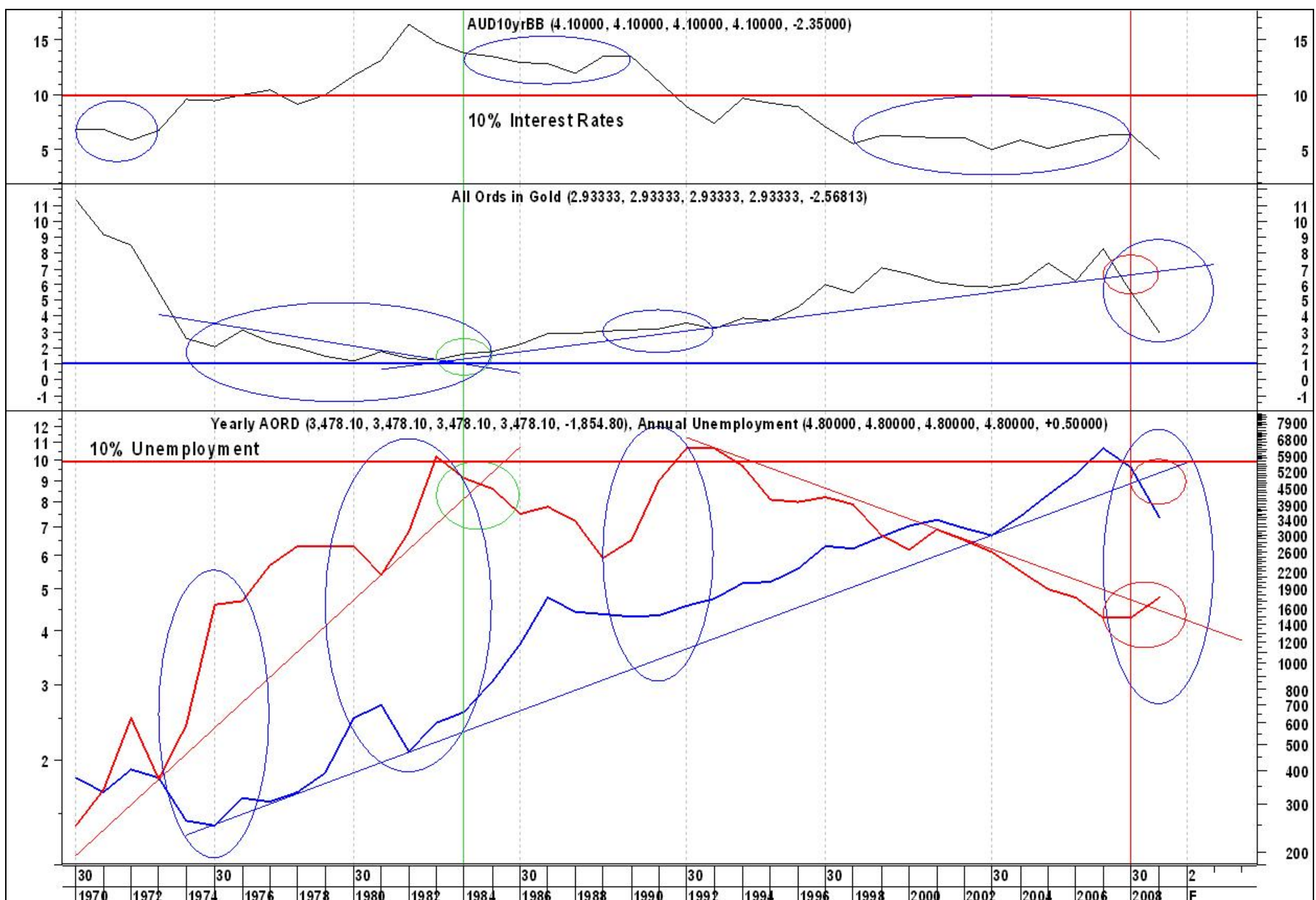
RISING UNEMPLOYMENT = POOR MARKET PERFORMANCE

Most rational people would associate rising unemployment levels with poor market conditions. Yet of late, some politicians and market experts would have us believe that we are turning the corner as markets rebound despite rising unemployment. Last I checked the long term relationship between the two was intact. Chances are the market rally we are presently seeing will be short lived. The following chart demonstrates this correlation with an important look at how the market performs relative to gold. Vast amounts of monetary inflation can create the illusion of "real" market returns, which is what occurred in the 1970's.

Unemployment versus All Ordinaries Index



In the bottom section of the chart unemployment is in red and the All Ordinaries Index is in blue. The blue circled areas represent periods of sharp rising unemployment typically during recessionary periods. We can see that the All Ordinaries Index during these episodes has lived up to its name and made very ordinary returns. The 1970's has often been referred to as the lost decade, because the economy drifted in and out of recession. The unemployment rate peaked at 10% in the early 1980's. Looking at the All Ordinaries for that decade we can see

that it did rise marginally in nominal terms. But a quick glance at the middle section of the chart exposes those gains for what they were, that is a monetary inflation illusion. The All Ordinaries in real terms (priced in gold) fell. Fast forward to today and we can see the All Ordinaries has recently broken a 34 year old up trend. These falls have been much more pronounced in real terms. The All Ordinaries priced in gold (middle section) has lost a staggering 65% since 30 Jun 2007 and has also broken a long term up trend. The unemployment rate recently broke a down trend which has been in place since the peak of the 1990 recession. The obvious conservative target for the unemployment rate is 10%, in line with previous recessions. There is every indication this down turn will be more severe thanks largely to historically higher debt levels. What will a rising unemployment rate mean for equity markets? The same thing it has always meant. Mediocre nominal returns at best with negative real rates of return.

Looking at the above chart, another question looms large. Will this recession resemble the relatively short 1990's recession or the decade long battle of the 1970's? To answer that question we need only look at the interest rate levels leading into these periods (top section of the chart). During the late 1980's interest rates were high, private debt levels were more manageable and savings rates were adequate enough to ensure a comparatively swift recovery. The one important attribute the current recession shares with those of the 1970's is the preceding period of historically low interest rates (blue circled areas in the top section). Unlike the late 1980's, the resulting higher debt levels and lower savings rates will ultimately lead to a significantly deeper recession and a longer recovery period.

Central banks and governments around the world, armed with aggressive monetary and fiscal policies, are attempting to reignite and prolong the previous boom. They are quite literally flogging a dead horse. That dead horse being the debt ridden consumer. The sooner we go into recession or depression, the quicker we can start the recovery process of restructuring businesses that were overly reliant on the easy money of the previous bubble. Interest rates need to rise to encourage savings and eliminate poor investment decisions. Banks in Australia have already started tightening their lending practices, especially to small business. This is creating a public outcry. Small business has become addicted to easy credit.

Banks historically have relied on people's deposits to provide a significant part of the capital they lend out. How do banks cater for an increase in loan demand when savings rates have been at record low levels for the past decade? Up until now the banks have benefited enormously from the increasing money supply brought about by unprecedented levels of credit growth. Alternatively they have borrowed internationally. The trend towards international borrowing by Australia's commercial banks has been fueled by ongoing Current Account Deficits. Literally hundreds of billions of dollars have been drained from Australia's economy over the past decade. When the Reserve Bank of Australia (RBA) lowers official interest rates the cost of "domestic" borrowing for commercial banks declines. They pay their depositors less and then make a decision whether to pass these savings on to borrowers. However, the lower the interest rates offered to depositors, the less attractive it is for them to leave their deposits at the bank. They naturally start looking for more lucrative alternatives. This puts increasing cost pressure on the banks as customer deposits are their cheapest source of available finance. With credit growth declining, the capital benefits once derived from a rising money supply are also diminishing. Furthermore, a cut in the discount rate by the RBA has no impact on internationally sourced finance, except for the negative currency effects. This only serves to increase borrowing costs. The point I want to make here is we can't continue to have our cake and eat it too. In other words, we can't continue to save less and then expect the banks to pass on interest rate cuts and continue lending with reckless abandonment. This just simply isn't sustainable. In a last ditch attempt the RBA may resort to the money printing practices of the UK and the USA. Cheap loans are made available to the commercial banks providing them with fresh capital to lend. Historically the outcome of this practice has always compromised the purchasing power of the unit of currency in question and led to excessive levels of inflation.

Government needs to ensure they run their affairs more efficiently and cost effectively. They need to make certain as much free capital is made available to the recovering private and business sectors. This means "**cutting" spending** and most importantly **"minimizing" taxation**. To argue that government is more effective at investing money than the private and business sectors makes about as much sense as central banks having the ability or the intent to set responsible interest rate levels. It just doesn't happen and it is the underlying reason we are in this mess. The present unfunded fiscal policy employed by the Australian government will only serve to prolong this recession as the private sector now competes with government for scarce capital resources. The share of the economy run by the government will also increase. Antiquated, ineffectual Keynesian economics lies at the heart of

our financial problems. As they say, the definition of insanity is doing the same thing over and over and expecting a different result. Prolonging the inevitable with more of the same has a day of reckoning and much of the surrounding evidence would suggest that day is upon us.

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