

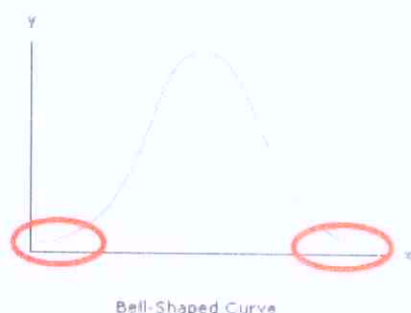
Themes for the decade: Jobs, debt and food

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Three key global themes will influence investment strategies in the years ahead. Mathew Kaleel looks at these themes, how they are likely to play out, and the potential ramifications of each.

The phrase "may you live in interesting times" is possibly the best description of the Global Financial Crisis, and we believe will also be an appropriate description of investing in the decade ahead. The phrase (which may or may not have originated in China), is a curse dressed up as a blessing, and is a very simple way of describing "normal" and "interesting" markets, or the traditional bell curve. "Interesting times" in the financial world mean the circled areas at each end of the curve, below. These are environments which are generally more active, volatile and unpredictable.



Here, we focus upon three particular themes that present both risks and opportunities going forward: jobs, debt and food. A proper understanding and ability to manage portfolios around these larger tail risks will be critical in delivering less "interesting times" for an investment portfolio.

Theme 1: Where will the jobs come from?

There is no doubt that the massive amounts of government stimulus averted a complete collapse in financial markets over the last two years, but this stimulus is not the basis upon which the global economy can emerge from recession. For a truly sustainable recovery to take hold there has to be job creation in the private sector, pure and simple. The recent turmoil in global markets has led to the wholesale destruction of jobs in many developed countries. Taking the most glaring example, the most recent non-farm payroll (ie employment) figure in the United States, which is released on the first Friday of each month, showed 431,000 jobs being created. Whilst this was on the surface a 'good' number, the immediate and ensuing negative reaction in stocks was due to the fact that of those 431,000 jobs, approximately 20,000 originated from the private sector.

This one figure highlights the whole problem in particular for Europe and the United States going forward, which indirectly affects the employment of people in emerging economies. The risk is that without a recovery in private sector jobs, relatively high levels of unemployment will be a feature of the next decade in most developed economies. Additionally, the amount of time a person remains unemployed has increased. Higher levels of long term unemployment crimp government revenue, reduce tax receipts and provide significant uncertainty about future budget outcomes.

The ongoing strength of the Australian jobs market, and unemployment levels stabilising at current levels in the 5 per cent range is extremely important in gauging potential longer term returns of Australian assets. Benign levels of unemployment have allowed government revenues to normalise, avoided a significant spike in mortgage defaults (as has occurred in the US), and will probably lead to a return to surplus faster than originally forecast (any event in the future is unpredictable, let no one tell you otherwise...).

Ramifications: Whilst elevated, long- term unemployment levels remain in place, the US and Europe will probably not provide significant forward returns in many asset classes. Alternatively, countries that are able to create private sector jobs and maintain relatively low levels of unemployment (eg Australia and Canada) should be relatively attractive places to invest over the next five to ten years. Low unemployment allows significant flexibility for governments who do not have to be completely focussed on 'creating' jobs that may or may not be productive. This positive backdrop should impact the long term returns of stocks, bonds and other assets.

Theme 2: Who will pay the bills?

As with the first issue, countries with higher debt levels will have less flexibility going forward, and this will crimp growth rates in those countries and hence the potential returns an investor can make.

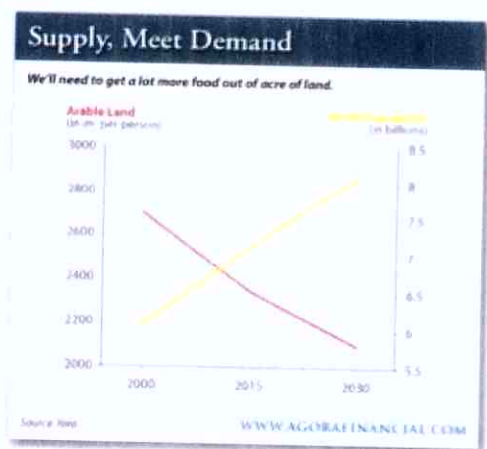
As an example, we just clicked on the debt clock, a fantastic website for those who love watching a lot of numbers change very rapidly - <http://www.usdebtclock.org/>. As we watch, total debt is \$US13,097,013,794 and rising, and debt per US family is \$US669,565. This is not an insignificant number, but even scarier than this, the US debt-to-GDP ratio sits at around 60 per cent. Debt-to-GDP levels in many other developed countries (especially in Europe) are increasing, with some countries now surpassing 100 per cent debt-to-GDP. Japan sits at a 200 per cent level, whilst Greece and Italy are at 123 per cent and 119 per cent respectively. A debt-to-GDP ratio in excess of 100 per cent effectively means that a country has to grow each year by at least the level of interest being paid in order to avoid falling into a debt spiral. Here is how this works:

Southern European Country 'A' debt level: **\$100**
 Interest rate on debt: **6 per cent**
 Interest per year: **\$6**

If the country's GDP does not grow by at least 6 per cent of \$6, then the country's debt/GDP level (all else being equal) will increase simply based upon the increase in interest owed over and above the increase in GDP. Here is where things get interesting, and this is important. Some countries, such as Ireland, are doing the "right thing". They are shrinking their deficits, slashing spending and reducing the level of government employees. Whilst this is something which is necessary and in the end unavoidable, the end consequence is that GDP has fallen faster than debt levels, which results due to less public services being produced, less public servants paying taxes and generally lower consumption and investment. As such there is a second less noticed effect and a paradox - doing the right thing means debt/GDP levels may increase. The potential to generate above market returns in countries where high debt is present and deflation is a significant risk is not that great. Look at Japan for the last twenty years to show what can happen to investment returns in such an environment.

Ramifications: Look to invest in countries and asset classes with relatively lower debt levels.

Theme 3: Where will the food come from?



One of the biggest themes, risks and opportunities over the next decade, is shown in the chart above (thanks to the *Daily Reckoning*). The world is at a crossroad where the increase in population is creating a level of demand for commodities that is unsustainable. Ongoing deforestation, a reduction in arable land and declining access to clean water present the biggest threats to global stability, prosperity and peace. There will be in the very near future and end to 'cheap food'. As with jobs and debt, countries with fewer people per square metre and more arable land will be less affected by this very important issue.

Ramifications: changes in population and arable land will lead to more supply shocks, higher input costs and potentially high food inflation. In an environment in which food and water are constrained, and inflation is an issue, real assets such as land, water and hard commodities should perform relatively well. This theme can be accessed by any number of land/agricultural stocks, managed funds in this space or direct investments. Real assets such as gold should provide effective portfolio diversification going forward.

The "new black"

Of all the questions we are asked, the most common one relates to the future price of gold. Whilst we simply don't know where the specific price will be (or any other tradeable asset), we do know what gold is saying right now. The chart below shows the price of gold in Euros (green line) and US dollars (white line). This is telling us that investors globally are doubting the inherent value of all

currencies. To use a phrase from the fashion world, gold is the new black, and is once again behaving as a 'safe' currency. As confirmation, the movement in the gold price is decoupling from other industrial metals, and so long as debt, uncertainty and the future of the Euro are in question, gold should continue to shine. The added benefit is that gold historically performs as well or even better in deflationary environments, and as such is potentially a good hedge against a number of adverse investment outcomes going forward. The addition of gold into a portfolio may therefore provide good potential diversification benefits.



Next time, we will look continue to look at some other broad themes that will impact markets.

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