Colonial First State

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Market Bulletin

Investing in 2011

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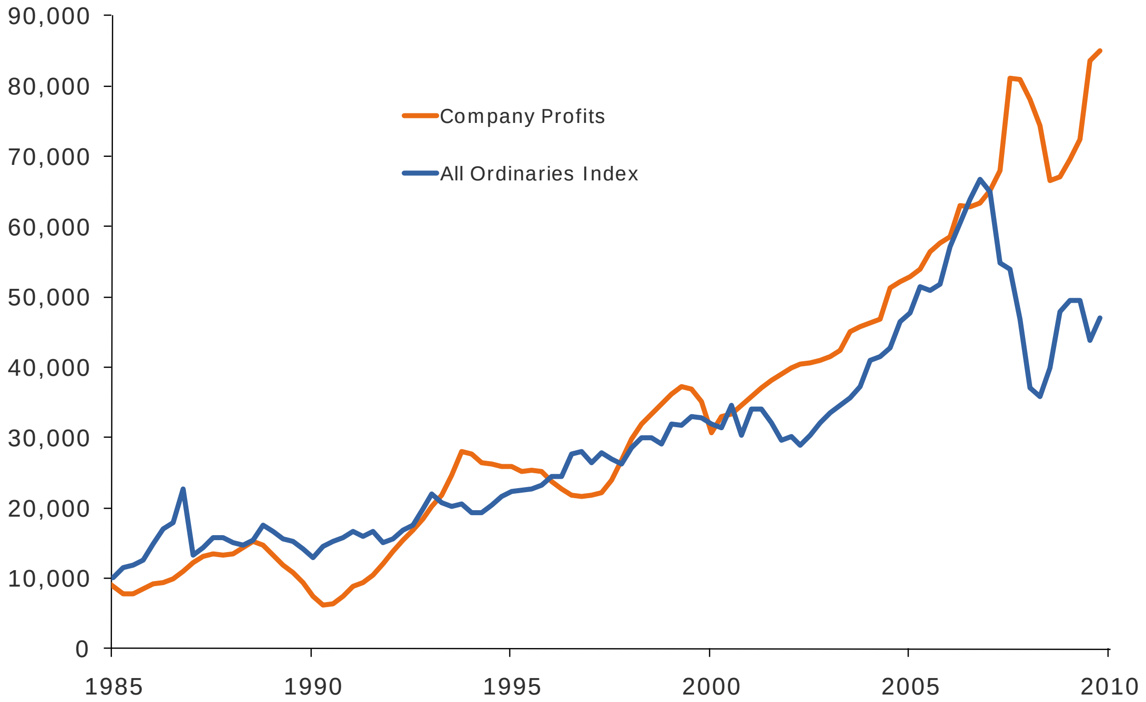
As 2010 draws to a close, the mind turns to what the investment climate might look like in 2011. After a very volatile and uncertain 2010 due to government debt concerns in Europe, a weak economic recovery in the US and uncertainty over the ability of the Chinese government to engineer a slowdown in economic growth, we must ask ourselves whether anything has changed to make a difference in 2011? Currently the situation remains touched with uncertainty and will continue to have implications for the Australian equity market, the Australian dollar and interest rates. We take a look at these issues below and how they could impact investing in 2011.

Australian equity market: After trading relatively sideways in 2010, market fluctuations are likely to continue into 2011. This stems from the imbalanced nature of the global economy and impacts local market sentiment. However, some positives remain for Australian companies and the equity market. These are centred on the strong growth in emerging Asian countries, such as China and India. Australia's economic performance has been very solid, driven in part by our exposure to the fast-growing Asian nations. This has led to a recovery in Australian company profits with a large disconnect now evident between company profits and the All Ordinaries Index (see chart below). The historical relationship has broken down, not due to fundamentals but to offshore uncertainty. The test for 2011 will be a return of confidence in the global economic recovery and continued profit growth by Australian companies.



Source: ABS 5676.0 Gross operating earnings, All Ordinaries index, Bloomberg. Earnings to 30 September 2010. All Ordinaries index to 25 November 2010. Index created starting in 1985 at 10,000.
Past performance is no indication of future performance.

A$ at parity: One of the key events of 2010 was the rise of the A$ to above parity with the US$ for the first time since the local currency was floated in December 1983. Will this continue in 2011? The rise of the Aussie dollar reflects both positive A$ factors and negative US$ factors, which looks set to remain the case for the near future. On the Australian side, the A$ is being pushed higher by the rise in prices received for our key commodity exports and the increase in our terms of trade (the ratio of export prices to import prices) to an all-time high. Higher interest rates in Australia are also supporting the A$, as is the general strength of the economy and the need for foreign capital inflow to help us grow. On the US$ side is the weakness of the US economy, very low interest rates and the move to reintroduce quantitative easing (printing money) in an attempt to get the US economy on the path to a faster recovery.

Overall, the rise of the A$ is a positive for Australia. The higher currency reduces the price of imported goods, both consumer items and capital equipment, and these lower prices leave consumers and businesses with more money to spend on other goods and services, both those made offshore and in Australia. For those exporters, however, who are not seeing price increases, the higher A$ makes their exports more expensive to foreign buyers (examples include manufactured goods and services such as tourism and education). The strong A$ also holds back returns from unhedged global investments in local currency terms.

Official interest rates: The RBA is concerned that the pace of inflation could exceed its 2-3% target range over the next few years, given the strength of the local economy, the expected large income effects from the record high terms of trade and the significant upswing in private capital spending. With limited spare capacity in the economy, the RBA lifted interest rates to more normal settings and is likely to lift further in 2011 from the current cash rate of 4.75%. Combined with additional rate rises from the banks, most lending rates (for mortgages and businesses) are now back around average levels. Rising borrowing costs and signs of emerging cost pressures could start to hurt business bottom lines. It will also impact fixed interest and cash investments – as yields rise cash investors should benefit.

What are some of the main issues that will continue to impact the investment landscape in 2011?

US and QE2: While the US economy has shown some signs of recovery, the pace of improvement in both the housing and employment markets has remained disappointing, while the pace of inflation continues to decline to very low levels. As a result, the US Fed introduced another round of quantitative easing (QE2). From November 2010 to June 2011 the Fed will purchase US$600bn in government bonds, effectively printing this money and increasing liquidity into the economy, in order to lower bond yields, provide more funds for the banks to lend, help encourage some more risk taking by investors and lower the value of the US$. This is designed to support economic growth when official interest rates are already near zero, but many in financial markets are sceptical about any real positive impact from this new measure.

EU debt crisis: One of the key features of 2010 was the European government debt crisis. This has yet to be resolved despite both Greece and Ireland accepting a bailout from a combined EU and IMF. A number of European countries, particularly Greece, Ireland, Spain, Portugal and Italy, will be introducing very tough spending cuts and tax increases in 2011 to bring their debt levels under control. One result is likely to be weaker economic growth for some time to come as governments reduce their roles in the economy. The impact on financial markets is uncertain. Large countries like Germany and France are benefiting strongly from a weak currency, which is positive. However, the rest of Europe will face a tough time in 2011 as it works to reduce government debt levels, which will crimp economic growth and leave unemployment at relatively high levels.

The rise of China: China will once again be a hot issue in 2011. Currently the government is attempting to slow down the pace of economic growth and cool rising inflation pressures by tightening monetary policy. This is being achieved by lifting official interest rates, restricting bank lending and requiring banks to hold more capital. The exact outcome of these measures will impact the investment landscape in 2011, especially for Australia and the demand for commodities. China's economic rise looks to have many years to go as it industrialises and modernises, and as millions of people move from the poor rural areas into the more productive cities. Reinforcing this trend, China officially became the world's second largest economy as at 30 June 2010, taking that mantle from Japan.

Summary

As 2010 draws to a close and we look at what could influence markets in 2011, we can be sure of several points. The global economy is growing again and has made much progress since the depths of the financial crisis. While some countries still face headwinds, 2010 has presented opportunities for patient investors. The same is possible for 2011 with China continuing to grow, Australian companies earning good profits and new policy actions helping the US economy. As always economics is a complex mix of fact and forecasting, but given the uncertainty in financial markets, it is always best to speak to your financial adviser when making any decisions about your financial future.

Want more information?
To find out more, please contact your local Business Development Manager, Adviser Services on 13 18 36, 8am to 7pm Sydney time or visit our website at colonialfirststate.com.au.