

economic & investment horizons

Grant Thornton 

Strategy to address market imbalance

In our June Financial Market & Economic Review Breakfast, we spoke about the recent and increasingly dramatic divergence of actual economic output levels and investors' expectations of financial market returns.

Theoretically, in a rational market, economic growth and financial market returns should align. Financial markets and the economy are after all comprised of the same components: businesses, employees and households. Businesses drive economic growth and therefore share-market returns. The difference between the two is that the financial markets are also driven by sentiment, speculation and capital flows, which can very easily cause imbalances and “bubbles” which are far removed from economic reality.

How far the economy and financial markets have diverged

The 55% growth in the Australian stock-market index over the last two years has been an excellent example of financial market and economic divergence. Excess liquidity has been the cause of the divergence. Excess capital flowing into financial markets and into residential property investment has created a virtuous circle. The cheap debt thrown into residential property has caused homeowners to drive consumption by spending the consequent property gains. This consumption has further driven up financial markets, thereby perpetuating the positive price momentum.

Why the divergence is potentially dangerous for investors

With house prices stagnating and household debt at record levels, consumption is beginning to tail off and there is a realisation that the consumers will not be there to support the very high earnings growth estimates and stock valuations. Importantly though, we do not feel it is time to panic: corporate health is historically good and the consumer will continue to spend, albeit at lower levels. However, for the majority of investors, such is the height of their expectations of financial market returns, that any pullback to economic reality, is a crash down to earth.

Grant Thornton's view on reality

Regardless of where the current fashionable destination of capital is, regardless of how exuberant fund managers are in the hope of realising huge capital growth, Grant Thornton Investment Management continues to base its expectations and forecasts for portfolio returns within economic reality: GDP plus inflation plus a suitable risk premium, depending on the investment. To achieve our objective of consistent returns, we do not ride the “rollercoaster” that is over-exuberant financial market expectations. We continue to invest in the best businesses in the Australian economy - a practice that has stood us in excellent stead amidst global volatility.



The oil price...it's high and that matters

Recent commentary would have us believe that consumers, businesses and the economy as a whole can withstand the effect of a high oil price without much problem. We are not believers in this optimistic theory.

The background of the rising oil price is based on a number of factors:

- Tight supply from OPEC
- High demand from India and China (where consumption grew by 16% last year)
- Financial speculation
- Fear premium over Iraq's invasion and terrorist activities in oil-producing countries (thought to have added US\$15)
- Lack of investment into oil infrastructure and exploration over recent years has seen reserves almost entirely depleted by strong demand. It is this reserve that can be used to control the direction of the oil price.

A high oil price has two negative effects on the economy. First, it raises input prices and that has the effect of raising inflation. Second it dampens consumption, by diverting consumer's spending into a higher petrol price. The unfortunate combination of these two factors produces stagflation: inflation combined with depressed growth. Every \$US10 increase in the oil price is thought to drain 0.5 % from economic growth, so this year's \$US20 move must have had a significant impact on global economies.

For economies to withstand this drag from the oil price, other areas of the economy must be strong. No doubt the global consumer's growth in wealth has been assisted by low interest rates and rising house prices, and national demand has been strong from US, China and India. However, interest rates are rising, house prices are moderating and China's demand for commodities is not predicted to continue at the current rate. Therefore, the rising oil price will inevitably start to bite.

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Woolworths (WOW)

Woolworths (ASX: WOW) has been a recommended stock within the Grant Thornton Investment Management (GTIM) Model Equity Portfolio for over ten years. Over this period, WOW has been one of the most consistently strong contributors to the GTIM equity portfolio return. WOW's outperformance as a business is reflected in their share price movement against Coles Myer (a stock which is not in our portfolio) as seen in the below graph.

Core Businesses

Supermarkets – WOW generates most of its earnings from this sector, with over 700 supermarkets trading under the Woolworths and Safeway brands and supported by a discount fuel loyalty scheme.

Liquor - in addition to existing brands such as Dan Murphy's, BWS, First Estate and Safeway Liquor, WOW has acquired an additional 4% of market share in the retail liquor market through the recent acquisition of Australian Leisure & Hospitality Group.

General Merchandise - Big W, Dick Smith Electronics and Tandy outlets have performed well in favourable economic conditions for discretionary spending.

Financials

Despite the fiercely competitive supermarket sector, WOW has been able to achieve excellent earnings growth. While costs have been lowered through a focus on supply chain management, a more significant factor is the ability of WOW to negotiate very favourable supply contracts. This has enabled WOW to keep prices low, building sales while still enhancing margins.

