

Economic and market developments, July 2010

Below is an edited transcript of a video recorded on 6 July, 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 we recorded our last video, the world's major share markets have lost more ground. Markets in the developed economies have seen share prices fall by around 2.5% over the month. Since their recent peaks in April, share prices in these markets have fallen by around 15%. If we look at the emerging share markets however, the picture looks a little different. Share prices in those markets are down from their recent peaks, but only by around 9%, and over the last month or so, prices are actually up by around 1%.

If we turn to debt markets, Government bond yields have fallen in most countries since our last recording, with the exception of some countries on the European periphery – Greece most notably - where yields have risen as sovereign risk concerns still persist. In commodity markets, the price of oil and most key industrial metals have risen over the last month or so, but are still well down on their recent peaks.

In currency markets, the Australian Dollar recovered some lost ground, but is still trading around 10% lower than this year's highs against the US Dollar. As usual, John Owen, in another recording on this website takes you through the performance of markets in some more detail and how MLC's portfolios have fared.

I think there are two broad concerns facing markets right now. One is that investors are still more risk averse than they were some months ago, and sovereign risk concerns remain a big part of this. Despite a massive package of measures announced by the European Union earlier this year, markets continue to price in a very high likelihood that Greece, in particular, will end up having to default on its obligations. In the last month or two, we've seen Spain, Portugal, and the UK announce packages of austerity measures designed to reign in excessive budget deficits.

As we've highlighted previously, concerns over the health of Government finances aren't solely focused on the Euro-zone or the UK. The reality is that budget deficits and rising public debt levels are a concern elsewhere – most notably in the US and Japan. The new Japanese Government has signalled that it will introduce measures, including higher consumption taxes, to address Japan's massive budget deficit and public debt. In the US, the political debate has increasingly veered away from the need for policy to support the economy towards the need to take steps to reduce its fiscal deficit.

All this talk of austerity packages and the need to reign in fiscal deficits seems to be contributing to the other great concern of markets right now, namely, the sustainability of the economic recovery. All other things being equal, higher taxes and lower Government spending are a drag on economic growth. The economic data released over the last month or so highlights just how fragile the global economic recovery is. The numbers still look OK, but on balance, they haven't looked quite as good as they did earlier this year.

We have argued previously, that *barring new shocks*, the global recovery will be sustainable, albeit a relatively modest affair. One of the shocks that could easily upset that view is a premature tightening of either monetary or fiscal policy in the major economies. Policy makers have to walk a very fine line here. Yes, large budget deficits are a concern and will require policy tightening over the medium term, but tightening too soon could seriously derail the recovery. As a number of market watchers have noted recently, Governments will have to walk and chew gum at the same time.

Let's turn now to Australia. On the whole, the economic news continues to be a little mixed. If we look at the business surveys, they seem to be consistent with an economy growing at about a 3% annual pace in the first half of the year. Employment continues to grow, and the unemployment rate is still trending lower. On the other hand, consumer confidence has fallen quite sharply in recent months, and retail spending growth seems to be slowing. Looking ahead, the outlook looks reasonable to us. A healthy pipeline of investment spending, a sustained global recovery and a modest upswing in housing activity should support growth over the next year.

After raising the official cash rate to 4.5% earlier this year, the Reserve Bank has again opted to leave rates unchanged after their July meeting, acknowledging that the global environment has become more unsettled, and that key lending rates are broadly back to what might be called neutral levels. While I think the Bank is likely to remain very cautious in raising rates further, I still 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.

Our medium term estimates of return prospects look reasonable, and have risen closer to long-run norms after the recent weakness in equity markets. In short, equity markets are cheaper than they were a month or two ago. Over the medium term, equities still seem to offer the best chance of delivering decent real returns for investors, particularly because traditional safe haven assets, such as Government bonds appear to offer poor return prospects, especially 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 funding requirements for some years to come.

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

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