



Confidence the key to recovery

Columnist: Don Williams, Platypus Asset Management chief investment officer

The relative strength of the economy so far this year has been extraordinary given the global backdrop. Not surprisingly, it has baffled the majority of market participants. Most economists remain resolutely bearish on the prospects for the economy in the next six months, expecting retail sales to fall back to a 2 per cent annual growth rate from the current 7 per cent, and gross domestic product to revert to negative territory.

In my view, the problem with these forecasts is that they are ignoring a number of data points that, in aggregate, are quite supportive for retail over the next three to six months at least.

The most obvious is consumer confidence, which at Platypus we believe is the most important leading indicator for the economy, but very hard to forecast. The reading on consumer confidence is unambiguously bullish. The 40 per cent reduction in mortgage rates and \$20 billion of cash handouts have had precisely the impact the federal government and Reserve Bank of Australia (RBA) were hoping for.

Confidence improved despite the recession and retail sales followed confidence higher. Trends have also been improving in single-dwelling housing, auction clearance rates and house prices, suggesting the worst is over for housing. In our view we are on the cusp of what should be a multi-year improvement in residential housing construction.

Sceptics quite rightly point out housing and retail sales in particular have been boosted by one-off measures – such as the cash handouts in the case of retail and the doubling of the first home buyers grant in the case of residential property. There is no question these measures have inflated the numbers, but in our view we also think there is an underlying improvement driven by lower interest rates that a lot of commentators are ignoring.

The drop in mortgage rates from 9.75 per cent in August 2008 to 5.75 per cent by April 2009 was unprecedented for the current generation of home buyers and they are likely to keep responding to multi-year lows in

mortgage rates. The bearish case for retail sales is that growth will inevitably slow as the unemployment rate rises and the impact of the government handouts dissipates. We too are looking for a moderation in retail sales, but more towards a 4-5 per cent growth rate compared to the 2 per cent predicted by many economists. Furthermore, what the sceptics fail to mention is that the correlation between retail sales and employment is poor compared to the correlation to consumer sentiment.

The forecasters that are expecting retail sales to slow to 2 per cent seem to be saying that Australian consumers will be as downbeat as they were at the peak of the global financial crises, which in our view is a very unlikely scenario. They also ignore the possibility that the government and the RBA can still take action to try to prevent a second dip in activity. Policy measures to date have worked well to shore up the economy and slow the deterioration in employment, so why wouldn't they repeat the dose?

Looking at the share market, it has been largely range bound and will remain so until reporting season starts in mid-August. However, our prediction is the reporting season will be relatively well received, as much of the company-specific 'bad news' has now been announced to the market and there is unlikely to be much that will shock investors. As always, company outlook statements will be heavily scrutinised, but we think we will see fewer companies prepared to make forecasts, compared to last reporting season, given the elevated level of uncertainty in their operating environment.

An example of a company that we think may have a strong reporting season is Fantastic Furniture. It recently raised \$12.3 million of fresh equity capital to strengthen its balance sheet and for future growth purposes. Shares are currently trading at \$2.85, having appreciated 80 per cent off their 52-week low, however, they are still down 40 per cent from their 2007 high of \$4.70. The stock is trading on 14 times price-earnings and our view is the share price can trade higher, given the

low expectations for the stock. Recent macro-economic factors are supportive of a reasonable performance by Fantastic Holdings for the six months to 30 June 2009 and beyond. Some of these economic factors include the \$20 billion federal government consumer stimulus payment, interest rate cuts, first home owner grant and reduction in personal tax rates. The most important leading indicator for Fantastic, and retailing more generally, is consumer sentiment. The Westpac Consumer Sentiment Index, after bottoming in mid-2008 at 79.0, has just recorded the largest ever two-month percentage increase to reach 109.4 in July 2009. This improvement in consumer sentiment, combined with recent profit upgrades by other consumer discretionary retailers JB Hi-Fi and David Jones, gives us confidence Fantastic can deliver a better than expected result in August.

Adding to our more optimistic view is the continuing improvement in credit market indicators. We anticipate these credit indicators will continue to give some guidance to the future health of the economy and equity market.

The question of whether the bear market has finished continues to tax investors. We expect this financial year will represent a cyclical low point for corporate earnings and anticipate a substantial earnings recovery next financial year.

However, the market will not wait until then to reflect this fundamental recovery, but rather over the next six to 12 months we expect the recovery in earnings to increasingly be reflected in stock prices. We do not think we are at the stage where an earnings recovery has been fully factored into stock prices. As such we expect investors will display a 'buy the dips' mentality, hence corrections will be shallow. The most recent market pullback since the start of May has been more of a sideways pattern rather than a sharp decline, and confirms our view that investors do not want to miss the eventual recovery in corporate earnings and economic conditions. Clearly, optimism and perhaps even greed are starting to creep back into the market. «

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