

# Quarterly investment outlook

March 2011

## Introduction

Many of us can empathise with the people of Japan as they go through one of the most difficult periods in their history. We recognise that recent events have created uncertainty in investment markets and that many clients are looking for a greater understanding on how this uncertainty might affect their portfolios. This quarterly update (which we are publishing earlier than usual due to current market events) aims to address some of this uncertainty and provide some useful portfolio construction thoughts.

## Uncertainty

The events in Japan are a stark reminder of the unpredictable nature of the world. Each year economists and market forecasters make predictions about market returns as well as the issues that investors should focus on. Often these forecasts prove to be incorrect. This is not because forecasters are inept, but rather because the future is uncertain. Even though we can be more confident about the long-term returns from assets like property and shares, predicting short-term outcomes is really just a guessing game. This statement also applies to the environment in which we live. There is a big difference between saying that Japan is in a region of high earthquake activity and actually predicting that an earthquake will occur in a given month.

You will already have seen graphic images and information about the damage to buildings, infrastructure and, critically, to Japan's nuclear energy assets. There have also been unsettling stories about longer term health risks from radiation, as well as concerns about whether Japanese citizens are being kept adequately informed.

Clearly the rebuilding task will be large, much bigger apparently than the Kobe earthquake of 1995. Authorities will drive this process, rebuilding critical infrastructure and finding workable solutions for any ongoing health and safety issues. Eventually homes and office buildings will be rebuilt. Of course, economic measures have no way of accounting for the vast number of lives lost.

With many countries still recovering from the global financial crisis, the Bank of Japan is acutely aware of the fragile state of the global economy. They are already taking steps to anchor interest rates near zero and ensure that there is sufficient liquidity in the financial system.

## Markets react swiftly

The investment market reaction to the Japanese earthquake was swift with the Japanese share market falling by more than 10% in the days following the disaster. Global equity markets also fell, although this was due to risk aversion rather than any direct impact on company earnings. Investors targeted safe-haven assets like high quality government bonds; indeed, although the cost of reconstruction will increase Japan's sovereign debt (which is likely to be a negative for Japan's credit rating), it will not necessarily have a negative impact on bonds given that Japan is a nation of savers. As the initial panic subsided, markets began to recover some lost ground.

There was also significant volatility in currency markets with the Japanese yen rising sharply on speculation that insurers may need to repatriate offshore funds to pay claims. The Australian dollar also fell below parity against the US dollar. In times of uncertainty the major currencies tend to hold more appeal for investors.

Interest rate expectations changed abruptly. While this was most likely a short term over-reaction by financial markets, fixed interest markets have now removed their expectation of a rate hike in the short term.



## Quarterly investment outlook

The investment outlook will be driven by broader issues rather than the specific events in Japan. There are two reasons for this. Firstly, the Japanese earthquake is a humanitarian disaster rather than an economic one. Although it is early days, we understand that the potential impact on global growth could be a few tenths of one percent. In global terms this is moderate. Secondly, markets were beginning to react to a number of financial market issues before the Japanese earthquake occurred. Some of these pre-existing market concerns are listed below:

- civil unrest in the Middle-East and North-Africa
- concerns that the current US stimulus package was unsustainable
- news that major fund managers were selling out of US government bonds
- speculation that inflation (and higher interest rates) were looming into view for 2012, and
- worries that oil prices above \$150 per barrel would cause global economic growth to stall.

The global economy continues to be underpinned by government spending and borrowing. While these initiatives have delivered a partial recovery, such activities cannot go on forever. There are also potential inflationary risks. For a sustainable recovery to take hold, the private sector has to step in and become the engine of economic growth. While there have been some early signs of this, the global economy remains fragile.

## Your portfolio

The best defence against market events is to hold a well-diversified portfolio that is designed to meet your long term objectives. For most investors the actual amount allocated to Japanese shares (via global equity fund managers) will be a small component of the broader portfolio. Further, the strengthening of the Japanese yen against the Australian dollar means that in Australian dollar terms some of the Japanese holdings may actually have done better than shares listed in the US and elsewhere.

The key risks that Australian investors should be thinking about are unlikely to have changed as a result of the Japanese earthquake. For many of us, these risks include not having saved enough for retirement, not having an adequately diversified portfolio, being under-insured or simply not having reviewed our position recently.

We appreciate that market downturns can be an uncomfortable time for investors and intend to keep you informed. As you probably know, we believe that reacting after market declines usually does more harm than good. We therefore recommend that investors ride out this volatility and focus on their long-term strategy.

If you have not met with your Genesys adviser recently for a review, this may be an opportune time to consider doing so.

## ***Genesys Research***

