Economic and market developments, April 2011

Below is a transcript of a video recorded on 3 May 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 I spoke to you in April thankfully no new major disasters have befallen the global economy. The crisis in Libya is ongoing, and oil prices have continued to rise. As I mentioned last month, developments in the Middle East and Northern Africa are important for Western nations due the significance of these countries for the flow of oil.

The consequences of the disaster in Japan are still unfolding. Japanese industrial production and consumer spending dropped at their sharpest rates on record in March, and Japan continues to face rolling blackouts and the uncertain impact of a nuclear disaster. The economy is facing supply constraints from damage to production facilities, malfunctioning supply chain networks, and a lack of stable power supply. These constraints are unlikely to be overcome any time soon. We expect there to be flow on effects from Japan to its Asian neighbours as input supply and inventories disrupt production and exports. In the longer term, however, there remains the possibility that policy responses may shift Japan out of its economic slump.

Share markets generally produced positive returns over the month. The European and US share markets performed best, while emerging markets, Japan, and Australia had a more lacklustre month. Global bond markets rallied through April, and the US dollar fell. Most notably for us here in Australia, our dollar rose from $1.03 US dollars at the end of March, to over $1.09 at the end of April. I'll come back to discuss the Australian dollar shortly.

In terms of policy, some anticipated tightening of monetary policy has occurred. The European Central Bank increased interest rates by 0.25% at its April meeting. On one hand Germany is performing well under loose monetary policy conditions, while the periphery continue to struggle, with Greece announcing another round of austerity measures during the month.

The People's Bank of China announced the fourth reserve requirements hike for the year during April. Data during the month confirmed that China's GDP did slow in the last quarter of 2010, but inflation remains a concern.

Meanwhile the US Federal Reserve has its eyes on oil and gold prices which have continued to rise. Although rising commodity prices push up headline inflation rates, the Fed continues to look through these price rises, viewing them as essentially temporary impacts on inflation, but also as negative for growth because they act like a tax on spending. At the end of April, the US Fed held its first ever press conference after a policy meeting of the Fed Open Market Committee. It confirmed that they are allowing the current quantitative easing to finish, but also that they are a long way from starting any policy tightening.

The flow of economic news indicated that the US economy continues to grow at a moderate pace. Manufacturing is outpacing demand, but demand is limited by income growth. Credit growth remains relatively slow, though it is improving. There has been moderate employment growth as firings have declined.

Despite improving global economic data, the resolution to the global debt problem is still unclear. Standard and Poors released two important sovereign credit ratings in April. The US maintained its AAA credit rating. However, the outlook on its long term rating was revised to negative from stable, based on their very large budget deficits, rising government indebtedness and an unclear path for addressing these issues. Similarly, Japan's sovereign rating outlook was cut to negative from stable, as the country's reconstruction needs post-earthquake will likely add to what is already the world's biggest debt load

As I mentioned earlier, the Australian dollar has appreciated dramatically against the US dollar recently, though it is more stable against other major trading partners. US dollar weakness is related to the Fed's policy stance and greater resilience by risk takers.

The strength of Australia's currency is due partly to US dollar weakness, but also to various inter-related factors such as interest rate differentials, growth across Asia, speculative flows, and Australia's extremely high terms of trade. The tightening moves in Europe and China that I mentioned earlier are important for our dollar, as they will reduce interest rate spreads between Australia and our major trading partners. At MLC, while we acknowledged that there are sound fundamental reasons why the Australian dollar should be strong right now, the currency does look overvalued on traditional measures, and is highly vulnerable to any significant reversal in commodity prices, or to a renewed sense of crisis in global financial markets.

Despite a higher dollar, Australian inflation for the first quarter came in higher than expected, with headline inflation above 3%. This was largely due to sharp rises in fruit and vegetable and petrol prices. Australian economic growth remains reasonable, and unemployment remains low. Though it may not happen for a while, we continue to expect that the next interest rate move by the RBA is likely to be up.

Inflation is moving up the agenda of policy makers and commentators, with surging food and commodity prices particularly evident in emerging markets. The strength in the global economy that is producing inflation pressures is centred on emerging market countries and will require tightening by those same countries. However, emerging market economies have cramped their monetary policy flexibility by their exchange rate policies.

Policy makers will be required to exercise extremely difficult judgements in coming years to sustain growth, prevent a slide into deflation, while guarding against an excessive, undesirable rise in either asset price or general inflation. Additionally they have to rein in excessive budget deficits over the medium to longer term.

In summary, we recognise there are many uncertainties and many risks, but although there are structural problems in the global economy there is also a decent chance that the world economy will muddle through or even do a little better than that. In short, there are reasons for cautious optimism. For example, we continue to be encouraged by the strong financial position of many companies, and by the financial health of many countries in the emerging world.

When we look at how financial markets are likely evolve over the coming years, we still find that equity markets offer the best return prospects for investors, particularly when compared to traditional safe haven assets such as sovereign bonds and cash.

Thanks for listening.

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.