economic & investment horizons

Grant Thornton

Quiet achievers provide balance to world growth

The global economy is enjoying its strongest sustained growth for 30 years, and this is set to continue. For all the noise, we would expect China and America to be the sole drivers of this growth. On closer inspection, Japan and Europe, previously the laggards of world growth, have been increasingly contributing to this positive state, providing balance and support to the global environment.

Japan

Most statements about Japan at the moment are prefaced by either "the fastest in 8 years" (consumer prices, wage income, retail spending, housing starts) or "the fastest in 15 years" (consumer and business confidence, GDP growth, labour demand). Deflation, a previous burden on Japan's economy, has been replaced with inflation and corporate profit growth has been picking up by 11% year-on-year, led by the manufacturing sector (and strong exports).

Since mid 2004, strong exports and domestic demand have created an expansionary virtuous circle, beginning with corporate expansion, leading to increased credit provision which itself has led to housing and construction activity, finally resulting in the consumer's positive response to the end of deflation.

Europe

As seen from the graph below, which plots Europe's and Japan's recent and forecasted GDP growth, whilst Europe's growth rate does not match Japan's, almost all of the Euro area's leading indicators point to an acceleration of growth in 2006. Europe is benefiting from the strong global demand conditions which have resulted in growth in business investment. Global demand has driven industrial orders, which are an excellent predictor of industrial production, to surge over 5% in December 2005. And in terms of consumer spending, French households are driving a consumption revival in the Euro area.

The future

Whilst Europe and Japan finally enjoy some economic strength, there are risks omnipresent within their own economies as well as the global economy, to which they are inextricably linked. The potential of a bird flu pandemic, an out-break of inflationary pressures, the risk of a chaotic adjustment to global imbalances and a continued rise in the oil price will apply breaks to both the European and Japanese expansions. And it would seem that these countries' financial markets, that have risen dramatically at the early signs of economic recovery, are not reflecting these possible risks.

Europe and Japan: Recent and forecasted GDP growth

Growth where the sun shines

Whilst overall, Australia's growth rate remains reasonably strong, the contribution from the different states is unequal. Victoria and New South Wales (NSW) are being left in the shadows of sunny Western Australia and Queensland.

Reasons for Divergence

Commodities - Whilst Australia's overall GDP growth has retracted to just above 2.5% in 2005/06, the resource-rich Western Australian economic growth rate will be 6% this financial year. And as the national economists sweat over Australia's trade deficit, Western Australia, which accounts for 30% of Australian exports, has reported a trade surplus of $24 billion this year.

Construction - NSW has experienced a decline of 17% in dwelling construction and is 30% off the peak of building approvals. Queensland and Victoria are 20% below their building approval peaks in 2003. Western Australia is the only state where building approvals have continued to rise.

Consumer spending - Housing and construction activity have a major impact on income growth and spending. As NSW residents have experienced the most dramatic fall in their house prices, whilst having the highest level of mortgages of all the states, there has been a resultant fall in consumer spending as their rising debt to equity levels starts to bite. A similar, yet less dramatic effect, has been seen in Victoria.

Employment - The key issue is whether a tail-off in housing construction will lead to a fall in employment, as seen in NSW recently. This has yet to happen in Victoria, whilst in Western Australia, unemployment is still declining. However, if Victorian employment does drop as a result of less construction activity, households will get concerned about their ability to find or retain a job and this, together with the slow-down in house prices, will reduce spending further.

The whole picture

Currently, the risks inherent within NSW and Victoria are being buried under the massive growth rates of Queensland and Western Australia. For Australia overall, so long as the strength continues from these latter two, the picture looks rosy. However, the risk is that NSW represents the future direction of all the states. It seems to depend on whether the commodities boom can out-live the impending end of the construction/employment/consumer spending cycle of recent years.

Portfolio stock in review: Coates Hire (COA)

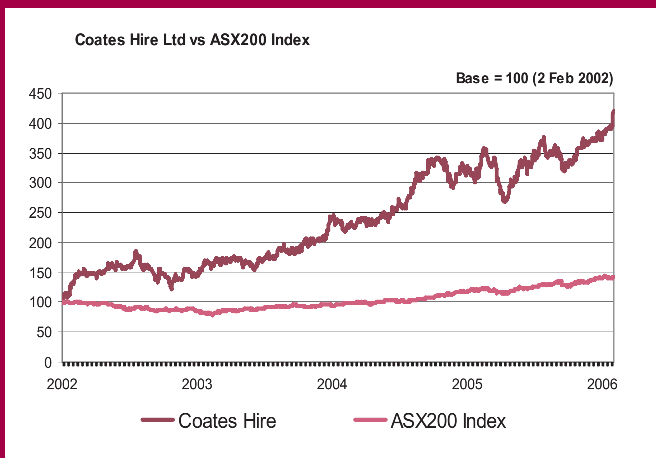
Coates Hire (ASX:COA) has been in the Grant Thornton Investment Management (GTIM) domestic equity portfolio for over four years. COA's management has sought to balance long-term growth through acquisition and margin expansion, whilst sustaining returns to shareholders, and in doing so has made it a sound portfolio investment.

The business

COA deals primarily in the supply of general equipment hire across a wide variety of continually developing market segments, including building, engineering, mining & resources, government, special events and domestic maintenance. Through the key acquisition of Wreckair in 2001 and quality, smaller businesses in recent times, it holds a significant proportion of the (estimated) $900 million domestic industry and has modest operations in the United Kingdom and Indonesia.

The financials

As illustrated in the graph below, COA's share price has risen consistently since 2002, significantly outperforming the ASX200 index in the same period. Strong recent results support the market's valuation, with revenue for the first half of the 2005/2006 fiscal year reaching $344.2 million, up 34.80%. After-tax profit rose 60.50% to $49.5 million, leading to an interim dividend of 9 cents per share, up 20.60%.



The future

COA has a sound demand 'pipeline', particularly in infrastructure and mining activities. Given its cyclical nature, we are actively monitoring this demand cycle, and particularly how COA manages its capital expenditure in a potentially slowing environment.

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