THE INDICATOR

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ECONOMIC INDICATOR SERVICES



We start this issue with a review of the world economic situation. In our view the prognosis is not good. Extreme caution is required. First up we look at **Russia**.

The situation in Russia could only be described as grim. Many of Russia's banks are insolvent. Some have not reopened since August. Many key commodities are in short supply or highly priced on the black market. Some areas of Russia have been reduced to barter, (not that Russians are unfamiliar with this process), and a lot of Russian workers have not been paid for months. And when they are paid, it is often in goods produced by the company employing them.

The situation is a disaster waiting to happen; not unlike Germany of the 1920's.

Russia has debts falling due next year of some $US 20 to 25 billion, with little prospect of further lending availability. Their actual outstanding foreign borrowings is well in excess of US$100 billion. If the government resorts to printing money, watch out. Every previous historical instance of serious fiat financing produced hyper inflation, usually ending in revolution. As Fortune magazine noted, Nov 9th, page 34, (and it is indeed ironic); Lenin himself once declared the best way to destroy the capitalist system is to debauch the currency.

We could be wrong, but it looks like Russia is disintegrating into lawlessness.

**Asia**

All subscribers would be well aware of recent events to our northern shore. We point out further, only that the problems that have surfaced - the boom leading to bust - will not be overcome in the next 6-12 months. Most of Asia will remain depressed for several years yet. EIS recently was able to have another good look at Hong Kong:

Hong Kong's official unemployment rate is 5%. This is very high compared to the usual rate experienced in HK of between 1 and 2%. Union response was that the real rate was around 13% due to lack of registered unemployed. Few social security benefits are paid for unemployment in HK.

Those in jobs are having to face the reality of pay rises of around 2% rather than the 10% that they have become accustomed to in recent times. For many young employees this is the first time in their working life that they will be entering the new year without a 10% pay rise. Employers are also questioning the one month's bonus which has traditionally been paid to staff in January to help them cope with the additional expenditure for Chinese New Year.

Poverty in HK appears to be on the increase, with an increasing number of beggars on the streets. Once you venture out of the tourist precincts, even a few streets from Nathan Road, the local accommodation resembles shanty towns.

Real Estate prices have slumped by 50% since January 1998. Twelve months ago potential buyers were awarded flats by lottery with the apartment number and then a name drawn out of a barrel. Whilst in Hong Kong, news bulletins reported that real estate agents had come to fisticuffs on the streets as they strived to be first to reach potential buyers. Two days later front page headlines told of rival bank representatives coming to blows as they waited outside housing developments in an attempt to be first to reach buyers who had just been signed up by the real estate agents !

The general feeling of doom and gloom in HK is pervasive. Much of the rest of Asia is suffering from a critical lack of capital - in the form of bad loans and doubtful debts. A substantial rebuilding process will be necessary, which has hardly even started yet.

Some estimates have put the recapitalising process at a cost of around $US100 to $120 billion. For the more troubled economies of Thailand, Indonesia, Sth Korea and Malaysia, such a bail out of bad loans will cause economic contractions over the next two years at least. This will be for some Asian economies not unlike what Victoria went through in 1991/92, except their problems are much worse.

**China**

China has not been immune from trouble either. It is interesting how deflation is now a worldwide phenomenon.

China's Guangdong International Trust Corporation, (GITIC), went bust in early October with $US 2 billion in debts to western banks. GITIC had been considered a safe investment but was caught out playing in shares and real estate, having shifted from its prime reason for existence - infrastructure building.

China has massive overbuilding in most of its major cities now. Expect to see China being forced to write off a lot of real estate losses - a problem that will not be solved overnight. This will lead probably to a few years of very little growth.

**Japan**

Japan's bad loans might be a lot worse than is being publicly admitted. Fortune Magazine, Nov 9 issue reports; "When Japan's asset-price bubble was being inflated in the late 1980s, bank loans increased by almost $1.7 trillion - the lion's share of that secured by real estate. The government's Economic Planning Agency reckons that in 1989, when the bubble was at its most distended, the market value of land in Japan was $20 trillion (four to five times Japan's present annual GDP, and three times America's). Tadashi Nakamae, who runs an economic consultancy in Tokyo, thinks Japan's land is now worth only about $8.5 trillion. On the conservative assumption that about 10% of that $11.5 trillion loss is tied to bank loans, Nakamae calculates that the banks' bad debts amount to some $1.2 trillion - about 30% of GDP and twice the official estimate".

EIS likes this evaluation as it involves a realistic estimate of their land value. Japan will not solve these problems in the near future. In their favour however, is the fact that Japan is a net creditor nation, and maintains a high savings rate.

We continue our review of the world economic situation with a look at the Sth American / **Latin American** region. Events in this region are important for the US market more than any other. US banks have a higher exposure to this region than other areas. Latin America is considered important to US exporters as well. One fifth of US exports are to Latin America. Within the region, Brazil is the perceived problem.

Brazil's GDP is larger than SE Asia, including Hong Kong. Brazil has its currency pegged to the US dollar. But capital has lately been flowing out of the country, putting pressure on the currency. To defend his currency, Brazil's President has been lifting interest rates and spending precious foreign reserves. (Sound familiar ?) Speculators see the currency as overvalued, which it is, inviting speculative attack.

With Brazil's interest rates lifted to over 40%, it has added to the interest burden the government still has to pay on its own debt, making its own spending deficit even larger. Any suggestion of a currency devaluation is perceived as not helpful to investor confidence either, as it rekindles memories of rampant inflation. Brazil's inflation rate in 1994 was 2600%, (two thousand six hundred), one of the prime reasons for the introduction of its latest currency, the Real.

Devaluation problems are also linked to Brazil's debt problems, some $US 300 billion of it internally, and $US 60 billion externally via the current account deficit. Devaluing the currency makes this debt harder to pay off. Just ask Russia; it couldn't manage, and defaulted.

The proposed solution; another G7 bailout, via the IMF. A $US 40 billion rescue package is proposed. Why ? To preserve the present value of the Real, so it doesn't devalue like what happened in SE Asia. This, it is hoped, will restore confidence and allow the Brazilian government to eventually lower interest rates back to normal levels. And of course pay its debts when due.

Brazil is considered fundamental to the operation of the world system by all the big international market players; the worlds banks are owed more than $US300 billion by Latin America. But the IMF imposed conditions are austere, just like they were in SE Asia; return of the public sector debt to surplus ie, higher taxes, lower spending. Good proposals for a recession if anything.

Is an Asian rerun in Latin America possible ? Who knows. But the IMF have to win this one. Watch developments here closely.

**United States**

From Bloomberg, off the net, December 4th; "December is the 93rd month of the current economic

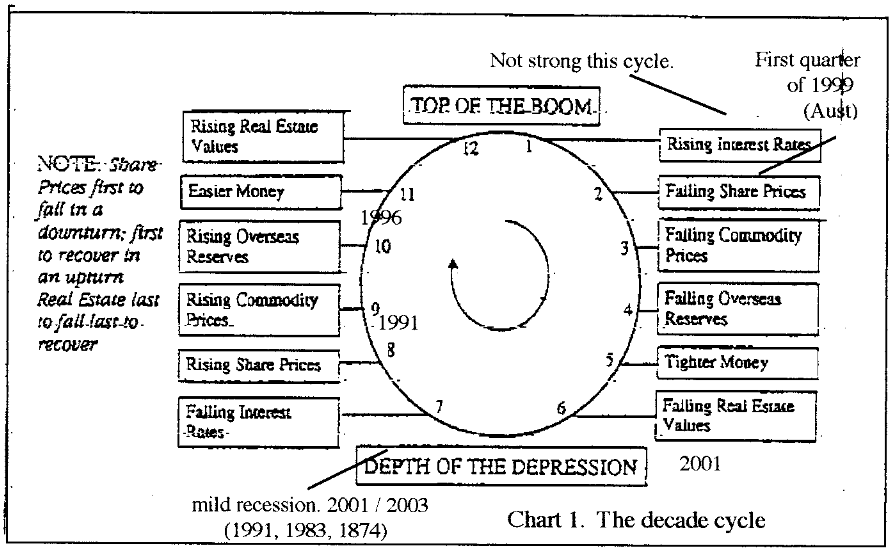

Chart 1. The decade cycle

expansion. This exceeds the 92 month Reagan era expansion of 1982 - 90. The only longer expansion was between 1961 - 69, coinciding with the build up of the Vietnam war"

In fact the Vietnam war extended the expansion. Of course there could always be a first time, but these expansions don't run forever.

**Overview**

So what is to be made of all this ? In the past, with such doom and gloom around, buying the stock market has been in order. As we have continually suggested. But what has been interesting this decade, is that each economic 'crisis' has become progressively worse. A classic Kondratieff wave phenomenon on the downside of the wave. The 1991 property crash and then gulf war. The '92 UK currency crisis, '94 Mexico crisis, '97 Asia, '98 Russian bond default, with Japan just continuing to drift.

~ Governments have 'rescued' the situation each time, setting up what some are calling a 'moral hazard' situation; speculators and reckless lenders becoming reliant on automatic lender of last resort bailouts. But note, the liquidity of the IMF is now below 20% of its reserves, the lowest point ever reached. And still more nations are queuing up to request support; the Ukraine, Pakistan and now Argentina. Member nations of the IMF may have to dig much deeper yet.

~ We are seeing Reserve banks around the world lowering interest rates in the mistaken belief that their actions control the business cycle. Central bankers are reducing interest rates in an attempt to bolster world growth rates in 1999. This is seen as a pre-emptive strike to stave off possible recession next year, at least for those economies not already there. Do not be fooled by Reserve Bank actions.

Reserve Banks cannot control the business cycle, though they attempt to do so through manipulating interest rates. In the past, such actions have always made the business cycle more volatile, and usually worse. Current actions will not be an exception. The forces governing the business cycle are endogenous to the system and way beyond the control of market players. The business cycle has not yet been repealed.

Lower interest rates feed first and foremost into higher asset prices. This is making the American bubble economy even higher than it should be. Stock markets do not defy the law of gravity forever.

~ What EIS also finds disturbing is the extent of government buying, to support asset prices. It has been very large purchasing this time around. All the IMF loans for a start (more than $US 120 billion committed), then Japan with all its stimulus packages (highest in modern history), and now Hong Kong authorities intervening directly in their own stock market, spending almost $US 20 billion of its $US 100 billion or so foreign exchange reserves to do so. We alluded to this likely scenario in our May Indicator, with the use of a WD Gann quote;

"*When everybody had bought to capacity and started to sell, there was no one else who wanted to buy and collapse was inevitable.*"

When the buying will stop who knows, but it will happen. (Time cycles are suggesting soon). The economic scenario in which this may occur, is not encouraging.

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Chart 2. Aust. interest rates.
(90 day bills commenced 1969.)

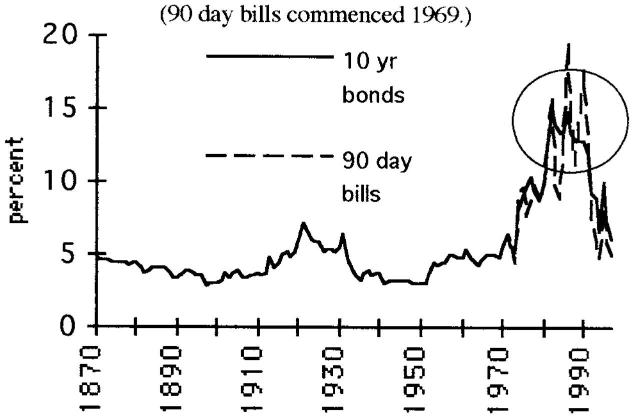


Chart 2 illustrates the extreme volatility of interest rates over the previous twenty years. (Note also the volatility, though less so, of the 1920's.) The current extreme volatility is an historical abnormality, and most unlikely to continue. It seems to be linked in with the longer wave price extremes that have been measured over much longer time frames, shown clearly in chart 3. The final thirty years of each of the four price peaks shown in chart 3 gave the world unprecedented volatility in all markets. The same as now. History repeating ? There is strong evidence to suggest so.

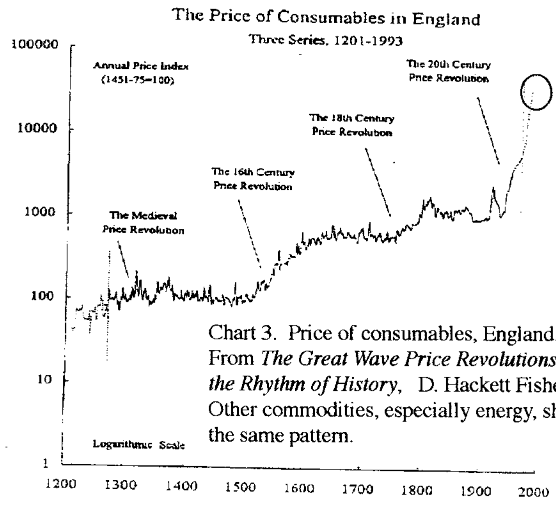


Chart 3. Price of consumables, England. From *The Great Wave Price Revolutions and the Rhythm of History*, D. Hackett Fisher. Other commodities, especially energy, show the same pattern.

**Bull market signals.**

In trying to assess where the stock market is, in relation to the business cycle, EIS keeps a list of ten or so headings for a helpful comparison of history. At the moment, this list is more appropriate for the US market, which has been running full steam ahead most of this decade.

Our bull market indicators, as we call them, go as follows, and many of them have recently gone past amber. The headings are interesting to watch as economies move into the peak of the business cycle.

Valuation
Valuations are stretched, though they can remain this way for years without worry. Average P/E ratios in the US are around 24. In other words, an investment in a basket of S&P stocks will take 24 years to get your money back. This is high by historical standards. The average dividend yield is at all time low levels of 1%. Valuation matters. Markets have in the past always returned to historical norms of around 12 to 14.

Floats
These bring in the "mum and dad" investors. It puts stocks in the hands of 'weak' investors, many of whom will be first time investors with no experience of a real bear market. And bear markets always follow bull markets. Floats are running at record levels, heavily oversubscribed. And when everyone has bought to capacity........

Mergers and Acquisitions
These are running at record levels in the US. Red light flashing. Mergers and Acquisitions are a continual process of course, but this year the mergers have been huge.

Leverage
We note that US brokers last month lifted margin requirements for those trading internet stocks, from 10 to 50%. Also, stock markets approaching peaks get more violent, with bigger swings between tops and bottoms, often exposing the most highly leveraged players. Long Term Capital Management (LTCM) hedge fund broke all records with its leveraged positions. It's leveraged position was beyond belief.

Speculation in other assets
Noticed how hard its been to hail a taxi this year in Melbourne ? Circumstantial evidence we agree, but taxi licence plates (a government granted privilege) are being hoarded. A regular business cycle peak occurrence.

Sentiment
Bullishness in the US is hot, so too the speculation. The internet business Earthweb listed at $14 the first week of November and immediately shot to $70. globe.com recently traded to $97 from its list price of $9. This company has lost money each year.
Note also the comeback in cigars. Now there's a cyclical pattern. Mr Rene Rivken is just about to start up a new cigar store business, and says "the new wave of popularity is off the back of the US sales surge......" (AFR Nov 20)

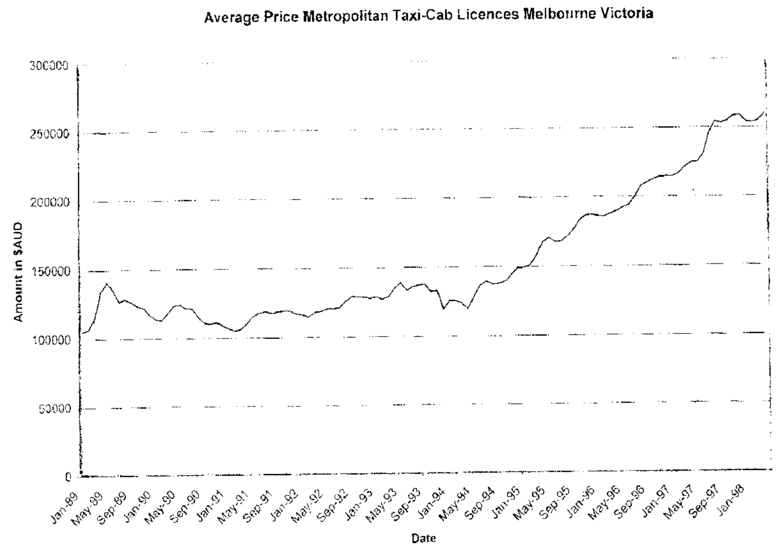


Chart 4. Taxi licence plate prices, Victoria.

Gurus
As the speculation heats up, financial experts are all the rage, and take regular column space in all papers. Nobel prizes are even going to mathematically minded derivatives 'genii'. (Though the gloss has come off this with the latest LTCM debacle).

Fraud levels
A tough one to judge. What we look for are public company accounting standards irregularities. Chairman of the US Securities and Exchange Commission, Arthur Levitt, announced in October that he believes many US companies are tweaking their results, and that the quality of management reporting is eroding so rapidly that "managing may be giving way to manipulation".

Bloomberg reported December 9 that more and more corporate clients are "feeling pressured" to boost earnings, by fair means or foul, to please Wall Street. (Though they caught 'Chainsaw Al' Dunlap at Sunbeam, when he tried to bring forward sales to bolster Sunbeam accounts, the share price, and hence his options on stock).

Watch this, it means earnings are coming under pressure.

Earnings outlook
It is difficult for EIS to believe US company earnings will improve into next year. Our view is that world fundamentals are deteriorating.

Bank credit growth
This one is very important. Bank lending almost always surges just prior to the decade cycle peak. We quote from Dr Jim Walker, chief economist at Credit Lyonnaise Securities (Asia), also reported in the AFR, Sept 12th. In the US. "relative to trend, the bank lending proportion has risen sharply, especially in the period since the end of 1996. The seeds of a sharp economic downturn have already been sown in the US....")

EIS measures similar stats, only we use land value as a proxy, since most bank lending is secured by it, as we illustrated in October's Indicator. Dr Walker warned in advance of Thailand's impending bust. The sole economist to do so. He measures the right statistics in our view. You have to measure these sorts of things to understand why economic prosperity mostly terminates cyclically in economic collapse.

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As Australia moves into the downside of this decade cycle, our current account deficit can be expected to worsen. We highlighted this expectation in the February '98 Indicator. Other economic institutions may start forecasting large upward moves in interest rates to control this deficit, as per immediate past decade cycle patterns. We believe interest rate increases are unlikely.

Prices, interest rates and inflation are more likely to settle into much greater stability at lower levels. Our reasons for this view were outlined in charts 2 and 3, page 3.

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EIS is no longer bullish about the Australian economy, indeed the rest of the world also, and its prospects into next year; the first time this decade our view has changed. It may not be the popular view going into 1999.

We anticipate a final stock market surge, expecting a price of 2950 on the All Ords, or slightly higher, to complete the price and time cycles currently in operation.

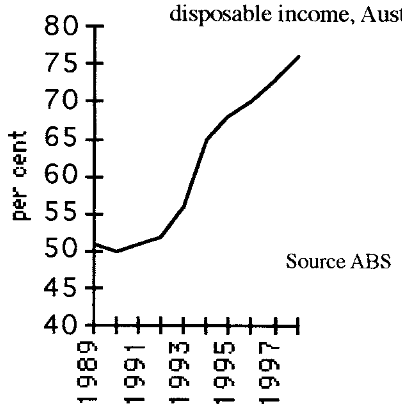
Land price has gone too high, and much of the world is now indebted to banks, up to their eyeballs. This is a dangerous situation

A lot is now dependent on authorities and government action over coming months. More than is generally realised by the investing public. The IMF must win in Brazil. But they are up against powerful speculative interests, a currency clearly overvalued when measured against fundamentals, and a resource owning elite not interested in the wider community. A default from Brazil will produce economic chaos.

We strongly emphasise that the impending US stock market collapse, that everyone else has spent the last three years forecasting, hasn't happened yet. It may not happen at all. Some extremely productive inventions, and amazing productivity improvements have taken place there this decade. It is a very strong economy. And it is possible that Brazil / Latin America, Russia, and SE Asia could recover okay next year. Who knows ?

What can be said with certainty is this: it is a time to be exceedingly cautious, with a good deal of spare cash on the side, pay down debt, and a have strict savings plan in operation.

Chart 5.
Household debt as a percentage of disposable income, Australia.

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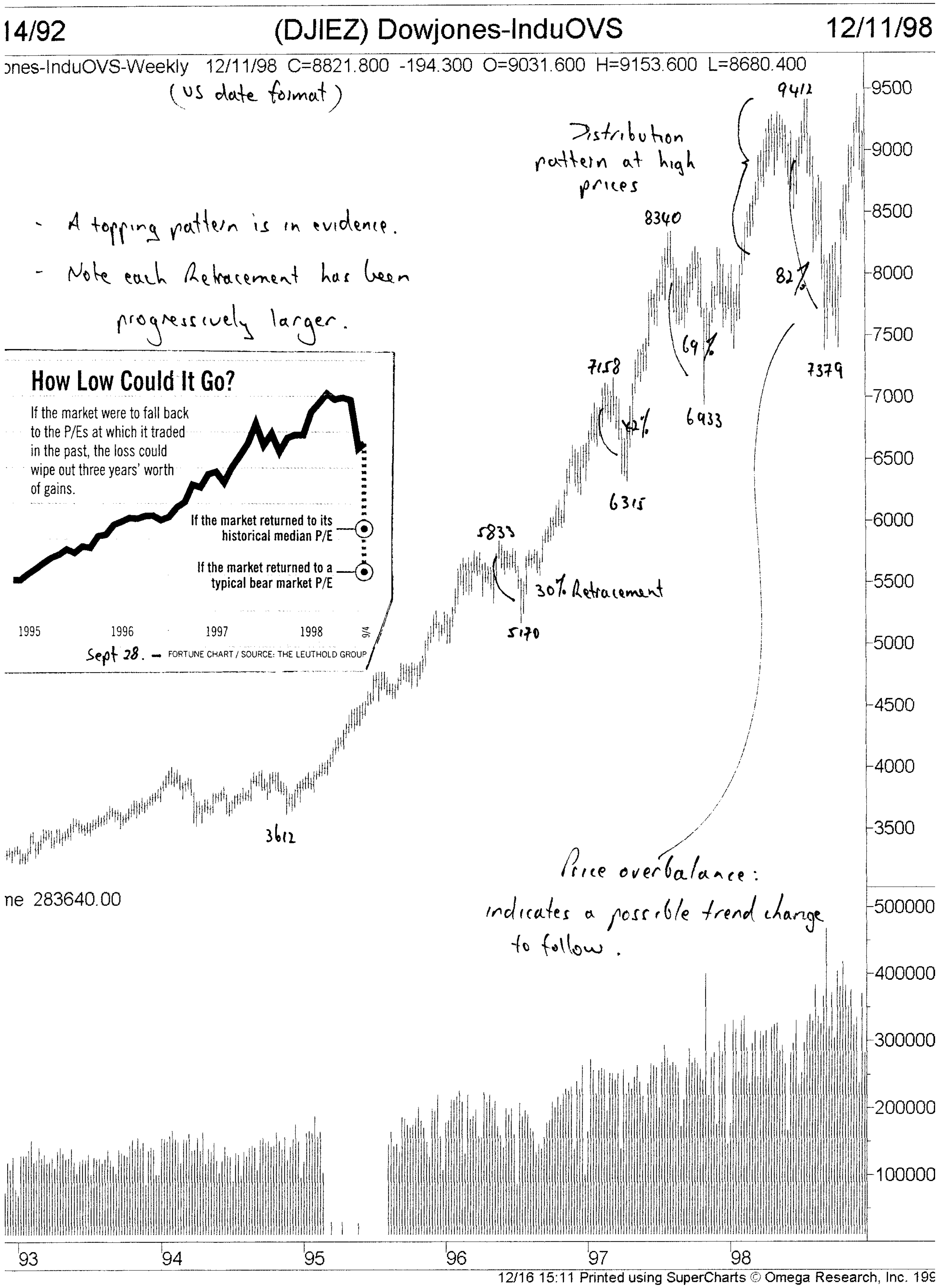
14/92
(DJIEZ) Dowjones-InduOVS
12/11/98
ones-InduOVS-Weekly 12/11/98 C=8821.800 -194.300 O=9031.600 H=9153.600 L=8680.400
(US date format)
- A topping pattern is in evidence.
- Note each Retracement has been progressively larger.
Distribution pattern at high prices
How Low Could It Go?
If the market were to fall back to the P/Es at which it traded in the past, the loss could wipe out three years' worth of gains.
If the market returned to its historical median P/E
If the market returned to a typical bear market P/E
1995
1996
1997
1998
9/4
Sept 28.
FORTUNE CHART / SOURCE: THE LEUTHOLD GROUP
9412
8340
82%
69%
7158
7379
42%
6933
6315
5833
30% Retracement
5170
3612
Price overbalance: indicates a possible trend change to follow.
ne 283640.00
9500
9000
8500
8000
7500
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# The new world order means low inflation

*Comment*

**ROGER BOOTLE**

THE WESTERN world is entering a new period of prolonged low inflation, approaching conditions of price stability. Yet, although we have come to think of continued inflation as the norm, it is in fact the exception.

Until the Second World War there was no persistent inflation in the UK, nor, indeed, aside from the isolated bursts of hyper-inflation, in the industrial world as a whole.

After the Second World War, however, there came 20 years quite unlike anything that had gone before. Prices rose in every single year without fail but, aside from the short Korean war period, never by very much.

After that we had 15 years of inflationary crisis. Some commentators even talked of hyper-inflation round the corner. This was followed by 15 years of broadly decelerating inflation. By 1994, inflation in most of the industrial world, including Britain, was back down below 3 per cent. It is not that the post-war inflation rates were particularly remarkable; it is rather the persistence of inflation which has done the damage.

When the economy was dominated by agriculture, prices were flexible in both directions. But as the relative role of industry increased, this characteristic faded. For it was in the character of the new industrial structures of the early twentieth century to be comparatively resistant to falls in wages and prices. High fixed costs, a tendency towards concentration and monopoly and the advance of union power and image marketing all pointed in this direction.

Moreover, as the relative importance of industry began to give way to services, the lack of downward price flexibility took on new importance. For productivity growth was much faster in manufacturing than in services. Normal market principle, as well as considerations of equity, would ensure that workers in the two sectors received broadly similar wage rises.

For this to be possible without causing inflation overall, the price of the result was that workers in the service sector had to press for inflationary wage claims. But the root cause of the problem lay with manufacturing.

A regime in which prices always rose was very vulnerable to an upsurge of inflationary expectations if anything should occur to disturb the inflationary equilibrium. In the event, in the early 1970s, three things occurred to ignite the tinderbox — a worldwide boom, which led to an explosion of commodity prices, a huge rise in oil prices and the breakdown of the European Union's fixed exchange rate system.

During the 1980s, the world economy slowly and painfully worked its way back from the inflationary abyss, largely thanks to restrictive policy. But, more or less simultaneously, several structural changes started to take place.

At the most general level, these can be described as changes which helped to make markets work better and helped intensify price competition. Some of these were natural. The role of manufacturing was on the slide in all the industrial countries.

On top of this, however, there were some "man-made" changes — notably the sharp reduction in union power. Also most pronounced in the UK, but increasingly copied elsewhere, was the drive towards privatisation which introduced competitive behavior into large areas of the economy where it had been smothered.

More recently, the development of the Far East and Latin America and the increased globalisation of production has intensified price competition everywhere. Moreover, this development has struck right at the heart of the West's inflationary weakspot, namely manufacturing.

In whole swathes of industry, prices are now under downward pressure because of the combination of technological progress and eastern competition.

The upshot is that, just as in the 1970s when there were intense inflationary forces operating in the world economy, so there are intense disinflationary forces at work now.

It will always be possible, even in these new conditions, for inflation to resurge if the economy is run at too high a level of capacity or if some new disaster strikes. Equally, there will continue to be countries where governments resort to inflationary finance and end up with hyper-inflation.

Keeping inflation low will remain more of a problem in the developing countries of the east. But in the countries of the developed west it will be more difficult to produce high inflation than it has been at any stage over the last 30 years, and possibly the last 60 years.

If we do indeed experience several years of very low inflation, and especially if we then experience a period of falling prices, after a while people may begin to believe that something like overall stability of prices is now normal. Once this has happened, then we really will have witnessed the end of the inflationary era.

● *Roger Bootle is chief economist of Midland Bank in Britain.*

— **Guardian**

The only economist, apart from E/S, to have publicly raised the prospect of deflation, way before it eventuated. Bootle went on to write a great book. Reserve Banks continued to fight ..

July '95

PROPERTY/OPEN TODAY

# Research group tips interest rise

By Kevin Norbury

INCREASINGLY bad economic news will force the Federal Government to lift interest rates before June next year, pushing home loan interest rates up, according to a report by economic researchers BIS Shrapnel.

The report predicts that by June next year the variable housing rate will be 11.5 per cent, but suggests that increasing competition between banks and other lenders for a decreasing new home loan market will minimise the increases to home buyers.

The BIS Shrapnel forecasts were contained in a joint report released yesterday by the Urban Land Authority, the authority's first quarterly report since joining forces with Australia's biggest independent economic and marketing group.

The report says that "for the moment" interest rate rises were "unlikely". However, it expected that increasingly bad economic news would force the Government to lift interest rates over 1995-96.

"We are forecasting a rise in the 90-day bank bill rate from its current level of just over 7.5 per cent to around 10 per cent by June 1996," the BIS Shrapnel report says.

"Recently a number of financial institutions have dropped their fixed home loan rates while leaving the variable rate unchanged. This highlights the difference in the short and long-term outlook for interest rates.

"The fixed home loan rate is primarily determined by long-term expectation of interest-rate movements.

"A fall in the fixed rate indicates banks expect future economic growth will be achieved in a lower interest rate environment."

The report says that fixed home loan rates will come under increasing pressure to rise as long bond yields increase to 10.5 per cent by June 1996.

However, it says that of greater importance in the short term is the housing variable rate which is linked to the 90-day bank bill rate.

"With short-term rates set to rise in the coming months, we are forecasting the housing variable rate will rise to 11.5 per cent by June 1996.

"Increasing competition between banks, and more so with home lenders for the decreasing new home loan market, will minimise increases to home buyers."

On release of the joint report yesterday, the head of the ULA, Mr John Lawson, said Melbourne's continuing slump in the housing market was caused by a crisis in confidence brought on by uncertainty over interest rates and job security.

Mr Lawson, who is executive chairman of the ULA, said the Victorian housing and land development industry faced one of its toughest challenges in the past decade to restore consumer confidence in the housing market.

He said outer Melbourne land production had peaked and was now showing an initial downward trend.

The major factors influencing the housing market were "the lack of demand caused by the historic high levels of building and the lack of population growth".

"However, the major problem is the crisis in confidence in the first, second and third home buyers in relation to the interest rate question and their ongoing job security," he said.

Mr Lawson said this had become clear as a result of an informal poll conducted over the past three weeks by the ULA at its "land shop", at Melbourne Central. The poll was held to get an indication of buyer sentiment. "Security of employment, housing affordability and interest rates have been the dominant areas of concern."

Variable housing rate June 1996 9.75 %
June 1997 7.2 %
June 1998 6.7 %

Very very few forecasts called interest rates to move below 5%, BIS did.

90 day bill rates June 96 7%