Economic and Market Update

Below is a transcript of a video recorded on 5th December 2011, by Investment Analyst, Kerry Gill.

What's the latest on Europe?

The European crisis has continued to be the major influence on world markets. At the time Brian Parker spoke to you last month Greece couldn't decide whether or not to have a referendum – and they eventually decided not to. A bit of political reshuffling has since taken place, with new leaders now in Greece and also in Italy. But promises of action by national political leaders still haven't led to a clear resolution to the current indebtedness problems. The can continues to be kicked down the road. As a consequence of the uncertainty, yields have risen, with Italy now facing bond yields as high as those when Greece and Ireland were bailed out. Germany, despite representing the stronger European core, failed to attract sufficient bids for its 10 year bonds at its late November auction.

It is not yet clear how the European situation will be resolved. The likely outcomes seem to be bipolar – either stronger fiscal integration or disintegration of the Euro from its current form as members are kicked out or choose to leave. Either way, it appears that Europe is in for a significant bout of slow growth, if not outright recession. The biggest issue is whether policy makers can act to achieve a resolution before the market unravels further.

Have things become better in the United States?

US leaders are stuck in their own version of a stalemate. Unless politicians can reach agreement, then automatic spending cutbacks will soon come into force that were agreed to as part of the debt ceiling negotiations in August.

Unemployment in the US remains stubbornly high, though economic growth has been holding steady. Production indicators are positive, but there are some strong headwinds to growth due to hit in 2012 and 2013. Should the US situation deteriorate again, it becomes more likely that policymakers will react with a version of QE3.

What has this meant for markets?

Equity markets have experienced some dramatic moves over the last month as the flow of news drove investors up, down and rarely sideways. During the month, Global markets were down over 7.5% at one point in late in November, but, in this incredibly volatile market, they staged a last ditch recovery to close down just over 1% for the month. In a similar vein, European markets closed down just over 1.1%, the US was down but near enough to flat, and Australia fell 3.4%.

In bond markets, US 10 year bonds ended the month pretty much where they started it, while Australian yields fell after the RBA announced a November interest rate cut of 25 basis points.

With the retreat in markets, the Australian dollar fell back close to parity. Gold moved around but ended the month a little higher. Oil was also up around 3% over the month.

How does Australia compare in all this?

Australian growth continues to be driven by the emerging Asian region. Despite this, our markets are influenced by movements on overseas exchanges, so our share market declined in line with international markets over the month.

Our close ties to China are a source of benefit to us, but also a source of risk. Though concern is growing about the Chinese shadow banking sector, levels of bad credit, and the ability to continue to rely on infrastructure spending to sustain growth, for the time being China retains significant economic strength. China, with its vast international reserves, is in a position where it is one of the few who could potentially help rescue Europe. However, Europe is unlikely to want to be beholden to the Chinese, and the Chinese have their own social policy worries and domestic demand that they need to continue to keep growing.

Where to from here?

It's not hard to see that economies and markets remain depressed. At this stage, policy makers aren't worried about short term inflation – it's pretty benign, especially given the low levels of expected economic growth most of the developed world is experiencing. Monetary policy reactions by central banks in developed markets are focused on providing liquidity and keeping funding markets functioning. The central banks of Europe and Australia cut official cash rates in November, the Bank of England is engaging in further quantitative easing, China reduced reserve requirements, and 6 major central banks including the US Fed, reduced the cost of swap lines in early December.

Offsetting this is a worrying trend towards increasing fiscal austerity. The consequences of this are uncertain. Where markets go from here is dependent on policy maker action versus inaction.

Where are the investment opportunities?

Market falls have made equity valuations more attractive, but only as long as the downside that is priced in does not eventuate. However, there are a range of potential scenario outcomes that we look at when positioning portfolios. Importantly, when the traditional safe haven assets – nominal bonds – are overvalued, we believe that selected equities continue to provide some of the best long term investment opportunities.