

# Market Musings: The damaging visible hand

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Students of economics learn early on that 'there is no such thing as a free lunch', an expression of the scarcity of resources. Those resources include things like labour and time as well as physical resources such as arable land. Given that resources are not unlimited, much of early economic theory was devoted to the optimal and most efficient allocation or use of resources, as well as their valuation.

Classical economics provides a foundation for much of our understanding of the economy. Adam Smith, in *The Wealth of Nations* of 1776, describes the benevolent workings of the invisible hand of the market. Self-interested competition in the free market tends to benefit society in general by keeping prices low, while still building in an incentive for a wide variety of goods and services to be produced and supplied.

The workings of the free market break down where there are monopolies, where prices would not remain low without some supervision or restraint, and where there are negative externalities that are not naturally priced or costed such as the quality of the environment.

The poor performance of planned economies in general (leading to the fall of the Soviet block and evidenced in the disparity in wealth between North and South Korea) is generally attributed to the removal of useful price signalling and incentives that exist in free markets. Free markets and the invisible hand undoubtedly have flaws, but history has shown price controls and manipulation inevitably lead to shortages, inefficiencies and distortions.

Over time most economies have begun to adopt several measures to mitigate against some of the undesirable or politically unpalatable effects of free markets including minimum wages, universal minimum healthcare, and public housing, as well as competition bodies to ensure that industries do not become so concentrated that the markets no longer operate effectively.

Modern economies have one outstanding characteristic that is different to traditional economies: there is potentially no scarcity in money that is not backed by something physical like gold. Furthermore, interest rates and therefore the credit markets are explicitly manipulated by governments or their agencies. It is one of many areas where the visible hand is quite dominant, and the influence is far from benign.

We are living in a period where growth is much slower than it was before the GFC, arguably because some of the credit excesses pre GFC have not been erased by an extended recession, and a proper reset did not occur. Despite quite high levels of overall prosperity and high material standards of living across much of the developed world, rising income inequality and upheaval in traditional service and manufacturing industries has contributed to political polarisation and a rise in populist parties and leaders. This in turn has made politicians in general more populist and likely to meddle in markets and more reluctant than ever to embrace any necessary but unpalatable economic policies.

Examples of poor policies abound and three Australian examples are discussed below: the insulation scheme, energy policy and the NBN. The focus will then turn to interest rates and credit.

### Insulation scheme

The Rudd government, as part of a package designed to combat the economic effects of the financial crisis of 2007-8, announced a home insulation programme in February 2009. By the time the scheme was abruptly abolished in February 2010, four installers had died and a Royal Commission was then set up to investigate the deaths. By artificially boosting demand for insulation in a very short period, against the advice of the companies who made insulation, the government ensured huge distortions in the market. The local producers, CSR and Fletcher Building, had to step up production and import product to keep up with soaring demand. Knauf, a private German company saw the demand bonanza and set up in Australia for the first time using imports from the USA. Insulation is a product one would normally not ship between distant continents as it is bulky and of low value, but the policy led to significant higher cost imports. When the scheme was aborted:

- huge excess inventories of insulation had to be destroyed at considerable cost to the producers (as insulation has a shelf life because it is packaged tightly to minimise space at the end of the production process),
- a new competitor was introduced who arguably would not have spent the money setting up distribution, warehousing and sales channels, and
- four people had died in the rush to take advantage of subsidies without reference to safety and training.

### Energy Policy

In Australia we have had a very inconsistent approach to energy policy in the area of renewables and carbon emission minimisation. Going through all the history in detail would no doubt be an insomnia cure for readers, the intention is simply to highlight that government meddling has distorted normal business economics.

Renewables have needed subsidies to make them economically viable, particularly in Australia where we have traditionally had abundant cheap coal and gas. Gas drilling has been outlawed in several states creating a shortage. Elsewhere new coal power plants are currently being built delivering electricity at much lower cost than power prices in Australia, while locally coal would not be considered as a new source of power.

Over time renewables will come down in cost, and in the distant future we might conceivably get all our electricity from hydro, wind and solar combined with battery storage, but that is some time away. In the meantime, Australian manufacturing is struggling, shrinking in an environment of very high power prices. Because we have disincentives for power from our cheapest and most reliable base fuel source, the consequence is higher power prices. Of course many people disapprove of coal and the carbon emissions, but at present we can't have the luxury of being green and having the cheap power manufacturers require to be competitive internationally.

At present, owners of coal and gas generation have little incentive to invest in new generation or allocate capital to existing power plants. Not only do renewable power sources receive subsidies, renewable plants have priority in supplying electricity to the grid, and it is expensive for baseload power to turn generation up and down depending how much wind there is. Unsurprisingly, coal fuelled Hazelwood has closed in Victoria, almost all generation except renewables closed in South Australia and Tasmania, and Liddell (coal) is scheduled to close in NSW in 2022. The previous excess supply of electricity has disappeared, and electricity prices have increased. We have built renewables but of course renewables need the sun to shine or the wind to blow at the same time as there is demand for electricity. Gas peaking plants are used to supplement renewables but are more expensive.

The Government, wearing a populist hat, does not like the higher electricity prices which have resulted from uncertainty and their policies, and hence is seeking to restrain prices. This will remove incentives to invest in the sector and possibly lead to shortages and emergency measures as happened in South Australia, and in

Tasmania which had to buy expensive diesel generators because the rainfall was insufficient to provide all the required hydro power. It is almost certain that government intervention in recent years has destroyed effective market signals, and politicians don't welcome the unintended consequences.

## **NBN**

In the telecommunications sector, the newly elected Federal Government decided in 2007 that Australia should have a national fibre optic network to carry broadband telecommunications, in a spirit of "nation building". Tenders were submitted by various private parties including Telstra but none were accepted and overnight the Government Telcommunications Minister Stephen Conroy instead decided to form the NBN Corporation as a monopoly and to use Government funding to construct and operate the new network. Estimates of the build cost quickly rose from tender levels (less than \$10bn) towards \$30 and \$40bn, with the final number (over \$50bn) still outstanding for a network that is not going to consist of as much fibre as originally claimed and speeds that have so far disappointed most users. The sorry tale of this white elephant will no doubt be material for a lengthy book in future.

The effect of the NBN has been to decimate the fixed line revenues and earnings of incumbent operators from Telstra and Optus to TPG and Dodo. Unsurprisingly, companies reacted to mitigate the loss. In particular, TPG has sought to cherry pick sites that would ordinarily be profitable for the NBN such as CBD buildings and apartment blocks where density makes for excellent economics in the context of pricing that is set with a view to cross subsidizing costly services to remote areas. TPG has also bought spectrum to allow it to offer mobile services in the densely populated east coast cities, with the principal intention of offering mobile broadband as an alternative to the NBN (circumventing the NBN's charges) rather than to become a major mobile player in itself. The Government's visible hand has greatly disrupted the industry, and few could argue that the project has been or will be an economic success. It is certainly not living up to the fanfare with which it was announced.

In a low growth environment where many companies face challenges to maintain and

increase profits, dealing with government interference can create significant unforeseen headwinds. It is also hard for investors to anticipate these headwinds because they not only create market distortions; it's often hard to find any beneficiaries other than lawyers and lobbyists as neither consumers nor businesses benefit over time, and hence such irrational policies are difficult to forecast.

## **Interest rates and credit**

The greatest influence on the corporate and investment landscape by the visible hand of government is through interest rates and money. Over time governments and their agencies have effectively devalued money through years of inflation which would not have been possible with disciplined monetary policies. Inflation effectively favours borrowers over savers and therefore redistributes income without growing the value of the pie. In recent decades credit growth has vastly outstripped income growth as banks have competed to lend to customers with increasingly poor creditworthiness, as lower interest rates have improved the affordability of the interest portion of loan service.

Because interest rates are effectively set or at least manipulated by governments, the huge expansion of credit is a direct result of government policy or at least government complicity. Since the GFC the deliberate expansion of money and credit has been very explicit as Quantitative Easing has been pursued in many developed countries despite there being little or no evidence of any efficacy other than boosting financial asset prices.

Credit tends to support both asset values and consumption as many people now buy things they cannot immediately afford whereas a few decades back people only could buy what they had already saved up for. Easy liquidity has driven up many asset values such as real estate, shares, commodities and bonds of varying quality. Very low and even negative interest rates have destroyed useful market signals that would normally occur as investors have been pushed to take on risk beyond their usual preference in a desperate hunt for yields greater than the near zero safe yields.

This in turn has allowed highly speculative companies and start-ups to prosper because they have had access to unusually cheap

funding, in turn creating problems for their established competitors who may be relatively disadvantaged by having a more traditional and conservative approach to funding. As Amazon has proved, it is very difficult to compete with a business that is very well funded by investors and lenders without having to deliver profits or cash flows for years. A business that can sell things very cheaply and offer great service overall will virtually always succeed assuming that a lack of profits in the medium term is not a problem for the lenders and backers. These are unusual times in that a lack of profitability is not necessarily perceived as a problem. Abnormally low interest rates may have assisted consumers by creating competition in the short term but will not have helped should the disruptors become so strong they are effectively monopolies.

Governments' visible hand in fostering the huge build up in debt and very loose credit conditions globally has also created a great deal of vulnerability for the economy. High debt levels mean anything that changes perceptions of risk and therefore the willingness of private lenders to extend credit could have a major negative impact on the economy.

**At IML we are very cognisant of the heightened risks in the economy and therefore continue to favour more defensive companies with more reliable and steady earnings. This style has underpinned returns for our investors through a number of booms, busts and fads, and will continue to do so.**

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