

Investments

# Reading the signs

A guide to investment markets in 2010



redefining / investments



# Reading the signs

Now the dust has settled somewhat after the most severe downturn in living memory, it's time to take stock.

The scale of the downturn was unprecedented. The global financial crisis shook the world's economic foundations to the core, tarnished millions of investors' dreams and even created its very own acronym – GFC.

As markets continued to plummet in early March, there seemed no light at the end of the tunnel and many investors were understandably becoming nervous and losing confidence in the markets.

Ten months later, the more extreme prophecies of doom have thankfully proven unfounded. Global sharemarkets have risen strongly, with the Australian All Ordinaries Index rising by 57 per cent<sup>1</sup> from its lowest point.

While the rally came as welcome relief, it has thrown up new questions and challenges for investors.

- How sustainable is the recovery?
- What do improvements in economic conditions mean for your investments?
- Should you consider changing your well-planned long-term investment strategy in the light of recent developments?

This guide has been developed to help you make sense of the investment markets and navigate your way through the noise and confusion of conflicting market signals with the help of your financial adviser.

<sup>1</sup> As at 13 January 2010.



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# Where are we now? /

Although markets have now returned to more stable levels, there are likely to be aftershocks as the global financial system repairs itself.

## From recession to recovery

The past year has seen a sustained recovery in domestic and global sharemarkets, with the All Ordinaries Index improving 33 per cent over the course of the year.

Over the past century downturns have generally been followed by periods of sustained recovery (see figure 1). This cycle, while more pronounced, has so far conformed to a familiar historical pattern, whereby a very bad year is more often than not followed by a strong rebound.

## Settling down

From 2003 to late 2007 investment markets were relatively stable and then everything changed.

The GFC saw unprecedented daily stock price fluctuations, reflecting investor uncertainty and exacerbating the challenge for those already grappling with seeing their investments fall in value.

During 2008, the Australian All Ordinaries Index rose or fell by more than 2 per cent in a day on no fewer than 64 occasions, followed by 29 the following year (see figure 2).

Many investors reacted to the unpredictable market by seeking to exit any form of risk whatsoever.

While unsettling, periods of high volatility tend to create investment opportunities as assets are temporarily undervalued. Share prices initially rallied as the market underwent a broad revaluation and investors slowly became more comfortable with taking risks.

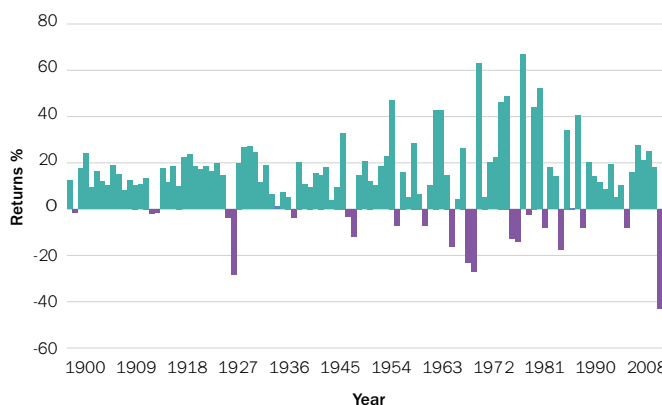
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## Markets lead the fightback

After periods of immense upheaval, investment markets tend to rally ahead of a wider economic recovery.

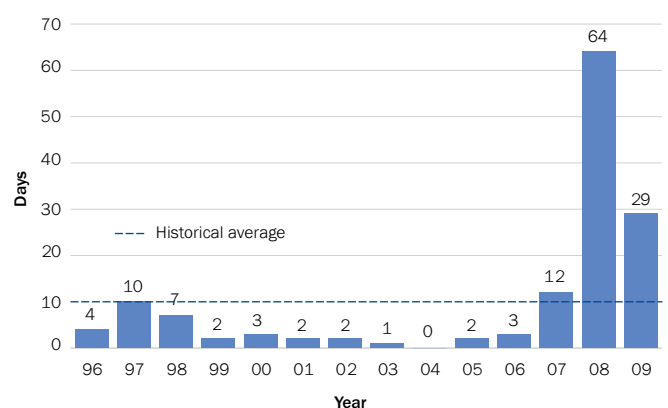
As we move from a recession to a recovery, the current market cycle is proving to be no exception. Most sharemarkets around the world have rebounded strongly since bottoming out in early March, even in countries which are still struggling to emerge convincingly from recession, such as the US, where stocks are up by 63 per cent (see figure 3).

Figure 1  
Australian sharemarket  
1900 to 2009



Source: Bloomberg, ASX All Ordinaries Index Data through to December 2009.

Figure 2  
Volatility Number of 'big move days'  
Market up or down by more than 2 per cent 1996 to 2009



Source: Bloomberg, FactSet, MSCI, Standard and Poor's, Datastream and AllianceBernstein. US S&P 500, Australia All Ordinaries Index. Data from 1996 through to 31 December 2009.

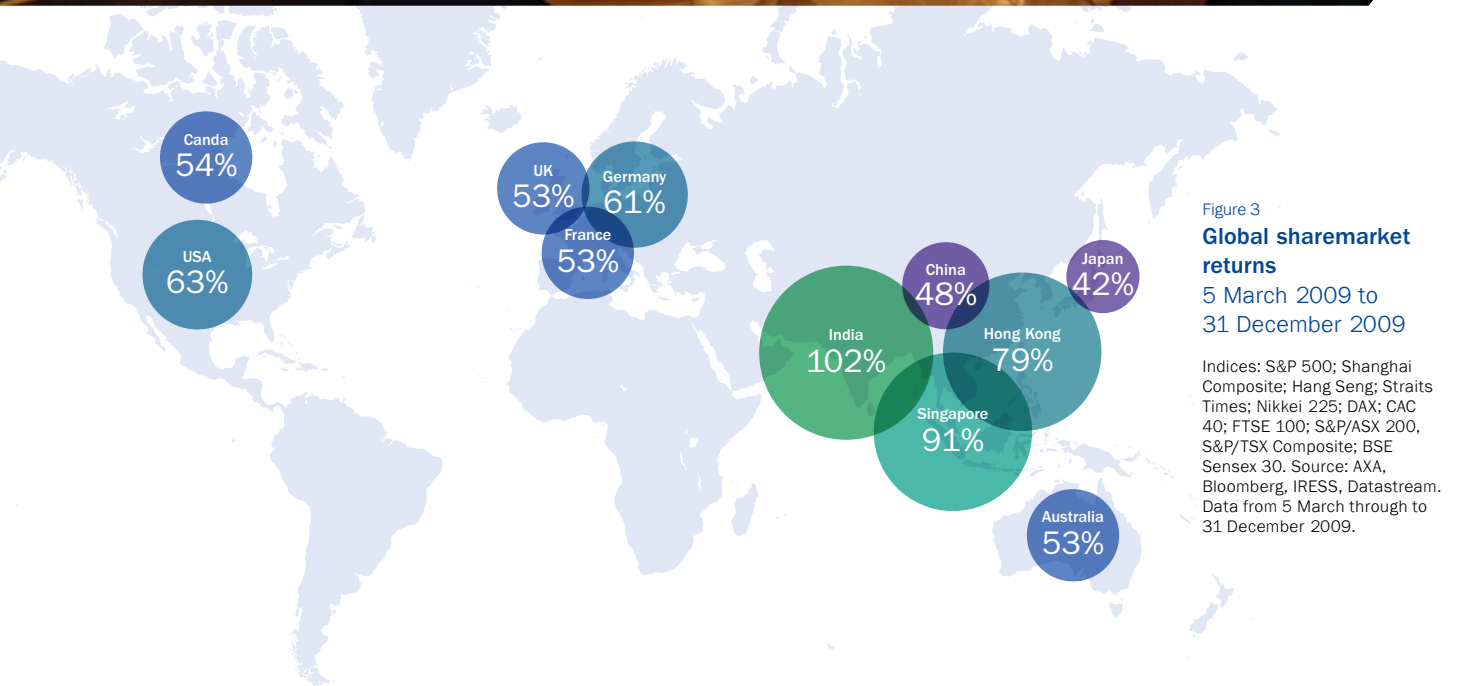


Figure 3  
**Global sharemarket returns**  
 5 March 2009 to 31 December 2009

Indices: S&P 500; Shanghai Composite; Hang Seng; Straits Times; Nikkei 225; DAX; CAC 40; FTSE 100; S&P/ASX 200, S&P/TSX Composite; BSE Sensex 30. Source: AXA, Bloomberg, IRESS, Datastream. Data from 5 March through to 31 December 2009.



# Will the rec

## Back into the black

Most major economies around the world endured painful contractions in gross domestic product (GDP) during the course of 2009. Australia is the only developed country to have avoided a technical recession, helped by a strong banking sector and a healthy surplus going into the downturn.

As global markets rebound strongly, economies are starting to follow, with government stimulus packages helping to lift their countries out of the red and back into the black over the coming year (see figure 4).

Australia looks well placed to emerge towards the head of the pack, with forecast growth of 3.5 per cent for 2010<sup>2</sup>. Domestic economic indicators are generally moving in a positive direction. Unemployment remains relatively low, consumer and business confidence has surged and inflation is under control.

In a further indication of the relatively robust health of the local economy, the Reserve Bank of Australia (RBA) started raising interest rates from emergency levels in October, making Australia the first developed economy to tighten monetary policy.

## The worst of times, the best of times

In some ways the GFC was a freak occurrence. Never before have markets fallen so far so fast, eclipsing other financial crises over the past century. But in other ways, particularly in how the subsequent recovery has panned out, it has followed a similar pattern to previous market cycles.

<sup>2</sup> Forecast by AllianceBernstein

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## Hand in hand

While the pace of recovery may slow down, and there may even be a correction or two on the way, rising GDP is good news for investors. As governments around the world continue to manage the global recovery carefully, and investors return to analysing opportunities based on market fundamentals rather than emotion, sharemarkets are likely to track improving economic conditions.

## Driving force

While sharemarket growth was initially driven by investors chasing bargain prices, the result of cheap valuations, further growth is now dependent on company earnings. The good news is that analysts are starting to increase their earnings forecasts as the wider economic picture brightens.

## Debt: the elephant in the room

The biggest economic challenge on the horizon is managing debt, for governments and households alike.

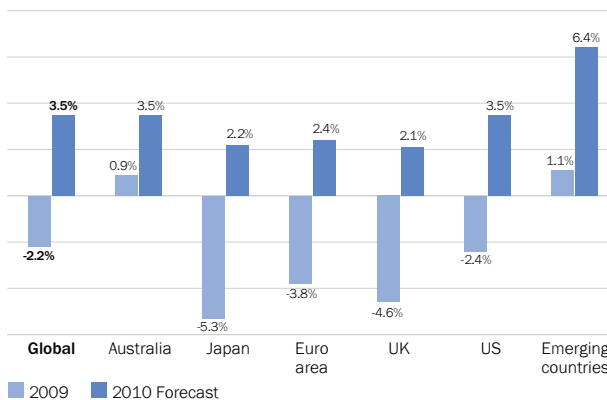
Consumer debt is an ongoing concern, particularly in the US, where consumer spending accounts for 70 per cent of GDP.

Australians are also labouring under high debt levels, with one of the highest ratios of personal debt to income in the world. Household debt surpassed Australia's annual GDP for the first time ever in late 2009 and now stands at 166 per cent of income. Australians owe about \$750 billion – that's about \$40,000 per person.

The silver lining is that Australians' personal balance sheets contain a relatively high proportion of 'good debt' (assets that will appreciate in value

Figure 4

Gross domestic product forecasts  
2009 to 2010



Forecasts may not be achieved. As of December 2009. Source: AllianceBernstein

such as mortgages), as opposed to 'bad debt' (credit cards, personal loans, etc).

Meanwhile, public debt stands at record levels after massive government intervention to stabilise financial markets. While initiatives such as the Australian Government's stimulus packages may have succeeded in stabilising financial markets, the sheer level of borrowing could be a problem in the long term.

How households, investors and governments manage the debt challenge and go about balancing the books will to a large extent determine the pace of recovery over the next 10 years.



## What does a rising Australian dollar mean for my investments?

### Good for travellers, not so good for some investors

We all know how fluctuating exchange rates affect our holiday plans. As the Australian dollar rises against its American counterpart, the temptation to hop on a plane to New York is becoming difficult to resist.

What's less well understood is the effect of currency changes on our investments.

As we have seen, global sharemarkets have delivered sustained profits since early 2009. But returns from overseas stocks have lagged behind those from Australian shares (see figure 5).

So why is this? Quite simply, it's the soaring value of the Aussie dollar. Increases in the local currency act as a counterweight to rising prices, dragging otherwise stellar returns back to earth.

During the GFC the falling Aussie dollar actually helped cushion some of the losses. From October 2007 through to March 2009, the fall in the global

sharemarket was not nearly as severe in Australian dollar terms compared with local currency.

The Aussie dollar has risen by approximately 50 per cent since its lowest point in 2008 (see figure 6). Since floating in 1983, its long-term average has been around US\$0.72, while the local dollar has traded at an average of US\$0.79 in 2009.

The local dollar is rising strongly relative to all major currencies, driven by higher interest rates, strong economic growth, high commodity prices and weakness among some other foreign currencies.

While there are as many opinions about the dollar's future movements as there are economists, even a modest move back closer to the long-term average would deliver increased profits to Australians invested in global equities.

Over the longer term, exposure to diverse international sharemarkets and different currencies can help smooth out the ride.



# Isn't cash the best option?

## Dividends: the gift that keeps on giving

Rising share prices are only part of the story. What's often forgotten in comparisons between different types of investment are dividends – the regular payments made to shareholders by listed companies.

Factor in capital growth in the form of rising share prices, and the sharemarket becomes an even more attractive option compared with cash investments.

## The power of franking

There's even better news if you invest in Australian companies which release franked dividends. In these cases, the company is already deemed to have paid tax on the payouts, reducing the amount of tax you would have had to pay if the dividend was unfranked.

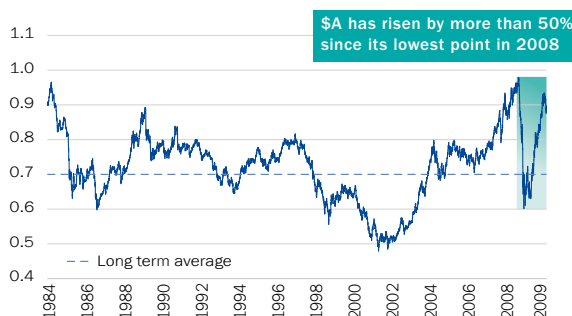
Figure 5  
**Sharemarket returns**  
January 2007 to December 2009

Source: Datastream. ASX300 Accumulation Index, MSCI World Index ex Australia (net dividends reinvested) in AUD. Data from 1 January 2007 through to 20 November 2009.



Figure 6  
**Australian dollar versus the US dollar**  
1984 to 2009

Source: Bloomberg. Data from 2 January 1984 through to 31 December 2009





## So what can I expect for 2010 and beyond?

### Untapped potential

As we have seen, this market cycle, while extreme, has followed the traditional pattern of bust and boom. And following every previous downturn the Australian sharemarket has recovered to post new highs.

The sharemarket has improved 57 per cent from its lowest point on 5 March 2009. But it still has another 40 per cent to go before returning to its previous high (see figure 7).

Even if it takes five years for the Australian sharemarket to recover the ground lost during the GFC, this equates to an average annual return of 7 per cent (see figure 8) – a considerable improvement on the current return from cash, particularly if you include dividends.

There is still a lot of potential in the sharemarket to deliver returns and keep you several steps ahead of inflation, both through regular dividend payments and capital growth.

Figure 7  
**Australian sharemarket**  
 February 2007 to December 2009



Source: Bloomberg, All Ordinaries Index, Data from 1 February 2007 through to 31 December 2009.



# Keeping your head, in good times as well as bad

It was important not to lose sight of your long-term investment goals when markets were on the way down. But it's just as important to remain focussed on making provision for your retirement years now that markets are in recovery mode.

In good times, it's tempting to chase 'quick wins', over-commit to the best performing asset classes and change well-laid plans. But markets remain unpredictable in the short term and modifying your investments based on the previous year's results rarely proves successful. Persevering with a diversified long-term strategy pays off, regardless of whether it's a bull or a bear market.

Retaining quality, secure assets managed by experienced financial professionals will put you in the best position to benefit from the market recovery.

Figure 8

## Market recoveries to index high

**Index high**      **6853.6**  
**Index now**      **4893.7**

Years to return to high	Annualised return %
3	11.9
5	7.0
7	4.9
10	3.4

Source: Bloomberg & iMac. ASX All Ordinaries Index (excluding dividends). Index high is at 1 November 2007. Index today is at 13 January 2010. Past performance is not necessarily indicative of future performance.

It's important to hold fast to the fundamental principles of investing

- diversify across a variety of asset classes
- invest for the long term
- take advantage of tax-effective superannuation, and
- seek quality financial advice.

**Important information**

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