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Charlie's morning thoughts; Australia being de-rated; Robin Rudd pressing the self-destruct button

Good morning,

“For every action there is an equal and opposite reaction” - Newton’s third law of motion.

I am finding it quite difficult to express in words exactly how disappointed/despondent I am with the Rudd Government’s management of the Australian economy and in turn the perception of Australian assets they have created in a global investment context.

It nearly brings me to tears because it is absolutely against everything I believe in and have worked for over the years (raising capital for Australian projects, promoting Australian investments, promoting foreign investment etc). I am watching Australia being de-rated before my eyes. It’s a disgrace, it is avoidable, but it’s happening. It’s like watching a bus crash, but a bus crash which I had a premonition of, yet, in which I am a passenger!

To watch the ASX200 fall -49 points yesterday after the Dow rallied +143 points was just heartbreaking. Why was it heartbreaking despite my very conservative Australian equity strategy stance? Because I am an Australian capitalist and **I am watching Australia commit global markets suicide.**

Even this morning, Australian ASX200 SPI Futures (-2.15%) are down more than the Dow (-2.02%). Yet it’s even worse when you currency adjust with the Australian dollar -1.65% and the US Dollar Index +1% overnight. **We are being de-rated as a Nation; make no mistake.**

If you read only the local popular press you would think this resource super profit tax (RSPT) was a grand idea, but that is certainly not what the influential global financial press is writing and I can assure you it’s the global financial press that influences global investor views of Australia, not our domestic press. I can also assure you that **the marginal pricer of Australian equities are global investors, not domestic investors.**

The Wall St Journal (News Corporation, buy) is without doubt the most influential global financial newspaper. Below I am going to publish the entire WSJ editorial on the proposed Australian RSPT. Remember this is what the global investment community reads and acts on.

The Rudd Mining Grab

Australia is the only developed country that didn't have a technical recession after the global financial crisis, mostly because its mining sector kept feeding China's economic boom. Now, the Labor Party government has decided all that wealth creation was a bad thing, and it's time to levy a 40% "super-profits" tax on these companies and redistribute the money.

The news was delivered Sunday in Canberra by Prime Minister Kevin Rudd and Treasurer Wayne Swan as the centerpiece of a proposed tax-reform package two years in the making. They argued that mining companies did so well that they sucked labor and capital out of other parts of the country, creating a "two-tier" economy. Mr. Swan says he wants companies to be "growing together," and would use the tax take to build infrastructure, help low-income workers with their pensions and "fund" a tiny, across-the-board corporate tax cut.

This economic thinking runs counter to everything that made Australia rich over the last three decades: namely, the embrace of competition and capitalism, which rewards high risk with high returns. Setting up a mining company is not akin to opening a restaurant. Companies invest billions of dollars in exploration, build infrastructure to bring their products to a port, and then have to compete in a global marketplace and deal with volatile prices for their goods. As Rio Tinto recently discovered, the political risks of selling to countries like China are high, too.

Now the Rudd government wants to impose an arbitrary diktat on one of the country's most globally competitive industries in the name of "fairness."

*The government claims it settled on the 40% rate by following the lead of other trend-setters, like the U.S. state of Nevada. But why not 50%? or 60%? **The truth is that all windfall taxes, however they are dressed up and sold by politicians, are arbitrary and economically damaging.** BHP Billiton estimates the "super-profits" tax would raise its total effective tax rate to about 57% from 43%, making Australia one of the most burdensome places to mine in the world. The increased tax burden would reduce profitability, discourage future investment and restrict companies' ability to return cash to shareholders through dividends.*

That money, instead, will be redirected to the Rudd government, which estimates it will reap 3 billion Australian dollars (\$2.8 billion) alone in 2012, the first year the tax would go into effect. The Minerals Council of Australia estimates mining companies already contributed about 16% of all corporate income tax revenue last year. BHP alone paid A\$6.3 billion in Australian company, state and other taxes over the same period.

What Messrs. Rudd and Swan didn't say Sunday is that this bonanza helped fund the Labor government's unprecedented spending spree, which sent the country from a A\$19.7 billion surplus into an A\$32.1 billion deficit in a single year. Lately Australians have been treated to a raft of revelations about how the Rudd government and the bureaucracy mismanaged billions of dollars of this spending.

*Given that record, it's hard to have faith that Sunday's announcement is about "fairness" as much as it's about plugging fiscal holes that the government itself created. **It doesn't hurt to whip up populist sentiment against big corporations in an election year, either.***

If Mr. Rudd really wanted to reform the corporate tax system, he would simplify it and cut Australia's sky-high rates much more than the proposed trim to 28% from 30%.

That would spur investment, create jobs and ultimately, a bigger tax base. What politician wouldn't like that?

I agree with all of the points the WSJ editorial makes. You can also see **many foreign investors agree via simply voting with their feet in the listed Australian resource sector and selling indiscriminately**. There has been relentless selling of Australian resource stocks across the board since the RSPT was first speculated earlier last week, with the cost of equity capital for every Australian resource company rising to reflect increased regulatory risk and lower future returns from existing and planned operations.

You must understand how bad this makes us look in a global perspective. The Federal Government basically said (in my words) “it doesn’t matter if foreign investors receive lowered returns on their Australian investments”, which I would suggest is the single most stupid thing you can ever say to a foreign investor. **It’s like flipping the bird to foreign investors and look what the market reaction has been.** This is also a very stupid strategy considering Australia, due to its low population and savings base, relies on foreign investment to fund growth (and even fill a wholesale bank lending gap).

This is a majorly negative event for Australia’s perception and relative rating in a global context. As much as people like me always like to talk up Australia’s prospects, the fact of the matter remains that at just 2% of the world’s global equity indices we are not a “must own” country. **But how stupid are we to give global investors an excuse to “move on” from Australia!** This RSPT is going to be used by foreign investors as an excuse to either go naked or underweight Australia. They are already sitting on huge Australian dollar gains so they can actually sell stocks at these new lower prices and lock in large US dollar based gains. In the case of BHP and RIO they can sell them here and buy them in London 20% cheaper. **But be very sure of one thing; if our currency also gets on the skids (which I think it will) it will ACCELERATE foreign investor outflows/repatriations from Australia equities.**

As I have written in these notes repeatedly, and clearly Canberra never read them, **the surest way to make foreign investors head for the exit is to continually move the regulatory goal posts, let alone tell them you don’t need their help.** However, wholesale change to a taxation system of our major export sector based on windfall taxes (p.s. how is it a windfall profit if you only have to achieve a return above the long bond rate to be taxed?) when your resource stocks attract a premium rating to the world is simply policy suicide.

Similarly, the other issue is that there is such a lack of detail in the government’s RSPT release that analysts can’t even model potential outcomes in the resource sector. Again, uncertainty and a lack of visibility leads to a lower P/E and trust me, while the government will never tell you this, **the policy is HURTING ALL AUSTRALIAN’S.**

Despite the spin from Canberra that foreign investors are the loser of the RSPT the truth is almost ALL Australians who have a super fund are. **BHP Billiton Ltd is 65% owned by Australians. I would suggest almost every Australian super fund, including industry super funds, has some direct or indirect exposure to BHP Billiton Ltd.**

BHP Billiton Ltd has 3,356,081,497 shares on issue. BHP Ltd shares have fallen around \$7.00 per share since the Resource Rent Tax was first speculated in the press. That equates to \$23,492,570,353 in lost market capitalisation. Australian’s own 65% of that \$23.5 billion lost market which equates to \$15.2 billion. Well done Canberra, you just lost Australian investors in BHP Ltd \$15.2 billion and I would argue that \$15.2 billion loss is across almost every Australian who has a super fund.

But wait there’s more; The negative sentiment from the destroying of Telstra (\$20 billion market cap loss itself) and now the devastation of the resource sector is **spreading to the broader market with the ASX200 now -7% below recent highs** and commanding an ever widening P/E rel discount to its 10 year average P/E, and a widening performance discount to the OECD world. **That -7% index**

loss equates to A\$82 billion wiped off the value of our benchmark equity index, and I can tell you that government policy has been the major factor in driving that fall. Again, almost all Australian super funds have exposure to that \$82 billion paper loss.

Again, this reminds me just how ridiculous the Henry Tax Review recommendations are. Put more into retirement savings yet simultaneously devalue Australian assets via new taxes. Genius, pure genius.

While there have been dramatic pullbacks in Australian resource stocks and better value is apparent, I want to remain tactically underweight (as I have all year) as the market digests the long-term ramifications of any RSPT. Remember this also coincides with the seasonally weak period for commodity stocks globally, while the short US carry trade is also under heavy pressure as we have warned (DXY +1% last night, industrial commodities creamed). Chinese data is also starting to disappoint, while Chinese property prices are also wobbly. I just think we have some time on our side here before trawling through the trading carnage in the resource sector. Sure, selectively there are resource stocks that have fallen enough and I will try and pick a few as the weeks go on, but **do not underestimate what a blight this proposed RSPT is on Australia's perception in the eyes of foreign investors.**

This is a majorly negative event for Australia's perception as a stable and safe investment location. That must effect our global P/E rel even if a RSPT tax never becomes law. It must also lead to the discount rate foreign investor's use in their Australian models rising to reflect increased regulatory risk. I see the P/E rel of the ASX200 not only reflecting the earnings potential of its constituents but also the broader perception of "management of the Australian economy". Even the WSJ is questioning that economic management ability now, and that is not good for the relative rating of our benchmark index, while foreign investors continue to vote with their feet (via selling) in terms of management competence of the Australian economy.

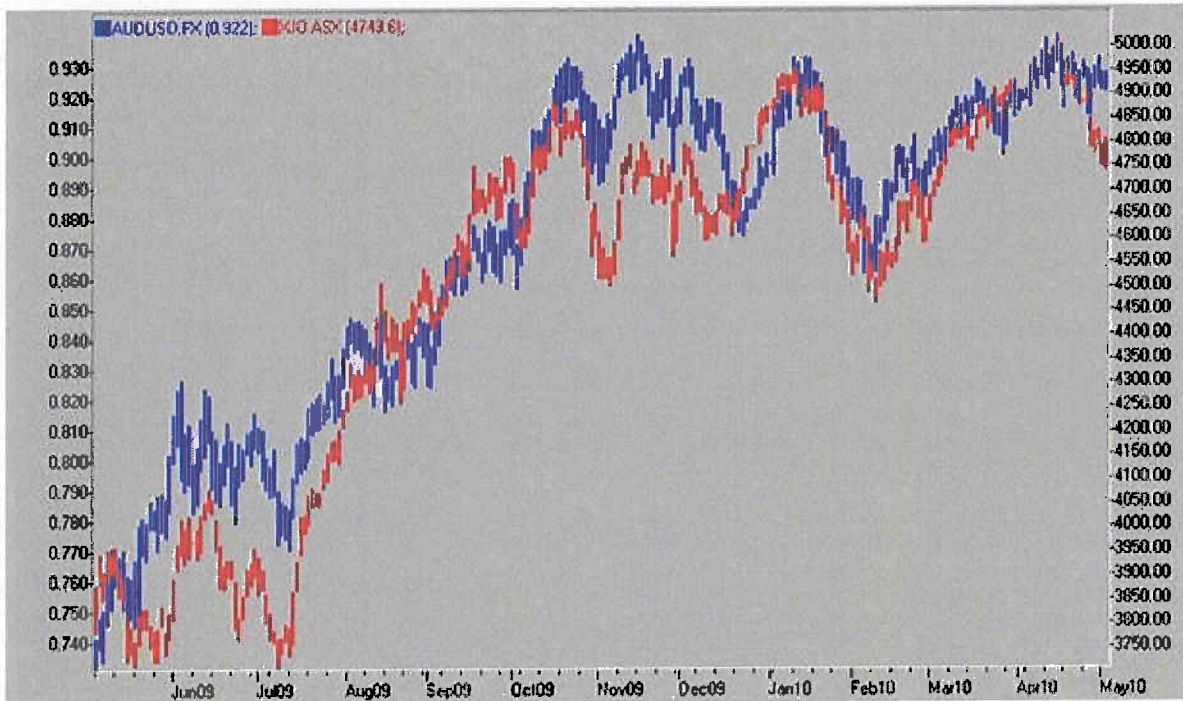
If you don't believe me, look at your screens. **The price action never lies, but politicians do.**

The other issue global investors point out to me as an issue with Australian equities is the seemingly heavy handed monetary policy of the **Reserve Bank of Australia**. I have also warned the RBA in these notes that they are out of touch with the reality of the slowing domestic consumer economy, but it seems they are targeting housing and housing alone. But **I simply don't believe targeting housing demand is the way to fix a chronic housing supply issue.** Similarly, do we think monetary policy slows immigration and population growth that is the real driver of housing demand?

I think the RBA has overplayed its monetary policy hand fighting a structural housing supply/population growth issue it can't fix and a somewhat imaginary inflation demon based off unsustainable commodity prices. I think the economy was already slowing (stimulus fade, retail sales etc) and the second half of this year could see a genuine slowdown as excessive interest rate rises kick in. That is why I continue to recommend a short Australian consumer discretionary strategy (MYR, DJS), versus long consumer staples (WOW, MTS, CCL) and US consumer exposure.

I also believe the Australian dollar MUST be a victim of all this. The currency is the "share price of a nation" and our **MUST fall**. The Australian dollar has held up better than the ASX200 but the correlation tells you the AUD is headed lower. Again, that reaffirms our overweight US dollar industrial earner stance.

ASX200 versus AUD; mind the gap, AUD target 86usc



This is just a terrible, terrible period for Australia Inc. **To write accurate domestic equity strategy I basically have to think like an increasingly desperate politician with socialist tendencies, a huge budget deficit and sinking opinion poll ratings.** I am fighting the invisible hand of policy irrationality. How would I react to stay in power? Would I act in the national interest or my own interest?

Simple answer; **put a windfall profits tax on banks and never touch anything to do with housing.** Never ever threaten the value of an Australian's house, but bank bashing and bank taxes are an automatic vote winner.

I see the first Australian politician to get on the "bank tax free kick bandwagon" surfaced yesterday and I am certain he won't be the last as I warned yesterday.

Family First Senator Steve Fielding said the government should start taxing the super profits of the big four banks with their "obscene" billion-dollar profits. "Instead of penalising the miners with a tax for being successful, the government should look more closely at the big four banks, which have been ripping off ordinary Australians for decades." Senator Fielding said in a statement.

All I will say is "beware the populist politician in an election year".

In the mean time I maintain my strategy of being invested as far away from Canberra as possible. Large scale US dollar earners did outperform in a horrible market yesterday and I expect that to continue in today's horrible market (NWS, WDC, CSL, QBE, AMC, BBG, RMD, COH, ALL, BXB, CPU etc). And just to rub salt into the wounds, **resource stocks with PNG assets outperformed our Australian assets!** Dear me.

I just hope Canberra via their ill-conceived, short-sighted policy hasn't made Australian equities the easy hedge fund short of the Asian region. This week's price action would suggest they have. That is a terrible outcome for all Australian's, any Australian with superannuation, and our future growth prospects.

Oh Mr Rudd, what a mess.

Go America.

Go Australia.

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