

Market Update – 22 September 2011

The world economy faces numerous problems, primarily resulting from imprudent use of debt over a number of years in important economies. Unfortunately the G20 nations so far look to be failing to address the underlying imbalances.

The European crisis stems from several European governments with excessive debt burdens and deficits.

However, it is also a banking crisis, as European banks own large holdings of government bonds of the problem countries and potential loss on these bonds impairs the balance sheets of these banks.

The European economy therefore faces the twin threats of:

1. government budget tightening as public sector jobs and wages are cut, and taxes raised to reduce deficits, in itself this slows the economy; and
2. banks with impaired balance sheets, which have difficulty funding themselves and which increasingly are reluctant to lend, depriving businesses and households of access to credit.

This crisis is most intense in Greece, Ireland, Portugal and Spain. It looks to be spreading across Europe via the banking system and damaging the confidence of businesses and households.

While the European Central Bank (ECB) is supporting the banks and problem governments, the crisis remains unresolved pending a credible bailout supported by all the Euro member countries, particularly those with strong credit standing such as Germany.

In the US, the economy faces numerous problems:

1. Banks have been cautious in lending, while households have been cautious in borrowing as both look to work down the excessive debt accumulated in the property bubble which is depressing growth.
2. Housing remains depressed – prices are now typically 25-30% below their peak in 2007.
3. State and local governments are cutting back on spending and jobs to balance their budgets – remember most states cannot run deficits.
4. Migration of jobs offshore in manufacturing and increasingly service industries has hollowed out many industries – so some jobs are not coming back.
5. Damage to real wages from inflation in energy, clothing and food.
6. Broader weakness in consumer confidence and sluggish employment (with the private sector growing slowly while public sector employment is still contracting).

Even the depreciation of the US dollar against its developed world competitors has so far failed to produce the trade surpluses necessary to pay down debt. The economy is struggling to grow despite unprecedented monetary and fiscal stimulus. The Federal Government looks incapable, for now, of major new stimulus plans due to opposition from conservatives and its already sizeable deficit. No doubt we will see further measures from the Federal Reserve as it does what it can to depress long-term interest rates (such as the recently announced so-called "operation twist").

Turning to China, we have:

1. Inflation remaining a continuing problem – after 20 years plus of incessant growth accompanied by abundant credit.
2. Continued tightening measures in lending and property markets.
3. Signs of slowdown in construction related sectors – cement prices are falling in many regions, while sales of construction equipment look to be faltering (e.g. excavator sales are down 11% on last year) and machine usage (trackable via GPS attachments) is registering a decline in July.

The Chinese government aims to reorient the economy away from investment and construction towards consumption, however, due to the heavy dependence on investment spending it may be difficult to achieve this without disruption and slowing of growth. We feel it would be most unusual for this transformation to be achieved seamlessly. Importantly, the Australian dollar and commodity prices are vulnerable to a slowdown in the construction sector.

What is most notable is the lack of co-ordination among G20 nations to tackle the underlying imbalances which threaten to push the world back into recession. Whilst a recapitalisation of the European banking system would be part of this, the world really needs Asian economies to unpeg their exchange rates so both Europe and the US can gradually deleverage.

Turning to the strategy of the International Fund, our returns were impacted late last year by pre-emptive caution about the economic outlook, though returns in a relative sense are starting to improve. Our short positions in the International Fund today are now moving in our favour, with some extremely highly rated stocks (e.g. in the REIT's (Real Estate Investment Trust) and cloud computing arena) seemingly not priced for any kind of economic difficulty. We have been migrating more of our shorts from indices increasingly into stock specific positions.

Several months ago we shifted our currency holdings in the International Fund almost entirely out of Euros, principally into the US dollar, and more recently have been cutting our Asian currencies down so we now have 45% in US dollars. In a world of poor choices amongst currencies, the continued problems in Europe make the US dollar relatively more attractive.

In this environment there is a shrinking group of businesses and industries which offer the potential for growth. We would expect further pressure on commodities and commodity oriented businesses. Even gold which is a commodity (and some say currency) may come under pressure, as reappraisal of the economic outlook causes weakness across the spectrum of asset classes.

However, in any environment even when growth is absent there are always parts of the economy which will grow and parts which will shrink. We have been reorienting the portfolios further towards companies with structural growth potential and strong pricing power.

Technology remains an area with fertile growth, particularly with increased migration of media online. Heavy bandwidth requirements for video-on-demand promises substantial upgrades to fibre-optics networks, hence our investments in optical networking stocks such as Cisco, Ciena and Infinera. In addition, we have added holdings in two software giants with growth potential – Google, which continues to benefit from innovations in its search and online advertising technology, and Oracle, a global leader in database technology. This also reflects a broader orientation in our US holdings to technology oriented companies, whether in technology hardware and software, or in the pharmaceutical arena.

We have had queries about how much exposure we have to financials, and the figure is 10%, of which 6% is in Asia (principally life insurers in Japan and China, and Bangkok Bank), 1.7% in Bank of America (which we think is selling on three times pre-provision earnings), and 2.2% in two European companies – the German stock exchange Deutsche Boerse, and insurance company Allianz.

In Europe, we are taking advantage of the recent sell-off to add to companies with global businesses with strong pricing power which can continue to grow profits. Despite global economic problems, the Asian middle class should continue to grow and purchase desirable brands, and we are adding to our holdings of businesses like Adidas, branded spirits company Pernod Ricard, and the owner of Gucci (PPR).

In Asia where we have 17% invested, our principal interest is in consumer facing companies and internet plays.

A useful analysis is to categorise companies into those rare businesses with the ability to differentiate their products significantly from their competitors, which we call "price makers", and those which don't have such power.

Analysis of the Platinum International Fund portfolio suggests that the blend of price taking companies to price making companies is 52% to 37%, implying an 89% invested position. Adjusting further for our short sales, the ratio of price takers to price makers improves even further to say 40% to 37%. This is not to say that our holdings of so-called price makers – which includes companies engaged with brands, drug makers and IT companies are not susceptible to economic weakness but simply to emphasise that they are less vulnerable. Moreover, they tend to be highly profitable and hence often have debt free balance sheets. So when thinking about them as investments, they tick more of the boxes such as:

- low financial risk
- low product substitution risk
- low government intervention risk
- low susceptibility to cost pressures

and so on.

We are aware that we haven't painted the prettiest picture but values are now largely factoring in a very weak 2012. There has been a severe repricing of risk, especially in Europe, with many stocks down over a quarter. Some companies will find profits under pressure but we remind you that corporate balance sheets globally outside the financial sector have seldom been stronger. The challenge, as always, is to find companies that will navigate their way through this difficult period.

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