LATELINE. BUSINESS

Ali Moore speaks with Shane Oliver, Gerard Minack

Australian Broadcasting Corporation
Broadcast: 08/12/2006
Reporter: Ali Moore

Ali Moore speaks with Shane Oliver from AMP and Gerard Minack from Morgan Stanley.

Transcript

ALI MOORE: Well, in our last program for the year we thought we'd bring you a look at the year just gone and the year ahead for the share market and the economy. To that end we enticed well known bull, AMP Capital's Shane Oliver, and well known bear, Morgan Stanley's Gerard Minack, into our studios earlier this evening.

Gentlemen, welcome to our last program for 2006. 2006, of course, was an easy year where, so far, the Australian equity market has returned around 19 per cent, a not inconsiderable gain. If we'd been sitting here this time last year neither of you would have predicted that, would you? Shane?

SHANE OLIVER: I'm must say I'm certainly surprised by the strength of the market through 2006. At the start of the year we were looking for gains of around 10 per cent; still pretty good, but nowhere near as strong as they have been. I think the key surprise has been the ongoing strength in company profits, which have come in roughly double what I would have assumed a year ago.

ALI MOORE: Would you agree, Gerard?

GERARD MINACK: Absolutely. I wouldn't have been nearly as optimistic as Shane, in fact. So I've been astounded at the performance of company profits, particularly when you think that through the course of this year we've had quite disappointing growth numbers. We've also had a lot of anecdotes from the corporate sector complaining about rising labour costs. Put those two things together, and if you had have told me that at the start of the year I would have thought, "I'm on the money," saying that earnings were going to disappoint, but instead they've shot out the forecasts.

ALI MOORE: So what has driven company profits?

SHANE OLIVER: I think the bottom line is that Australian companies have been far better at adjusting to higher costs than most of us would have assumed. They've basically done it through productivity gains, squeezing the best out of their workforce and out of their capital to generate ongoing good returns for shareholders. I think that's been the key driver.

GERARD MINACK: And you have to add, Shane, I think the other thing that's helped earnings has been the rise in asset prices globally. We now have a lot of companies that make money when asset prices go up and we've continued to see very heavy borrowing by corporates, but also the big surprise for me is how much the consumers continue to borrow, so the banks have done very well. At the end of the day our market is a very bank heavy market. So the financial related earnings - and I'd say in some respects the financially-engineered earnings - have also surprised on the upside, in my view.

ALI MOORE: Let's look at going into 2007. If we look at the economic landscape we have an American economy that's slowing, but no one seems to know just how fast. We have an Australian economy where we're also slowing, but have very low unemployment. Things seem to be tracking quite well. Do you think that this year can be another year of 19 per cent returns on the equity market. Gerard?

GERARD MINACK: My big problem is that I've got exactly the same thoughts on '07 that I had on ’06, and obviously I was wrong on ‘06. We've have got some new news; the housing market in the States has turned and I think that's going to slow the consumer, so there's earnings risks there. I think the disappointment in domestic growth will intensify next year, given that we’ve got, firstly, a drought. Secondly, it seems that the capex boom is over. Thirdly, the household sector has to cope with the impact of higher rates, so I think the growth slow down is likely. Finally, in terms of asset market pricing, I think we've pushed the envelope almost, perhaps not quite as far as we can take it.

ALI MOORE: Before I ask you, Shane, what does that all add up to, though, for an overall performance in ‘07? Not quite as negative as you're tempted to be?

GERARD MINACK: The real problem I've got is I think we're developing a bubble. As we saw with the tech boom, picking the top on a bubble is very difficult, even the timing. But if this thing goes parabolic the top may not be that far away, but it may be a fair way away in terms of prices. I guess my view is, I wouldn't be surprised to see a strong start to the year, but I'd be very surprised if we didn't see some outright declines in the second half of the year. How we finish up? Not sure. I think we'll be down on a December-to-December basis.

ALI MOORE: Shane, you're nodding, but do you agree?

SHANE OLIVER: No, I don't. Basically, people have been worrying about a bubble in the Australian share market, or global shares for the last couple of years. But the bottom line is that the companies not overly valued, they’re trading on PEs below historical averages. I don't see a global recession or a sharp downturn in growth. If you look at the US economy, sure it's slowing down, but there are even signs the US housing market is starting to hit bottom, and the likelihood is that the rest of the economy can sail on at a reasonable pace. So, yes, a bit slower than it has been, but certainly not a hard landing. I think profit growth in the US will remain positive. Likewise when you look at Australia; yes, we’ve had a slowdown, in fact growth over the last year has just been 2 per cent, but yet companies have still been able to generate reasonable profit growth. My feeling is that that will continue. On top of all of this we have the added uncertainty, as Gerard alluded to, of M&A activity and fund flows into the share markets.

ALI MOORE: And that momentum?

SHANE OLIVER: And that the momentum is still building up. My feeling is that the build up in M&A activity, that’s merger activity, partly funded by private equity firms, is still early days yet. If you look at the level of M&A activity relative to the overall market, it's still relatively low. With the cost of capital still staying low, corporate gearing is still extremely low. It can go up a hell of a lot higher than it currently is. My feeling is that this whole story can go on for a lot longer. At the end of the year I see a return of around 14 per cent from Australian shares.

ALI MOORE: Would you agree, Gerard?

GERARD MINACK: I do agree with Shane that the M&A boom can continue for a while. But the one thing I'd say in response to Shane’s comment about leverage is that although average leverage is lower than it was several years ago, the leverage deals that are being done are now as leveraged as the deals that were being done back 1999, 2000, and they ultimately proved to be bad deals with a lot of bankruptcies.

ALI MOORE: But there's more headroom this time around, isn’t there? If you look at the ratio of debt to equity?

GERARD MINACK: In aggregate that’s absolutely fine, but the average company never goes broke. You’ve got to look at the companies that are leveraging up, and in the States what we're starting to see now are debt to broadly defined earnings, EBITDA, so earnings before depreciation, interest and tax, going to ratios of about six, so six times the debt to that earnings base. They were exactly the same sort of ratios that we saw in 1999. If we subsequently see a pull back in earnings, then the leverage intensifies.

ALI MOORE: That's true, isn't it, Shane? Everything is priced for perfection at the moment?

SHANE OLIVER: I wouldn't say that. Back in 1999, 2000 the US share market was trading on a forward PE of around 25 times; today it's about 15 times. So it's very hard to say the market is priced to full perfection. The other thing to note is that the thing that brought all of this undone in the late 1990s, early 2000 - of course we had this massive bubble in tech stocks. Tech stocks went on to a PE of infinity, in some cases, or 100 times for the NASDAQ. But interest rates rose a lot further. Through next year we actually see the Fed starting to cut interest rates and so the threat to the leverage that Gerard is referring to, I think will start to fade away as interest rates start to come off.

ALI MOORE: Gerard, what do you think on interest rates? Do you agree with that?

GERARD MINACK: I don't. I agree that rates clearly aren't as high as they are, but debt levels, particularly amongst consumers, are a lot higher. The overleveraged sector back in the late 1990s was the corporate sector and they crumpled under the weight of those rates. This time I think it’s going to be the consumer that will crumple and the corporate sector, in a sense, will be collateral damage.

SHANE OLIVER: 80 per cent of loans in America of US consumers are fixed rate. They’re locked in. They haven't been affected by what the Fed has done in terms of raising interest rates. So they're protected, to a large degree, from what's gone on, so therefore I don't see the US consumer getting into big trouble.

ALI MOORE: Both of you are going to have to agree to disagree on this one. There are three quick points that I want to cover off with you because I know people are really interested in them: We talked about American rates, domestically, interest rates. Shane, what's your call for what's going to happen next year?

SHANE OLIVER: Interest rates are now on hold and they're probably going to stay on hold out to the middle of the year, after which we see the Reserve Bank starting to cut interest rates probably to about 5.75 per cent by the end of next year. That's going to be driven by continued moderation in growth in the Australian, growth of somewhere between 2 and 3 per cent, and an abatement of the inflation worries that have scared the Reserve Bank through 2006.

ALI MOORE: Gerard?

GERARD MINACK: It seems to be the case tonight; I half agree with Shane. I certainly think the RBA is done. I also expect the Reserve Bank to make its first cut in interest rates before the middle of next year. Beyond that it will depend how the consumer responds to what I expect to see as rising unemployment. If the economy continues to deteriorate in the second half of next year, then I think we could see a succession of rate cuts.

ALI MOORE: The other issue a lot of people who hold these stocks, in particular, everything is meant to be premised on the China boom or the commodity boom if you're in the resource sector. Gerard, can I ask you; the boom in commodities, has it peaked, is it over? What's going to happen?

GERARD MINACK: I think it's peaked in terms of the big windfall we've got, which, at the end of the day, is price related. We've had to do nothing over the last few years and yet we got a huge pay increase from the Chinese, effectively. Gains beyond that we'll have to work for.

SHANE OLIVER: Gerard is right in a sense, that we've seen the huge run up in commodity prices. My feeling now is that now we're going through a typical correction. Nothing new here. By the second half of next year, as global growth starts to pick up again and the Chinese boom continues because the Chinese boom is not a short term story, this is a long term story. It has a long, long way to go. That will see commodity prices start to pick up again.

ALI MOORE: You're saying new highs, in fact, aren't you?

SHANE OLIVER: Yes, by the end of next year we see new highs for copper prices, oil prices and most commodities. But we might go through a roughish patch for the first half of the year as global growth remains subdued, but by the end of the year I think it's back on again.

ALI MOORE: Finally, gentlemen, I'm going to ask you to stake your claim and put yourselves on the line: Today, or tonight, the ASX 200 is at 5,465. If I was going to talk to you in 12 months sitting here, Gerard, where will it be?

GERARD MINACK: I think it will go higher on year turn, but in 12 months time I think it will be 5,000.

ALI MOORE: Shane?

SHANE OLIVER: I've got an opposite view to that. I think it will be 6,100, at least, in 12 months' time. The risk, I think, is still on the upside, not so much of another year of booming earnings, but from continued strengthened inflows into the market via M&A activity, superannuation inflows and so on.

ALI MOORE: It's on tape; we'll check it in a year's time. Many thanks for joining us.