

Is this the time to start investing again?

Since the Internet ‘bust’ proved that the rules of economics had **not** been re-written, and the resulting economic hang-over seems to be a more drawn out affair than many are used to, people are not surprisingly reluctant to think about investing more money into an uncertain future. Yet, it is at such a time when a general mood of uncertainty prevails that early recognition of improvement in sentiment leads to new opportunities that, with hindsight, provide the basis for new fortunes to be created. You know, those events that with hindsight were ‘obvious’, but strangely not acted upon!

The equity downturn of 2000, followed by terrorism and the Iraq war followed by western awareness of SARS (severe acute respiratory syndrome), created a grim time during the first half of 2003 to be thinking about new business. It seemed as though the entire business community went into hibernation. In the circumstance this was probably a sane and rational decision.

The reality is that the world economy is ticking over better than many realise and a major recession seems likely to be avoided. Stock markets are regaining some of their confidence, house prices in the UK and USA are still increasing but at a slower rate and in the Anglo Saxon economies, employment levels are more or less holding up. The only caveat here might be for the Australians who seemed to have bucked the trend of a downturn over the past two years as the weakness in the Aussie dollar boosted home demand and companies booked increased profits from translation profits. However, the Aussie dollar has recently strengthened and the effects of this are already causing concerns about domestic profitability over the medium term.

The structural difficulties in Japan and Asia still exist, with the need for improved commercial and banking transparency and a reduction in cronyism before long-term investment prospects improve on a sustainable basis.

But, how risky is the current economic environment? The IMF (International Monetary Fund) recently analysed the effect of bubbles on economies and companies¹. In this report, the IMF pointed out that equity bubbles tend to occur on average every thirteen years or so, with housing bubbles being less frequent. The subsequent recession, or down turn, then typically lasts for about two and half years for equities and for about four to five years for housing recessions. What this means is that we are about six months behind this “schedule” given that the world’s equity markets peaked in March 2000. Housing price inflation has slowed, but not bust and it looks increasingly probable that a softer landing for house price inflation is more likely than not in the Anglo economies. With the recent phenomenon for most of us of low inflation, concerns exist about deflation, and although this is a risk the majority of commentators seem to think that this will probably be avoided in the market driven (principally, Anglo-Saxon) economies.

Reasons for the longer recovery following post equity bust are easy to determine. The higher than normal investment boom generated by the Internet boom in the 90’s, the effect on global confidence of terrorism and the increased assertiveness of the US in military terms, culminating in the recent war in Iraq, followed by the SARS outbreak all conspired to increase the nervousness of corporate and individual investors alike.

¹ When Bubbles Burst, World Economic Outlook, April 2003,, International Monetary Fund

The other factor that is different this time is the high level of commercial and consumer debt acquired by companies and individuals. Commercial debts were built up on the basis of increasing expectations of ever-rising returns (Greenspan's "irrational exuberance") and, similarly for homeowners, the increased wealth effect generated by increasing house prices.

The psychology behind all this is not hard to fathom. As people, we respond to what we expect to happen and for businessmen and consumers, the wealth effect of increased profit and asset values leads us to believe it can never end (even though history shows us otherwise). Do you remember the advocates of the New Economy? They thought that they'd reinvented economics: 'If you don't understand that it's a new paradigm, you just don't 'get it'? You're a dinosaur!' I wonder where they all are now!

This excessive excitement about future wealth creation led to increased debt on the basis that growth and inflation will take care of the cost. So confident were many companies that they stopped paying into pension schemes. The true cost of this over confidence is now affecting many large companies and the pensions 'black hole' probably ranks above commercial debt as the main solvency problem for the corporate world as new accounting standards insist on full disclosure of pension liabilities.

Despite these fears, there is every reason to believe that things are improving. Anecdotally, the job adverts for IT specialist are increasing, suggesting that this sector

is beginning to shrug off the problems of the last three years. As the information technology sector suffered more than any other during the bust, this has to be an important indication of change. This can also be seen by the significant improvement in 'tech stock' on the Nasdaq where heady increases in share prices have been booked in the first half of 2003².

In Asia, and this seems to mean China these days, growth rates are still impressive. The problem here is that we cannot trust the numbers. Most analysts will shave off at least 2% of the Chinese governments growth numbers – but even then it leaves a healthy 5 – 6% growth. Countries surrounding China are adjusting to the reality of its low cost base with economies like Singapore moving toward high technology value added services, such as design and development leaving it in a strong position to build economic wealth. As for Hong Kong the adjustment to gradual integration into the broader Chinese economy is having its effect. Most of the wealth in Hong Kong was built on property, which, isolated from China as part of a British territory meant that the short supply of land always underpinned property prices. Now that residents can buy property at a quarter of the price in neighbouring Shenzhen, it's no wonder that property prices have dropped in the territory by 60 – 70%.

The factors, then, that over hang a confident recovery are high levels of debt, pension black holes and the possibility of a housing slump. So, is this the time to invest? And if so, where?

² Financial Times, London 3 July 2003.

Well, the IMF points out³ that the recovery from equity bust is a lot quicker than from housing busts as the impact on the wealth effect of individuals is more intense following a housing bust when people react by cutting back sharply on spending. A housing slump has not happened and is probably not going to. The IMF points out, however, that with a housing ‘bust’ there is a 40% chance of a subsequent recession. For equity busts this drops to around 25% probability. As housing is holding up and spending is cooling but with prices still rising slowly, there is a very strong chance that we have avoided the types of recession that occurred in the late eighties and early nineties following the housing bust of that time.

There is an overlap between equity and house price movements which should be considered when assessing investment risk. As shares increase, people feel wealthier and invest in housing, which in turn drives an increase in share prices as the wealth effect underpins investment sentiment. On the downside, the IMF reckon that half of all housing price busts overlap, in part, with equity down turns, but that only one third of equity downturns overlap housing busts. This means that the probability of a housing bust is greater following an equity bust than is an equity bust following a housing bust. That is why the housing slow down is being followed so closely now. The good news, however, is that joint equity and housing busts are less frequent than busts in either class alone.

The IMF goes on to report that economies that are market led suffer larger output losses following an equity bust than bank led economies that suffer greater output loss following housing busts. Market led economies include Australia, UK, the

³ Ibid.

Netherlands and USA and the bank led economies include Germany, Japan and France. It may be no coincidence therefore that the two groups have been experiencing different post boom economic fall out. Although equity markets may experience deeper downturns, the market clearing effect is more rapid, and that is probably where the Anglo economies are now. The Anglo economies are probably passing through the bottom of their down turn.

This means that now is likely to prove a very good time to consider investing and for those whose balance sheets are strong, this is a brilliant time to buy assets and make investments at prices that will bring tears to the eyes in a few years for those less able to move now.

This does not help with answering the question, where to invest? The answer to this depends on the circumstances of the individual company or investor, but in general terms we think the following factors need to be considered:

- The days of the conglomerate have passed. At best, turnaround operators who seek to profit from improving business performance and exiting through trade sale or public flotation should consider this approach. In fact, there are likely to be very good buy-out opportunities as companies continue to rationalise operations.
- Technology is always worth a look, but don't get excited about technology for technology's sake. In the 80's Sony did well with the Walkman even though there was no obvious demand, but the problem with technology is that the mere fact that something can be done doesn't mean people want to do it. There

is a lead-time before new technology is assimilated to deliver real benefits to consumers. The Internet world of an online society went against the human desire for social contact. Interoperability between systems is always an issue and most technology companies still have concepts rather than reality to sell. This applies to 3G technology and the latest ideas for technology piped to customers as a utility. Just make sure that there is a definable demand based on market needs. You can always make good money by being a follower with technology.

- Consider investing in your own extended supply chain: if you're a manufacturer see if you can get your brand direct to market. Look at competitors and substitutes. But, make sure the business operation can and will work together. Investment bankers make obscene amounts of money bringing companies together to 'create value', but as these assessments are based on financial re-engineering principles alone and do not include operational due diligence, it's no wonder that 70-80% of mergers fail to meet shareholder expectations, let alone that of the management. Merger and acquisition activities fuelled a significant destruction of shareholder value during the nineties boom. Business is about selling products and services that people want – when this fundamental truth is lost, everyone loses.
- There is a growth in private equity companies acquiring the processes of public and private entities. This is outsourcing and has a lot of attractions. Investors need to be sure, though, that the outsourced activities are real businesses that can be bundled together and made to work profitably, and consolidated to build efficiency gain and or sold to provide an exit.

- Avoid companies where there is a CEO ‘cult of personality’ or where the rewards paid to senior management underpin their failure rather than shareholder success.
- Geographically, China and India have to be considered as they both provide financial and intellectual pools of talent that can drive down costs and provide significant supply chain efficiencies. In both cases investors need to understand what they are getting into and should analyse the economy and sector they are interested in. India has democratic structure and rule of law. China is slowly moving in that direction and, barring domestic upheaval, is set to provide an environment in which western commercial practices can properly flourish. The caveat on China is that there is rising tension as unemployment increases in rural areas and the differences between rural and city areas exacerbate these pressures.

Finding the right partner in emerging markets is important and background checks on companies are now becoming easier. Many investors have lost money in these markets, but they have usually done so because of a lack of commitment to the long term, or because they have often left their business judgement at their home airport. There are cultural differences, but if a deal doesn’t make intuitive sense, there is little point in trusting the other party anymore than you would in similar circumstance in London, New York or Frankfurt.

- Australia can be a good base for regional business for Asia Pacific. It is a mature and open economy. The diversity of the population enables regional

capabilities and cultural affinity to be maintained but within a western model of governance. It's also a very nice place to live!

Investment is like good comedy: it's all about timing. Assuming that a housing slump does not destroy consumer confidence, that corporate debt and pension deficits are managed and that the war on terrorism does not get out of hand, there is a better than even chance that the next few years will see improvement in the global economy. We do not expect this to be a rapid improvement but a more gentle return to good earnings potential. This may be no bad thing. But getting the analysis right and having the courage to look to the future means that someone out there is going to make a lot of money. It might just as well be you.

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