

Economic and market developments, July 2009

Below is an edited transcript of a webcast recorded on 28 July, 2009 by MLC Investment Strategist Brian Parker.

Since we recorded our last webcast on June 22, world share prices have resumed the climb they began in early March. As this is recorded, share prices in the major world markets are around 8% higher than a month ago, while the emerging equity markets, in Asia, Latin America, Eastern Europe and elsewhere are closer to 10% higher. Locally, the Australian share market has lagged somewhat, with prices around 6% higher than when we last spoke.

In other asset classes, the improvement in the performance of non-Government bonds continued over the past month. Credit spreads, or the extra yield on offer by buying non-Government securities rather than Treasury bonds, narrowed sharply over the month. The mad panic in these markets that occurred after Lehman brothers failed has well and truly subsided.

Conditions are also improved in world money markets. Globally, banks and corporations are finding it easier to meet their short-term funding needs, although it's still too early to say that market conditions are entirely back to normal.

Government bond markets were a mixed bag over the past month. Long-term bond rates fell in Japan, France, and New Zealand, and rose to varying degrees elsewhere. However, in virtually all the major bond markets Government bond yields are still substantially higher than the levels they fell to at the height of the post-Lehman Brothers panic.

Commodity markets are telling a similar story. Prices for the key industrial metals have posted further gains over the past month. The main base metals traded on the London Metal Exchange are between 9 and 15% higher than when we last spoke. Oil and gold have posted some modest gains over the month.

That's how markets have fared, but what does it all mean? And what are markets trying to tell us?

Markets continue to run on the expectation that the while the worst may not be over for the world economy, there is at least an end in sight for the global recession. This view continues to be backed up by a range of key leading economic indicators released for the major economies over the past month. Markets are telling us that they see a recovery in corporate earnings in the major world economies at some point over the coming year, and for credit markets, it means that corporate default rates are not expected to be as bad as markets feared some months ago.

Our view at MLC is that prospects for the world economy look considerably brighter than they did late last year, however, we caution against becoming too optimistic about just how strong any global economic recovery is likely to be. Properly repairing household and financial sector balance sheets, particular, but not exclusively in the English speaking economies is going to take time, and in the process of that repair job, consumers are likely to go for an extended period where any growth in spending is slower than the growth in incomes. Similarly, we expect banks and other financial institutions in those economies and elsewhere to remain much more cautious providers of credit for some time to come.

For Australia, a run of better than expected economic data, including some key data on retail spending and housing has fuelled a good deal of optimism. It looks like not only has Australia avoided a recession – technical or otherwise – but that a return to solid growth is at hand.

Regrettably, we don't share that optimism. While a recovery in housing activity does seem likely, and retail sales have been better, we're yet to see the full impact of the crisis on business investment, exports, and on employment. The market's apparent optimism has led some to expect, and markets to start factoring in, a raise in interest rates sooner rather than later. Once again, that's a view we don't share. We expect the Reserve Bank, and indeed all the world's major central banks to be very cautious in removing the massive monetary stimulus that been put in place, meaning that rates are likely to stay lower, for longer, than markets seem to anticipate.

I've previously described the current market environment as one in which share markets take three steps forward and two steps back. That's really only partly accurate. There's been many steps forward, but few steps back in this market upswing. The economic news has been better, but we're still some way from a point where global consumer and business spending returns to sustained growth.

Even though measures have been taken to restore the world's banking systems to health, and to restore the availability of credit to the world economy, it is likely to be some time before the private sector's demand for credit picks up.

It's worth remembering that financial markets tend to be more forward looking than any analyst, economist, or piece of economic data, and that markets are having an extremely good run on the expectation that economic conditions will improve. While that improvement is now underway, there are some indications that markets have gotten a little ahead of themselves. At MLC, we spend a lot of time focusing on the medium to long-term outlook for the economy, financial markets, and investment returns. The longer term outlook for returns is still very favourable, but as we noted last month, we caution against extrapolating the recent stellar run for world equity markets too far into the future.

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