

# Musing

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## A tale of two economies...

*"It was the best of times, it was the worst of times; it was the age of wisdom, it was the age of foolishness; it was the epoch of belief, it was the epoch of incredulity; it was the season of Light, it was the season of Darkness; it was the spring of hope, it was the winter of despair; we had everything before us, we had nothing before us; we were all going directly to Heaven, we were all going the other way" ..... Charles Dickens*

**What is going on? Australians' are told that their economy is doing wonderfully well, while other developed nations are virtually in states of despair, and key indicators back that up. So why isn't this being reflected in market returns?**

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## Let's pick on the United States...

The starting point for this pondering is **the daily assumption that whatever happened in US markets 'last night' will be directly reflected in Australian markets today**. Anyone who watches markets closely would notice that this pretty much holds true (in other words, it is more often correct rather than wrong).

We're not really going to pick on the United States – goodness knows that they already have enough detractors in the world. Rather, we are going to look at the relative positions of the United States and Australia to see if this daily market correlation is justified.

We'll start with a quick look at sharemarkets (which is where the average person will see the results of economies and businesses operating in them) then move on to look at the respective economies.

## Sharemarket performances

If we look at the Australian sharemarket and compare it to the United States, you can see that a local investor will have pretty much the same outcome from investing in either country over the last couple of years. In fact, Australia's market underperformed markedly during the depths of the global financial crisis (GFC).



### Notes on the chart

*The trickiest part of any market analysis is to determine a fair and correctly indicative time period for comparison, and what to use as your benchmark for measurement.*

*In this case, I've chosen the S&P/ASX 200 Price Index for Australia. It is the most recognised index, representing the top 200 companies listed on the Australian Stock Exchange.*

*For the United States, I've chosen to be a bit arbitrary, and use a share listed on the Australian Stock Exchange. It is an Exchange Traded Fund (ETF) run under the "iShares" business name. The code on the ASX is [IVV](#). It is basically an ETF listed in the US with the price altered each day to account for Australia's currency movements.*

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*Why have I chosen this measurement? Because it is the most accessible tool for keeping track of the relative performance of the US sharemarket in Australian dollars – in other words, it is as close to a 'real world' measure as we are likely to get.*

*The underlying index is the S&P 500 Index, which is much broader than the Dow Jones Index, and more representative of the overall US economy.*

*The IVV shares have been listed since 2007, so they are not long term BUT we are really looking at the relative performance post the Global Financial Crisis (GFC) and it is here where we should see any differences emerge.*

The long-term performance of the two markets suggests that Australia's economy *is* being correctly reflected in its sharemarket. The chart below shows the medium term outperformance of the Australian sharemarket against that of the United States.



**Figure 1 - Australia vs U.S. S&P 500 index**

You can see from the chart above that Australia's leading index (the S&P/ASX 200) has outperformed the US S&P 500 index.

We could consider shorter time-frames. If we look at the figures over 5 years then it still suggests our economic performance is being correctly reflected in our sharemarket.

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Figure 2 - Australia vs U.S. markets over 5 years

However, the key point we are looking at in this musings, is the relative performance during these 'best of times/worst of times'. That is, since the start of the Global Financial Crisis, a period in which the two economies have diverged markedly. So let's look at a simple plotting of the two indices, using Google Finance graphs..



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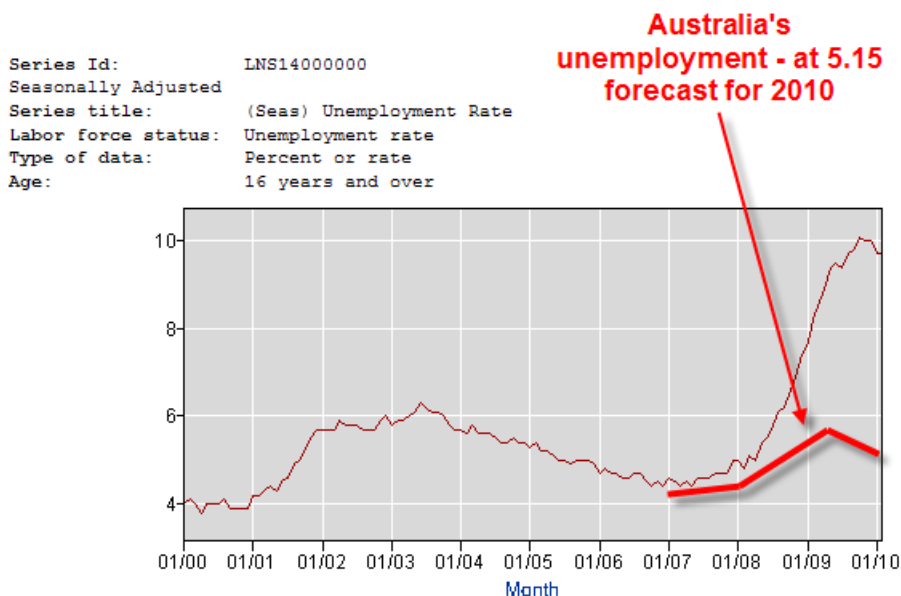
## Relative economic conditions - unemployment

The United States is currently going through a financial crisis that permeates all levels of society. The GFC has dented or destroyed house values, household wealth, the country's balance of payments, global prestige and power. National debt has exploded to levels last seen in WWII, just as the government receipts from taxes have dropped dramatically.

Unemployment is running at just under 10%. 41% of those unemployed have been looking for work for more than 6 months. Many analysts consider these 'long term unemployed' as being more likely to NOT return to the workforce at all. Now compare Australia...

Data extracted on: March 15, 2010 (3:55:51 AM)

### Labor Force Statistics from the Current Population Survey



I have taken this chart from the US Bureau of Labor Statistics and have shown in red Australia's approximate unemployment level as a comparison. Australia is clearly in a better position than the United States in terms of keeping a bigger percentage of the population employed, earning an income and able to spend money to keep the economy turning over.

To give an idea of just what this means, there are now 8,180,000 less people employed than was the case in June of 2007. Imagine the drop in 'spendable' money when millions of people are no longer bringing home regular work income? The average wage in the US is \$759.15 a week (\$39,475 a year). If we use that statistic on the increase in unemployment, we are dealing with \$322,912,044,000 of wages that is NOT moving through the economy anymore. Ponder that figure while looking at the chart and table below, which will help give an idea of the massive impact of this recession compared to that of 2001. (ref: <http://www.bls.gov/news.release/pdf/realer.pdf>).

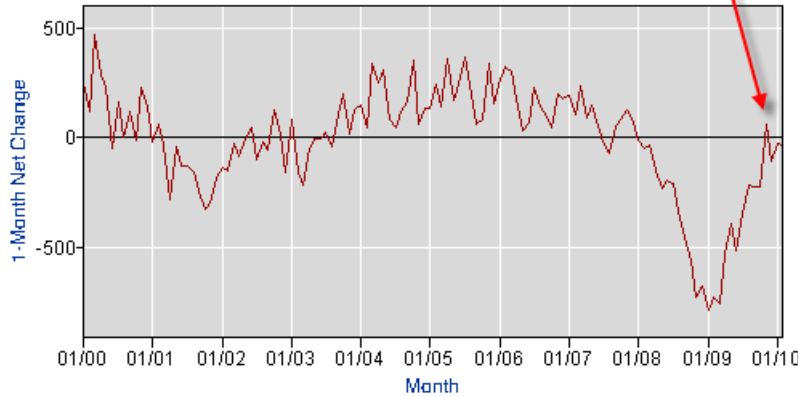
Data extracted on: March 15, 2010 (4:04:52 AM)

**Employment, Hours, and Earnings from the Current Employment Statistics survey (National)**

**1-Month Net Change**

Series Id: CES0000000001  
 Seasonally Adjusted  
 Super Sector: Total nonfarm  
 Industry: Total nonfarm  
 NAICS Code: -  
 Data Type: ALL EMPLOYEES, THOUSANDS

**All the graph shows is that the loss of jobs has slowed. It hasn't yet shown an actual improvement by the creation of jobs.**



Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Annual
2000	249	121	472	286	225	-46	163	3	122	-11	231	138	
2001	-16	61	-30	-281	-44	-128	-125	-160	-244	-325	-292	-178	
2002	-132	-147	-24	-85	-7	45	-97	-16	-55	126	8	-156	
2003	83	-158	-212	-49	-6	-2	25	-42	103	203	18	124	
2004	150	43	338	250	310	81	47	121	160	351	64	132	
2005	136	240	142	360	169	246	369	195	63	84	334	158	
2006	262	326	304	174	31	69	232	141	100	43	201	177	
2007	194	104	239	92	149	55	-20	-71	52	86	128	70	
2008	-10	-50	-33	-149	-231	-193	-210	-334	-458	-554	-728	-673	
2009	-779	-726	-753	-528(C)	-387(C)	-515(C)	-346(C)	-212(C)	-225	-224	64	-109	
2010	-26(P)	-36(P)											

C : corrected  
 P : preliminary

**Figure 3 - Highlighted area shows job losses since July 2007**

Of course, official statistics rarely paint the full picture. In addition to the 9.7% unemployment rate (that is, 14,871,000 people in Feb 2010), the US has 8,791,000 people in part-time jobs simply because they cannot find full time jobs. To work out the full impact of reduced job prospects for a country, you need to add these two versions of unemployment together. It's referred to as 'underemployment' and helps provide a better understanding of just why the United States is in the grip of recession and just how hard it will be for it to work its way out of it. Underemployment running at over 15% is disastrous for an economy attempting to cope with a massive loss of household wealth.

You could argue that at least 138.6 million people ARE employed (compared to Australia's 10.97 million), and that is a valid point. The problem is that the number of people employed in February 2010 is the same as the number that were employed in June 2000. That is a 'lost decade' in terms of jobs.

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In researching this note, I stumbled upon an awful outcome of all this – even worse than those above. It became obvious that the number of new jobs created during the (apparently) credit-fuelled growth from the 2001 through to the 2007 GFC was unlikely to be repeated by a savaged economy and yet, during these 'best of times', the United States economy only managed to create 7,867,000 new jobs.

**In other words, ALL of the jobs created in the good times were lost in the bad times - only it was achieved far quicker! All of that debt-funded credit was required to produce 7,867,000 jobs in 49 months, while it only took 33 months to lose 8,180,000!**

No wonder commentators are suggesting that it will take years to escape the clutches of this recession. Looking at minorities is even worse. Teenage unemployment stands at 25% nationally. (ref: <http://www.bls.gov/news.release/empsit.nr0.htm>). Imagine the impact that has on a national psyche?

**By contrast, Australia's unemployment has so far failed to reach a full 6% and is projected to reduce to around 5.1% (Commsec's current forecast).**

This would suggest to you that Australia is in a considerably better position than the United States.

## Housing Markets

Negative equity is a 'given' in many developed countries around the world. In the UK, 3.5 million households have less than 15% equity in their homes, while one in six 'prime' mortgages are in negative equity (ref: <http://www.guardian.co.uk/money/negative-equity>). Again, we here in Australia need to pause for a moment to ponder just what this really means. Think of those millions of people going to work, skrimping and saving where they can, just to repay a loan that is bigger than or close to the value of their home. You could argue that those millions of people would have been better off renting.

In the United States, **11.3 million residential properties with mortgages are in negative equity** territory. 29% of residential properties with mortgages have either negative equity or equity of less than 5%. Expressed in dollars, this means that there is a shortfall of \$801 billion on these properties. So even if the US Government were to spend \$801 billion supporting these people, all that would be achieved would be to bring them to the position where their homes were worth similar amounts to their loans. You can see the size of the job in front of the Government in dealing with this issue.

(ref <http://thebulletin.us/articles/2010/02/28/news/nation/doc4b8acfb5af21e906159789.txt>)

The amount of wealth wiped out by the declining price of residential homes in the United States is staggering. It is measured in trillions and defies human understanding.

A more helpful figure is to consider the average US house price. For new houses, it is \$203,500 for January 2010 (a six year low point) while for all single-family homes across the United States, it is \$163,600 (the same price as May 2002). Australia's average house price is somewhere near \$500,000 (note: the "average" house price is a hotly contested issue of late

but the overall figure for Australian capital cities varies from ~\$400,00 to \$500,000+). By way of comparison, the UK's largest property website, Rightmove suggests the average asking price for houses in England and Wales is £229,614 (\$381,574 in Aussie dollars). (Ref : AFR 16<sup>th</sup> March 2010, p43 Overseas Markets snapshot graph).

The best way of imagining what impact such changes would have on Australia's market would be to consider either the home you own or the house you live in and its price today versus its price in 2002... For most people that price would be half the current expected price. Now consider what impact a price decline of that size would have on you. (ref <http://www.bloomberg.com/apps/news?pid=20601109&sid=aYZxJTOI3w74&pos=15>). Alternatively, you could consider the impact while pondering the idea that Australians hold 60% to 70% of their accumulated wealth in housing and what it would mean if this was to suddenly halve in value?

And while pondering all of that international misery, consider for a moment the position of people living and investing in **Japan, where land prices are the lowest they have been in 36 years!** (Ref <http://www.businessweek.com/news/2010-03-18/japan-commercial-land-prices-slump-to-record-on-economy-credit.html>)... and it seems that the figure is set at 36 years only because price records started to be kept in 1974!

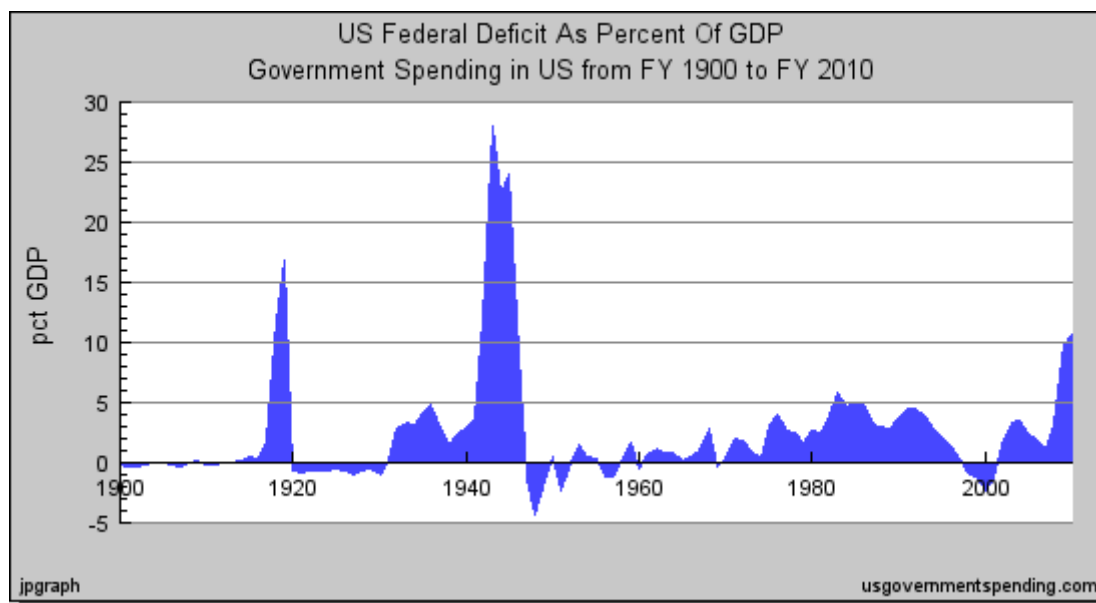
The ability of Australian housing to show only a relatively shallow dip through the early parts of the global recession could be attributed to a number of factors – but the key ones would logically be the subdued impact of unemployment and the ability of the major banks to continue to lend for residential property (even while clamping down on commercial property lending).

There are issues about this from the point of view of ongoing affordability, social cohesion and urban planning (see <http://www.demographia.com/dhi.pdf>) but we'll cover that in a later issue. Matthew Drummond reports in the AFR (13<sup>th</sup> March 2010, p24) that NAB's Joseph Healy suggests CBA and Westpac have pushed home loans to the detriment of job producing funding for small businesses. In other words, money has been kept or taken from productively efficient areas (business) to prop up an 'inefficient' area (houses). Others argue that housing makes up a fair slice of the Australian economy, and keeping the sector healthy is good for the economy. For an economists' view of the negatives of Australia's debt-binge on residential property, visit <http://www.debtdeflation.com/blogs>.

For the moment, let's just say the Australian property position is positive in terms of the overall economy. At any rate, Australian property economics are substantially better than those of the United States.

## Budget Deficits and Debt

Australia's current account deficit sits at 7% of GDP, while that of the United States has grown to over 10%. However, Australia has a decades long history of running a deficit whereas the United States position has deteriorated from that of 2000. The chart below shows the long term position of the US Federal Deficit.



**Figure 4 - U.S. Deficit as a % of GDP since 1900**

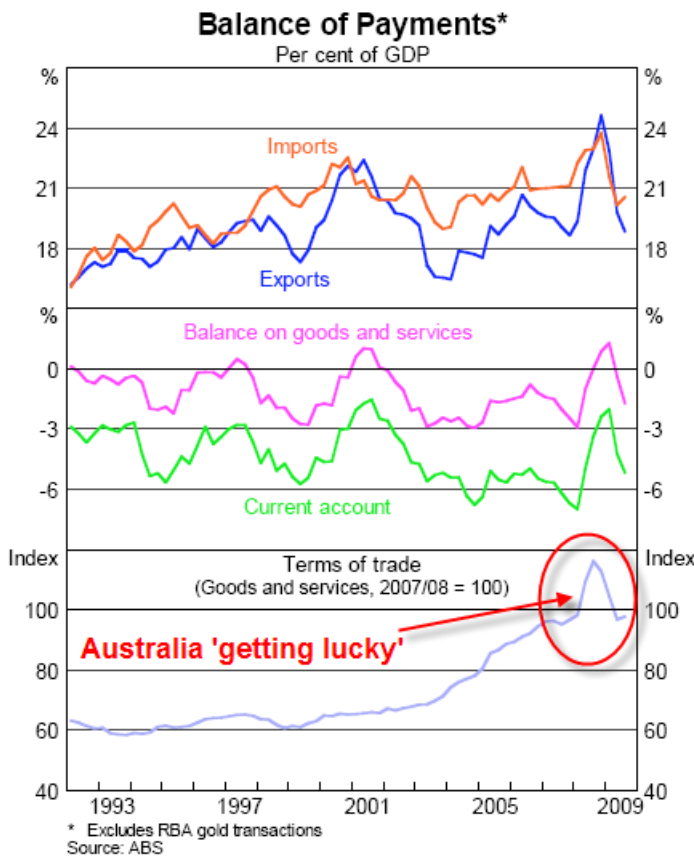
You can see from the chart that the Federal Deficit has reached levels last seen in World War II. Again, this highlights the reduction in Government income from taxes and other forms of revenue at a time when the claims on Government expenditure (two major regional conflicts on the other side of the world, increased unemployment benefits, interest costs on international borrowings, healthcare costs etc, etc) are skyrocketing. (ref: <http://www.usgovernmentsspending.com>)

The United States debt position is deteriorating so far that even Moody's is finding it necessary to start discussion on the [possibility of the US losing its AAA credit rating](#). This is truly momentous stuff. The linked article from Bloomberg points out that lenders are now, in effect, asking for a lower premium on debt issued by the large US corporates than they are for US sovereign debt! This may not sound like too big a deal – but it is worth remembering that the pricing of most fixed income securities and debt starts with comparisons against Government security benchmarks (such as US Treasuries).

To again go back to some fundamentals, classical economic theory suggests that government “crowding” of markets creates inefficiencies. That is, if the Government takes up too big a proportion of available credit then it can “crowd out” more productive business borrowers. “Last year the US Government borrowed \$2.1 trillion – compared to the \$1.08 trillion issued by investment grade companies” (same article). That is a lot of crowding out! And it is likely to get worse, with Public Debt forecast to move above \$20 trillion (90% of GDP) by 2020 – while the largest corporations have reduced debt to an historically low 28% of assets and increased their cash positions to \$2.3 trillion!

## Trade Position

Australia's terms of trade are currently very, very good. You'll notice from the chart that the commodity price spike of 2007-2008 benefitted Australia immensely. The price spike provided a boost to the national accounts that was a "fluke", in that volumes were not



that much different (Australia 'getting lucky'). It is one of the few times that we have benefitted from being a "price-taker" on world markets. I remember economics classes many years ago, where lecturers railed against Australia's incapacity to set prices for its goods – and giggle when I remember enduring years of updates from analysts suggesting that Australia would fall further and further behind global trends because all we did was dig stuff out of the ground instead of setting up intellectual capital in the form of websites... And then along came the "Tech Crash". Funny how the world turns, isn't it?

Still, the fact is we remain 'very lucky' when you consider we didn't do much extra to deserve the improved position...

(ref for charts : <http://www.rba.gov.au/chart-pack/balance-of-payments.pdf>)



The US balance of payments can be found here...

<http://www.census.gov/foreign-trade/statistics/historical/gands.pdf>.

Interestingly, the size of the deficit has reduced substantially over the recession period (improving from an annual \$701 billion deficit in 2007 to a \$378 billion deficit in 2009 – US\$). Is it because the United States is exporting more or importing less? History suggests that terms of trade in the US actually improve during recessions. Perhaps that is because an economy based heavily on domestic consumption can show a large

turnaround when its people simply save a little more and spend less?

Investment gurus and analysts are heavily divided on the likely long-term impact of the US economic mix of subdued employment, rising international debt, historically low interest

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rates and moribund housing markets. Some suggest the United States remains a powerhouse of the world's finances, and that this is nothing more than an adjustment for a period of 'irrational exuberance'. Others see the printing of money (so-called "quantitative easing") as being wildly inflationary, and forecast doom and gloom for the world's largest economy. From where I sit, the divergence is heavily reflected in the tone of the different investment newsletters from around the world that I subscribe to. Common themes for those coming from the US and UK are terms such as "investors will be blindsided", "if you don't act now, you stand to lose a large proportion of your wealth". In other words, inflammatory language that does nothing to paint a balanced picture of the potential outcomes.

For the more technically minded, here's a quick overview of the issues facing the US in the area of trading... (<http://www.tradingeconomics.com/Economics/GDP.aspx?Symbol=USD>)

### **Interpretation of US vs Australia globally - in 'michael-speak'**

One way or another, the United States is printing money to finance the release of cash and funding into the system. The hope is that this cash will find its way into productive areas, fuelling a recovery in the overall economy.

Unfortunately, the badly kept secret is that to achieve this, the Government first needs to provide funds directly to the same institutions that managed to create the GFC in the first place – and at ridiculously cheap rates. These same institutions are doing what they usually do – speculating those funds into areas that are likely to generate the highest/quickest return, and that process is highly unlikely to result in job generation – at least in the short term. The more likely result is speculation, such as commodity and currency speculation. In fact, a few economists have tried to quantify just how much of this 'hot' money has been used that way. One suggested answer is \$3.5 trillion of 'new' demand. (ref: [http://www.moneymanagement.com.au/articles/Economists-debate-bulls-vs-bears-at-van-Eyk\\_z513699.htm](http://www.moneymanagement.com.au/articles/Economists-debate-bulls-vs-bears-at-van-Eyk_z513699.htm)). So speculation abounds, while productive economic growth stagnates.

In other words, the US could see a 'jobless recovery' for a long time yet.

The US economy is definitely capable of moving out of recession. However, doing so will require strong policy-making decisions in the face of immensely powerful lobby groups. In other words, many commentators do not see the US as having the political willpower to make the changes that are required. Raising taxes may be 'doomsday material' in a supposedly free-market economy but is it logical to try to escape a debt-fuelled recession through the application of more debt aimed at generating growth? Wouldn't it be more appropriate to save more, spend less and take away the market power of the institutions that caused the havoc of the past? The recent court decisions in the US that allow corporations to spend more and more money on lobbying and political party contributions do not bode well for improving rational decision-making in the world's largest economy. Fuelling speculative activity is a dangerous pathway in such an environment.

In contrast, Australia has benefitted from this increased speculative activity, as the rising prices for our major commodities (iron ore, coal, oil and gas) has allowed shelved projects to be kick-started again, new projects to be commenced and suddenly we are back in pre-GFC "labour shortages" territory – with the result that wages and incomes are more likely

to be upheld. Currency 'carry trades' have benefitted us as traders use cheap US money to invest into our higher yielding dollar.

The United States debt position will improve as savings improve – but again that does not necessarily translate into growth. The trade position improves if the currency falls, and it is logical (but not necessarily certain) that the United States dollar has to devalue to reflect its overall economic position. To this extent the US has benefitted from its currency's position as the global reserve currency – in other words, it is the only currency market that holds the scale, liquidity and global acceptance to provide security for those trading internationally. That status basically 'rescued' the United States from a currency implosion. There is no doubt that most participants realised the absurdity of the US dollar becoming a "safe haven" during the depths of the GFC, with institutions prepared to pay the US Government to look after their cash. [Albert Camus](#) would be muttering into his coffee-cup.

## China and the United States

The catalyst for a great deal of this fluidity of currency positions is related to the actions of China. As the GFC unfolded in 2008, China moved to 'peg' its currency to the United States dollar. Since that time, the exchange rate has remained fixed at 6.83 yuan to the US\$. The primary reason for doing this is to ensure that China's exporters are able to keep their products lower priced in the global market. If China's currency were to lift in comparative value then their goods and services would be more expensive internationally – and it must be remembered that China's global reach has increased predominantly because of the strength of its exports (its 'manufacturer to the world' status). To achieve this dollar stability, China continues buying US dollars, creating a false market in the currency.

If this were to stop then perhaps there is room for United States dollar to depreciate, and for exports to lift in relative value as a boost for the economy and growth prospects? The currency issue is a big one, as the Chinese authorities have basically used it to provide their exporters with an advantage in the global scene. That advantage has seen the Chinese foreign reserves lift to \$2.4 trillion, a world record – up over \$450bn in 2009 alone - when the bulk of the developed world has been looking into a financial abyss. Although it can be argued both ways, this has undoubtedly helped them to fund the continuing purchase of their \$889bn of US debt. In effect, it could be argued that the United States is providing China with the cash for China to lend back to it. Feel free to contradict me on that one but that is my reading of it. For a look at alternative views, see this argument between more serious economists

(<http://www.bloomberg.com/apps/news?pid=20601087&sid=aUIA5q4yU8dg&pos=5>)

China has been reducing the time horizon of its US debt portfolio, increasing the risk to the US that the funding could be removed – leaving the US in a difficult position to try to raise further funds in the global market. The end result would be dramatically higher interest rates. One alternative open to the US Government is to allow inflation to lift, thereby reducing the comparative level of debt – but this is an option that is regularly denounced by US policy makers. Another alternative is for the US to allow the value of its dollar to fall (which in 'international speak' means it is giving up its global superpower status).

The United States may have had its sovereign prestige dented but it is far from toothless in dealing with its problems. It could be more strident in demanding China remove the currency peg to take away that price advantage. After all, China's economy is currently looking stronger and displays better growth characteristics than the US economy so why shouldn't its currency increase in relative value? Some may argue that this would start a 'trade war'. If so, the United States is most likely just as capable of sustaining a trade war as China is, as its economy is based heavily on domestic consumption whereas China's is heavily reliant on exports.

Let's just hope that it doesn't get to that point, and I am certain the "Depression-schooled" powers in the Federal Reserve will do their utmost to make sure it does not. The current Federal Reserve Chairman is renowned for his studies of the Great Depression and many see a trade war as an invitation to send the US economy into a plunge equivalent to those horrible times. An optimist will say that 'The Fed' will not let that happen. A pessimist would ask, "does the Fed actually have any control..?" Here is comment from a newsletter that has a rather negative outlook on such matters.

<http://www.elliottwave.com/freeupdates/archives/printer/2010/03/17/RATE-ing-In-Vain-Market-The-Fed-Is-Not-In-Control.aspx>).

Similarly, let's hope that the US currency issue resolves itself slowly, and in gentle steps. If not then we are likely to return to our age-old position of hostage to global markets. Remember the phrase "when the US sneezes, Australia catches a cold" (probably terribly misquoted but you get the idea...).

## China and Australia

In contrast, Australia has its fortunes now firmly tied to those of China. This has benefitted the total economy immensely over the past few years and has helped cushion us from the worst of the global financial crisis. The massive financial stimulus unleashed when Chinese Authorities allowed hugely increased lending resulted in rebounding demand for iron ore, coal, copper, nickel and other key industrial inputs.

However, these ties bring a greater risk to us from any potential for a slow-down in the Chinese economy. There are arguments that China is currently in the midst of the 'Greatest Bubble in History'

(<http://www.bloomberg.com/apps/news?pid=20601010&sid=aNZe4JWeV1aw>). I am not so certain but there is no doubt that the Chinese economy is strongly driven by speculative plays. The Chinese sharemarket is "valued at 32 time reported earnings compared with 52 at its peak in October 2007. the U.S. benchmark S&P500 Index trades at 19 times earnings." However, the Chinese economy is growing at over 10%, while the US economy is nowhere near that. Chinese land prices have rebounded to pre-GFC levels.

It doesn't mean China is cheap or expensive but it does mean that the growth is likely to be fully priced into markets at the moment, suggesting that any correction in growth will have a leveraged downward impact on markets.

This is reflected in the market volatility increasing each time Chinese authorities make changes to their national lending levels – as they recently have when increasing the level

of reserves that banks have to keep for a given level of debt. Those changes have immediate impact on Australia.

However, Australia is to some extent fortunate that we are so small on a global scale. The world does not need to spend all that much on our goods for our economy to benefit in a proportionately large way. It remains to be seen just how much our future prosperity is tied to the 'China story'.

### So, what does this mean for our markets?

The key point of our considerations however, is the comparison between Australia and the United States, and to ask ourselves why our better economic position is not being reflected in the pricing of our markets...?

Australia's sharemarket is up 56% from its 2009 low point, while the S&P (in its own currency terms) is up 72%!! In the face of the economic fundamentals, how do we explain that?!

Does it mean that Australia's sharemarkets are due to move higher? Does it mean that our markets will "delink" from the daily gyrations of the US markets? Are currency markets taking away the gains we should be displaying?

These are all 69 dollar questions, aren't they? If we get enough feedback, perhaps we can ponder that in a lot more detail. As usual, comments and corrections cheerfully received – even if often ignored.

### Michael O'Hara

Ps.. lovers of irony will relish the fact that the comments on China being in the midst of an asset bubble were made by a previous head of [Long Term Capital Management](#), while comments on the credit-worthiness of the US Government were made by the (ex) head of [Lehman Brothers](#) fixed income trading division.... Irony rarely gets better than that...