



Investment Briefing

Another year of living dangerously

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As we approach the end of another year, it's a good time to review economic and market events over the course of 2011, assess the state of the world, and try to imagine the range of paths the world could take from here. After a promising start, world equity markets look like ending 2011 badly. Early in the year, markets had much to contend with – the turmoil in North Africa and the Middle East, sharply higher oil prices, the tragedy of Japan's earthquake, tsunami, and nuclear disaster, and the ongoing disaster that is European policymaking – and yet equity markets managed to produce solid returns during the March quarter. As the year progressed the weight of adverse news continued to build, and since the end of April, share prices have fallen sharply.

In the US, negotiations over measures to rein in the budget deficit and to raise the US Government's debt ceiling descended into near farce, as the US political climate became about as poisonous as anyone can remember. In Europe, economic conditions and public finances in peripheral Eurozone economies continued to worsen, while policymakers seemed both unwilling and unable to come up with anything resembling a solution. As I write this, the European authorities continue to insist that the solution is more austerity, stricter controls on budget deficits and punishments for recalcitrants. What's that old saying about the definition of insanity? Doing the same thing over and over again and expecting a different outcome each time?

Here in Australia, we have not been immune to developments offshore, and have had our own issues to deal with. We started the year with the disastrous impacts of the Queensland floods, and felt the flow-on effects of the Japanese catastrophe. Over the course of 2011, the overall economy has performed reasonably well, but the term 'multi-speed economy' has gained greater currency. For any business, industry, or region exposed to mining or benefiting from the enormous amount of work going on to feed the mining boom, life has been fine. Elsewhere, the picture has been far more mixed. Traditional retail has struggled – no question – but overall consumer spending has been quite solid. Housing activity indicators such as building approvals and housing finance look subdued, and house prices are drifting lower across much of the nation. Undoubtedly, the strength in the Australian Dollar is having an adverse effect on a range of industries and businesses, from traditional manufacturers, to our major Universities, who compete against institutions in the US and elsewhere for overseas students. Australia's inflation performance has been favourable enough, and risks emanating from overseas serious enough to allow the Reserve Bank to begin reducing official interest rates – a trend that seems likely to continue in the New Year.

In recent weeks, world equity markets have remained extremely volatile, but the technicians and chartists would no doubt point out that key support levels have thus far held – is this a



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sign that a recovery is around the corner? In reality, the share market has spent much of the past few months trading a broad range. Are we through the worst of this latest bout of market wobbles? Nobody can know for sure of course – anyone who tries to argue that he can is either a fool or a charlatan or both. If there's one thing I've learnt in 20-odd years in the investment business, it's that humility is a useful investment tool – as that wise investor Clint Eastwood would say: a man's got to know his limitations. To try and make sense of where we might be heading from here, let's start by talking about the positives – yes there are some!

Our own scenario analysis and traditional valuation measures both suggest that equity markets are at least reasonably valued. There are plenty of things to worry about, and the range of medium-term scenarios that we spend a good deal of time worrying about include some quite adverse environments – in short, it's difficult to imagine how the world could turn out really well over the coming years. However, equity markets seem to have factored in a good deal of adverse news. Moreover, the single best determinant of medium to longer-term equity returns is not macroeconomic developments or politics – it's starting point valuations. At the very least, today's valuations in a range of key equity markets are far from excessive. Many companies in Australia and around the world continue to produce exceptionally good profits, have strong balance sheets, and have sustainable dividends. That does not mean that in short term equities can't become cheaper. The Europeans continue to play an extremely dangerous game of chicken with the economic and social future of Europe, and the prosperity of the world economy. Today's valuations simply imply that if we wanted to start an investment journey involving equity investments, today is not a bad starting point – and clearly a better one than late 2007.

On matters macroeconomic it's clear that the outlook for economic growth in much of Europe and the UK is dire. Overall, a European recession is likely to be underway right now. Conditions on the European periphery are catastrophic. The UK economy, already economically fragile, remains weighed down by fiscal austerity. However, the US economy, still the world's largest, has, if anything, improved in recent months. Employment is growing, albeit not fast enough to bring about substantial falls in the unemployment rate, but nevertheless, the US private sector has been adding jobs every month for 21 consecutive months, enough to provide some support to income and spending growth. If we look at the US corporate sector, balance sheets are healthy, and corporate lending is growing again. The US is still caught in the midst of a household de-leveraging cycle, and there remains a risk that fiscal policymakers could derail things by tightening too aggressively, too soon, but at the very least, the signs for the world's largest and (still) most important economy are brighter. Elsewhere, despite concerns about the durability of growth in China, particularly in the wake of efforts by the authorities to rein in inflation and excessive property investment, growth remains robust, and the authorities have both the ability and willingness to use the arms of policy to promote growth.

While there are positives to be aware of, that doesn't mean that the world is all of a sudden a wonderful place to be – it clearly is not, and there is no point in trying to 'sugar-coat' things for any audience. There is a wide range of possible paths the world can take over the coming years. There is still the very real threat that financial market developments in Europe overwhelm Europe's increasingly dithering policymakers, and lead to a full-blown banking crisis on the continent with potentially damaging consequences for the world financial system. However, there is also the chance that just when you think things can't get any worse – they don't.



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In the meantime, what are investors to do? At MLC, we and our managers remain focused on trying to avoid the worst of the pitfalls out there; analysing new strategies designed to provide further protection in tough times, and ultimately more reliable investment outcomes; and taking advantage of the opportunities that tough market conditions provide. Volatile market conditions tend to provide good opportunities for skilled active managers to add substantial value; our global equity managers in particular are doing just that. One pleasing result is that MLC's portfolios, across a number of performance surveys, are significantly above the median manager over one, three and five year periods, but we are conscious that for many clients, that is little comfort when absolute returns are often disappointing.

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