

# Capital markets update

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by Michael Churchill

With European debt markets the topic on most lips, a 2011 wrap couldn't start without contemplating what major debt write-offs mean for this part of the world...

The US economy is down but not out. China has slowed.

Major European debt write-offs (Italy needs to carve up to €1 trillion off its debt to have a sustainable level of debt) will cause shock waves through the European banks that have lent to Italy and Greece.

This year saw a number of smaller Spanish PPPs defaulting on concession payments. Not only do we see sovereign debt costs at all time highs (Greece is 25% and showing no signs of reverting any time soon) but the view of many investors that PPPs represent safe havens has been shattered.

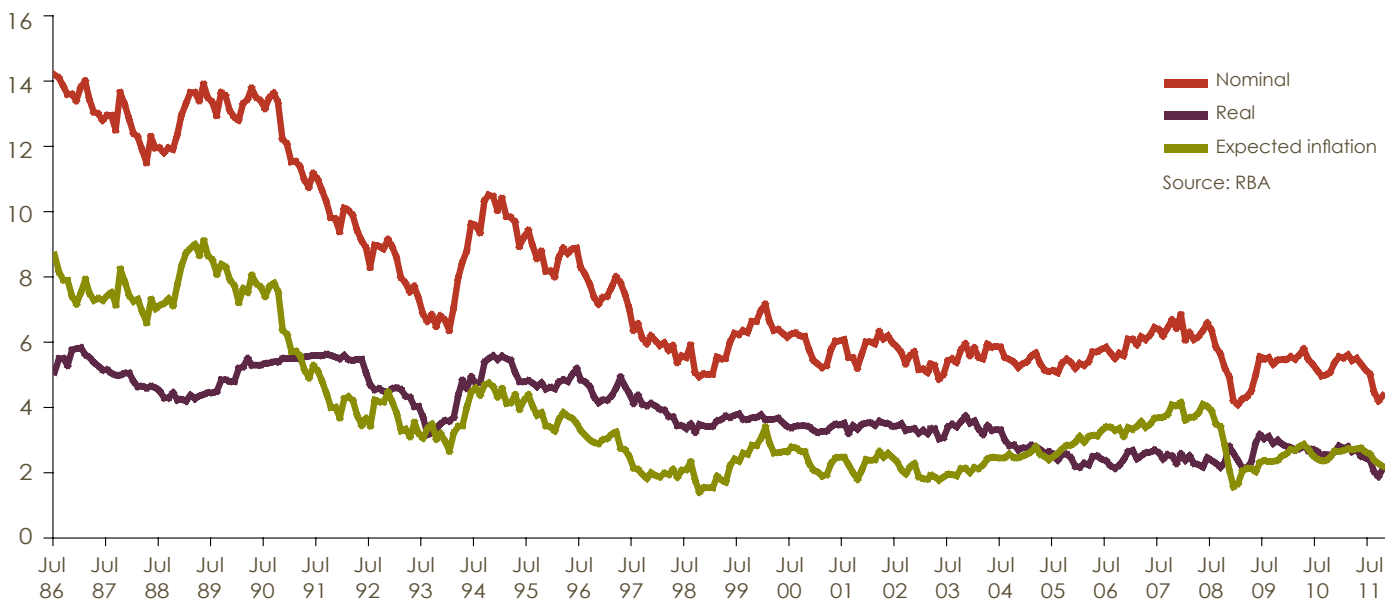
The knock-on effect for Australia is likely to manifest as lower exports and a significantly lower dollar. The AUD is seen by the rest of the world as a leverage play on Chinese growth. A drop in European and US demand will slow the Chinese economy and consequently, Australian production. It has been suggested that we could see the AUD at 0.70 once again.

However, whilst this is good news for unhedged exporters, the AUD is expected to rebound strongly when the turmoil has passed and most pundits believe we will see the AUD : USD in a range of 1.30 to 1.70 in the mid to longer term.

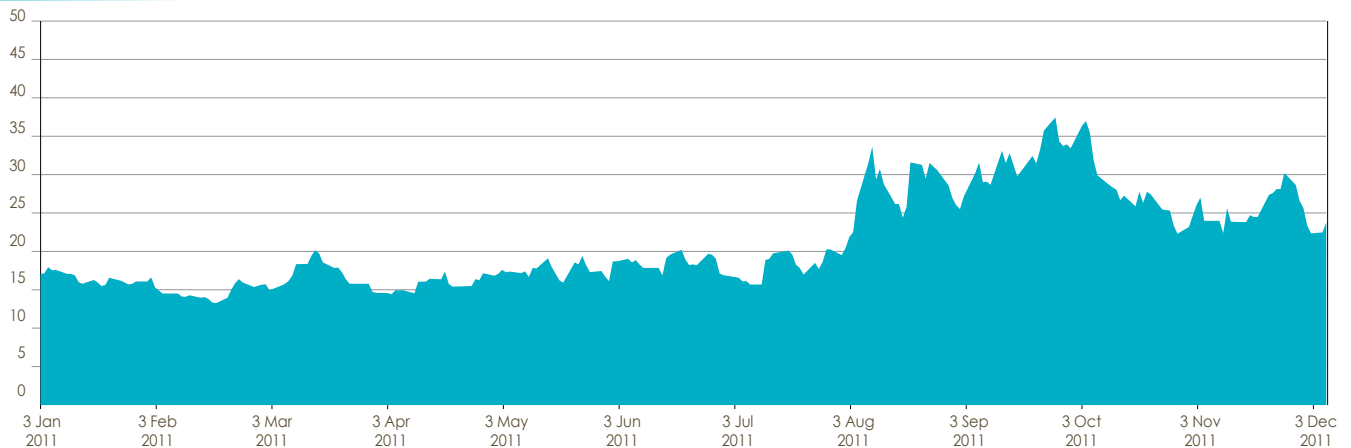
Interestingly, our government bonds are trading at a low level (around 4%) – less than the implied long-term inflation outlook of around 3% and a real interest rate of around 2.5%. This phenomenon is described as a convenience yield, reflecting the demand for low-risk assets and a flight to quality. Investors are effectively over-pricing our bonds in order to reduce the risk of loss of capital.



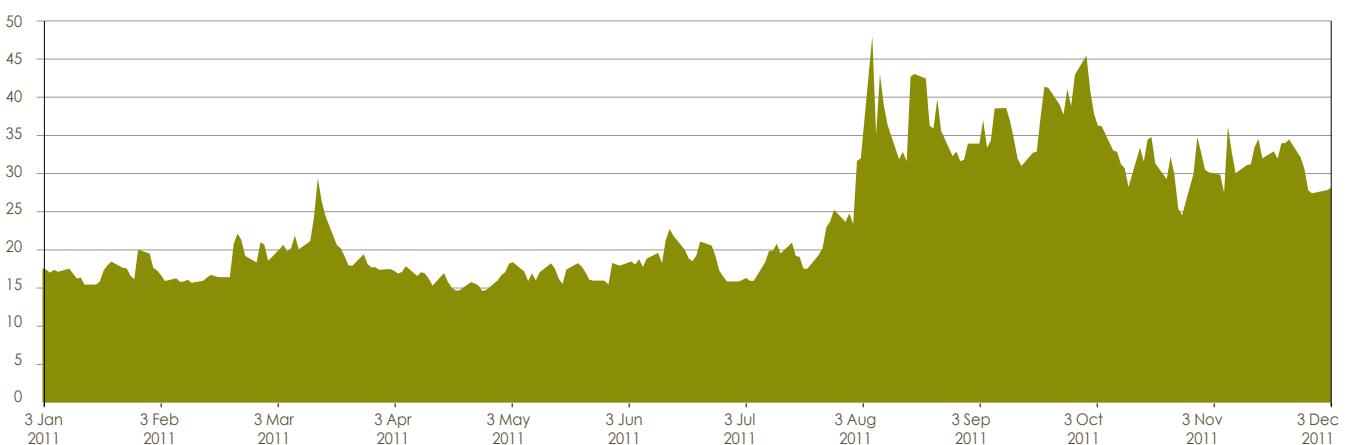
## Indexed & Nominal Treasury Bonds (%)



## Equities Volatility, Australia 2011 (%)



## Equities Volatility, US 2011 (%)



By comparison, the equities markets remain turbulent with the VIX (a useful measure of short-term return expectations due to high correlation with the equity market risk premium) sitting in a trading range of 30-40%. What does this mean? The VIX is one of the few actively-traded instruments which prices the volatility of the S&P500 (and there is an equivalent Australian instrument known as VXI). The volatility measure is calculated by reference to options over the S&P500. The near-perfect correlation with the equity market risk premium means we can use the VIX as a proxy for short-term market returns.

Currently, the outlook for equity market returns is in excess of 18% (a riskless return of 4% and a 12-month expectation of equity risk premium of around 14%).

Sounds unlikely? Not so.

We've seen short-dated instruments issued in the current market which closely match this construct. On balance, the cost of capital in most sectors has risen slightly during the year – largely due to the short-term volatility and the failure of credit spreads to revert to long-term averages.

However, the more significant issue for valuations is the possibility of cashflow/earnings weaknesses as a consequence of the two-speed economy, weaker demand in our major trading partners and critical skill shortages in the resources sector impacting operating costs.

The carbon tax and MRRT will also have a bearing on the profitability of many of the larger emitters and resources companies. However, the net position for the economy is nil as the carbon tax and MRRT spoils are redistributed around the economy (in the form of government spending, compensation and incentives in the renewable energy sector).

Don't expect any coal fired generators to be shutting down anytime soon though – we just don't have the capacity in the installed generators or a pipeline of projects to fill the void left by knocking out a large proportion of supply (e.g. Loy Yang A – one of the generators that we value – provides 2gW of power to Victoria and South Australia and there is no near-term substitute). ▽▲



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