Real trouble brews across Australian economy

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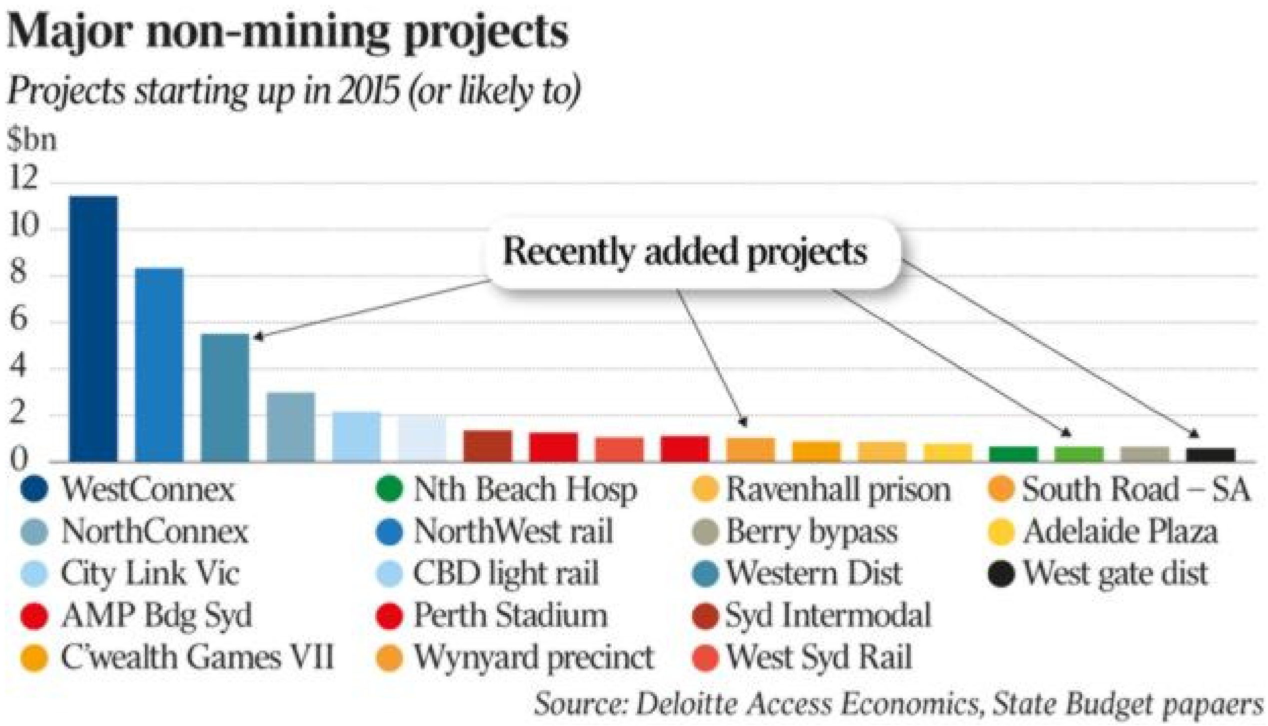

Major projects other than mining that are likely to start in 2015. Source: TheAustralian

The Australian economy is in real trouble and global investment trends are increasingly reflecting mounting concerns about our investment case.

Of all of the core OECD economies, Australia is the only one which has somehow been able to avoid a forced or cyclic recession not only since the Great Recession but since even further back in September 1991.

While this was initially seen as an achievement, it has now begun to deeply concern international ultra high net worth investors, who hold significant sway and influence over several of our key domestic investment markets.

Economically, the benefits of going through recessions are that they ultimately clean out inefficiencies and stimulate future productivity growth.

Productivity growth is the most important driver of longer- term economic prosperity and one aspect that our domestic economy has not only failed to improve upon but has, in fact, begun to noticeably regress from.

Innes Willox, chief executive of the Australian Industry Group and Larkin Group Advisory board member, says: “Given Australia’s high cost base which is very difficult to shift, all roads lead to the need to make significant productivity gains as the key way to increase our competitiveness.”

“The reality is that while our regional competitors have made real productivity gains over the past decade, we have stood still through a lack of investment, overregulation and the lack of ongoing reform. Standing still really means we have gone backwards”.

Through the optics of a global investor it is now being perceived that a near perfect storm of headwinds is now swirling around the Australian economy.

Recent events in China have not helped ease these concerns.

Taken collectively, there is also an increasingly strong case for domestic Australian investment communities to batten down the hatches and take evasive action, such as reallocating towards most robust global investment opportunities.

One of these significant headwinds is the continued oversupply of iron ore and it is becoming increasingly obvious what this continued trend means for future commodity pricing, tax revenues and listed mining valuations.

It is well known that the historical long-term average spot price of iron ore sits somewhere nearer to $US10-$US20 a tonne but what isn’t well understood is why the current spot price remains buoyed around $US50/t.

Rather than an equilibrium matching level between Chinese demand and Australia plus Brazilian supply, the current $US50/t price range actually reflects producers current unscheduled bottlenecks, which, importantly, are expected to dissipate in the coming weeks. When operations among major Australian producers are back at full strength — and when Roy Hill’s 55 million tonnes per annum mine opens in a couple of months — the downward pressure on iron ore prices will predictably resume.

For current iron ore prices to remain at this price point, up to 84 million tonnes of marginal seaborne capacity must be displaced in 2015, in order to balance the market. This simply will not happen.

Equally importantly, as mine closures require prices to fall below the $US50/t estimate of “marginal production costs” for most Australian majors, this dissipating bottleneck spells further downgrades for three of Australia’s largest listed miners.

Taking a look at the ASX 200 — which is the easiest Australian investment market to dissect from a valuation and future expected earnings perspective — if we discount the foreseeable future downgrades in these three listed miners, alongside the four highly geared Australian listed banks which will be affected by the fact that the credit cycle has peaked in terms of growth momentum, then there is a clear negative drag on the remaining two-thirds of the bourse that cannot be avoided.

Further, a large portion of the other ASX 200 constituents have priced forward earnings on an assumption of a declining Australian dollar, which is most definitely not a certainty, by any measure.

Taking a look at UHNW and institutional direct investing, the significant consolidation in Australian private equity since 2013 has meant that other than real estate development, large capital private sector investments in Australia have been near to non-existent. This is considered a “red flag” for any OECD economy of our size.

What is alarming about the graph above is that nearly all major non-mining Australian capital projects in 2015 are government or quasi-government (that is, public private partnership) initiatives. One could be forgiven for viewing Australia as more centrally planned than Communist China. But what makes this perfect storm complete, is the souring tone of China’s contraction seen across Australia’s bond and debt markets.

There is a general “risk-off” tone since June and the strong links between China and Australia provide an additional reason for the market to be nervous about semi-government bonds, such as NSW Treasury Corporation bonds or WA State Bonds, 2019 maturities, for example.

The complicating factor for domestic Australian investors is that it is never wise to sell-down your own domestic investment allocations and fully redistribute abroad.

So given these growing headwinds, tough decisions need to be made by those who wish to remain proactive and capital gains positive. It must also be remembered that the global backdrop will shift, once again, in less than a month, when the US Federal Reserve does or does not lift US interest rates.

In either scenario, global rates, currencies and debt markets will realign and such shifts could place further prejudice against the “out of favour” Australian investment thematic.

At the crossroads of external pressures and internal constraints, it is time to take more than a serious look at the Australian economy and our best future investment options.

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