

Economic and market developments, April 2011

Below is a transcript of a video recorded on 4 April 2011, by MLC Investment Analyst, Kerry Gill.

Hello everybody, my name's Kerry Gill, and I'm an Investment Analyst in the Capital Markets Research team at MLC Investment Management.

Since my colleague Michael Karagianis spoke to you in March, tragic events have unfolded. The Japanese earthquake and tsunami were devastating in terms of human loss, and the subsequent nuclear threat is still being resolved. The economic and short term market impact of the disaster was significant, with Japanese equity markets falling over 16% in the days after the earthquake. Share prices in the region also fell, with Chinese, Hong Kong and Australian markets losing at least 2% in the same period. Markets rebounded, but Japan's market is still 8% below pre-disaster levels. US 10 year bond yields fell and the Yen rallied on expectations of Japanese repatriation, but both subsequently reversed over the month. The Australian dollar looked a little more fragile in the jittery risk-averse week after the quake, but rallied strongly as confidence returned.

Over the last month, the political crisis in Libya has seen oil prices continue to rise. Risks have been escalating in the Middle East with tensions also rising in Saudi Arabia's neighbour, Bahrain. Developments in Bahrain and Libya are important for Western nations due to the significance of these countries for the flow of oil. The benchmark Brent oil price has risen by over 20% to US \$117 per barrel since the start of the year.

In the midst of all this, policy stimulus is gradually being withdrawn from the global economy. While the US is an important exception to this, the European Central Bank has begun talking about tightening monetary policy, with an increase in interest rates expected from April. China continues to increase its reserve ratio requirements, making their third tightening move for the year during March.

On balance, the economic news released over the past month remains consistent with a growing world economy, and the key leading indicators that we track suggest that this growth is set to continue. In the US, housing data continue to be relatively dismal, and unlikely to lend any support to the recovery. However, US leading economic indicators have been rising and the labour market continues to improve. A stronger labour market boosts household incomes and spending, which in turn boosts overall growth and generates more employment. This is the essence of a self-sustaining economic recovery. However, the US is not out of the woods yet. There remains risk of delinquent mortgages and further house price weakness derailing the economy.

The sequence of adverse shocks in recent months, from floods in Australia, to earthquakes in New Zealand and Japan, through to Middle Eastern turmoil, have occurred to a global economy that is still somewhat fragile. The world is still working through the aftermath of the developed world's excessive build up of debt and the resultant global financial crisis. However, the world economy is better able to withstand the kind of shocks currently being experienced than it was just two years ago. The Japanese crisis is a negative for global growth, but it is unlikely to de-rail the global economy. While Japan is the world's third largest economy, the global recovery has not depended on Japan for its momentum. In fact, the contrary is true, with Japan's recovery being highly export dependent. It will be a while before the economic impact will be revealed, but it is hoped that in the medium-term the Japanese crisis will bring both a boost from reconstruction, and the kind of decisive policy action that could perhaps help end Japan's twenty-year long economic malaise.

Japan is a major trading partner of Australia, and for a time the disruption to Japan's industrial activity is likely to affect demand for Australia's exports. However, a resource intensive recovery effort is likely to boost our exports to Japan over time. The Reserve Bank of Australia continues to look like it will keep interest rates on hold for now. However, if rates are going anywhere over the coming months, it is still prudent to assume that they are going up.

Events in Japan have caused the world to scrutinise the reliance on nuclear power as a safe and clean source of energy. Sustained rises in oil prices, which are not unrelated to the turmoil in the Middle East, could undermine global GDP growth. Inflation measures may also get a temporary boost. In particular, recent catastrophes push out the time frame within which policy settings will be normalised and a successful, sustainable recovery can emerge. This increases the risk of an inflationary end game.

In the medium term, the course of policy action remains a critical variable. With the fiscal stimulus now going away in advanced economies, the European Central Bank talking about tightening monetary policy, and the UK facing rising inflation, can the recovery in advanced economies be sustained once the stimulus is gradually phased out? This is a pivotal question. It is still not clear that the global economy is on a path to normality. The fundamental issue is that debt levels have not yet declined. A private sector debt problem has become a public sector debt problem, but the resolution of the problem is uncertain.

There are a number of potential paths forward. Our medium term scenarios envisage a range of benign or even positive futures, but also some more challenging environments. There may be a lower probability today of the tail risks such as deflation and a major global recession, but the world is not without risks right now. There is continued sovereign risk from rising public debt and deficits across not just the European periphery, but also the US, Japan and the UK. The strength of the Emerging markets may now be implying overheating, rising inflation, and a risk of asset bubbles in those markets. Emerging markets have not yet been willing to use interest rate policy and exchange rate policy to any significant degree.

Overall, what do prospective returns look like?

We remain in a highly uncertain environment. Given the relatively robust position of many companies, we continue to believe that equity markets offer the potential to deliver reliable returns over the medium term, with global bond markets still appearing expensive.

If we have learned one lesson in the last month, it is again the lesson that diversification matters. The unpredictability of nature's actions in Japan and events in the Middle East highlight the importance of diversification. Diversification needs to consider both the impact of predictable risks, but also those risks that are by their nature completely random or unexpected.

Thanks for listening.

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