggest.

"It's the equivalent of everyone in the financial services industry each making 250 trades a day," O'Brien said.

"Investors need to be careful that they don't suffer any adverse effects as prices move under the impact of such large and fast trading."

A second black hole is the potential for adverse effects from the use of hypothecated collateral, or the transfer of assets backing financial transactions, especially those by large banks acting as prime brokers.

Such practises have been curtailed in the United States, but remain available to banks in Europe, where the financial system is under severe strain in the aftermath of the global financial crisis.

O'Brien told the conference the IMF recently estimated that the value of trades worldwide using such assets had fallen from $US30 trillion to $US25 trillion from 2007 to 2008 – "a huge drop in the value of the system that simply disappeared".

Bank valuations in recent years are also concerning. The market valuation of emerging market banks remains consistently higher than those of developed nations. This is despite their relatively small size and the fact that emerging market equities have traditionally traded at a valuation risk premium.

"In Australia, Bendigo and Adelaide Bank for example has more assets

JOHN O'BRIEN

than those of the four biggest banks in Indonesia combined. Yet those banks trade at higher price to earnings valuations," he said.

How the valuations adjust should remain of interest to investors because it is an apparent anomaly that has persisted for years."■

CONTINUED FROM PAGE 3...

was a "deficit of democracy".

Dr Baz said earnings forecasts for equities "were less about economics and more about theology" these days. Dividends were a better way of measuring valuations and on that basis equities were not cheap. Corporate bonds were better value; even US Treasury bonds were cheaper. He said the global equity risk premium over bonds was only 2.5 per cent when 5 per cent was more realistic given the economic situation.

However, there were some beaten down equity markets he advised investors should be overweight in, such as Russia, the Middle East and countries in Peripheral Europe.■

COMPLEXITY POSES OPPORTUNITIES AS WELL AS THREATS

Rising protectionist sentiments are adding to already high levels of uncertainty and nervousness in financial markets post the GFC, according to Dr Robert Czerznkowski, an expert in heuristics or market expectations formation.

It is one of a plethora of factors weighing in on market behaviour, that are not easily measured or understood,

"WE ARE FORGETTING WHAT WE USED TO KNOW ABOUT MARKETS"

in contrast to price signals that usually inform behaviour, he said. "The world has become so complex when trying to tease out what might be driving it, that we easily overlook or simplify too much in the search for understanding, and that can lead to errors of judgement."

Politicians are become more protectionist, for example, which could have big implications for capital flows and our idea of what happens in markets. "Judging by usual standards of how efficient capital markets should work, it is probably not a good thing, but judging by the potential opportunities for profitable investments, especially by monopolies, it could be good."

Culture can be important for the operation of markets too; for example, in Germany, the distaste for inflation-based strategies that reflected the domestic experiences of the 1920s and 1930s will have a strong influence.

Dr Czernkowski, a senior lecturer in accounting at the University of Technology in Sydney, said the challenge for investors was to recognise that markets are not working as expected and act according to the extra risk generated.

"We have cognitive overload – we are forgetting what we used to know about markets, and failing to understand the full implications of all the complexities," he said. A clear analogy was the behaviour of fish markets, where shortages were not being reflected in higher pricing, probably as a consequence of serious anomalies on the supply curve.

For investors, the lessons are clear: deal with the risk by considering the widest range of implications of any market change. "Recognise the discontinuities or black holes, allow for geopolitical effects and remember the fundamentals," he urged. "Know that complexities are not easily dealt with, and if something is not performing as expected, take a view that you have probably left something out of consideration."

Dr Czernkowski urged investors to undertake stress testing on deals to allow for extremes of possibilities. "Think out of the box, and be very wary – in fact be scared".

Drawing a parallel with global fish markets, he urged consumers to prepare for markets to become fished out as a consequence of wrong price signals. "If you like sushi, eat it now; it might not be around real soon!"■

"I LIKED HEARING ABOUT VOLATILITY – THE FACT THAT HE WAS TALKING TO RETAIL INVESTORS"

JEREMY GRAHAM-HIGGS, BT FINANCIAL GROUP

"I LIKED JOHN O'BRIEN'S TALK ON ETFS. ALTHOUGH, WHILE HE TALKED ABOUT THE RISKS AROUND MARKET MAKERS, THERE'S A POSITIVE SIDE AS WELL"

VINNIE WADHERA, BETASHARES

"THE STUFF ABOUT FUND FLOWS AND EMERGING MARKETS AND THE US DOLLAR WAS INTERESTING. PEOPLE SHOULD START THINKING ABOUT THAT."

MATTHEW HADODO, AMP

"THE THEMATIC IDEAS FROM SPEAKERS LIKE ANDREW HUNT WERE GOOD. WE ARE BIG BELIEVERS IN THE COMING FOOD SHORTAGES."

RONAN ZILLE, IMR FINANCIAL ADVISORS

CROSSWORD

ACROSS

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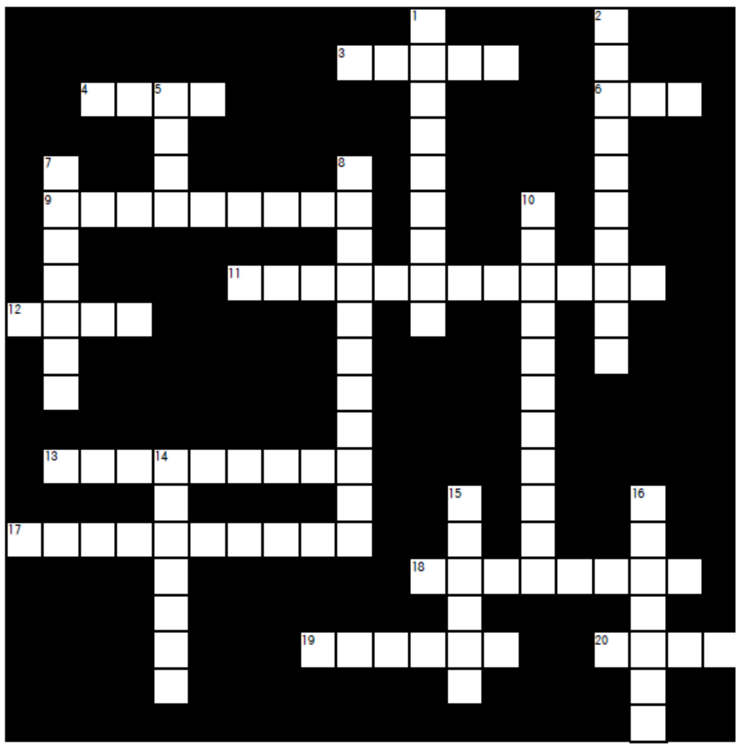
Most answers can be found in the articles, but those who attended the conference will have the advantage.



ANSWERS:
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