Market Watch

MLC

Economic and market developments, December 2010

Below is an edited transcript of a video recorded on 3 December 2010 by MLC Investment Strategist Brian Parker.

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

Much has happened since we last spoke. Since we recorded our last video, world share prices have risen by around half a percent, with the major developed markets, most notably Japan, responsible for the bulk of that gain. Emerging share markets as a group were weaker over the past month, but there was quite a bit of variation in the performances of the individual emerging markets. Not surprisingly, equity markets in peripheral Europe fell sharply. Portuguese and Spanish shares were hardest hit, with prices falling by around 7% and 8% respectively. Australian share prices underperformed other developed markets, falling by around 1%.

In bond markets, Government bond yields in the major markets rose across the board. In the US, bond prices fell despite the Federal Reserve's announcement of a second round of quantitative easing. Sovereign risk concerns in Europe flared up quite dramatically in recent weeks. The announcement of a financial rescue package for Ireland, following on from the package for Greece announced earlier this year, failed to restore confidence. If we look at the pricing of the bonds issued by the worst affected countries, markets are still pricing in a very high probability that Greece and Ireland will end up defaulting on their obligations and this despite all the rhetoric and actions about austerity. Attention has now turned to Portugal that is widely tipped to also require a financial rescue of some sort.

With this backdrop, the sharp falls in Spanish and Portuguese share prices is no surprise, and neither is the fall in the value of the Euro over the month against the US Dollar. After breaking above parity with the US Dollar during November, the Australian Dollar fell back below that level, as sovereign risk concerns heightened.

In addition to sovereign risk concerns, geopolitical risk also reared its ugly head. North Korea's artillery barrage on South Korean territory, unsettled financial markets towards the end of November.

Shortly after we recorded our last video, the US mid-term Congressional elections resulted in the Democrats losing their lower house majority, and having their Senate majority trimmed. The potential for policy gridlock is very real, and the exact implications of this for the US economy and markets is unclear. Any attempts to use fiscal policy to further stimulate growth will quite likely fail to successfully pass both Houses. However, attempts to aggressively tighten fiscal policy in the near term will also likely fail to pass, and given the fragility of the US economic recovery, that is no bad thing.

As usual, my colleague John Owen will address the performance of markets and MLC portfolios in more detail in a video elsewhere on the website.

Turning to the economic data released over the last month, the picture of global growth that they paint still looks quite reasonable. In Australia, national accounts data for the September quarter showed that the economy posted growth of just 0.2% for the quarter, a result that was a little softer than markets were expecting. Both private and public spending contributed to growth, offsetting a drag from net exports. Consumer spending continues to grow, but consumers are not growing their spending as quickly as we might expect given how strong their income growth has been. Consumers' caution is perhaps best shown by the fact that the household saving rate (the percentage of our income that we save) has soared over the past year or so. After saving -2.5% of our income at the end of 2003, Australian households saved 10.2% of their disposable income during the September quarter of 2010.

The picture of a somewhat cautious consumer shown in the national accounts has been backed up in the last day or so by a surprising fall in retail sales during October.

Softer than expected economic growth and a more cautious consumer increases the likelihood that the Reserve Bank will keep interest rates unchanged over the next few months. In fact, the RBA Board generally doesn't meet in January. Key borrowing rates for home owners and small to medium sized businesses are now higher than longer term averages, even though at 4.75%, the cash rate is clearly not. I'd expect the RBA to be very cautious about raising rates further from here. However, as I've repeated often in recent recordings, it is still prudent to work on the assumption that if Australian cash rates are going anywhere soon, then they are still likely to go up.

We remain of the view that growth in the major economies is likely to remain reasonable, but unspectacular. The environment remains highly uncertain, but we don't expect a renewed recession in either the US or the other major economies. For those countries on the

European periphery, the outlook remains much worse. If we look at Greece and Ireland in particular, what those countries are facing is nothing short of depression. In the absence of their own, floating currencies, and without any monetary policy flexibility, and with huge budget deficits, the only way back to competitiveness and recovery is falling wages and prices, and hence a period of prolonged economic decline. At some point, cost structures in these economies become low enough to bring buyers and investors back. However, that could take many years. As the economist John Maynard Keynes so eloquently put it many years ago: in the long-run, we're all dead.

When it comes to prospective returns for the major asset classes, we are still of the view that over the medium term, equities still seem to offer the best return prospects for investors, particularly because traditional safe haven assets, such as Government bonds appear to offer poor future returns, especially in overseas markets. Overall investment returns are still likely to be more modest than many investors enjoyed for much of the decade or more leading up to the Global Financial Crisis, and the environment is likely to remain quite volatile. The events of the last month have served to highlight just how uncertain is the world in which we live and invest.

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