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Economic and market developments, September 2009

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

Hello everybody, my name is Brian Parker and I'm an Investment Strategist with MLC Investment Management.

Since we recorded our last video on August 24, share prices have fallen in Japan and China, but have posted further gains virtually everywhere else. As a group, the developed equity markets posted a gain of nearly 2% since we last spoke, while the emerging equity markets are nearly 4% higher. The Australian share market is around 5% higher.

If we look at just how far the recovery in share prices has progressed this year, world share markets, including both the developed and emerging markets, are more than 53% higher than their recent lows. However, it's also important to point out that these markets are still around 33% below their peak levels reached in late 2007. Percentages, like appearances, can be deceiving!

Government bonds yields in the developed markets have fallen again over the month, and corporate debt markets have continued to recover, producing further solid gains for diversified debt portfolios. In commodity markets, prices for the major industrial metals were mixed over the last month, while the price of oil has fallen by around 10%, to around US$66 a barrel.

In world money markets, the trend towards easier funding conditions for the world's financial institutions continues, but yet again, we'd caution that conditions could not yet be described as 'normal'.

On the economy, the economic data we've seen over the last month for the global economy have, on balance, continued to indicate that economic conditions are stabilising. The key leading economic indicators for the major economies continue to tell us that a recovery is coming. In recent comments the Chairman of the US Federal Reserve Ben Bernanke suggested that a modest US economic recovery may have already started.

Here in Australia, the run of positive economic news culminated in some better than expected economic growth figures for the June quarter, and an apparent upgrade to investment spending plans on the part of Australian business. As we've mentioned previously, consumer and business confidence surveys have rebounded, housing indicators such as house prices and housing finance applications have picked up, and unemployment has not risen any where near as far as many had predicted. On the other hand, the latest data on retail spending show that the impact of the Government's cash hand-outs is starting to wane.

The fact that a global recovery seems to be underway, and the domestic economy has held up much better than most had expected means that the emergency that would justify an Australian cash rate of 3% has not materialised. At some point in the next few months, the Reserve Bank is likely to move that rate back towards more normal levels.

Now let's talk about what all this might mean for financial markets and equity markets in particular. My previous description of the market environment as one in which share markets take three steps forward and two steps back, really hasn't worked out. True, there have been plenty of steps forward, but not very many steps back. However, I think equity market gains from here are going to get tougher.

The economic news has been better, but a lot of that improvement looks like being a rebound from the very aggressive cuts to global trade, production and employment that occurred after the failure of Lehman Brothers. Financial market conditions have recovered from the mad panic we witnessed during the last quarter of 2008 and early in 2009, and those markets are no longer priced for a world on the edge of financial abyss. Credit spreads for example, particularly for high yield securities, or junk bonds, have come racing in. Those securities still offer quite attractive yields when compared to Government securities, but the vast bulk of the narrowing in spreads is behind us.

For markets to continue the kind of gains we have seen this year, they'll increasingly need to see signs of genuine economic recovery, not just a post-crisis bounce.

For that, we need demand from the private sector to start growing again, without help from the range of stimulus measures that Governments have put in place. Indicators of consumer and business spending in the major economies remain very weak.

As we've discussed previously, it will take some time for heavily indebted households in the US and elsewhere to get their balance sheets back in order. Even if there is an economic recovery underway right now, it is still highly likely that credit losses will continue to emerge, not least because unemployment typically keeps rising, and companies continue to experience difficulties even after an economic recovery is underway. The world's major economies, particular the US and the UK, are likely to experience an extended period where consumer spending grows at a considerably slower rate than household income, as those households rebuild savings, and reduce debt. This doesn't mean there won't be an economic recovery to follow, and indeed reinforce, the equity market gains; it just means that the recovery is going to be a modest affair.

Markets continue to see the light at the end of the tunnel, and are assuming that the light isn't an oncoming train. It's an assumption I'd still agree with. The longer term outlook for returns in our assessment is still reasonable, but we continue to caution against extrapolating the recent stellar run for world equity markets too far into the future.

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