

Economic and market developments, February 2010

Below is an edited transcript of a video recorded on 8 February, 2010 by MLC Investment Strategist Brian Parker.

Since we recorded our last video, we've seen a significant change in market sentiment. While sharemarkets ended 2009 strongly, so far this year it's been much tougher for investors, and world equity markets have lost ground. My colleague John Owen, in another recording on this website takes you through the performance of markets and how MLC's portfolios have fared. In this recording I want to focus on what's been driving markets, and more importantly, where we think they might be heading over the remainder of 2010.

In our previous videos, we've indicated that in our assessment, the longer term outlook for investment returns was reasonable, however we cautioned against extrapolating the recent stellar run for world equity markets too far into the future. We argued that equity market gains were about to get much harder – that the easy gains had already been made, as the world economy took many steps back from the abyss, and markets breathed a huge sigh of relief. In short, perhaps the most surprising thing about the gains of 2009 wasn't that markets recovered, but that we saw very few set-backs along the way.

In the latter stages of last year, the financial problems of Dubai hit the headlines and unsettled markets for a time, prompting Dubai's wealthier neighbour, Abu Dhabi to step in and stabilise the situation.

More recently, developments in Greece, where the nation's budget deficit is running at around 12.5% of GDP, and public debt has topped 113% of GDP, have spooked markets. Efforts by the Greek authorities to rein in spending and boost revenue have been greeted with considerable scepticism by investors, and there remains a real risk that Greece will default on its sovereign debt obligations. Elsewhere in Europe, similar concerns exist (or have already come to a head) over the public finances of Spain, Italy, Ireland, and Portugal.

Any serious effort to address these concerns will inevitably involve significant cuts to public spending, higher taxes, and a prolonged period of economic weakness in those economies.

If we look at the economic data released over the last few months, it's fair to say that on balance, the numbers are still consistent with a recovery in the global economy, albeit a modest one. We've only just started to see signs of a pick-up in private spending in the major economies. Too much of the improvement in the world economy last year reflected the temporary impact of a range of Government programs. Only recently, have we started to see signs of a more sustainable recovery emerging, and these signs are still very tentative.

In addition to the problems of Dubai, Greece, and others, it's doubts about the strength and durability of the economic recovery that's bothering market participants.

Here in Australia, our recovery from what was (at worst) a mild recession, seems to be on track. Some of the economic news recently has been a bit more negative. Retail sales figures and some of the key business confidence measures were disappointing. However, we still seem set for housing activity and business investment to improve over the next year, and leading indicators on employment are looking pretty solid.

Even though the Reserve Bank opted to pass on a February rate hike, surprising pretty much everybody, their statements seem to strongly suggest that more rate increases are likely over the coming months.

As usual, let me offer my take on all this, and what I think it means for investors.

Firstly, even though the worst of the Global Financial Crisis is over, the aftershocks are set to continue, and at least some of those shocks are going to be quite severe from time to time for financial markets. In short, not all the financial sins committed during the boom have been atoned for.

Secondly, it's still our expectation that we'll see a recovery in both business and consumer spending in the major world economies, and that a modest but sustainable economic recovery will result. However, 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.

In addition, Governments around the globe are going to have to rein in the extraordinary stimulus measures they put in place in recent years. While those measures helped to avoid an even worse economic downturn, unwinding them is going to detract from economic growth for some years.

Finally, our medium term estimates of returns still look reasonable, and if anything have probably increased as share prices have declined of late. However, the fact that our prospective return estimates look no better than reasonable at this point, speaks volumes about just how far and how fast markets rose during 2009.

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