9th March 2012

Life outside the cubicle

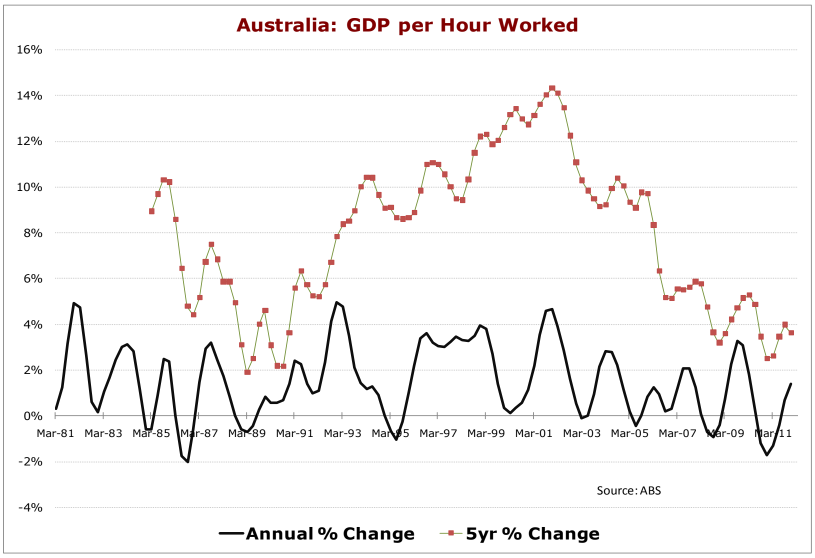
Economic challenges take various forms – inflation or deflation; excessive private sector debt or excessive private sector saving; excessive public sector debt or excessive public sector saving; demographic change; too much growth or not enough; high unemployment; a large trade deficit or a large trade surplus etc. Looking around the world, it is obvious that the mix of challenges facing each economy is different. In Australia, we are very good at telling the world about the problems we don't have; but very poor at acknowledging and addressing the problems that we do.

Australia's primary economic challenge lies in a now decade-long deterioration in our economic competitiveness – a product of rising relative costs and faltering relative productivity. It does not lie with excessive public sector debt or whether the FY13 Commonwealth Budget will be in surplus. Messer's Swan and Hockey are taking every opportunity to espouse their capacity to solve a problem we simply don't have. Their respective comfort zones are quickly revealed to be little more than comfort cubicles should the debate threaten to move beyond "deficit" or "surplus". Thankfully, the business community is becoming increasingly agitated as Australia's competiveness decline accelerates into its second decade. The comfort cubicles, however, appear well-defended.

We first raised our concern about the long term deterioration in Australia's competitiveness in late 2009. Since then, the problem has clearly intensified. To be clear, this is not a protest against the structural reallocation of capital away from the non-mining economy into WA and Queensland. This is an inevitable and healthy response to shifting relative returns and comparative advantage. We struggle, however, to see how Australia will progress – both socially and economically - if the rise of the mining/energy economy is accompanied by a steady degradation of the non-mining economy. The former is not directly contributing to the latter – that is emanating from trends that first emerged in the early 2000's – but it is helping to shield the truth (as did the stimulatory implications of escalating house prices through the mid-2000's) and foster complacency.

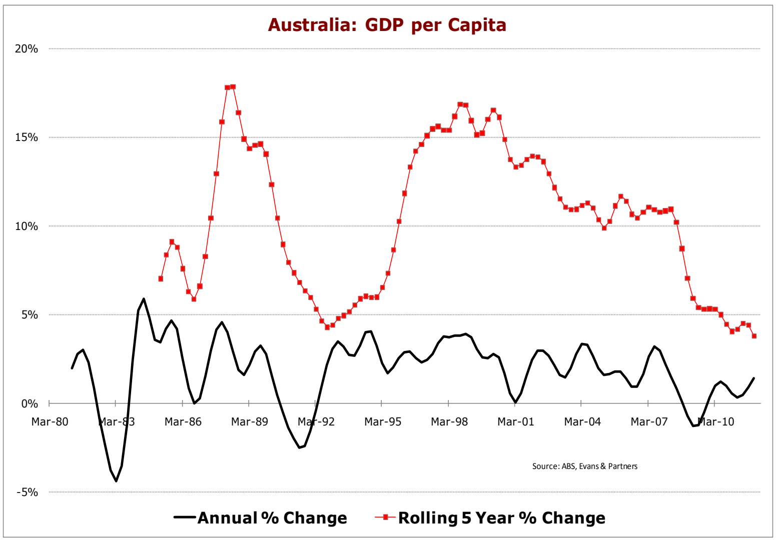
For local investors, the long term structural decline in Australia's competiveness is a far more significant issue for future investment returns and portfolio design than anything we are likely to see out of Europe or US in the year ahead. Its negative implications for risk adjusted returns – particularly from equities and property – are already emerging. We struggle to see a happy ending. In the absence of inspired political leadership and a relatively rapid policy response, the prevailing trends can only end with a "cleansing recession" – the ultimate provider of a competitive cost base (and currency). To the extent that this point still lies well in the future, it raises the question as to whether Australia will still then have a diversified industry base that can leverage the benefits of the "cleansing".

We will leave an esoteric debate on productivity to others, suffice to say that all indicators point to material slippage in Australia over the past decade – particularly relative to the period from the early 1990's to early 2000's (refer chart). At a more basic level, an economy's productivity performance is easily observable. A productive economy delivers solid growth, low inflation, strong profits, strong job creation and takes market share from the rest of the world. As we shall see, Australia has struggled with respect to all these benchmarks.

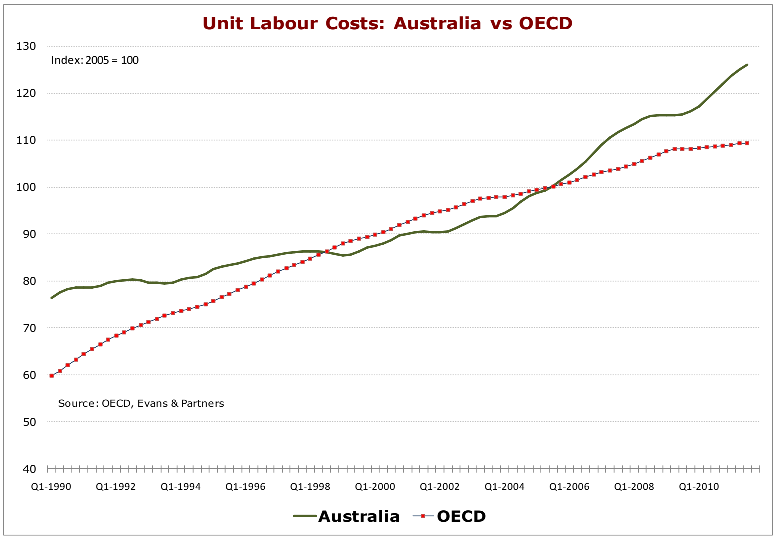


What follows is a story board of Australia's growing vulnerability.

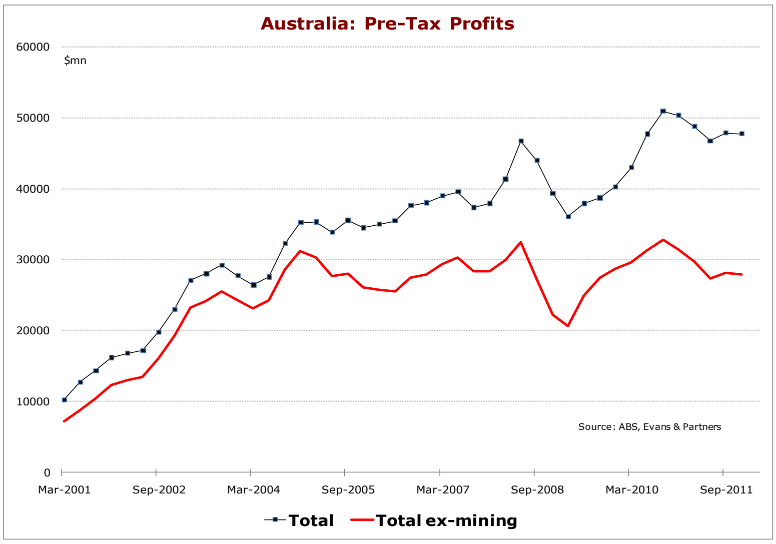
We conclude with a few observations on a possible remedy and the key investment implications.



A productive economy delivers solid growth, strong profitability, low inflation, solid job growth and takes market share from the rest of the world. While there have been other factors at work apart from faltering productivity - and the performance relative to other advanced economies has been strong – growth in GDP per capita over the past five years has been muted.



After a strong performance through the 1990's, unit labour costs (i.e. wage costs adjusted for productivity) in Australia steadily increased over the past decade. This increase has outpaced that experienced in the OECD, particularly over recent years where the "cleansing" recession in advanced economies has depressed labour costs and fostered efficiency.



Rising unit labour costs do not co-exist well with corporate profits. On an ex-mining basis, pre-tax profits in Australia have seen little growth since 2004.

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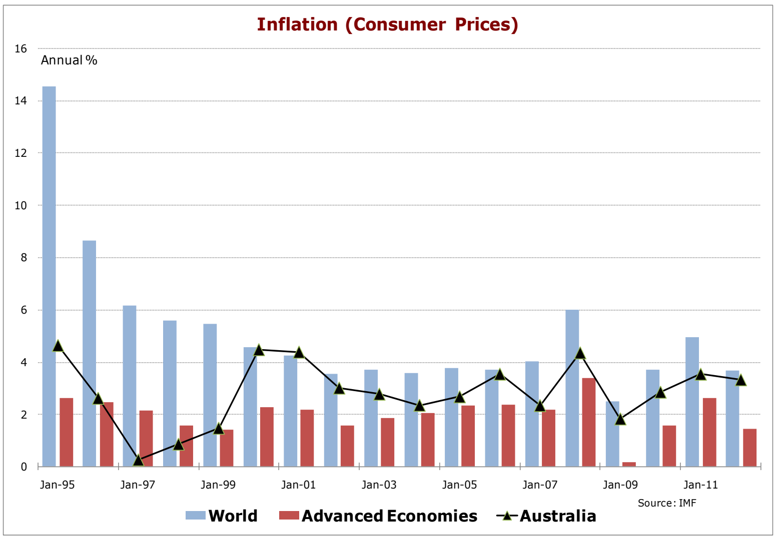
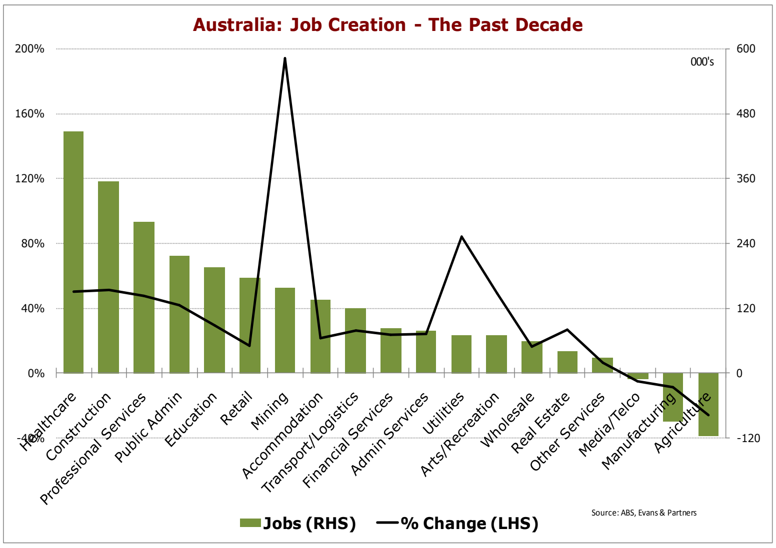
The View from the Outer

Mike Hawkins, Chief Investment Officer

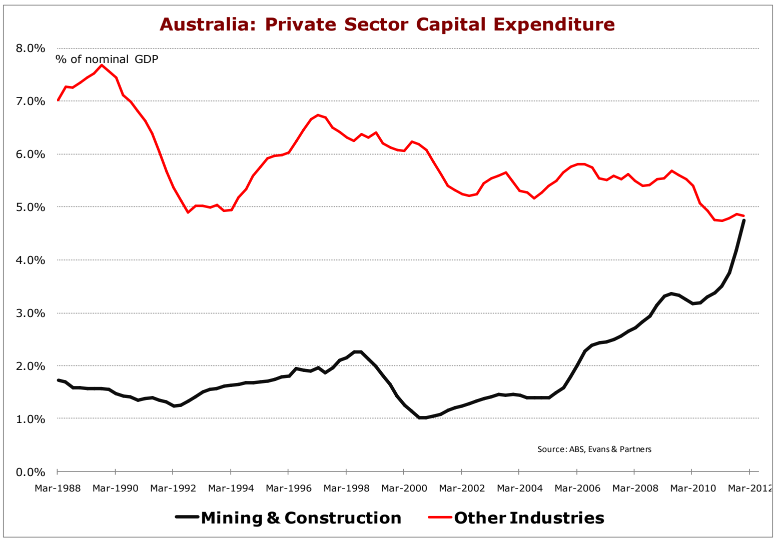


Rising unit labour costs are inflationary. For most of the 1990's, Australia did better than the world and advanced economies with respect to consumer price inflation. Over the past decade, the relative performance has been inferior – more-so versus the advanced economies. An inflation rate ~3% may not sound that alarming, but when the rest of the world is ~2% it is still an uncompetitive outcome – particularly when it persists for a decade.

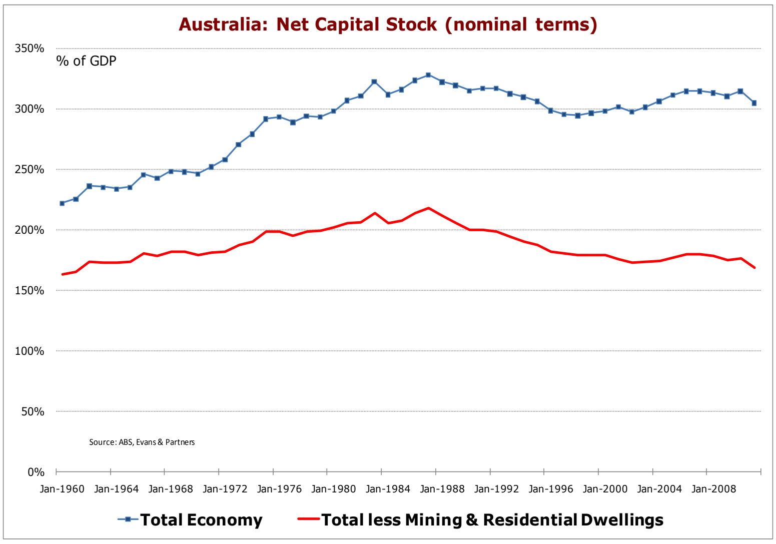


Job creation is a struggle in an unproductive economy because the only avenue open to companies to improve cost outcomes is to employ less or retrench. In our defense, job creation in Australia over the past decade has been solid at an annual rate of ~2.5%. Outside mining and construction, however, job creation has been biased towards non-discretionary sectors – health, education, public administration. Notably, employment has been flat over the past year.

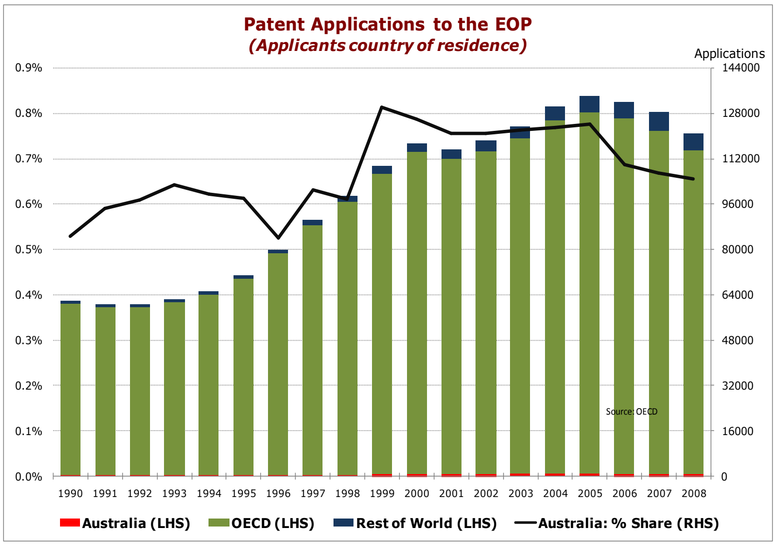
On an ex-mining basis, exports of goods and services peaked in 2000 at ~15% of GDP. It now sits ~10% of GDP. Australia is losing market share. Note the market share gain accrued through the 1990's when our competitiveness was steadily improving.



Why is Australia losing ground? The factors at work are numerous and encompass national competition policy, tax distortions, labour market shortcomings, the build-up of industry regulation and the fading benefits of reforms undertaken during the 1980's/early 1990's. At a more basic level, however, Australia is failing to sustain and upgrade its physical and human capital. On an ex-mining & construction basis, business investment measured as a % of GDP has been trending down since 1999.



Our failure to reinvest in the business inevitably leads to a degradation of the economy's capital stock. On an ex-mining and dwelling basis (dwellings absorbing an excessive proportion of our capital allocation over the past twenty years), the value of the net capital stock measured as a % of GDP hit a 45 year low in FY11.



Maybe we are investing less, but investing smarter? First impressions are not that encouraging. Australia has recently allocated ~2.1% of GDP to R&D each year, broadly in line with the OECD average but lagging the R&D leaders (US, Germany at ~2.8%, Japan ~3.4%, Sweden ~3.6%). Similarly, global patent applications do not point to a sudden burst of ingenuity or risk-taking – particularly relative to the surge in applications emanating from the BRIC's. Just maintaining what we have been doing is now not sufficient – a solution requires better than average performance.

Expenditure on Educational Institutions % of GDP
Source: OECD Education at a Glance. 2011

	Total		*of which*	Trend Population
	2008	1995	*Public Funding*	Growth
Korea	7.6%	5.0%	*4.7%*	0.4%
USA	7.2%	6.6%	*5.1%*	1.1%
Chile	7.1%	4.6%	*4.3%*	1.2%
NZ	6.6%	4.7%	*5.4%*	1.0%
Argentina	6.1%	na	*5.3%*	1.1%
Canada	6.0%	6.7%	*4.6%*	1.0%
OECD	**5.9%**	**5.6%**	***5.0%***	**0.7%**
Mexico	5.8%	5.1%	*4.7%*	1.1%
UK	5.7%	5.2%	*5.1%*	0.6%
Australia	**5.2%**	**5.0%**	***3.7%***	**1.5%**
Japan	4.9%	5.0%	*3.3%*	0.0%
Germany	4.8%	5.1%	*4.1%*	0.1%
Russia	4.7%	na	*4.1%*	-0.2%

Australia is failing to sustain and upgrade its stock of physical capital. Unfortunately, a similar conclusion holds for the treatment of our human capital. While more a case of failing to keep pace with a rising global benchmark, the long term implications are still disturbing particularly overlaid against a world where technology is breaking down barriers to entry – both at the industry and geographic level.

The Table above provides a snapshot of where Australia sits with respect to spending on education relative to the OECD average and a variety of other economies. Our relative commitment – particularly when assessed on the basis of public sector spending and population growth – has clearly slipped.

There has also been a steady decline in education attainment. This is evident in the following Table, taken from the recent Gonski Report, which relates to the attainment of 15 year old students. With respect to this PISA study, the Report noted: *"In 2009, an average of 1 in 7 students performed below the proficiency baseline… compared to 1 in 8 students in 2000. If this ratio were to apply to the current total student population, some 500,000 students would leave school without the skills and knowledge to participate effectively in a globalised society. Just as concerning, is the fall in the percentage of students excelling. Between 2000 and 2009, the percentage of students performing at or above this level declined from 18% to 13%."*

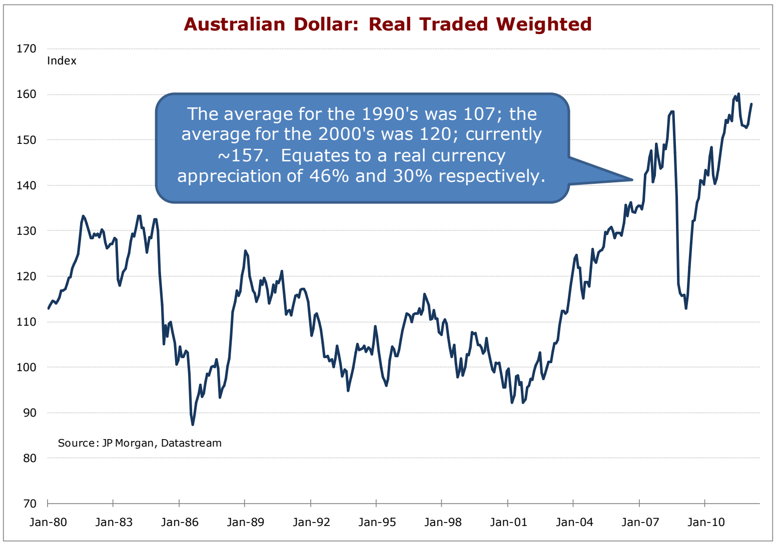
The Report also noted –

"…Australia has a high degree of performance inequality, higher than the OECD average. …Countries that have high educational outcomes tend to also have low levels of performance inequality".

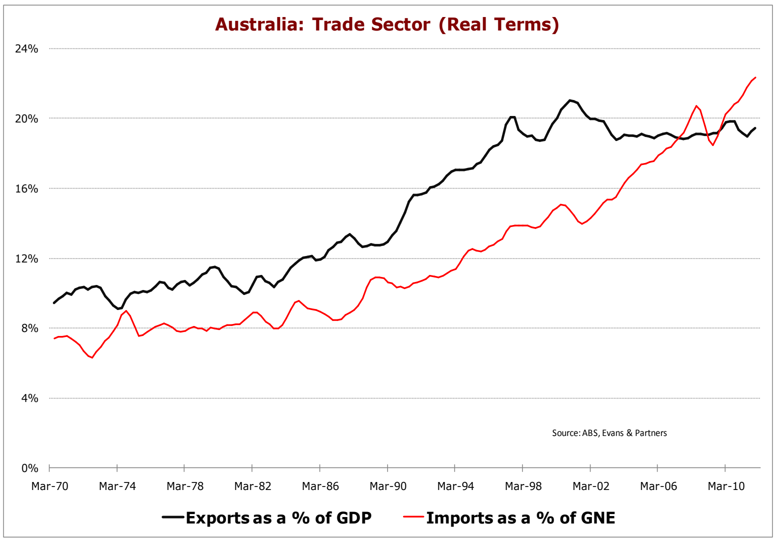
Programme for International Student Assessment (PISA)
Australia's Mean Scores

		Australia Mean Score	OECD Average Score	Highest Country Score	Lowest Country Score	Number of Countries Significantly Ahead of Australia
Reading	**2000**	528	500	546	396	1
	2009	515	493	556	425	6
Mathematics	**2000**	533	500	557	334	1
	2009	514	496	600	419	12
Science	**2000**	528	500	552	375	2
	2009	527	501	575	416	6

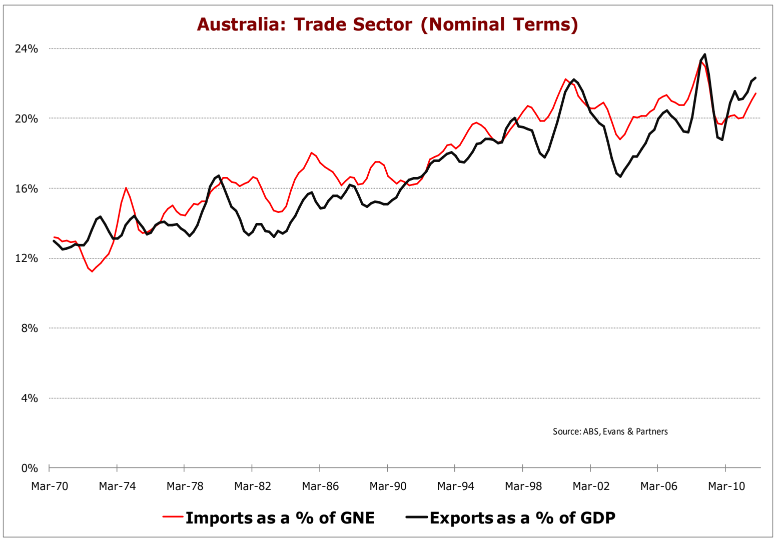
Source: Taken from Gonski Report - Review of Funding for Schooling
PISA is a standardised assessment that is administered across 34 OECD countries and #! Partner countries involving 15 year-old students in schools.



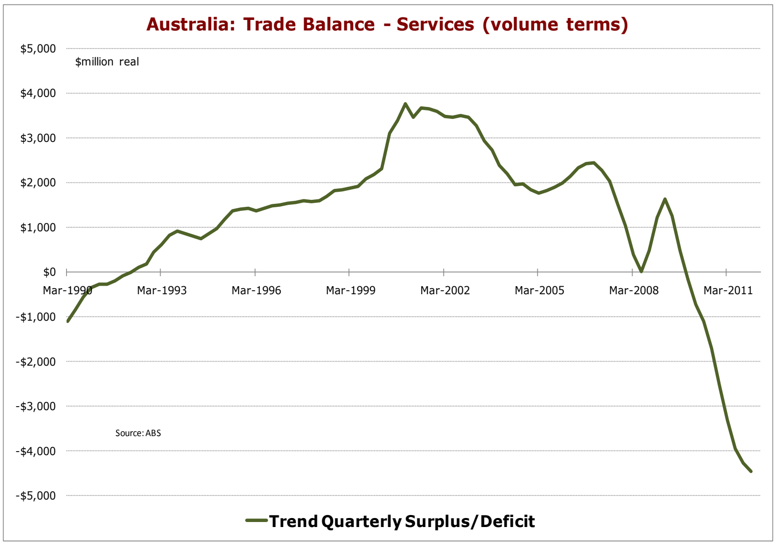
As noted, Australia's international competiveness has been slowly declining for over a decade. Of late, the rate of decline has accelerated. This reflects the temporary disproportionate allocation of resources to the mining investment boom, poor political outcomes and the significant impact of the overvalued A$. In theory, rising relative prices should depress a currency, but in Australia's case the currency has appreciated. We are yet to see the full implications on Australia's industry base of a parity-plus exchange rate.



A more benign assessment of Australia's prospects would highlight that the material uplift in mining/energy capacity now being established will, from 2014, deliver an equally material uplift in export volumes. Yes, this will be the case but for the economy to be a net beneficiary it will need to be reflected in our net export performance. Consistent with an uncompetitive economy, import penetration is steadily increasing.



At the nominal level, the structural uptrend in import penetration is being absorbed by the strong terms of trade – hence Australia is currently delivering a trade surplus. The sustainability of high terms of trade into the medium term is far from guaranteed. Apart from the exposure to any slowdown in China, strong global supply growth across iron ore, coal and LNG over coming years will – as the market currently anticipates – ultimately depress prices.



To date, the implications of declining competiveness are most evident in the manufacturing and tourism sectors. In the background, we suspect that a range of service industries/occupations are also at risk. This appears to be an inevitable outcome of declining relative education attainment, higher relative labour costs and ever improving communication technology. The NBN will accelerate the outsourcing of service sector occupations in Australia. Tourism largely accounts for the large reversal that has emerged since 2009.

What should we be doing?

Last May, we graciously wrote a Budget Speech for the Treasurer (refer, *The View from the Outer*, May 11th). The policy agenda we proposed at that time, along with providing business with greater scope to align labour market practices with the challenges of the prevailing environment, remains a critical first step towards addressing the structural challenges facing Australia in the coming decade.

"*We favour an industrially diverse and socially equitable growth path. A model that rapidly transforms Australia into a one-trick economy servicing a single customer with a highly interventionist approach to economic and political management is not a path we wish to take.*

Accordingly, the key elements of our policy agenda are –

- *We seek to facilitate a more balanced approach to economic management across fiscal and monetary policy. As such, we are tonight introducing **a Budget that will deliver material fiscal restraint through FY12 and FY13**. In part reversing the spending largess of recent years, our primary objective is to reduce the pressure on monetary policy to contain domestic demand and inflationary pressures in a fully employed economy.*

- *While many vested interests will squeal on the decisions made tonight, our aggression is motivated by a desire to contain the rapid structural changes unfolding across the economy. In our view, the victims of this adjustment are currently paying far too high a price. As such, **we anticipate that our actions will provide scope for the Reserve Bank to reduce interest rates…** Not only will this provide some relief to stretched households and small businesses, it should also serve to take some of the speculative heat out of the A$.*

- ***We have decided to deepen and broaden the mining tax. The proceeds will be used to fund a 5% reduction in the corporate tax rate (from which mining companies will also benefit).** This is not ideal, but we feel it is the most equitable way to redistribute the wealth created in ~5% of the economy (by exploiting the countries finite natural assets) to the remaining ~95% who are being disadvantaged by the cost pressures, interest rate pressure and currency strength which the success of the resources sector has delivered.*

  Some may argue that Canberra should take a more selective or interventionist approach to redistributing the wealth emanating from the resources sector, but we would prefer to put the cash in the hands of Australia's companies and entrepreneurs than attempt to pick winners or support vested interests close to our heart.

  ***To the extent that a broader mining tax proves a disincentive to new investment then so be it. Capital will be released to support growth in other parts of the economy**. The resource projects* *that proceed will be based on high quality, long life, and low cost assets. As such, we will reduce Australia's exposure to the risk of over-investment and the extreme cyclicality inherent to the mining sector. When the inevitable global downturns come along, the higher cost producers elsewhere will be the first to suffer.*

- ***More broadly, we will also revive many of the core recommendations from the Henry Tax Review**. After a decade of relative decline, Australia desperately requires a productivity kicker. Tax reform is one of the few tools available that can deliver a relatively immediate benefit. In general, tax distortions that encourage a misallocation of resources (e.g. home ownership, property investment etc.) will be phased out.*

- ***We will also roll-back the various tax and spending initiatives that various governments over the past decade have used to favour vested interests or provide a quick-fix to short term political problems.** In aggregate, these programmes have distorted price signals in the economy and worked against an efficient allocation of capital. As such, the first home owners grant, the baby bonus, the renewable energy target, the National Broadband Network etc. etc. will be no more**. The savings to the Budget from this initiative will be significant. These savings will be allocated to the education sector with the intention of reversing Australia's relative decline with respect to spending levels and student attainment**. The public policy landscape in Australia needs to be cleansed. If we do not do it now, a recession will do it for us at some point in the immediate future.*

This is a broad and controversial policy agenda, but it is required urgently. There will be a political cost, but we are confident that we have created such a vast array of winners and losers that it will beyond the capacity of the Daily Telegraph or Twitter to encapsulate the implications into a single emotive headline. Divide & conquer!"

Investment Implications

The fundamental message is clear – diversify away from this risk. At the very worst it represents a path where the ultimate destination is a deep and cleansing recession. At best, it presents an opportunity cost where Australian-based assets will continue to underperform international alternatives. With a large part of the ASX industrial universe exposed to the deleveraging of Australian households, the added burden of an uncompetitive economy can only be a drag on absolute and relative performance. As such,

- We believe that "Australia" is evolving into a high beta investment. The growing sensitivity to the terms of trade and the growing influence of the inherently cyclical mining sector, has increased the volatility of the economy and the business cycle. This trend will continue until countered by a more competitive non-mining economy. Increasing volatility/cyclicality can only be to the detriment of the valuation rating applied to Australian assets.

- In the absence of a sudden and sustained reversal in the currency (i.e. sub US$0.85), we struggle to see how Australia can avoid the "cleansing" recession. Outside a sudden downturn in China, this is unlikely to occur inside the next 2-3 years as the mining capex surge underpins private sector activity. As such, it is not a risk that we are formally incorporating into our asset allocation strategy or portfolio recommendations. It is, however, the primary macro driver for our desire to see clients diversifying into international assets.

- The case for a material allocation to international markets is based on –

    - The need to diversify away from an uncompetitive and increasingly high-beta Australian economy.
    - The need to diversify away from the limitations of the Australian equity market in terms of industry breadth and company quality.
    - Access to superior quality-adjusted valuations.
    - Access to superior profit growth both via more opportunity-rich businesses and, in the case of advanced economies, cost bases that have already been cleansed by a deep recession.
    - The rare opportunity to use an overvalued asset – the A$ - to buy undervalued assets.

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