

# Quarterly investment update

## Introduction

The end of June saw most investors receive their first positive financial year return since 2006/07. Despite the strong gains since March 2009, the last few months have been unsettling for investors in growth assets. The main driver of recent volatility is concern that the global economy will double dip back into recession.

Historically, in times of market volatility we have written to investors to reinforce the importance of portfolio diversification and a long-term investment focus. The message this time is no different. It remains our view that the probability of long-term investment success is higher for investors who plan and implement a sensible investment strategy and adhere to it. While there are investors who move into and out of the markets on a regular basis, few of these speculators enjoy long-term success.

Although we are not advocating any changes to our long-term investment approach, we thought that you may be interested in an update on recent events.

## Market update

It seems that every week there's another financial markets news story. They are seldom of the comforting kind. While we know that the media often prefers a bad news story to a good one, it is human nature that we tend to overemphasise the bad at the expense of the good. The fact is that financial markets still are digesting a great deal of news – some bad and some good - and this has led to the current situation of increased volatility and a degree of turmoil in specific markets.

The table to the right shows the returns of major asset classes over the last quarter and the last year. All asset classes posted positive gains in the 12 months to June 2010 (larger gains for growth assets like shares and property). However, these growth assets struggled in the last few months on the back of fears of sovereign debt defaults in Europe, moderating growth in China and some weaker than expected US growth data.

Asset class	3 months to Jun 2010	1 year to June 2010 (pa)
Australian shares	-11.1%	13.1%
International shares - unhedged	-4.6%	5.8%
International shares - local currencies	-11.0%	12.1%
Australian Listed Property	-1.3%	20.4%
Australian fixed interest	3.6%	7.9%
International fixed interest	3.5%	9.2%
Cash	1.2%	4.1%

Source: Datastream

To put the recent market volatility in perspective some background is required. Many factors were at play to drive the strong market performance from March 2009. At that time, share market valuations were pricing in a deep global depression. When this scenario appeared unlikely, markets surged. Getting to this point involved a coordinated effort from governments and central banks to stimulate economic growth. Major developed economy governments expanded borrowing to historic levels, while central banks purchased toxic assets, freeing up capital and shoring up the balance sheets of major financial institutions. China embarked on a commodity purchasing spree that not only put a floor under the prices of these assets but also stimulated commodity rich countries like Australia.

## Outlook

The current market volatility is a reminder that headwinds are likely in the recovery period ahead. As described above, the global economy is now underpinned by government spending and borrowing. While these initiatives paved the way towards a partial recovery, these levels of spending and borrowing cannot go on forever. **For a sustainable recovery to take hold, the private sector has to step in and become the engine of economic growth.** Likewise, developed country governments need to reduce deficits and increase/maintain creditworthiness without damaging economic growth rates. This is a tough ask and market participants are questioning the ease with which this can happen.



It is difficult to mention 'government spending and borrowing' without mentioning inflation, as over the long term large increases in government debt are likely to have an inflationary impact. Yet, the supply and demand of credit is currently weak and movements in long term bond yields suggest that **inflation may be a distant prospect**. Investors chasing inflation hedges (like gold and commodities) may have the long term story correct. However, there is a chance that they are too early with this call (or wrong).

The difference to previous recoveries is the contribution of emerging markets. **The emerging economies (led by China and other Asian/Latin American countries) are producing robust recoveries and are likely to continue growing faster than the developed world**. Emerging market investments are therefore likely to become increasingly popular; a trend that provides opportunities for investors but is not without significant risk. There is some concern at the moment regarding a possible slowdown in China due to policies being implemented to rein in the property development and infrastructure sectors (Note that in 2009, China experienced a 35% year-on-year increase in bank lending with many loans used to fund property development). It is probable that efforts to contain this bubble will affect the real economy. That said, the longer term outlook for China is positive and it remains in a strong financial position.

Perhaps a more important risk for Australian investors though is the **risk of overexposure to China/Asia in the event of an unexpected disruption to the Asian economic growth story**. The following points summarise this risk:

- Most Australian investors have significant exposure to quality mining, materials and energy companies through their Australian shares holdings (probably between 30-40% of this exposure).
- Continued strong performance of these companies relies on demand persisting from emerging countries.
- This demand will only be strong if the growth rates within these countries remain intact.
- Recent periods of emerging market under or outperformance have been highly correlated with the amount of money flowing into or out of these sectors (eg. as risk appetites returned in 2009 significant capital flowed back to the sector).
- This highlights the potential vulnerability of emerging market investments to any setback to the global economy that may make investors more risk averse.

The current economic environment is characterised by muted global growth expectations and significant uncertainty surrounding those expectations. Importantly though, **economies and share markets do not move in tandem**. The share markets of the world run on corporate profits and the valuation of businesses. Here, the picture is much brighter than expected. Corporate profits have exceeded expectations since mid 2009, the earnings outlook appears favourable and it has been decades since corporate balance sheets have looked as healthy as they do now (as a result of companies deleveraging and re-capitalising). This strength is likely to underpin improvements in employment numbers and investment by businesses (both of which will have a positive influence on economic growth).

## Conclusion

From March 2009 to April 2010 share markets globally posted **large gains as an economic recovery took hold**. Since then, however, share markets have fallen as the effects of the stimulus-led recovery have begun to wear off. The key points of this note are:

- The investment landscape is **likely to remain volatile**
- Investors should be prudent when allocating to sectors subject to speculative capital flows (i.e. commodities, precious metals and specific regional investments), and
- Despite continuing economic challenges, the earnings outlook for companies is positive, valuations are reasonable and interest rates remain low across the globe.

We appreciate that market downturns can be an uncomfortable time for investors and intend to keep you up to date with developments. As you already know we believe that reacting after markets have already declined usually does more harm than good. We therefore recommend that investors ride out this ongoing volatility and **focus on their long-term strategy**.

Please contact your Genesys adviser if you would like to discuss these issues or the current positioning of your portfolio.

## Genesys Investment Research

