

Economic and market developments May 2010

Below is an edited transcript of a video recorded on 8 February, 2010 by MLC Investment Analyst Kerry Napper.

Hello everybody, my name is Kerry Napper, and I'm an Investment Analyst in the Capital Markets Research team at MLC Investment Management. I'm filling in for Brian Parker who's currently overseas.

Since Brian recorded the last video, world sharemarkets have lost ground, with much of the damage having been done in the last week or two as the crisis in Greece has intensified. Corporate debt spreads have narrowed a little further, and oil and key industrial commodity prices have fallen. As usual, John Owen, in another recording on this website takes you through the performance of markets and how MLC's portfolios have fared.

When we look back over the last month, it's pretty clear that markets have tended to focus less on the economic data and company earnings news, which have tended to be quite positive, and more on issues of sovereign risk, and on the impact of policy tightening moves in several economies, but most importantly in China.

Overall, the economic data released over the last month have tended to pleasantly surprise; particularly in the US and Asia. There are signs that the quality of the US economic recovery is improving. In particular, there are further signs that private sector spending is improving, without relying as heavily on Government support. The strength of the Chinese economy and signs of overheating in their property market, have prompted a number of policy tightening moves by the Chinese authorities, including imposing tough new minimum deposit requirements on residential property purchases.

During the past few weeks, market sentiment towards Greece and other countries on the European periphery has worsened. In Greece, there are severe doubts over the ability of the Greek Government to implement its austerity program and to bring down Greece's budget deficit. Efforts by the European Union to support Greece provided a temporary respite. More recently, a bigger package of support for Greece, involving both the European Union and the International Monetary Fund, has so far failed to stabilise markets. Instead, market turmoil has spread to Spain and Portugal, and Greece's credit rating has been downgraded by each of the three major credit ratings agencies.

It's therefore not really a surprise that European sharemarkets have tended to fair worse than other markets over the last few weeks; with the Greek, Spanish, and Portuguese markets falling sharply.

The turmoil in peripheral Europe is a reminder that even though world sharemarkets are still significantly higher than their crisis lows, and the world economy is in much better shape, there are significant imbalances to be rectified, adjustments to be made, and past financial sins that still need to be atoned for.

Here in Australia, our markets have not been immune from the weakness we have seen globally. The economic data continue to describe an economy that is probably growing at an average or trend-like pace, but also one that is on the verge of getting another significant boost to incomes and business investment from sharply higher resource export receipts. The recent release of the Henry report included new resource taxes, and though this was pretty well anticipated, it has caused some concern for mining stocks.

The improving outlook for the Australian economy has prompted the Reserve Bank to continue the process of normalising interest rates. In early May, they have again raised the cash rate by 25 basis points to 4.5% - the sixth such move since October last year. While this level of the cash rate is still historically quite low, key borrowing rates facing households and business are more in line with longer-term averages. This suggests that the RBA is likely to slow down the pace of rate hikes over the coming months.

Let's turn now to the economic and investment outlook.

We continue to view the global economic recovery as sustainable, and we remain in the camp that says the recovery is going to be more modest than usual. We also believe that the shape of the recovery will continue to vary significantly from region to region. Prospects for Europe, the UK and Japan for example, look quite a bit worse than the US. However, the relative performance of Asia and other key emerging economic regions is likely to remain impressive.

We also still believe that the outlook for the world economy is subject to much greater uncertainty than usual. The risk of a policy error - or even errors - is quite high, and the consequences could be quite dangerous. A renewed global downturn could occur if policymakers tighten too early and aggressively or we could see resurgent inflation if policy stimulus measures are left in place too long.

Another key risk we are focusing on is the risk of a more pronounced slowdown in China. The authorities have acted aggressively to rein in excesses in property markets, and do have a much greater ability to target their tightening measures than authorities in less regulated economies. However, if those tightening measures went too far, the impact on Chinese growth could have serious effects on growth across the globe, and indeed here in Australia.

Our medium-term estimates of return prospects look reasonable, but it is fair to say that prospective equity market returns – both here in Australia and globally - are a little lower than longer term norms. This speaks volumes about just how far and how fast markets rose during 2009, and how much of the recovery story is already priced into markets. That said, recent market weakness has probably enhanced prospective returns a little.

At the time of this recording, we are awaiting the Federal Budget. However Federal Budgets should rarely, if ever, cause medium to long-term investors to change their investment strategy. We don't expect this budget to be any different.

Thanks for listening.