

# Investment markets update

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## Introduction

As an investor your patience will have been tested during 2008 and the early stages of 2009. The most surprising thing about 2009 was that against a gloomy backdrop it actually ended well, with global markets staging a comeback from March 2009 through to the middle of April this year. Since then, however, markets have fallen sharply on the back of:

- events unfolding in Greece and other financially weak European countries
- policies (that could slow economic growth) being implemented in China to reign in the property development and infrastructure sectors, and
- concerns regarding the impact of the proposed Resource Super Profits Tax on the future investment plans and share prices of Australian resource companies.

The purpose of this note is to help you make sense of current financial events and offer some guidance for the future. While we are confident of better times ahead we recognise that these types of market conditions can test the resolve of even the most experienced investors.

## Market Update

Share markets globally have fallen sharply in the past six weeks, with the Australian market down 13.5% and most other markets down around 10-14%. After riding high on booming commodity prices and interest rates that are higher than those in other developed economies, the Australian dollar has also fallen 12% against the US dollar. Note: For many investors in international shares the results will look a little better on account of the falling A\$.

To put the recent falls in perspective we need to provide some background. Essentially, the Global Financial Crisis was the result of excess debt in the private sector caused by interest rates kept too low for too long. When you combine too much debt (some lent to people and companies that had little hope of making their repayments in tougher times) with debt securities no one really understood, it's a recipe for a financial crisis.

**Debt problems in Greece and other Eurozone countries** (Spain and Portugal in particular) are directly linked to these events. Greece (and others) spent up big when interest rates were low and the government thought economic growth would continue forever. Now that growth is weaker, they don't have a big enough economy to pay back the debt. In fact, the proportion of the economy that will be needed to pay back the debt is so big that it will slow the economy (because of the higher cost of borrowing). You may have seen reports showing some of the Greek population rioting about the austerity measures planned by the government (e.g. increased taxes, pay cuts/pay freezes for public sector workers, raising the retirement age). No wonder they are upset. The people in power want to stay that way and the population wants to know why they should suffer for the excesses of the rich and powerful. Meanwhile the Germans are wondering why they should help out people who don't pay their taxes and don't stay at work all day. In any case, while the €750 billion support package announced by European finance ministers recently allayed the market's worst immediate-term fears, investors remain worried as the Eurozone still faces a number of long-term challenges: cuts to government spending and lower economic growth.

While these issues in Europe are being worked through, **concerns over a possible slowdown in China are also impacting markets**, particularly Australia. During 2009, when many countries were in recession, China's economy grew by over 8%. This impressive growth occurred despite a sharp drop in Chinese exports and can be explained by aggressive stimulus spending by the Chinese government. These policies resulted in a massive 35% year-on-year increase in bank lending with many loans used to fund property/infrastructure development or to expand China's manufacturing capacity. Now, a credit fuelled investment boom is not a sustainable way of



achieving economic growth, which China knows. It's just that they wanted to withdraw the stimulus and have the global recovery take up the slack. This doesn't look likely, especially seeing that much of Europe will be buying less from them for a while. Note: Europe is China's biggest export market.

This brings us to Australia where the issues above (particularly a possible slowdown in China and the likely impact this would have on commodity prices) have pushed share prices lower. The proposed **Resource Super Profit Tax has put additional pressure on Australian resource stocks** and the falling Australian dollar means that foreign investors are less likely to provide support by buying Australian shares at this time.

## Outlook

While we can't predict the short term direction of share markets we know that they tend to improve well before the bad news ends. Investment decisions should therefore be based on the future outlook rather than reacting to the latest media headlines. Currently, sentiment is poor and investors are questioning the wisdom of growth assets like shares and property. Historically, these are the times when patient investors have experienced some of their better returns.

It is worth keeping in mind why shares are such an important element of diversified portfolios. The chart to the right demonstrates how shares have delivered a growing income stream over time. While there are periods when dividends decline (and this was the case during 2009) they typically resume their upward trend once the earnings outlook improves. By way of contrast, cash returns move with short term interest rates and offer no potential for capital growth over time.

It is likely that European debt problems and the ability of China to sustain current

levels of growth will remain front and centre for investors in the short term and that market volatility will remain high. Beyond the short term, however, the outlook certainly looks brighter. For example:

- Data on global economic activity has been quite positive in recent times (i.e. better employment numbers in the US, economic growth improvements in Japan and continued growth in the broader Asian region – albeit with some worrying political problems).
- While European conditions are tough, the countries at the centre of the crisis make up about 15% of the EU and business conditions have been more positive of late (downside risks remain though).
- The longer term outlook for China is positive and despite putting the brake on a possible property bubble, China has the luxury of being able to use both a brake and an accelerator.
- Profit reporting season has been good in Asia, Europe and the US and businesses can lift spending given the good profit results and widespread capital raisings during 2009.
- In Australia public debt is not an issue, a falling A\$ will assist exporters and while the Resource Super Profit Tax is having an impact on mining companies, there are many robust sectors that are delivering sustainable and growing earnings.

## Conclusion

It has been a tough time for investors over the past six weeks, particularly given that memories of the GFC are still fresh. What Greece does is remind investors that the consequences of the financial crisis are still being worked out. Those countries that are weakest in terms of their balance sheets and incomes will struggle most. What China does is remind investors that there is no such thing as a sure thing when investing and over-allocating to any one particular theme or sector can have unintended (and possibly negative) consequences. What we try to do with your portfolio is to invest for the long term while providing a range of financial assets, diversified across different asset classes, world regions and industries. We also aim to keep you invested and aware of what is going on in the world and how it affects you and your finances.

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

## Genesys Investment Research

