Economic and market developments, October 2010

Below is an edited transcript of a video recorded on 7 October, 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, world share prices have risen, with the strongest gains occurring in the emerging markets. Perhaps not surprisingly, European markets haven't performed as well, but are at least up over the month. This kind of price action might suggest greater confidence in prospects for the world economy – at least outside of Europe – and the fact that prices for a range of industrial metals were also up solidly over the month lends weight to this interpretation.

However, when we look at bond markets, we see that Government bond yields have fallen back over the month in most overseas markets. While this might be giving us a different signal about world growth prospects, I think there are other factors at play. It seems clear that markets still do not expect growth to be strong enough in the major economies to cause those countries' central banks to unwind the monetary stimulus measures that remain in place. In fact, it seems that at least some central banks are likely to take even further steps. In the last few days, the Bank of Japan has announced that they will be injecting even more liquidity into the financial system via what's known as quantitative easing – the outright buying of a range of financial assets. Moreover, over the course of the last month, comments from US Federal Reserve officials suggest an increasing willingness on the part of the Fed to conduct a further round of quantitative easing, or what's become known as "QE2".

In currency markets the Australian Dollar is up by around 6.5% against the US Dollar over the last month to trade at around 97 US cents as we speak, within sight of parity. To be fair, the US Dollar has weakened against most currencies, but particularly against the Euro. When riskier assets perform better, as we've seen over the last month, the US Dollar has tended to weaken. The likelihood of further easing measures from the Fed also undermined the currency, particularly against the Euro where the European Central Bank is not expected to take further monetary steps, and is more likely to let the measures they have in place unwind over time.

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.

If we turn to the economic data released around the world, they don't look as soft as they did earlier in the year. Surveys of business conditions in the US seem to have stabilised. While the data on the US housing sector remain almost uniformly bleak, other data show that business orders for new equipment are still improving, retail sales are growing again, and the private sector is still adding jobs, although clearly not fast enough to bring unemployment down in any significant way. In order for the much-feared double-dip in the US economy to emerge those numbers would need to be much weaker than they currently look. Elsewhere, business conditions indicators have picked up in Japan and in Europe, led largely by Germany. Conditions on the European periphery remain pretty dire, and markets remain extremely concerned about the financial position of those economies.

In China, economic growth has slowed somewhat over the course of this year, but the pace of growth remains extraordinary. The key data released over the last month on industrial output and retail spending have actually accelerated.

Turning to the Australian economy, the economic data have been something of a mixed bag. As we reported last month, the national accounts data are showing solid growth. So far in 2010, employment gains have averaged around 30,000 jobs a month, and the leading indicators of employment suggest that further gains are likely. Consumer confidence has fallen, but is still historically high. Retail sales numbers have been subdued, but other categories of consumer spending have grown strongly. In the housing sector, we've finally seen a pick-up in building activity appear in the data, but the leading indicators of housing activity such as loan and building approvals have come off. The outlook for business investment still looks very strong, led by the resources sector, where there remains a good deal of work in the pipeline.

At its September meeting, held shortly after our last video, the Reserve Bank left interest rates unchanged at 4.5%, and surprised nobody. In recent days however, the Bank has again opted to leave rates unchanged, and this time, surprised almost everybody, given that comments from Bank officials during the month were interpreted as signalling a near term rate increase. As I mentioned in past recordings, I still believe it's prudent to work on the assumption that if Australian official interest rates are going anywhere soon, then they're still going up. The Statement accompanying the Bank's decision to leave rates unchanged seemed pretty consistent with that view.

Let's conclude by discussing prospects for the economy and investment returns. On the economy, we still believe that growth prospects in the major economies are likely to be quite subdued over the coming years, but we don't expect a renewed recession or double-dip to occur. It is still a highly uncertain environment for the world economy and financial markets. The world economy still needs policymakers to make some difficult judgements over the coming years. Stimulatory measures need to be kept in place to insure that growth can be sustained, but there is a real risk that a premature move towards tighter policy in the major economies could derail things.

We expect growth here in Australia to remain pretty solid, but there are signs of a return to what became known as the two-speed economy. While mining and industries closely linked to it are set to grow quite rapidly, the remainder of the economy seems likely to produce growth that's more subdued, particularly as tighter monetary and fiscal policy settings start to bite.

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 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. In addition, 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. It's in these times when skilled active investment management become extremely valuable.

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

Important information

General advice warning and disclaimer - This information has been provided by MLC Investments Limited (ABN 30 002 641 661), a member of the National Group, 105-153 Miller Street, North Sydney 2060. Visit the MLC website for our general advice disclaimer. Currency and accuracy of Information - While the companies in the MLC Group have taken all reasonable care in producing this information, subsequent changes in circumstances may occur at any time and may impact on the accuracy of the information. Third party information - The MLC group relies on third parties to provide certain information and is not responsible for its accuracy. The MLC Group is not liable for any loss arising from any person relying, either wholly or partially, on information provided by third parties. Past Performance - Past performance is not indicative of future performance. The value of an investment may rise or fall with the changes in the market.