LOW INFLATION AND INVESTMENT PLANS

HOW SUPER FUNDS WILL PLAY THE 1990s

By GEORGE KERR

Australia's 20-year period of rampant high inflation looks to be ending. For investors, particularly superannuation funds, this means a new era of opportunities is beginning.

THE period from 1974 to 1990 was an extremely turbulent time for the world's investment markets, largely because of the inability of central banks and governments in many of the major economies to control inflation. Even the most casual observer recognises that inflation and investment methods do not go well together.

At times, sustained asset price growth resulting from underlying inflation gives the illusion that inflation is good for investment markets. However, in the long term, the relationship does not hold. Inflation distorts investment decisions, as it causes money to flow to non-productive assets that benefit from inflation, such as property and gold.

The inflation problem grows inexorably, and central bankers attempt to fight it with high interest rates and tough fiscal policies. In almost all cases this leads to severe overkill in the form of tight restrictions on credit with resulting damage to business confidence and new investment. Asset values based on excessive and inflation- adjusted income-stream growth become unrealistic. A correction becomes inevitable.

Over much of the 1980s, investment strategies based on asset growth generally benefited from Australia's persistently high inflation rate. However, expectations that this inflation cycle will continue to dominate investment markets through the 1990s are unlikely to be realised. This discussion will focus on why a low-inflation environment is more likely now than at any time over the past 17 years and how this will affect key investment strategies for superannuation funds.

A low-inflation environment

From 1900 to 1974 Australia enjoyed an average annual inflation rate of less than 4 per cent. However. between 1974 and 1990 inflation rose to a remarkably high average of 11 per cent. The oil crisis and wage indexation contributed to an inflationary spiral that has only recently appeared to be nearing an end. The current downturn in inflation figures can be explained partly by the recession; however, other fundamental factors, both global and local, should not be ignored in attempting to determine the long-term trend.

First, the global influences. The next decade is likely to bring relative price stability to the global economy. The damage caused by high and variable inflation to business activity, long-term employment and national creditworthiness has created an increasing awareness in the electorate and among policy-

George Kerr is a New Zealand-based analyst with the securities and investment firm IPAC Securities Limited.

makers of the need for responsible fiscal and monetary management. The international capital markets will impose severe disciplines on the economic policy-makers and punish those economies with high inflation. The South American countries with four-digit annual inflation rates are a stark illustration of the consequences of not observing the appropriate disciplines.

In short, the increasingly open financial markets of the world will reduce the ability of countries to set independent fiscal and monetary policies. Although in the short term some countries may ignore this reality, any country that aims to be competitive in the long term will have to submit to the disciplines of the financial markets. In the case of South America, most of the major economies are beginning to follow more orthodox economic policies.

Closer to home, we are beginning to see a more subtle example with the gradual divergence of bond rates between New Zealand and Australia. The New Zealand central bank is charged with achieving zero to 2 per cent inflation by the end of 1993, a goal that appears increasingly credible. While the task has certainly been made easier by a severe recession, the prospect of long-term price stability has recently been enhanced by a budget that tightened fiscal policy.

Over the past decade, Australia has generally experienced markedly lower bond rates than New Zealand, but in recent months the gap between the major long-term bonds of comparable maturity in the two countries has spread to well over 100 basis points. The central bankers of Australia have, in the short term, reduced their focus on inflation in favour of growth. The reaction of financial markets has been to attach a risk premium to Australia, relative to New Zealand, and to build in expectations of a slightly higher inflation rate than New Zealand's.

Australia's inflation expectations are low by recent standards—-hence the sharp drop in bond rates experienced so far—-but the bond market provides a telling comparison of the inflation prospects and the fiscal and monetary policy credibility of the two countries.

Australia's inflexible labour market and oligopolistic pricing structure will ensure that threat of inflation will still exist into the 1990s. However, the world trend towards price stability should outweigh domestic factors. In addition, as Australia increasingly loses competitiveness against countries with more deregulated micro-economies, structural reform will become more probable and palatable.

Combined with more disciplined macro-economic policies and lower global inflation, this should keep Australia's inflation rate well below that experienced between 1974 and 1990, a period that was exceptional in world economic history.

INFLATION (JUNE QUARTERS)

	1990	1991(f)	1993(f)
UK	9	5.8	4.5
US	3.4	4.7	4
Japan	3.0	3.4	3
Germany	2.7	3.5	2.7
NZ	5.5	2.8	2.0
Australia	7	4.3	4

Investment strategy issues in a low-inflation environment

Taxation: The interaction of inflation and taxation and the resulting impact on investor and company behaviour is a key investment issue.

During times of high inflation, investors earning interest are severely penalised by the Australian tax system. A major part of the interest payment is compensation for inflation but the tax system does not differentiate between the components of the interest payment, and taxes on a nominal basis. Consequently, after-tax real returns tend to be lower in a high-inflation environment than a low-inflation environment, and cash and fixed-interest saving is discouraged. Real after-tax yields from fixed-interest securities will be enhanced with a move to a low-inflation environment and the incentive to save should increase.

In particular, for superannuation funds with concessional tax rates of 15 per cent, the focus should be on high-yielding assets.

The interaction of the tax system and inflation also distorts investment decisions in the business sector. In a high-inflation environment businesses are encouraged to raise debt and increase holdings of real assets. This increases the risk associated with equity investment, due to higher gearing ratios often based on inflated asset-values. The most obvious examples of this in the 1980s were property investment companies, but industrial companies, too, were over-investing in real assets such as commercial buildings. Effectively, the artificially low real cost of money to fund real assets is being funded by the tax system, which in turn is being funded by the inflation tax on debt investors discussed above.

Cash and fixed interest. Despite lower nominal interest rates, mainly as a result of falling inflation, "real" interest rates will remain high for the foreseeable future. This is obviously beneficial for investors in cash and fixed interest.

A number of factors indicate that real rates will remain high. A growing worldwide demand for capital will tend to bid up its effective cost. There are several sources of added demand in the 1990s. The first is the cost of financing the bail-out of the US financial system, in particular the savings-and-loan institutions. Further competition for scarce capital should come from the development of Eastern Europe, economic support for the Soviet Union and the rebuilding of Kuwait. As demand picks up, particularly in the United States, normal business activity and healthy growing economies will reinforce the higher-than-usual demand for capital.

Equities. In a low-inflation environment, investors' attention should turn to maximising long-term income growth rather than asset growth.

Dividend yields are now, on average, above the annual inflation rate, on a sustainable basis, for the first time since 1970. At no time during the 1970s were dividends providing a real rate of return.

In times of low inflation and lower interest rates, high-quality shares will provide the best returns. This environment enables companies to plan their future with greater certainty. Moreover, in Australia, companies with strong cash-flows and those becoming more internationally competitive will attract higher values. With domestic demand likely to be relatively weak for the early part of the 1990s, companies with parts of their business offshore and exporting companies will perform well.

In the early-1970s, price/earnings ratios collapsed as inflation surged. The average price/earnings ratio for the All Ordinaries fell from 14 in late 1973 to less than 6 a year later. The recent decline in annual inflation in Australia has not seen a dramatic turnaround in these ratios, as the overall earnings-growth outlook has been poor. However, since January this year the valuation of shares in quality companies has risen. It is likely that the valuation of quality shares will be at higher average levels than the 1970s and 1980s as low inflation becomes more certain.

Given a high degree of market focus on earnings growth rather than asset growth, the ability of Australia's corporate managers will come under the spotlight. A cyclical downswing is an excellent opportunity for a business to lock-in very low costs; it is also a threat to those who do not contain their costs, since they are unable to increase prices to cover inefficiencies and cost increases.

Sustainable low inflation will be good news for the best of our managers, but low inflation is ruthless in exposing inefficiencies. Business margins have probably never been tighter, so to acquiesce on production costs, notably labour, at a time of relative price stability will directly and adversely affect the bottom line.

The impact of high real interest rates and low inflation will force companies into rigorous control of low-yield assets such as inventories and debtors. Management–whose performance had been masked by easy asset revaluations, liberal accounting interpretations and an inefficient tax system–will be exposed to tighter reporting standards and limited revaluation opportunities.

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Property. The international property markets in the past three years have been affected by the correction following the high-inflation, high-demand excesses of the 1980s.

Property investments during periods of low inflation should be made with an eye to the future growth of the income streams. The key criteria, as is true at any part of the property cycle, are the quality of the properties, tenancies and length of leases.

In the past, listed property trusts have traded more often at a premium to their net tangible asset backing than a discount. While the short-term volatility of listed property trusts is similar to that of the equity market, the long-term returns depend on the ability of the trust to produce a sustainable and growing income stream.

Through the discounting of prices, the listed property trust market has tended to anticipate falls in property values. The income returns from property trusts, compared with those of other income-earning investments, are currently very attractive.

With markets in a low-inflation environment focusing on yield, the listed property market becomes a higher-return/lower-risk option than many direct property alternatives.

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Conclusion

The current improvement in Australian inflation should not be seen as merely a function of the cyclical economic downturn. The 1990s is likely to be a period of relative price stability compared with the high inflation of much of the past two decades. The key reason is the use, in most major economies, of relatively tight monetary and fiscal policies to control inflation pressure. While recessionary phases, such as that being experienced in the US, will see short periods of looser monetary policy, it is likely that any growth focus will not be at the expense of long- term inflation prospects.

While Australia has a number of inflation influences of its own, specifically an oligopolistic pricing structure and an inflexible labour market, the low-inflation story is likely to be repeated here as policy-makers become less independent in their choice of fiscal and monetary settings. Investment strategies for superannuation funds should not be set on the experiences of the high inflation of recent years, but on the longer-term reality of relative price stability. The focus for strategy will move sharply away from asset growth, and more towards income growth. Some investors in the 1980s, especially in the property sector, ignored the fundamental truth of asset values in that income stream is the key determinant of value. Superannuation funds that ignore this in a low-inflation environment will sharply underperform. Inflated asset prices disguised the mistakes of many investors over recent years, leading to low performance differentials between players; however, a focus on yield as the major component of returns is likely to result in wider performance differentials