

Economic and market developments, January 2011

Below is a transcript of a video recorded on 4 February 2010, by MLC Investment Strategist, Brian Parker.

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

Since my colleague John Owen spoke to you last month, world share markets, when viewed as a whole, have enjoyed a reasonable start to 2011, with prices rising by around 1.5%. However, while prices in the developed markets were higher over the month, emerging equity markets are around 2% lower. We've also seen a good deal of divergence in the performance of individual markets, even within the same region. In our market, share prices have also risen – up by around 1.5% as we speak – with markets generally prepared to look through the initial adverse impacts on Australia's growth from the floods in Queensland and Victoria. Later in this recording, we'll discuss the likely impacts of those floods and Cyclone Yasi which has hit Far North Queensland overnight.

In bond markets, longer dated Government bond yields have generally continued to rise, while corporate debt spreads over Government bonds have generally narrowed. In the crisis economies on the European periphery, yields have actually fallen, and the spread between the yields of those countries and those of Germany have narrowed. While this points to a significant improvement in market sentiment towards these economies, whether it is justified or not remains to be seen.

Prices for oil and most industrial metals are up significantly, but the price of gold has fallen back a little. In currency markets, the Australian Dollar has again moved above parity with the US Dollar, which in turn has weakened against most of the major currencies.

If we look at the behaviour of financial markets as a whole, confidence in the global economy and in the likelihood of a resolution to the plethora of risks and uncertainties that have plagued markets for some time now, has clearly increased.

If we look at the major developed and emerging economies, much of the economic news released over the past month, particularly in the US, China, and Germany, would seem to validate that optimism.

The overall tone of the economic data in the US has been much better. While jobs are not yet being created fast enough to bring unemployment down meaningfully, the fact is that jobs are being generated, incomes are rising, and business surveys have been strong. While consumer confidence remains very subdued - reflecting the fact that unemployment remains stubbornly high and the housing market dead flat – consumers are nevertheless growing their spending.

In China, the economy accelerated towards the end of 2010, and continues to post astounding growth rates. At the same time, inflationary pressures continue to build. These have already resulted in a series of policy tightening measures by the Chinese authorities, and further measures seem inevitable as we proceed through 2011.

In the last few months, we've taken the view that growth in the major economies is likely to remain reasonable, but unspectacular. We've argued that the environment remains highly uncertain, but we don't expect a renewed recession in either the US or the other major economies. That remains the case – if anything our confidence in the global recovery has increased in recent months.

We have also argued that for financial markets it was likely to remain a volatile environment. Over the past few months, tensions between North and South Korea were a reminder that geopolitical concerns always have the potential to unsettle financial markets. While those tensions have abated somewhat, recent developments in North Africa and the Middle East – most notably in Egypt – have also proved unsettling for markets, and exactly how those events will pan out is highly uncertain.

For the Australian economy, the economic news remains somewhat mixed. The two speed economy is alive and well, with regions and industries linked to the resources boom posting solid growth, and elsewhere, growth being more subdued. Consumers in particular have been surprisingly cautious in their spending, preferring to save around 10% of their income, despite professing to be quite confident about their situation in sentiment surveys.

Let me make some brief comments on the likely impacts of the severe flooding in Queensland and Victoria, and most recently, Cyclone Yasi in Far North Queensland. At MLC, our hearts go out to all those affected, and frankly, given the extent of the human suffering involved, talking about the economic impact always runs the risk of trivialising the events. Nevertheless, there will be an economic impact. In the short-term, there will be a negative impact on Australia's recorded growth, and higher fresh food prices will add to inflation. Over time however, repair and reconstruction work will add significantly to the pace of economic growth, and the inflationary impacts of higher food prices will fade.

For the Reserve Bank, these shorter term impacts on growth and a more cautious consumer should enable them to leave cash rates unchanged for a while yet. They are also likely to look through any temporary spike in inflation when making interest rate decisions. If there is a rate change over the coming months, then the risk is that rates will still move higher. However, with key borrowing rates already above longer term averages, and with consumers cautious, and end to the Reserve Bank's tightening cycle may not be far away.

Turning to markets, 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. Although to be fair, yields have risen considerably, and prospective returns are somewhat better than they were. Broadly speaking, equity markets look to be fairly valued. While share prices have risen of late, so too have corporate earnings, and the outlook for the global economy remains generally supportive for share markets.

Thank you again for listening; I wish everybody the very best for 2011, and we'll speak again in another month.

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