

Market Forecast: It's more important than ever to be in good company

After the worst year for equities since the Great Depression, the key investment question for 2009 is whether risk assets will outperform safe assets.

This year will see a tug of war between apparently cheap asset pricing and rapidly deteriorating fundamentals. What happens in markets depends on what new information there is and how this compares to what is already priced in. Markets can rally even as the real economy continues to weaken, if the news isn't as bad as assumed.

We are in or heading into a severe synchronised global recession, but there's still a lot of uncertainty about how deep and prolonged it's going to be. There are certain to be both rallies and reversals as the outlook is reassessed through the year. But will equity markets move higher overall? A sustainable rally in risk assets remains unlikely until there is greater normalisation in credit markets, because this is what is required to stabilise the real economy.

Resumption of the credit creation process is the single most important foundation on which the recovery will be built – this will be the most important positive signal for risk assets.

Normalisation in credit markets will not mean the end of the downturn, but it will mean that this is a 'normal', though severe, cycle rather than a prolonged stagnation. Credit market normalisation means that credit flows resume for households and businesses.

Once this occurs and assuming continued policy actions, particularly fiscal stimulus, economic conditions should start to stabilise, but it will take some time for a recovery to come through. Don't expect resumption of economic growth before 2010.

This year's global recession will probably be most severe in the US, but also very significant in the other advanced economies. Recession is unlikely to be avoided in Australia and we can expect at best a very significant slowdown in the emerging economies, including China.

Also, as there is a global glut of supply relative to falling demand, the recovery may be muted. But it is very unlikely to turn into a global depression, where growth does not recover, because of the dramatic and determined US monetary and fiscal policy response.

Much of the early fiscal policy response has been directed at reducing the cost of credit spreads on mortgages and other loans in order to make the reduction in official interest rates effective.

Credit market normalisation will indicate falling risk of economic stagnation and this will flow through into reduced corporate borrowing costs.

Investment grade corporate debt has priced in an outcome similar to the Great Depression. In that market, implied default rates are multiple times higher than historical default rates, partly due to the illiquidity premium factored into corporate debt prices in the current environment.

This is very pessimistic pricing and makes these assets very attractive. In contrast, traditionally defensive treasury bonds may be vulnerable once the recovery comes – the market focus is on deflation just as medium-term inflation risks are rising.

Equity markets have not priced in as adverse a scenario as debt markets, and further substantial earnings adjustments should be expected. But some companies are certainly attractively priced right now, and looking through the next few years, our assessment is that the longer-term prospective return from equities is stronger than it has been for quite some time.

Those companies best positioned for the next year are: those with strong management and low or no debt; those with income and price inelastic demand, producing staples not luxuries; those with strong franchises that can weather tough economic times; and those that will benefit as weaker players get squeezed out.

In difficult economic times some companies will fail. Being in the right companies is now more critical than any of us can remember.

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