The return of complacency *Dec 09*

By James Dunn

You would barely credit it now, but nine months ago, investors were staring into the abyss.

Now that confidence is returning, the outlook has changed. In fact, there is a definite air of complacency – something that seemed unthinkable in March, when the global financial system looked to be shot, with US$4,000 billion-plus worth of assets written either down or off, and nowhere near the capital available to repair bank balance sheets.

Stockmarkets were at a level of confidence beyond panic, almost to despair, with many companies priced for collapse. A full-blown global recession – even a re-run of the 1930s Great Depression – was spoken of as a serious possibility.

Unemployment was expected to surge, government borrowing was considered the only thing that could prop up economies and house prices were expected to tumble.

Superannuation investors were told that they would face a second straight year of shrinking account balances, leaving those heading into retirement appalled that they had trusted the bulk of their savings to the stockmarket.

But then it turned around.

It is hard to isolate just what happened to induce the markets out of their nervous breakdown, but from March on, it is history that Australian investors have delightedly watched the local market rebound to the tune of 55 per cent.

There is still a long way to go to get back to the index's pre-crisis level – about 45 per cent from these levels. But the point is that post-GFC, many investors seem to think that the stock market is acting like a TV network that has just come back on air after a technical problem interrupted transmission: that it has simply resumed normal service.

Superannuation investors have seen the returns from balanced funds (which hold more than 80 per cent of Australians' super) post an astonishingly strong comeback, from minus 20 per cent on a one-year basis just seven months ago to back into positive territory.

It helped that the Australian economy defied the global trend and easily avoided recession, with a 0.6 per cent contraction in GDP in the December 2008 quarter followed by surprisingly strong growth of 0.4 per cent in the March 2009 quarter, and by an even more impressive rise of 0.6 per cent in the June quarter.

It is probably this performance of the Australian economy, more than any other factor, which has contributed to the complacency of Australian investors.

Three times in just over a decade, the Australian economy has been considered likely to fall into recession, only to prove the doubters wrong: the 1997-98 Asian Crisis (when eight of Australia's ten largest trading partners went into recession), 2000 (in the wake of the tech bust) and again in the GFC – the last being the most amazing escape of all.

This performance – the best in the developed world – has been built mainly on Australia's status as major supplier of raw materials to the engine of world economic growth, China and the north Asian economies. The other main contributing factor is the massive $43 billion in government stimulus that was ploughed into the economy.

Eighteen years (and counting) of unbroken economic expansion appears to have convinced many Australian investors that the economy is in fact recession-proof. Throw in the strongly confident readings given by surveys of Australian business, consumers and investors and you have a recipe for an economy getting ahead of itself.

Add to this a general global move from highly risk-averse investor behaviour to risk-embracing, and you have a return to what looks suspiciously like over-confidence.

In the Australian market, two observations indicate this. The first was the hype over the $2.3 billion Myer float in October, and the subsequent interest in the $400 million float of adventure retailer Kathmandu.

The second is the comments by Gerry Harvey, chairman of Harvey Norman Holdings, predicting a record Christmas sales season for the big retailer.

The Myer float was accompanied by a marketing blitz centred on supermodel (and Myer ambassador) Jennifer Hawkins on the cover of the prospectus and acting as the face of the share issue. Ms Hawkins did everything she was supposed to do, giving the float glamour and attracting attention, and generally making Myer the most talked-about and sought-after float for several years – particularly by retail investors, who, it was said, would be keen to back a household name.

Myer was priced at $4.10, or 15 times forecast earnings for the 2009-10 financial year. At the time, Myer's archrival David Jones was trading at 17.8 times forecast 2010 earnings, a comparison that led many commentators to judge Myer as "cheap". As a consequence of the Hawkins fever and the "cheap" price, talk started to centre on exactly what premium Myer would command when it began trading – and how that would flow through to Kathmandu when it floated subsequently.

As it happened, Myer did not come on to the stockmarket at a premium, and has not traded anywhere near its issue price. It remains 8 per cent below its issue price.

Kathmandu briefly achieved a premium of 4.7 per cent, but it too is trading well below its issue price.

The brief flurry of speculation over float premiums ignored two factors: one, that the 55 per cent recovery in the stockmarket has only brought the market back from the best value in 40 years to more normal price/earnings (P/E) ratios; and that the vendors of both Myer and Kathmandu were private equity investors, who are not renowned for giving things away cheaply. A stockmarket float is their exit.

Talk of premiums, and household-name stocks, obscured this fact. It was wishful thinking. The professional investor market was prepared to allow the vendors to exit, but it wasn't going to hand them a bonus for doing so.

Gerry Harvey's comments are also interesting. On the one hand, he is talking his book. On the other hand, retail sales in Australia are surprisingly buoyant, and don't forget, despite China's importance to the Australian economy, consumer spending still accounts for two-thirds of Australia's GDP.

In Gerry's defence, unemployment is still relatively benign, at 5.8 per cent, which is much better than the 8.25 per cent predicted by the government (Commonwealth bank reportedly stress-tested its home loan book for 10 per cent unemployment.)

But there are a couple of big potential icebergs around which the SS Australia must navigate. The first is the quick application of three interest-rate rises that the Reserve Bank has slapped on the economy. The second is the fact that the government stimulus effectively brought forward a lot of demand to this year (as well as loading up debt that eventually must be repaid.)

In addition to this, there is a global environment that is nowhere near as rosy as Australian investors' outlook is. They are of course influenced by their "lucky country" home base, which has unarguably performed spectacularly well. But the rest of the world is nowhere near out of the woods, and Australian investors would do well to remind themselves of that fact as they enjoy a Christmas dinner that will taste a lot less worry-packed than last year's.

Yes, the Australian market has mounted a stronger recovery this year than most thought possible, but it is factoring in very little in the way of earnings growth this financial year. If the rest of the world cannot recover as quickly as Australia, we may have to mark time until the other markets can catch up.

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