

Economic and market developments, June 2010

Below is an edited transcript of a video recorded on 7 June, 2010 by MLC Investment Strategist Brian Parker.

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

Since Kerry Napper recorded our last video, world markets as a group have lost more ground, although there were quite reasonable gains in some markets. Corporate debt spreads have widened, and oil and key industrial commodity prices have fallen sharply. As we record this, our market is down by around 3% from our last video, with much of this decline occurring just today. Perhaps most dramatically, the Australian Dollar has fallen by around 8% against a resurgent US Dollar, and is down by around 4% against the currencies of our major trading partners. As usual, John Owen, in another recording on this website takes you through the performance of markets and how MLC's portfolios have fared.

If we look broadly at the behaviour of financial markets over the last month, two key themes stand out. One is that market participants remain much more risk averse than they were some months ago. You can see this in wider corporate credit spreads and in the lower Australian Dollar. Our currency has tended to be a reliable barometer of investors' risk appetite for some time now. Late last year, we reduced our exposure to the Australian Dollar in the Horizon funds in favour of foreign currencies, because we viewed the Australian Dollar as being vulnerable to just such a decline – for the time being, that position remains in place.

The source of this concern continues to centre on Europe, where markets believe that Greece and other countries on the European periphery are not out of the woods yet. All this is despite the package of measures announced by the European Community and the International Monetary Fund that Kerry referred to last time, and the successful passage of austerity measures through the Spanish and Portuguese Parliaments.

Concerns over the health of Government finances aren't solely focused on the Euro-zone. The reality is that budget deficits and rising public debt levels are a concern elsewhere – most notably in the US, UK, and Japan.

The second theme that seems to be emerging from financial markets is the fear that the global economic recovery that seems to be underway will prove unsustainable, and you can see this playing out in weaker share prices, as markets fret over the implications of weaker economic growth for corporate profits, and in weaker industrial commodity prices. In commodity markets, recent actions by the Chinese authorities to arrest what many see as an emerging bubble in Chinese property market might cause a more pronounced slowdown in Chinese economic growth – an outcome which would have obvious implications for Australia.

The two themes are interrelated. One key reason why the global economic recovery might falter is if Government take steps to rein in their budget deficits, which would involve higher taxes, cuts to spending, or both, which would in turn slow the overall economy.

Perhaps ironically, these concerns over the outlook for the economy have come during a period where the economic data – in the US, Asia, and even in Europe – have actually tended to be better than market expectations. How long this remains the case is an open question, however, I think there are reasons for cautious optimism, particularly if we look at the US economy. As I speak, the local share market is responding adversely to what was a disappointingly small gain in US employment during the month of May. However, even though the data were disappointing relative to market expectations, there are still reasons for optimism. The private sector is still adding jobs, hours worked are still rising, and most importantly, the core source of household income – wages and salaries – are rising. We need to see this in order for US consumers to keep growing their spending – even modestly.

Here in Australia, the economic data we have seen have been a little mixed. Retail sales and some housing indicators have been softer, labour market indicators continue to improve. Business confidence levels are still healthy, although consumer confidence has fallen quite some way in recent months. On the external side of our economy, demand for our key commodity exports has improved, as have the prices we are receiving for those exports. The latest national account figures for the March quarter – released just last week, highlight just how important Government policy has been in maintaining a reasonable rate of economic growth during and after the worst of the GFC. Over the coming year or so, investment spending, exports, and a resurgent housing sector are likely to take over as the key drivers of growth.

After raising the official cash rate to 4.5% in early May, the Reserve Bank opted to leave rates unchanged in June, acknowledging that the global environment has become more unsettled. They have also noted that key borrowing rates faced by households and

businesses are much closer to what might be described as normal levels. I think this suggests that the Bank is likely to be much more cautious in raising rates from here. Nevertheless, I think it's prudent to work on the assumption that if Australian official interest rates are going anywhere soon, then they're still going up.

Barring new shocks, the global economic recovery is sustainable, but we remain in the camp that says the recovery is going to be more modest than usual. As we have repeated many times, households in a number of economies, as well as financial institutions still have more work to do to restore balance sheets to health, which will tend to restrain spending as well as the demand for and supply of credit. Governments in many economies will be forced to raise taxes, cut spending, or both in order to rein in budget deficits. The fact that economic recovery is underway and sustainable, makes these adjustments easier, but doesn't eliminate the need for them.

Our medium term estimates of return prospects look reasonable, and if anything, have risen to be much closer to long-run norms than they were a month or so ago. Over the medium term, equity markets still seem to offer the best chance of delivering decent real returns for investors.

Traditional safe haven assets, such as Government bonds appear to offer poor return prospects, particularly in overseas markets. The kind of yields on offer in Government bond markets in the US and elsewhere appear to offer little compensation for the risk that higher inflation may be the end result of the range of policy measures that Governments have put in place, nor do they appear to compensate for the fact that these Governments will still have enormous borrowing requirements for some years to come. It was largely these concerns that led us to reduce the global allocation within our debt portfolios earlier this year and also to reduce our exposure to longer dated securities in those portfolios.

Thanks for listening. And we'll talk again in another month.