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A Winding Road - looking back, looking forward

The past couple of months have certainly seen an increase in volatility in the share market. In May alone there were 15 days when the All Ordinaries Index rose or fell more than one per cent. Whilst it's unsettling to see your savings buffeted on a daily basis, share markets remain an integral part of investment portfolios, not least for the diversification they offer.

Indeed May saw both the Australian share market and the Aussie dollar experience their most volatile month since the peak of the Global Financial Crisis (GFC). And for shares, June's rocky start has continued.

During May, \$110 billion was wiped off the value of shares in the biggest monthly fall since 1984. But it's important to note the market at June 28 was still more than 30 per cent higher than its low in March last year.

The dollar meanwhile slumped by US7.76c or 8.4 per cent during May but has since recovered some ground.

And year-on-year our share market is up around 13 per cent — so it's just the journey that has been a bit choppy!





Australian experience

So what are these events? And how is Australia really travelling?

In reality, the Australian economy is travelling well, certainly when compared to other western economies. Debt levels are low – minuscule when compared to the US, Japan and Europe – unemployment is low, and inflation is just under 3 per cent. And even though GDP was only 0.5 per cent in the March quarter, annual growth of 2.7 per cent was in fact higher than the original forecast of 2.4 per cent.

Unemployment, for instance, is sitting at just 5.2 per cent in May, almost half the level in the Euro area (10.1 per cent) and the US (9.7 per cent). Much of our performance comes from our strong links with the growing economies of China and India.

In the words of Reserve Bank Deputy Governor Jillian Broadbent, Australia sells more to emerging economies than submerging economies.

The China story

And China appears to be still going great guns, despite some doubts that have been unsettling the market. May 2010 figures showed a 48.5 per cent jump year-on-year, triggering a rally on world markets.

Of course nobody is expecting the country to enjoy double-digit growth indefinitely but continued strength in China signals continued demand for our resources.

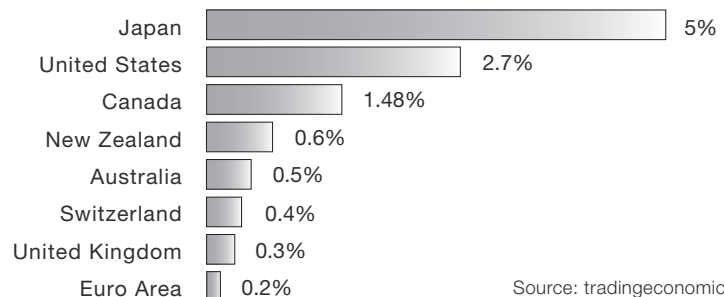
Flight from risk

A whole raft of events are causing uncertainty in financial markets but mostly it is based on a flight from risk to safer havens. There is always risk when investing in global share markets and in currencies like the Australian dollar with its strong link to commodities.

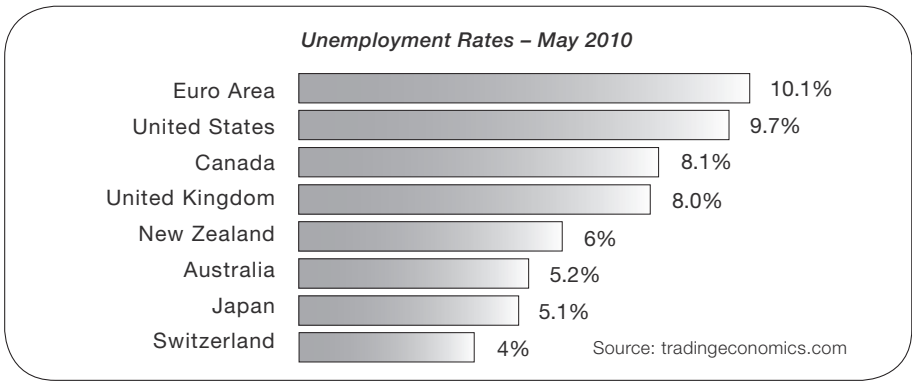
Of course some of this fear is irrational, as fear often is. With the GFC still fresh in everyone's memory, there is a heightened sense of caution that the market might just be getting ahead of itself and this feeds off the anxiety.

But as Reserve Bank Governor Glenn Stevens recently said: "The current events in Europe have triggered a market response that is similar to the global financial crisis in quality, but not in magnitude."

GDP Growth - March Quarter 2010



Source: tradingeconomics.com



Indeed, resources are the key to Australia's faster-than-expected recovery from the GFC in 2009 – with the exception of aluminium. Copper witnessed a 27.99 per cent growth in prices year on year, platinum 27.53 per cent, gold 24.25 per cent and silver 10.82 per cent.

When the world feels good about China, this encourages investment in Australian shares and our currency as both are seen as commodity plays. Conversely, if China looks shaky then there is a retreat from these investments – that's what we saw when the Aussie dollar tumbled from over US90c to as low as US80.66c in just a matter of days. The better export figures from China, however, saw it rebound to over US85c.

2010 Commodities (% increase)	
Aluminium	-26.49 %
Copper	27.99 %
Platinum	27.53 %
Gold	24.25 %
Silver	10.82 %

Source: tradingeconomics.com

What's happening in Europe?

The other factor weighing heavily on markets in recent times has been the debt crisis in Europe. Fears of a default by one of the troubled, debt-ridden economies, like Greece, Spain, Italy, Ireland and Hungary, have continued to unnerve investors. Along with fears

of default, are also concerns the austerity measures the European economies are taking to bring down their debt levels will reduce GDP activity, which in turn will lead to lower demand for goods.

But in reality how much will the fall out in Europe impact the economies of other countries? Head of the US Federal Reserve Ben Bernanke recently said the US economy was on track to grow 3.5 per cent, as he sees only a modest impact from the euro zone debt crisis as long as markets continue to stabilise.

So if the US is relatively dismissive of the impact of Europe on its shores, then Australia surely has even less to worry about.

Rent resources tax

Another cause of uncertainty in share markets is the rent resources tax which the Federal Government proposed in the May Budget. It's not just the proposed tax itself that is causing concern; the heated debate surrounding the issue is throwing up issues that may or may not be reality.

One camp says the tax is discouraging overseas investors from putting their money into Australia; others say it is just hot air from the mining companies.

While a recent study by KPMG found mining companies would face an effective tax rate 42 per cent higher than the global average if the proposed super profits tax is introduced, it now seems probable

there will be changes to the proposal. Only time will tell what will eventuate, especially now that Prime Minister Gillard is in the chair.

Consumer confidence

All these factors have undermined confidence among both businesses and consumers in Australia.

The Westpac–Melbourne Institute of Consumer Sentiment shows confidence dropping again in June, to give a fall over May–June of 12.7 per cent, the largest fall since March 2008 when we were in the depths of the GFC.

Respondents cited the budget and tax issues as key areas of concern, along with the hikes in interest rates in recent times.

Business confidence also took a beating in May especially in mining, wholesale and manufacturing, fuelled by the sharp declines in the Aussie dollar and equity prices.

The NAB Monthly Business Survey showed business confidence fell for the third month in a row and at +5 index points is now below its long-run average of +7 index points.



Snapshots



But while confidence may be shaky, the actual economic statistics belie this. Our GDP continues to grow, albeit at a much slower rate than some other western economies. But of course it should be noted that Australia never went into recession so the other economies are coming from a far lower base.

Overall the IMF expects the world economy to grow by 4.2 per cent this year while the OECD is looking at 4.6 per cent.

Interest rates

While the Aussie dollar is seen as a commodity-play currency, one would have thought with our attractive interest rates it will continue to be in demand. After all, our interest rates are well out in front of all other western economies at 4.5 per cent. Our neighbour, New Zealand, comes next at 2.5 per cent but then it drops away to one per cent in the Euro zone followed by Canada, the UK, US, Switzerland and Japan, all at less than one per cent.

It seems likely interest rates in Australia will be on hold in the near term given the slowing in our economy after six rises in the space of eight months. No doubt this will be a welcome respite for home buyers and small business.

Home affordability

Indeed, the recent increases in rates have had a negative impact on housing affordability. According to figures from the Real Estate Institute of Australia, 32.6 per cent of income is now required to service

Interest Rates	
Australia	4.50 %
New Zealand	2.50 %
Euro Area	1.00 %
Canada	0.50 %
United Kingdom	0.50 %
United States	0.25 %
Switzerland	0.25 %
Japan	0.10 %

Source: tradingeconomics.com

loan repayments (March quarter). This is up from 30.7 per cent in the December quarter.

So where to from here?

The end of June saw European shares fall sharply amidst concerns of a potential liquidity squeeze after the European Central Bank refused to extend liquidity measures to the banking sector. Over the next few months we are likely to see many more bumps in the fragile road to recovery both here in Australia and in world markets.

It's worth noting the Australian share market makes up less than 3 per cent of global markets compared with 24 per cent for the US market. However, because 40 per cent of Australian shares are owned by overseas investors, offshore events can have an unexpected impact on local share prices.

While investors might prefer a smooth investment ride, it's important to remember the wild swings we've experienced are not unusual over the short term. If you want to discuss your investment strategy or any other issues, please call us to arrange a time to meet up.



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