

JANUARY/FEBRUARY 2011

# PHYSICIAN Life

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# QE2 vs. AUSTERITY

What are the ongoing implications for your portfolio?

You would be forgiven for thinking QE2 is an acronym for Queen Elizabeth II, however in the world of finance this term has utmost importance for global growth. In the US, Ben Bernanke and his team at the Federal Reserve unveiled on November 3<sup>rd</sup> a second round of “quantitative easing” to the tune of US \$600 billion over the coming 8 months. This is equivalent to about 4% of the US economy’s annual output, which is a staggering number, but far less than the original \$1.75 trillion of QE throughout early 2009 to early 2010.

QE2 is a strategy based on pushing people out of safe-havens and into riskier investments.



## Quantitative Easing Defined

**T**HE REALITY IS THAT QE and now QE2 is a relatively new term for an age old method of stimulating the economy. With US interest rates near to 0%, the best available method to stimulate the economy is to hit the printing press; or technically the US government buying back Treasury Bonds.

In its simplest form, the methodology involves the US Government buying Treasury bonds to loosen monetary policy and cause Treasury yields to fall. This will push investors away from safe-haven investments and into riskier assets with a higher expected return. Banks are likely to be beneficiaries and they will in turn loosen their stance on lending, creating liquidity in the market and reducing the cost of funding for other corporates. A lower cost of capital and greater



liquidity will drive profits, investment opportunities and greater employment; ultimately creating shareholder value and GDP growth.

While great in theory, whether investors will bite is a key issue. Behavioural finance shows that investors like to be pulled into investment opportunities but resist being pushed. QE2 is a strategy based on pushing people out of safe-havens and into riskier investments.

Economic data from the US has produced mixed results since the initial QE in early 2009. The initial QE package did little to restore confidence as growth and employment remained subdued. However, many would argue it saved a likely “Great Depression” event.

Since the announcement of QE2, economic data has been generally improving with consumer confidence up and share markets have rallied in

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anticipation of further upside. We have welcomed the positive data; however GDP growth remains relatively subdued and unemployment bucked its recovery and unexpectedly rose to 9.8% - hardly positive.

#### **Europe in the Opposite Direction**

Across the North Atlantic Ocean, parts of Europe are actually doing the opposite. After years of debt-fuelled growth, both publicly and privately, concerns regarding public finances are

at an all-time high. Europe’s two biggest economies, the United Kingdom and Germany, are now taking the “austerity” approach, which can loosely be defined as belt-tightening or cutting of public spending to reduce fiscal deficits. This is very different to Ireland, Greece, and other troubled European nations who are clearly in crisis management.

Germany, led by Chancellor Angela Merkel, has announced their most ambitious austerity plan since World War 2. The aim is to save \$80 billion by



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2015 but large-scale public job losses are expected including 40,000 job cuts in the armed forces and 10,000 federal ministry civil servants.

The United Kingdom plans to save £81 billion by 2015 including welfare payment cuts to the tune of £7 billion and a whopping 490,000 public-sector jobs cuts.

Theoretically, implementing austerity during a contractionary phase will create large-scale unemployment, put downward pressure on inflation (potentially deflation) and exacerbate the negative effects on GDP.

This was the effect during the Great Depression from 1929-1933, where Governments desperately tightened belts to ensure sovereign debt defaults were kept to a minimum. It wasn't called "austerity" at the time, but the overall result was disastrous.

Even the world's most influential economist, John Maynard Keynes, supported QE over Austerity during a large-scale downturn. However, supporters of austerity claim that this time is different. Mums and Dads in the United Kingdom and Germany may take

comfort from the fact that Governments are finally acting responsibly and paving the way for a better future, which may create confidence and therefore increase their risk appetite.

### Impact and Likely Effects

The UK and Germany are arguably taking the higher risk stance – belt tightening may appear to improve the public finances, however, the Great Depression is a practical example of the risk associated with this strategy. The short-term result is largely unpredictable and the longer-term impact will be dependent on the success of the austerity plans. Only time will tell.

The US is also taking a risky stance, however the risks appear to be longer-term in nature. Should the Fed's QE2 efforts fail, do they continue to QE3? And if so, what if that fails? The hole in the public coffers could get deeper.

On the contrary, there is also the risk QE2 will work too well and drive inflation to dangerous levels – but this risk appears small. Regardless of the outcome, US public debt will be dangerously high, leaving the next generation to pay the bill.

So what does this all mean? In the short-term, you can expect to see an uptick in American GDP growth; however belt tightening and structural change is inevitable in the long-term, which will impact on enduring growth. The US is already on the borderline of surpassing its debt ceiling of US\$14.294 trillion and forecasts suggest this will be breached in March/April 2011. Congress is likely to extend the debt limit, but any political conflict could cause significant volatility on global markets.

### Our Views

As an investor, we still see the best opportunities in the Emerging Markets in the medium term; but even emerging markets are not without risks. On face value, this is an obvious portfolio allocation with outstanding growth and comparative public balance sheet strength. To our minds, the main concern is valuation and potential bubbles like that seen in Japan during the 1980s.

A key risk that is often overlooked when investing in emerging markets is the "transfer of wealth effect" caused by foreign speculative flows. If QE2 or austerity works and the developed economies turn the corner encountering a period of outstanding growth, foreign investors are likely to quickly rebalance their portfolios, causing a flow of funds out of emerging markets and back into the developed economies. This could be a catalyst for a downturn in emerging markets investments.

All in all, uncertainty creates opportunity. A close eye may identify an undervalued Dow Jones, DAX or FTSE as a more attractive investment proposition than an overvalued emerging market. However, based on current circumstances, our stance is that investors should remain overweight to emerging markets for the foreseeable future.

➤ Lachlan Partners is a Private Advisory Firm focused on client needs and financial goals with offices in Melbourne, Sydney and Brisbane. Roger Wilson (Partner) and Scott Dixon (Advisor) can assist you with your portfolio needs. T: (03) 9605 9200. [www.lachlanpartners.com.au](http://www.lachlanpartners.com.au)

# Protect your investments in 2011

2011 is shaping up to be a challenging year for investors  
- getting the right advice will make all the difference.

Lachlan Partners is bringing together some of Australia's foremost experts at their key seminars to be held in March 2011 across the Eastern Seaboard. Our eminent speaking panel includes

**Chris Caton**  
Chief Economist  
**BT Financial Group**  
'Global Economic and Market Outlook'

**John Marasco**  
Managing Director Investment Services  
**Colliers International**  
'Investing in Commercial and Residential Properties what is happening in Australia and Globally'

**Paul Saliba**  
Chief Investment Officer  
**Lachlan Partners**  
'Dynamic Approach to Asset Allocation - Applying the new Zone System'

## Seminars are being held in the following locations

**Brisbane**  
Tuesday March 8th 2011  
2 - 4pm  
The Novotel Brisbane  
200 Creek Street, Brisbane QLD

**Sydney**  
Wednesday March 16th 2011  
7.30 - 9.30am  
The Portside Centre,  
Level 5, Symantec House,  
207 Kent Street, Sydney NSW

**Melbourne**  
Thursday March 31st 2011  
4.30 - 6.30pm  
Level 1, Crown Towers,  
8 Whiteman Street, Southbank VIC  
(Free Parking Available)

**Lachlan Partners** is a Private Client Advisory Firm focused on client needs and financial goals with offices in Melbourne, Sydney and Brisbane.

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