

SPECIAL EDITION

5 July 2011

The end of a *frustrating year...* and the hope of *better things to come*

by Dr Chris Caton, Chief Economist – BT Financial Group

The turn of a year is always a time to reflect, and to think about the future. A year ago, markets had been falling for several weeks, mainly because of a litany of international worries. We fretted about double-dip recession in the United States, about a possible slowdown in China and about eurozone debt. A year later, we find ourselves in a remarkably similar situation. The bad news is that these worries are still with us. The good news is that the worst outcomes have not (yet?) eventuated in any of them.

As a result, financial markets had a mixed year. The US share market, as measured by the S&P 500 index, rose by an impressive 28.1%, while the Australian market lagged considerably, falling in each of the last two months and gaining just 7.1% for the year. This left it at a level first attained in late-2005! Of course, from the point of view of an Australian investor, almost all of the US market's gain was offset by the appreciation of the Australian dollar, which rose by 27% over the year.

The eurozone debt issue is not another 'Lehman'

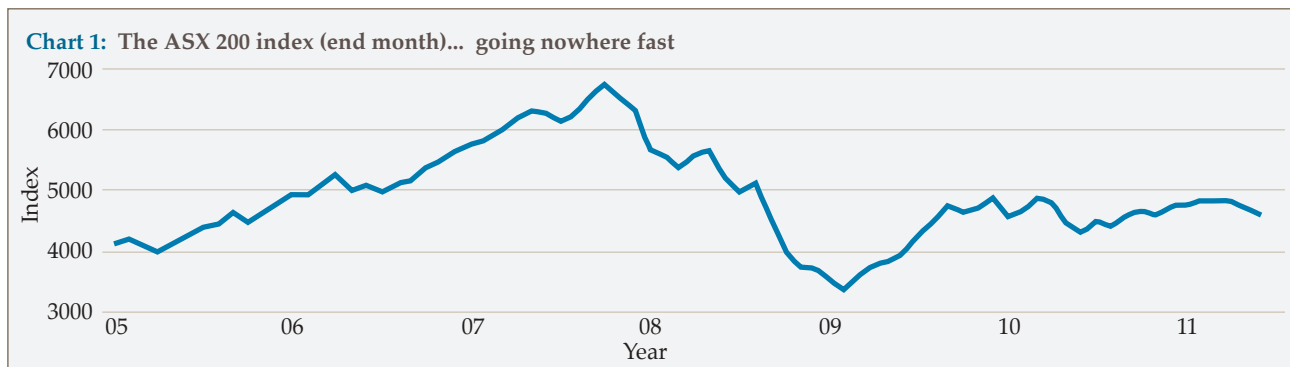
In the past week or so, the Greek parliament has agreed to a package of austerity measures to be implemented

over the next five years. As a quid pro quo, this entitles Greece to a further payment of 12 billion euro from the first bailout package as agreed to in May 2010. In addition, some lenders have agreed to restructure their debt, lengthening the maturity period and thus taking some of the pressure off. There is no way that Greece can grow its way out of this problem; further restructuring will be necessary. Whether or not this will be labelled a "default" is uncertain.

As long as there are uncertainties relating to this situation, financial markets will remain volatile but life will go on. The trick will be to manage the process – and expectations – so there are no ugly surprises for markets. In the past month, the word "Lehman" has been used quite often in connection with Greek debt, thus foreshadowing a possible rerun of the global financial crisis. This is a massive distortion in my view; believe it or not, the eurozone debt problem is smaller than the Lehman issue, and there is so much more transparency on this occasion.

The US is stronger than many think

I also remain convinced that the US is a long way from a double dip. It is stuck in a long slow patch, it is true,



Page 1

but this appears to be mainly due to the after-effects of the Japanese disaster, higher oil prices and even bad weather. Growth is almost certain to strengthen in the half-year ahead.

I have two simple statistical rules about foreseeing recessions in the United States. First, in the post-war period, whenever year-to GDP growth has dropped below 2%, a recession has followed, with just one exception. Second, whenever a three-month average of the unemployment rate has risen by 0.3 percentage point, a recession has invariably followed. Right now, year-to GDP growth stands at 2.3%. It will dip below 2% if annualised growth in the second quarter is reported at 0.4% or less. This is extremely unlikely. The three-month moving average of unemployment has risen slightly in the past two months. So both indicators are flashing yellow, but are unlikely to turn to red.

The other vexing issue in the US is the possible hitting of the Federal Government's debt ceiling. If Congress fails to raise the ceiling by 2 August or thereabouts, the Government will either default on its debt obligations or else it will have to pull revenues and outlays quickly into line. The only way this can be done is by means of a shutdown of all "non-essential" government services. Having to raise the debt ceiling is not unusual; it has happened more than 70 times in the past 50 years. This is not a Republican/ Democratic issue; it's a "party in power/party not in power" issue. What will eventually happen is that the ceiling will be raised after the Administration has made a detailed commitment to reduce future deficits. It is in the nature of the political progress that "brinkmanship" will be practiced, so nothing will be finalised until very close to the deadline, or possibly even later. If the government is forced to shut down for a few days, the world will not end and financial markets are likely to take it in their stride. There was a shutdown in late-1995 (twice) and markets were unperturbed. That shutdown came about because a Budget had not been passed; it also occurred because of the oversized egos of Bill Clinton and Newt Gingrich.

Concern about the effects of a possible prolonged shutdown are overstated.

Australian outlook looks good

I remain convinced that solid returns are likely for the Australian share market in the next twelve months. The market is cheap right now, with the price/earnings ratio at least 20% below its long-run norm. It's cheap because of the litany of worries, which I believe will dissipate slowly over the course of the year. As a result, I have a target of 5250 for the ASX200 index by mid-2012. This will represent a 14% return over the course of the year.

The Interest Rate Outlook – Curiouser and Curiouser

In early May, the Reserve Bank sent a message that higher interest rates would be needed to restrain growth in Australia. So hawkish was the tone that it led to speculation of a possible rise in early June. But then international worries increased and we ran into a patch of soft data – most notably a sharp slowdown in employment growth – so there was no rate rise in June. In mid-June, Governor Glenn Stevens had an ideal opportunity, in a speech in Brisbane, to walk away from the view that rates would have to rise.

He did not do so, although the message was refined to attach great importance to the next CPI inflation reading, due out in late-July. Then in late-June, bizarrely, financial markets began to speculate about the possibility of an emergency rate cut, apparently because of the European debt issue (just how this issue could constitute an emergency in Australia was never explained!). As always, what actually happens will depend on what we find out about the Australian economy in the months ahead. If employment growth continues to be only moderate, and inflation remains under control, then the mooted rate rises will not eventuate. But given the RBA's stated views, it would be prudent for investors and others to factor in a rate rise of up to 0.5 percent over the next twelve months.

If you no longer wish to receive 'Money Insights' please send an 'Unsubscribe' email to the person who sent it to you.

Contact us: You can contact us by calling your Australian Unity financial adviser, or you can call Advisory Services on 1800 806 603, or write to us at Level 8, 114 Albert Road, South Melbourne Vic 3205, or email us at advisoryservices@australianunity.com.au

Disclaimer: Unless otherwise indicated, the information in this newsletter is provided by Australian Unity Personal Financial Services Limited ABN 26 098 725 145 AFSL 234459. This information has been prepared without taking into account of the investment objectives, financial situation, tax position or particular needs of any individual person. Because of this you should, before acting on it, consider its appropriateness, having regard to your objectives, financial situation and needs. You should obtain a copy of the Product Disclosure Statement before making any decisions about any product. Reasonable care has been taken to ensure that information in this newsletter is derived from sources believed to be accurate, and that examples are fair and reasonable. However, it should not be considered a comprehensive statement on any matter nor relied upon as such and Australian Unity Personal Financial Services Limited does not guarantee the accuracy or completeness of the information. Any taxation position described is a general statement and should only be used as a guide. It does not constitute tax advice and is based on current laws and their interpretation. We recommended that you speak with a Financial Adviser to review your individual situation. This document produced in July 2011. © Copyright 2011