

The 2011 outlook – high growth and higher volatility



The 2011 outlook for the global economy and financial markets is more clouded than normal as the global recovery and Asia's industrialisation is weighed up against government and household debt issues in the advanced economies. Matthew Sherwood, Perpetual's Head of Investment Market Research discusses the 2011 outlook and concludes that while the growth outlook is dominated by Asia, the risks to this outlook reflect policy dilemmas in the advanced economies.

Key takeouts:

- The 2011 global outlook is for around 4% growth, driven by the emerging economies
- Market volatility is likely to remain elevated as Portugal, Spain, Belgium and Italy may need financial assistance in 2011
- Global shares have outperformed Australian shares in 2010 despite our growth advantage
- The earnings impact of Australian near-record terms of trade will be offset by rising domestic interest rates and continued political interference

Introduction

Our memories make us who we are. We can see this in Charles Dickens' 1860-61 novel *Great Expectations* when we learn suffering, transformation and social mobility in the aftermath of the industrial revolution. One of the sub-themes of the novel is the impact that memories have on our behaviour as the primary character, Pip, attempts to leave behind his working-class background as a blacksmith apprentice to be a gentleman, but ultimately remains scarred by his past. Although the novel was written in the 1850s and focused on the rising levels of social stratification in Victorian London, investment markets since this time have demonstrated that Dickens' assessment of human behavior is not limited to the industrial revolution and can be seen in probably every stage of economic development.

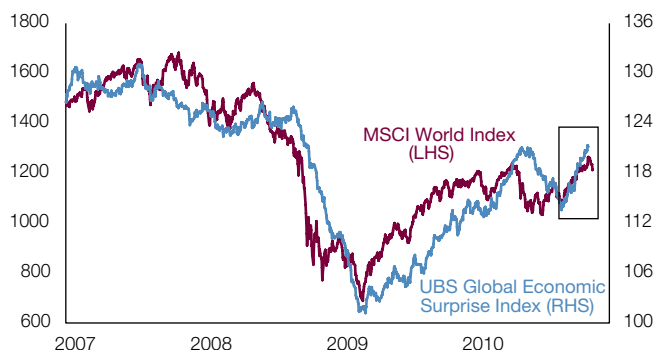
A subdued recovery to date

When compared with the global growth rates in 2006 and 2007, investors and policy-makers may be disappointed with the current global economic recovery considering the unprecedented amount of policy stimulus. While 2009 will be remembered as a year which demonstrated the power of macro-economic policy (preventing another Great Depression), 2010 will probably go down as the year which demonstrated the limitations of that power, in that the recovery has been somewhat subdued in the US, Europe and Japan. However, more recently, the economic recovery has been much better than expected. For example US private payrolls, construction work, consumer credit, jobless claims, retail sales and Q3 GDP have come in higher than market expectations.

The relationship between surprises in economic data and global share prices suggests the market has been buoyed by the improving global macro picture (see Chart 1). To be sure, other factors have played some role, including a supportive Q3 earnings season and the positive impact of QEII on US market sentiment. However, the latter's impact is likely to be transitory as the Fed's announced USD600 billion program is unlikely to have any immediate material impact on the real economy as sustained household balance sheet stress remains. Lower interest rates may quicken the process of deleveraging and hence shorten its duration, but it is highly unlikely to support growth and its impact on earnings and cash-flows is likely to be muted. Despite improving economic data, the US recovery remains one of the most subdued recoveries in history and Europe appears quite vulnerable to government funding crises.

Chart A: Global economic data has come in better than expectations and supported shares

Global sharemarkets and economic data (indices)



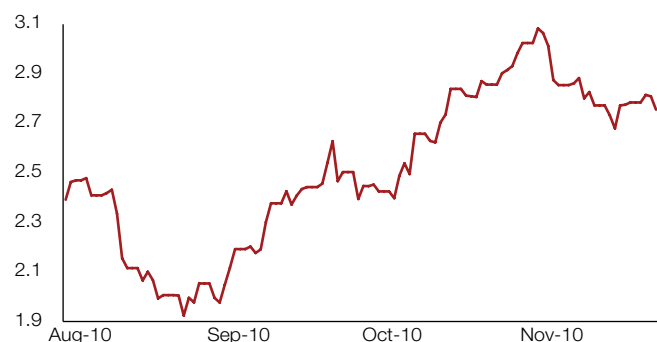
Source: UBS Australia Limited as at 20 November 2010.

US inflationary expectations are on the rise

The unevenness of the global recovery to date is likely to remain evident as Asia continues to benefit from its industrialisation, whereas advanced economies are held back by household deleveraging and fiscal consolidation. Indeed the better-than-expected growth and continued broad-based stimulus has resulted in a sharp rise in US inflationary expectations (see Chart 2). If US inflation starts to rise, it will eventually trigger a policy response. Given the precarious state of US Government balance sheet, fiscal policy will be tightened first and monetary policy last.

Chart 2: US inflationary expectations are rising

US inflationary expectations - five years (%)



Source: ICAP Australia Limited as at 24 November 2010. The break even inflation rate is the rate of inflation that equates an investment in an inflation protected security to a nominal bond of similar duration. So if inflation averages more than the break-even, an inflation linked investment will outperform the nominal fixed rate investment.

The 2011 global outlook is for a robust 4% growth

So while the global economy is probably entering 2011 with more momentum than initially expected, a key question is whether this growth rate will persist. While forecasting next year's outlook for the economy and markets is normally reasonably simple, the 2011 outlook is clouded with increased uncertainty with many tailwinds (Asia's industrialisation) and headwinds (including the state of household and government balance sheets in the advanced economies). At present, the world economy is growing above trend at around 4.5%, but this is unlikely to last. Overall, the central forecast for the global economy was still for trend growth (around 4%), over the next couple of years as growth in Europe, Japan and Asia eases back, but the US further strengthens.

What are the primary risks to the outlook?

There are many risks to the economic outlook and bouts of risk aversion are to be expected even if the growth outcome meets market expectations. Several European countries will require financial assistance in 2011 with Portugal, Belgium,

Spain and Italy the likely candidates. Meanwhile, there remains the possibility that European banks may have more bad debt problems as some areas of German house prices have declined. Accordingly, bank collateral has also fallen and this could produce trouble if there is a rise in non-performing loans. Meanwhile, the US could start to experience rising inflation if the US Federal Reserve continues to provide unnecessary stimulus and this spills into the real economy and forces a policy response before the economy is on a firm footing. Elsewhere, asset bubbles could develop in Asia as they import stimulatory US monetary policy at a time when they are trying to slow down their respective economies. Such an asset bubble would ultimately lead to a belatedly over-tightening in interest rates and the strains from currency adjustments could potentially trigger protectionist policies across the world.

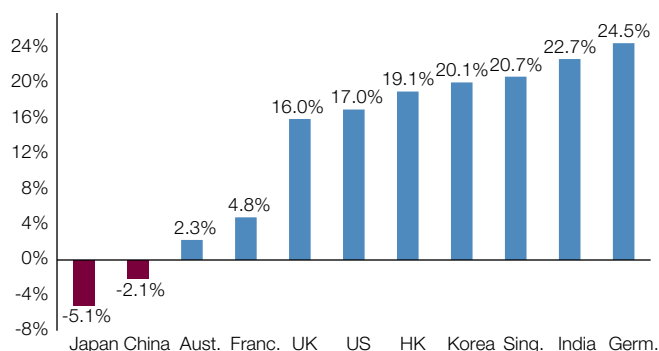
Chinese inflation is a concern insofar as it raises the possibility of policy response. The rise in inflation here is likely to be temporary, driven primarily by food and energy prices. Still, as inflation approaches 5%, investors may become unnerved and concerned about the policy implications. Meanwhile, geopolitical developments on the Korean peninsula have the potential to destabilise markets and economies, if tensions persist or escalate.

Global sharemarkets have recorded strong gains

There has been much recent discussion about side-trending markets over the past 12 months. However, only three markets have actually experienced that (China, Australia and France). Nearly all other significant markets have experienced high returns over the past 12 months (see Chart 3), with markets in the US, UK, Hong Kong, Korea, Singapore, India and Germany all recording strong double digit returns. Investors seem to be responding to a slowly improving economic environment, which would be expected to positively impact the earnings outlook.

Chart 3: Global sharemarkets have not trended sideways

Investment returns since August 2009 (%)



Source: Datastream as at 22 November 2010.

Could global sharemarkets trend higher from here?

The economic environment is likely to be supportive for markets in 2011. Indeed the balance of risks may be to the upside as a slightly better economic environment sparks the process of corporate re-leveraging. In the wake of the debt restructuring in the aftermath of the global financial crisis, there is little doubt that corporate balance sheets have low levels of borrowings (relative to equity) compared to history. However, as operating efficiency is further exploited (in terms of margin expansion), companies will look to increase their balance sheet efficiency by some company's re-leveraging their balance sheet. These funds could be used to either grow earnings or initiate a share buy-back program, either of which would raise return on equity. Such capital management decisions would most likely reflect general confidence in the economic outlook.

Why is Australia underperforming?

The Australian sharemarket has underperformed its global peers not only at a broad market level, but also in nine of the ten market sectors (the only Australian outperformance is in utilities) and the performance difference is very large in several sectors. For example, the performance difference between Australia and global shares is greater than 20% in the telecommunication services sector (40% in favour of global), consumer discretionary (29%), IT (27%), industrials (26%) and energy (23%). With the Australian economy having a significant growth advantage over nearly all advanced economies (which comprise around 98% of the MSCI World Index), strong exposure to Asian industrialisation and having an economy which continues to shrug off major global shocks, a key question for investors is why is Australia underperforming? There are a few possible reasons:

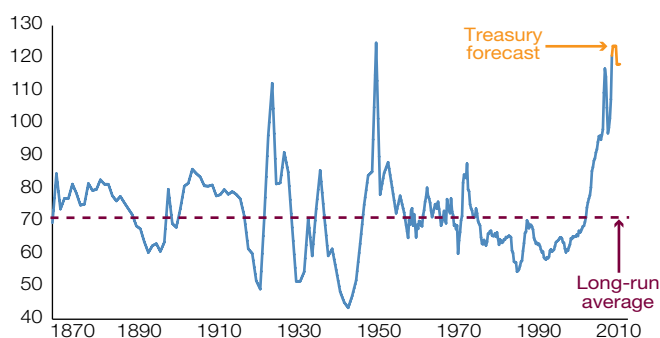
- Over-regulation and political interference in the Australian economy. This has been seen over the past year in the materials, financials, telecommunications and healthcare sectors. Whether it is additional regulation or the imposition of new taxes, markets do not appreciate such government interference. Interestingly, the three of the lesser performing sectors in Australia (telecommunication services (-12%), financials (1.7%) and healthcare (5.5%) have all experienced major political uncertainty over the past year.
- Australian earnings are relatively more expensive than global earnings given the movement in the exchange rate and this has encouraged global investors to look elsewhere.
- Interest rates in Australia are higher and rising and this could be impinging stocks exposed to consumer spending.
- The composition of the Australian sharemarket with a very high exposure to banks, which are experiencing modest credit growth in the wake of high household debt and rising interest rates, and this is likely to hold overall market returns down.

The Australian economic and market outlook for 2011

The outlook for the Australian economy is very strong over the next couple of years. Indeed, economic growth would be expected to be around 4% in 2011 and strengthening further into 2012. This view is underpinned by the expectations that unemployment will continue to decline as more labour resources are absorbed into the mining sector and the long awaited investment boom begins in the second half of 2011. This view is also supported by a recent upgrade to Australia's terms of trade, which is now expected to be around its highest ever level (see Chart 4) in the near-term. The income surge flowing from this will quickly flow throughout the entire economy with workers, corporations and the government all benefitting. In the absence of a severe shock to the Asian economies, it is very hard to envisage these trends changing in the near-term as producers in the global commodities markets are struggling to increase supply

in a meaningful way that would that could outstrip the expected growth in demand. While the terms of trade were expected to decline modestly in 2011, export prices are expected to remain elevated.

Chart 4: Australia's terms of trade is near a 140-year high
Australia's Terms of Trade (Index)



Source: Macquarie Equities as at 22 November 2010.

Implications for investors

The outlooks for the Australian and US economies are improving and this should provide support for asset markets in 2011. Meanwhile, growth in Asia, Europe and Japan is likely to lessen. The two keys risks in this outlook relates to policy – will China be able to manage its inflation without destabilising its medium-term outlook, and how far will the Europe's government debt stress spread, and how quickly and successfully will the European authorities be in dealing with these dominos? While growth prospects appear brighter than was the case six months ago, volatility how also increased and is likely to remain elevated throughout 2011. In this environment cash flow generation, dividend income and market valuations are things to watch. Companies with more sustainable business models that can deliver earnings growth and dividend income growth should be able to grind higher. As the market will not go up in a straight line, patience will be key for investors even though the economic climate is starting to look brighter.

Matthew Sherwood
Head of Investment Markets Research
Perpetual Investments

This analysis has been prepared by Perpetual Investment Management Limited (PIML) ABN 18 000 866 535, AFSL 234426 for the use of financial advisers only, it is general information and is not intended to provide you with financial advice. The views expressed in the article are the opinions of the author at the time of writing and do not constitute a recommendation to act. Any information referenced in the article is believed to be accurate at the time of compilation and is provided by Perpetual in good faith. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information.

INVESTING FOR GENERATIONS



Further information

Adviser Services 1800 062 725

Investor Services 1800 022 033

Email investments@perpetual.com.au

www.perpetual.com.au