

InScope

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Market Update – 27 September 2011

In this special edition of InScope, Belinda Allen, Senior Analyst in the Investment Markets Research team at Colonial First State Global Asset Management, answers client's questions about the latest market volatility.

Q: Why is this new round of market turmoil happening and is it different from the volatility in August?

The market volatility we've seen in recent days is an extension of the volatility financial markets experienced in August. There have been no new significant events in recent days but there is fresh concern over the pace of global economic growth. There's also been growing recognition that policy makers around the world, particularly in the US and Europe are constrained in their ability to stimulate strong economic recovery. This is in contrast to 2008 when interest rates were cut aggressively and fiscal stimulus measures were introduced. Currently, interest rates are near zero in the US and Europe and governments must reduce debt levels.

Downgraded global growth

In recent days the International Monetary Fund (IMF), has downgraded global growth expectations, with the revised expectations that world growth would now be 4% in both 2011 and 2012, compared to previous forecasts of 4.3% and 4.5% respectively. This is down from 5% in 2010. In particular these downgrades focussed on weaker growth in the US and Europe with the IMF stating, "the global economy is in a dangerous new phase". This continues to concern investors and expectations are being revised for what this means for financial market returns over the short and medium term.

European debt - more work needed

At the same time concern centres around sovereign debt issues in Europe – particularly Greece – where negotiations continue to secure the next tranche of funds from the IMF and European Union (EU), as part of Greece's bail-out package. Greece has been slow to implement announced austerity plans and the Greek economy has deteriorated faster than anticipated. This highlighted the challenges that many European economies face. This has also led to further austerity measures being announced in Greece and recognition that more work will need to be done to bring debt levels back on a sustainable path.

Concerns have also centred on the health of the European banking sector. It's important to remember that European banks are large holders of government debt in Europe. This has meant that some banks have found it increasingly difficult to attract funding and some share prices have fallen sharply. There are growing talks that some European banks will need a capital injection, although there are questions as to where this funding will come from given the stretched nature of government balance sheets in the region.

US political uncertainty

Political uncertainty has also remained at the forefront and led to questions about what policies can be introduced to promote economic recovery. In the US, there is ongoing debate about further fiscal stimulus with President Obama announcing a \$US447bn jobs plan package to be funded by tax increases, which is not supported by the Republican Party. Another political impasse looks likely; just like the debate that surrounded the increase to the debt ceiling and the subsequent loss of the AAA credit rating in August of this year.

All of this highlights that further policy stimulus will be constrained in Europe and US. Central banks globally will be forced to pick up the pieces. With interest rates near 0% in the US, the Federal Reserve is undertaking unconventional measures to help support the US economy. The most recent package was announced on 21 September, called Operation Twist. The aim is to lower longer term interest rates, which so far has been successful. However there is growing debate about the effectiveness of this policy on the US economy.

Q: Can we expect the market volatility to settle down soon?

The short answer is no. Markets have entered a period of volatility due to the large number of issues currently being faced by the global economy. Investors around the world have reacted to the more downbeat assessment of global economic growth in the medium term, driven by developed economies. It is possible that financial market volatility will calm down, but it's likely that we are moving into a period of slower economic growth and therefore, a period of asset price returns lower than investors were accustomed to prior to the Global Financial Crisis (GFC) in late 2007.

Clear policy needed

The biggest positive driver for markets would be clear and decisive policies to improve the outlook and reduce risks. The IMF highlights: "Only if governments move decisively on fiscal policy, financial repairs, and external rebalancing, can we hope for stronger and more robust recovery". This should involve further austerity measures in Europe, an expansion of the flexibility and size of the European Financial Stability Fund (the bailout fund being used for Greece, Ireland and Portugal), the continual assistance for the banking sector including liquidity and capital injections and political consensus about these policies. The US needs to involve a credible medium term fiscal consolidation plan to stabilise government debt levels, yet at the same time promote improvements in the housing market and falls in the unemployment rate. If this does happen consumer and business confidence would improve and limit the impact of financial market volatility on the real economy.

Q: To what extent does slow growth in US and Europe impact on emerging economies such as China and India?

At this stage it's too early to tell but these economies have powerful structural forces that will support growth over the medium term, most importantly the process of urbanisation and industrialisation and the pure focus on improving living standards. In China, the government has the option to stimulate its economy if growth slips below the targeted 8% level.

There are no easy solutions to the problems the global economy faces, but there are signs that the political leadership around the world are committed to resolving the issues, but this will all take time.

Q: Is Europe and the US headed for recession and if so, what does this mean for Australia?

The best way to characterise the current growth in Europe and the US is 'stall speed'. At this stage both economies are still growing, but not enough to promote a sustainable economic recovery, promote jobs growth or improve consumer and business confidence. This is why we are seeing central banks undertake unconventional measures to help boost growth. Economic data released over the past month show both economies have deteriorated faster than expected. Much of this has been driven by political uncertainty, financial market volatility and fiscal consolidation.

The Australian investor

For the Australian investor, we sometimes don't understand why our share market has fallen the same as the US share market, or what it means for our local economy. In the 1980s and 1990s in particular, the US economy was a major driver of the performance of the Australian economy. The Reserve Bank of Australia has highlighted that the closeness of this relationship was due to financial and cultural links between the two countries and the sheer amount of news we receive in Australia about the US economy. This directly impacts consumer and business confidence in Australia. This is one reason why our sharemarket still reacts to falls in the US despite the much better fundamentals of our economy.

In the past decade however, the Australian economy has, to some extent moved away from being driven by the US economy. The key reason of course is China. Australia has been fortunate enough to have natural resources which China has needed to fuel its fast growing economy. The Chinese economy has continued to grow and is leveraged to its own internal growth drivers rather than trade links to the US and Europe. This should hold Australia in good stead, but there will still be impacts given financial market linkages between Australia and the US.

The Australian economy remains in a good position. We have very low levels of government debt, the Reserve Bank of Australia has room to cut interest rates if needed and our banks are in a sound position. While it won't mean Australia is immune it should benefit our economy and sharemarket when calm returns.

Speak to us if you would like to understand more about how this may impact your financial situation.

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