

### 2003 International Outlook

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## Happy New Year!

Hope you had a great festive season – we did!



## 2003 International Outlook

If last year wasn't difficult enough for investors, 2003 may be shaping up with renewed uncertainty on both geo-political and economic fronts.

Perceptions regarding war against Iraq are currently the dominant short term influences on stock markets worldwide. Much has been written on worst case scenarios, however it is the investor's perception whether it is a diminishing risk or a deferred risk that may cause a short term rally in stocks provided that the military action is a success. Obviously any rally would be subject to other considerations such as the US current account deficit, mixed corporate earnings forecasts and the deflationary menace threatening the global community.

It may be perceived that a major benefit arising from an attack on Iraq and overthrowing Saddam Hussein would be that it could provide the required stimulus to revive their domestic economy via military spending, but presumably assure the US of cheaper oil to fight the deflationary menace and stimulate economic growth.

On the US home front, Bush's proposed personal tax cuts and abolition of double taxation on corporate dividends are other measures in an attempt to divert the US away from potential deflation and revive a flagging economy.

Why the emphasis on the US? Well, it is the largest and most powerful economy in the world and the implications (both foreign and domestic policies) arising from the US has a profound impact on the global community in general.

We have summarised three important topical issues which will impact government policy and investment returns now and into the future. The views expressed are the culmination of numerous written articles that we have perused from financial and investment "gurus". Where possible we have made reference to the article and the writer.

### Deflation

Deflation is popularly defined as a general fall in prices; it is the opposite of what most people think of as inflation. We normally view falling prices positively because we can buy more with our money. Yet as long as the price declines in some goods and services roughly matched the price increases in other goods and services, we tend to have overall price stability. Price stability is desirable because it enables producers, consumers, debtors and lenders to make long term plans.

Deflation, like inflation, upsets stability and can inflict unexpected consequences for key assets such as real estate to fall in price. Deflation means that debtors must pay back in more valuable dollars than the ones they borrowed.

In a recent editorial in the *Washington Post* dated 9 January 2003, the article warns of deflationary problems facing the US. "Deflation could pose extraordinarily serious problems for an economy where private-sector debt levels have soared in recent decades. That's because deflation increases the real burden of debt." The article states how much more difficult it would be for the Federal Reserve to conduct countercyclical monetary policy. "Once short-term rates fall to zero, they cannot fall any more. The Fed would then be compelled to use other, less-effective tools in its policy arsenal."

In the recent speech to Congress, the Federal Reserve Chairman, Alan Greenspan reassured Congress that “we are not close to a deflationary cliff” and that the central bank has the necessary tools to flood the country with money and get prices up and the economy going again.

Many analysts, looking at Japan’s deflationary demise over the last several years and China’s enormous deflationary impact on global manufacturing, have forecast that the US, Germany and a number of other countries would slide into deflation. This is why Greenspan’s Fed and the Bush Administration have stated that they will do whatever to stave off this deflationary menace.

*David Fuller*, the renowned international analyst and chartist, concluded recently with reference to this issue that “there is little chance that the US will follow Japan’s deflationary path.” This is because the US would undertake a more aggressive monetary policy and the fact that the US financial system is in relatively good shape – and hopefully there is sufficient capital to absorb any large losses such as Enron and WorldCom.

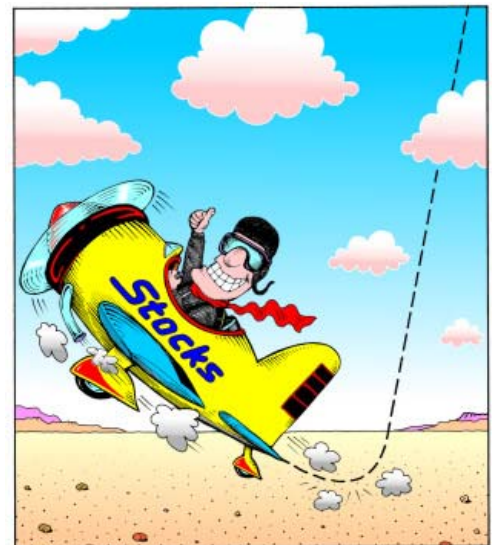
David Fuller added that any aggressive monetary policy would move long-dated government bond yields upwards and hence “bond prices dropping which could mean some cushion for stock markets as “safety first” investors reduce their weighting in government securities relative to stocks.”

## US dollar

There are strong views amongst the investment community that the US dollar is overvalued and we should see continued weakness. The weakness in the US dollar is attributed to a number of factors including, surplus dollars created by the Federal Reserve in recent years, concerns over the large US current account deficit, low interest rates, prospect of war and more recently, as reported by *David Fuller*, “Federal Governor Ben S Bernanke’s suggestion last month that the US could avoid deflation by printing money, a growing suspicion that the US government welcomes a somewhat weaker dollar and the strength of gold.”

For the past few decades, the US dollar has been the lynch-pin. It has been the currency that other countries have been prepared to accept as the “standard”, as a store of value.

A “strong” dollar policy has been part of the US economic mantra in recent times with the belief that a strong dollar would attract foreign investment. Foreigners now hold \$7 trillion of US assets: 13% of the US stock market, 35% of the US Treasury market, 23% of the US corporate bond market, and 14% direct ownership in US companies are now in the hands of foreign investors. So the question really is: how good are investments in the US at this time? This is where the foreign investors strike some real problems. This is best summarised by *Bill Gross*, *Managing Director of PIMCO* – bond fund specialists: “the strong dollar policy has created a market where bonds and shares now have lower yields and much higher P/E ratios than most other alternative markets. This policy has surely put the US in a corner from which either a falling dollar, depreciating financial markets, or both are inevitable.



## Gold

With an already uncertain global environment, there has been a lot of discussion regarding gold and the opportunities that it presents to investors. Over the last year there have been numerous articles discussing the pros and cons of the notion that the long bear market for gold may be on its last legs.

The dominant feature for the case in an optimistic outlook for gold is a shift in the supply/demand dynamic. Over the next few years supply will likely decrease due to;

- Continuing industry consolidation will likely result in closure of marginal operations
- Fewer new mines coming on stream, much reduced exploration activity and a time lag to bring new operations on stream
- Gold producers reducing forward sales
- Potentially less speculative activity on the short side (selling borrowed gold in the hope of buying back later at a lower price), alleviating some selling pressure

Additionally, there are several factors that may play a role in stimulating investor interest and improving the demand side of the equation such as:

- The slow US economy affecting the US dollar. Historically, the US dollar and the gold price have had a strong negative correlation.
- Economic uncertainty causing 'safe haven' buying. Derivatives 'blowups', the Enron debacle, dodgy accounting practices and Japan's precarious position do nothing for investor confidence.
- Technical factors triggering further activity - Recently, the six year downtrend line from a high of \$418 in early 1996 has been broken and longer term moving average crossovers have given a buy signal. A sustained break of the \$330 key level will be highly significant psychological factor.

*David Fuller* expresses his continued bullish outlook for gold. In his latest *Fullermoney* report, he discusses the trend for gold and its breakout from its 21 year secular bear market. Here is an excerpt from this article:

"I am always interested in recovery situations, since most secular bear markets are eventually followed by bull trends, often of a similar duration. What would fuel a long-term recovery for gold? Investment demand from holders of US dollars, including Americans, China's government, the Japanese and hedge funds. Japanese investors could also resume their purchases of gold in preference to yen-denominated assets. While gold's long-term outlook is unequivocally bullish in my view, secular uptrends usually begin slowly. It has already taken five years to complete a base in the US dollar price of bullion.

Recently, people have been rediscovering gold as a value play. Consequently it is being remonetized in the eyes of investors, and some central banks. Gold was the 3<sup>rd</sup> strongest currency last year, behind the high yielding South African rand and the Norwegian krone. Gold could easily be the strongest currency, not only this year but also over the next 10 years. However when everyone is talking about gold, as we have seen recently, it is susceptible to a pause and consolidation."

Interestingly, reports from the *Anglo Far-East Bullion Company* (a private bullion banking and services company), have confirmed strong hoarding and buying of gold by Russia, China, India and the Arab world. They suspect that the Arab world realise they are trading a diminishing asset (oil) and are not prepared in the long run to accept paper issued by a potential political adversary (US dollar).

### So what can we expect in the year 2003?

Despite the "good times are just around the corner" spiel so often expressed by investment advisers, we at **PlatinumHouse** have a cautious outlook for the following year. 2003 may be another negative year for equity markets especially overseas and particularly the US.

With a negative outlook for the US dollar, the attractiveness of investing in US assets will diminish as the threat from deflation unfolds. However the correction in the US dollar will not happen suddenly especially when we look at the sorry state of the world's second and third largest economies, Japan and Germany. The US may look a risky place to invest today but with a bit of luck, the tax cuts proposed by the Bush Administration and the impending war in Iraq may give the equity market a slight leg up in the short term and provide some (albeit low) positive economic growth for the year. If the Fed's aggressive reduction in short term rates from 6.5% to 1.25% in just short of 2 years didn't do the trick maybe war will.

**PlatinumHouse** agrees with these views and because of the prolonged weakness in international markets and continued economic uncertainty, we are actively recommending to many of our clients to reduce their international exposure upon any short term improvement in equity prices, based on each client's situation.

We are looking to re-weight client portfolios towards other asset classes and investments which have characteristics of income, capital preservation and lower overall volatility.

The opportunities that lie ahead are not the same that existed in the past.

Happy investing!

## Competition: Getaway to Hyatt Regency Coolum, QLD

How does 2 nights in luxury accommodation at the Hyatt Regency Coolum sound? To be in the draw all you have to do is send in your answer to the question in this issue of the HouseBulletin by **14 February 2003**. Too easy!!

### To Enter:

Send your answer on the flyer supplied to: "Hyatt Competition", GPO Box 5275, Sydney NSW 2001  
Or email us at [advice@platinumfp.com.au](mailto:advice@platinumfp.com.au), with your name, phone number, and your answer.

**Good Luck!!**

### Competition Question

"The \_\_\_\_\_ that lie ahead  
are not the same that existed in the past."

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