Investments

Charting the future

A guide to investment markets

Partner

redefining / investments

At the peak of the global financial crisis there were fears of catastrophe. At the height of the downturn, it was difficult to see how to navigate our way forward as all types of investments were affected.

Since investment markets reached their low point in March 2009, the turbulence has gradually subsided. We have emerged a little battered and bruised, and blown some way off our original course, but now are in easier waters.

Investment markets have enjoyed strong gains over the past year – anyone looking at the basic numbers could be forgiven for thinking it was plain sailing. But a closer inspection reveals a market buffeted by an ongoing series of headwinds caused by issues such as sovereign debt.

In an uncertain investment environment, the struggles of even a relatively small European economy to repay its debts can spread quickly. Governments and regulators are forced to work hard to prevent localised disturbances from becoming worldwide shocks.

Despite debt concerns, the global recovery remains on track but we are likely to continue to see periods of volatility. As financial structures continue to heal, investment markets are likely to show increased resilience to absorb shocks.

Taking stock

It's now more than a year since investment markets turned positive. Many investors are wondering exactly how to read this new market and whether their tried and trusted investment strategies still apply.

Now is a good time to take stock of our present position and look towards the investment horizon to see what might be in store for us in the months and years to come.

We have developed this guide 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.

Where are we now?

Calmer waters?

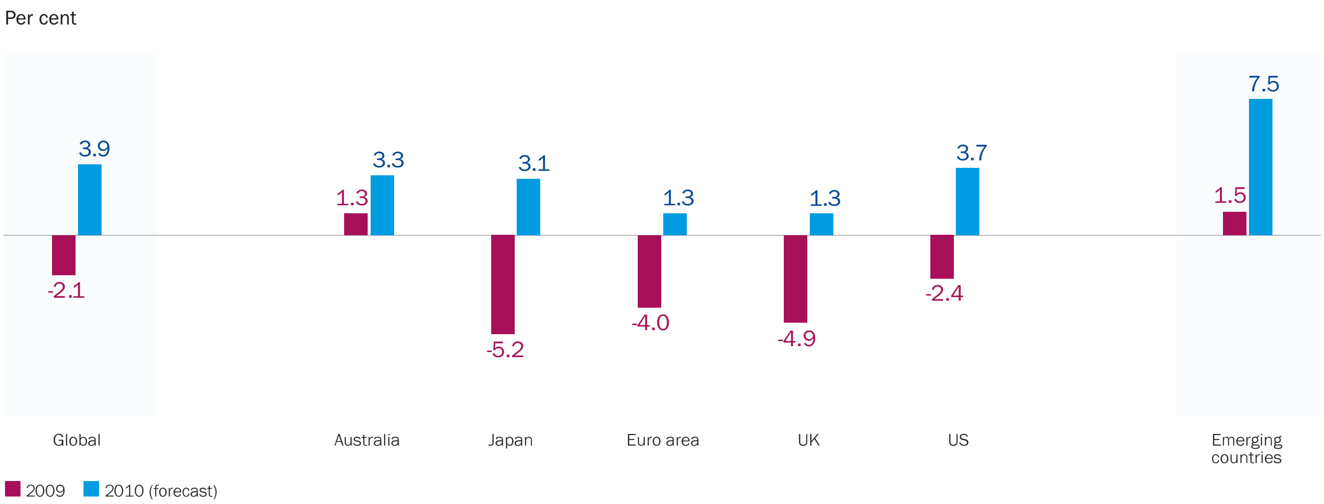
One thing is certain – we are in a dramatically different environment than we were this time last year. The major economies are tipped to return to growth in 2010, reflecting a decisive turnaround in global economic conditions.

Global gross domestic product is forecast to return to 3.9 per cent growth in 2010 (see figure 1), driven by emerging countries, whose vigour kept the world's economy afloat last year even as major developed economies floundered.

But this relatively quick turnaround has come at a cost. During the downturn, government spending prevented an even worse crisis. But governments now face the challenge of balancing the books.

As investors realise that debt from stimulus spending could act as a handbrake on future growth, markets are likely to experience further corrections.

Figure 1 **2010 Economic growth forecasts**



Gross Domestic Product
Source: AllianceBernstein. Forecasts may not be achieved. Data as of June 2010.

Living beyond their means

Many developed countries are busy grappling with fiscal deficit and debt that threaten to undermine their recovery (see figure 2). Debt is the total amount of money owed by a government, while the overall budget deficit is the difference between the amount of money the government spends and receives each year.

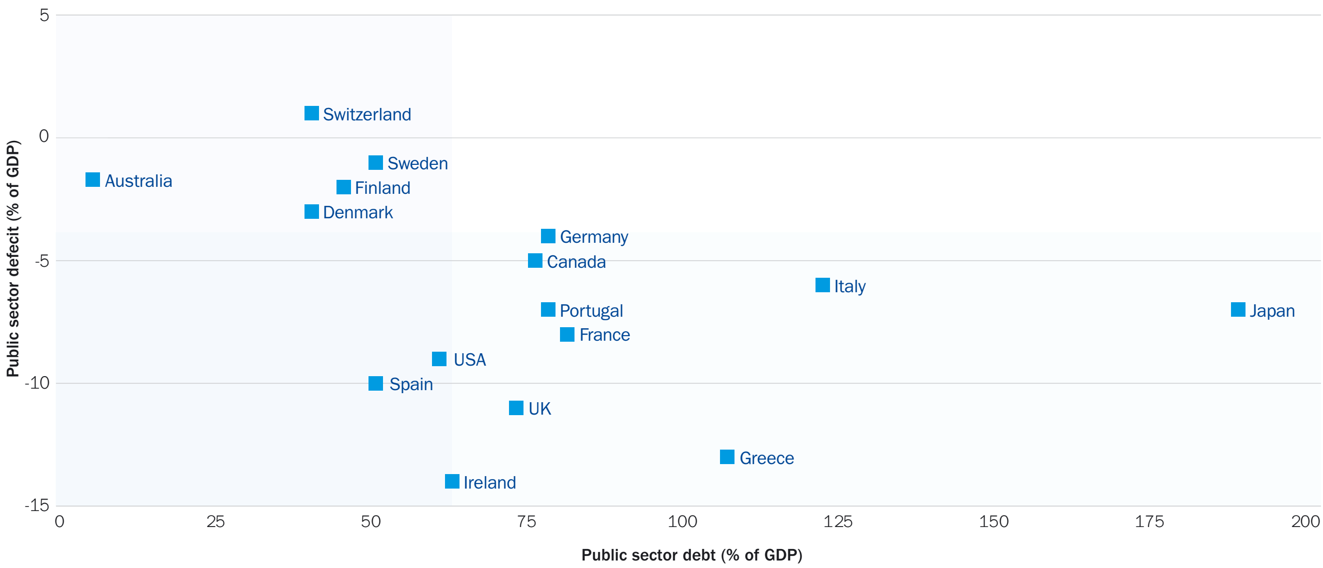
European Union rules stipulate that Euro-member countries need to keep their debt and deficit under certain levels. As a result of profligate spending preceding the downturn and government stimulus packages following it, some Eurozone countries have slipped below these thresholds.

This has caused concern on global markets about unsustainable budget deficits leading to possible defaults.

Greece is in a particularly difficult position, with a high debt and a high deficit. After some weeks of investor concern, the EU stepped in to calm market jitters by pledging Euro 750 billion to help Greece stabilise its economy and provide a funding lifeline for other Eurozone countries in trouble, notably Portugal, Ireland and Spain.

While there remain difficult political and economic decisions to be made, the bailout package represents a strong message that the EU will not permit any member countries to default on their debts.

Figure 2 **Public deficit and debt 2010-11**



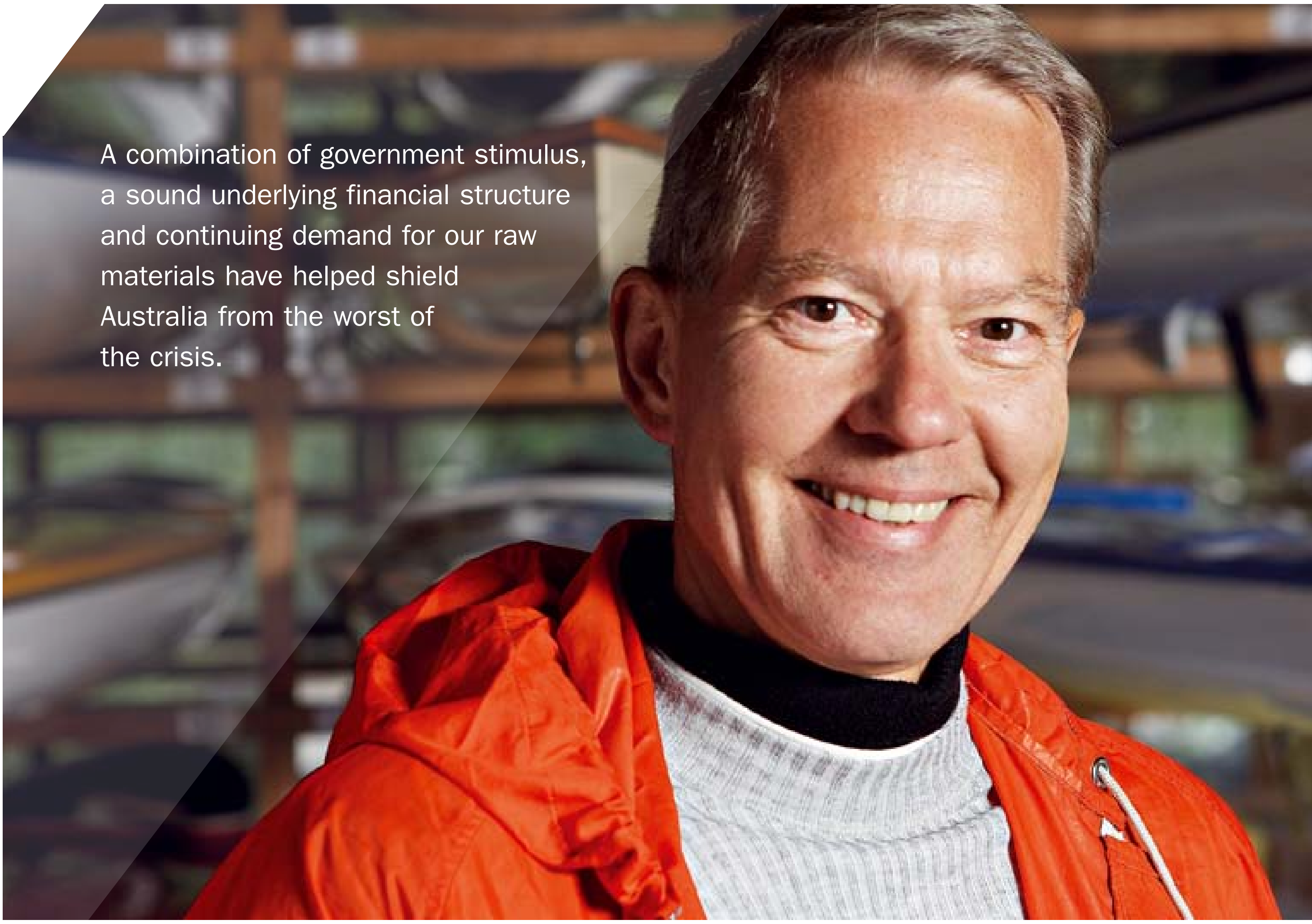
Source: Bloomberg, Federal budget papers 2010-2011. Data as of June 2010

Brave new world

The final stage of the recovery could see a new world order slowly take shape around us. This 'new normal' could differ from the 'old normal' in some key ways.

The 'old normal' was driven by developed economies and was characterised by low levels of banking regulation and public debt, high public spending, low taxes and easy consumer credit. This all added up to potentially very good market returns.

The 'new normal' will be increasingly driven by developing economies, with higher levels of banking regulation and public debt, low public spending, higher taxes and consumers busy paying down personal debt. There will still be market returns for investors with long-term diversified portfolios, but they are likely to be more modest than the double-digit returns investors enjoyed in the debt-fuelled boom times earlier this century.



Leading the fightback

As southern Europe tightens its fiscal belt and a new age of austerity beckons in Britain, Australia is in relatively good health, with very low public debt and a deficit of manageable proportions compared with many other countries.

A combination of government stimulus, a sound underlying financial structure and continuing demand for our raw materials have helped shield Australia from the worst of the crisis.

After being the only developed country to avoid a technical recession, Australia has emerged from the downturn well placed to capitalise on the ongoing trade boost from Chinese demand for our commodities and return to surplus.

Still the lucky country

In the past two recessions, Australian unemployment topped 10 per cent and many analysts were predicting a similar rate during the downturn. In the event, unemployment didn't come anywhere near this, peaking at a relatively modest 5.8 per cent.*

With more stimulus still in the pipeline, there is strong evidence that the Australian economy is in relatively good shape and capital expenditure is booming.

But investor confidence remains fragile and unexpected events such as the Government's proposal for a new super resources tax, which has met with opposition from the mining industry, has unsettled markets.

* Reserve Bank of Australia

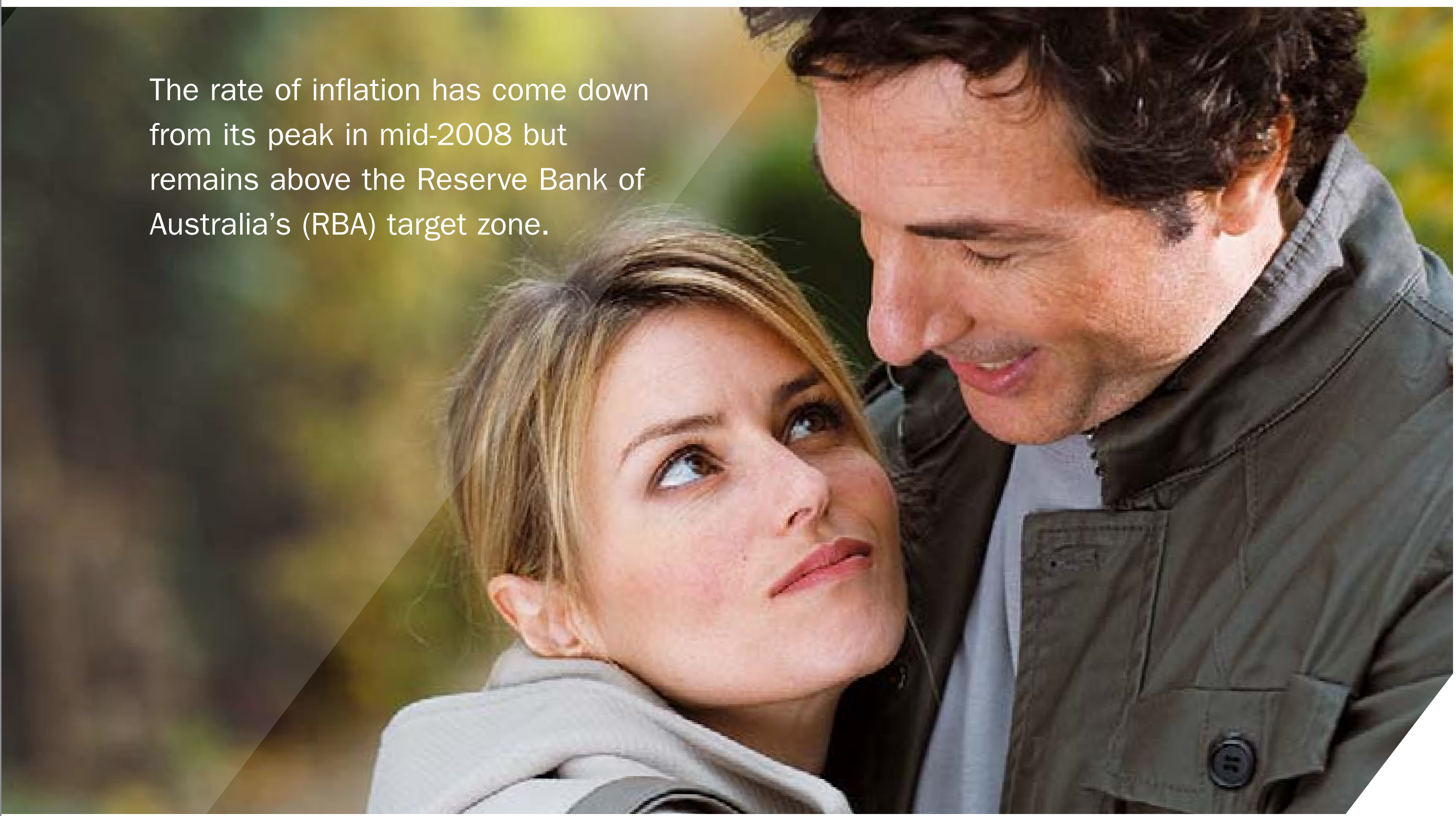
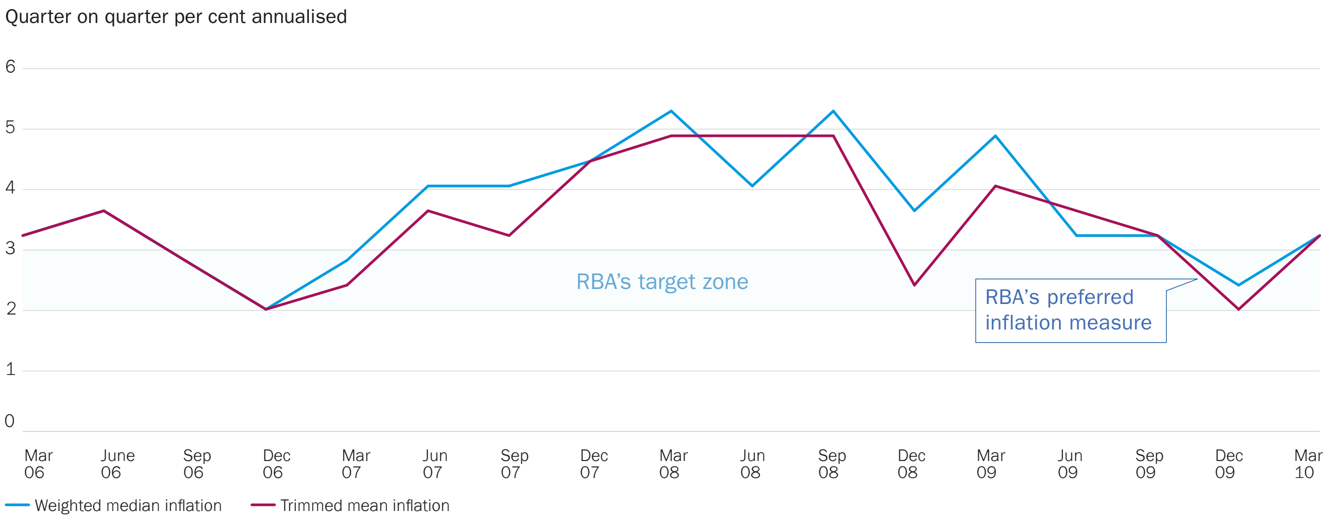


Figure 3 **Australian inflation 2006 to 2010**



Source: Reserve Bank of Australia. RBA weighted median and trimmed mean. Data from March 2006 through to March 2010.

The pitfalls of success

The Australian dollar has taken investors on a rollercoaster ride over the past financial year. A sharp rise in the dollar's value initially reduced returns for investors in overseas shares. But this was cancelled out by a fall in the dollar towards the end of 2009/10, which saw investors enjoy improved profits.

Currency movements are notoriously difficult to predict and can substantially affect investment performance, but geographical diversification can help smooth returns.

As many developed economies wrestle with falling prices and the spectre of deflation, in Australia we have the opposite problem. Inflation is once again emerging as a key issue, reflecting the relative strength of the Australian economy.

While the rate of inflation has come down from its peak in mid-2008 it remains above the Reserve Bank of Australia's (RBA) target zone (see figure 3).

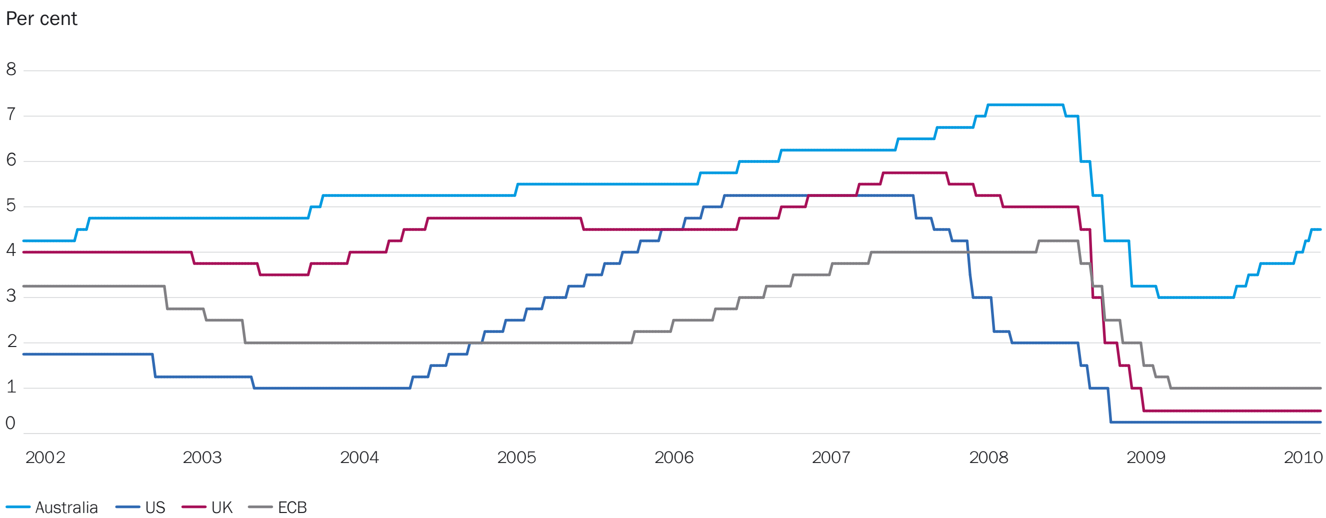
Inflation is back on the radar

Inflation is high on the RBA's radar and keeping rising prices at bay is one reason why the central bank has returned interest rates to more normal levels, with six rapid rate rises since reaching a low of 3 per cent in April last year.

But at present, the official cash rate of 4.5 per cent is still low by historical standards, providing some further stimulus to growth.

Australia is out of kilter with other developed countries, where interest rates continue to flatline (see figure 4), but in step with the more dynamic developing world, where India and China have also tightened monetary policy.

Figure 4 **Official cash rates 2002 to 2010**



Source: Bloomberg. Official cash rates used: Reserve Bank of Australia Cash Rate Target, US Federal Funds Target Rate, UK Bank of England Official Bank Rate, European Central Bank. Minimum Bid Refinancing Rate 1 Week. Data from March 2000 through to June 2010.

Will the recovery continue?

Volatility is part of the journey

Investment markets usually move in anticipation of the wider economy and this market cycle has been no exception. The markets have enjoyed substantial gains over the past year, despite some hiccups along the way as fears about sovereign debt threatened to blow the global recovery off course (see figure 5).

These market corrections have understandably worried investors and media reports have fanned the flames, emphasising short-term share price movements at the expense of overall trends.

But strip away the media hype and we can see that the markets are relatively stable. There have been 13 days during which the Australian markets have fluctuated by more than 2 per cent in the first half of this year, compared with 29 days last year and 64 in 2008.

We have not seen a return to anything like the turbulence experienced during the downturn (see figure 6).

As the global financial system continues to undergo structural repair, further aftershocks are likely as a normal feature of the recovery cycle.

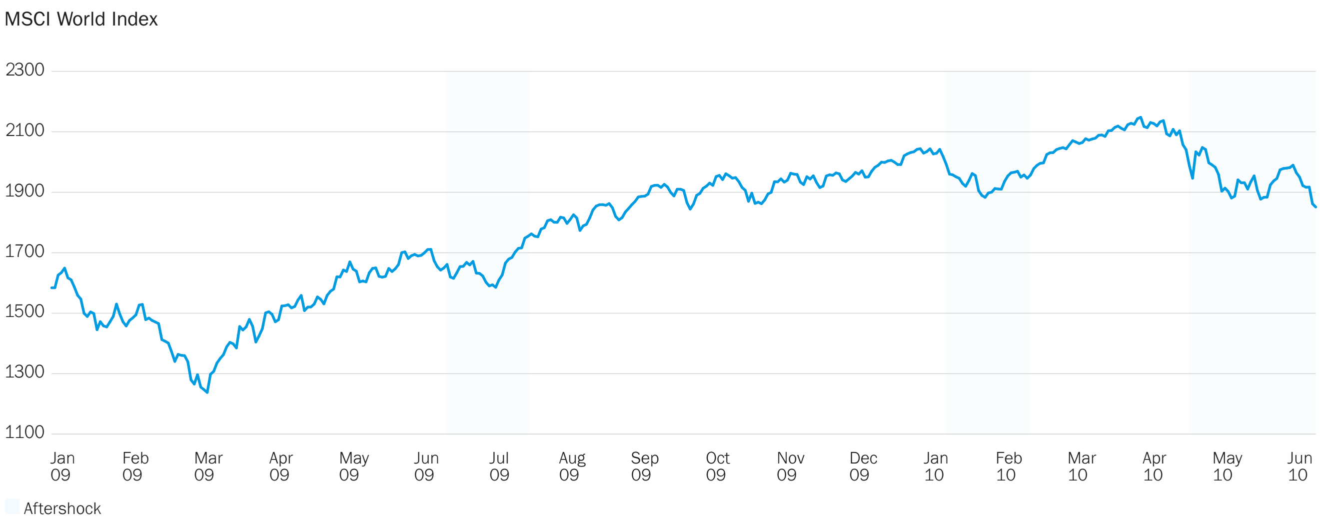
Great expectations

Economic turmoil in Europe is masking the bright spots in the global economy. In the early part of 2010 analysts raised profit forecasts.

And companies are delivering. In the March quarter, 92 per cent of corporate profits met or exceeded forecasts in Australia and 83 per cent in the US.*

* Credit Suisse, Bloomberg

Figure 5 **Global sharemarket returns January 2009 to June 2010**



Source: Datastream, MSCI World Index (net dividends reinvested) in local currency. Data from 31 December 2008 through to 30 June 2010.

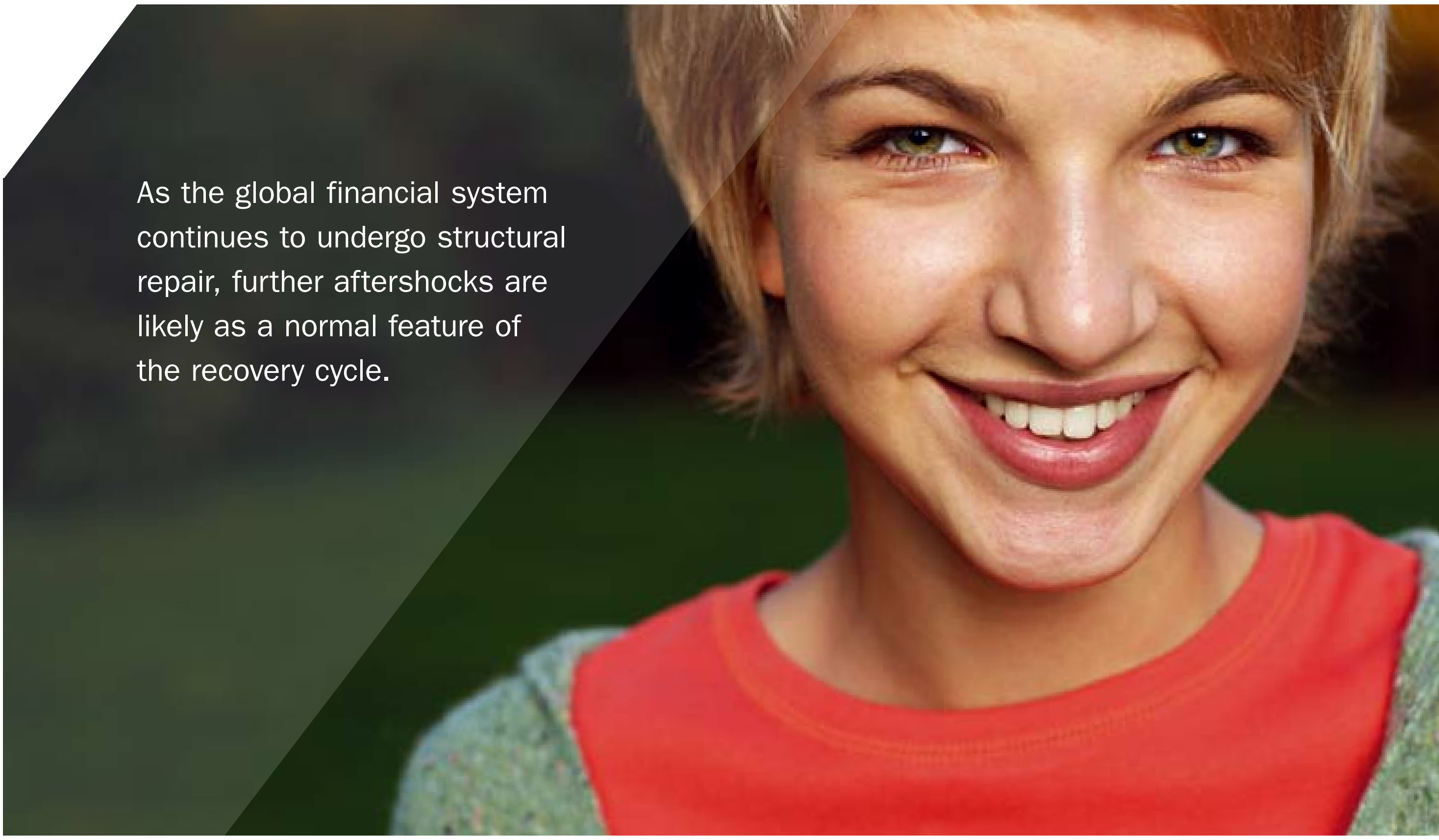
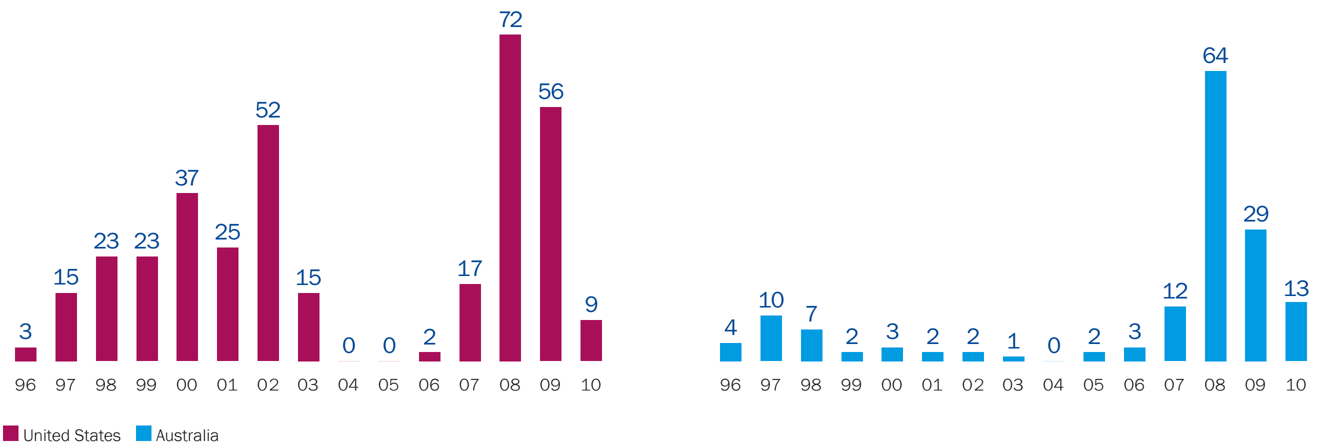


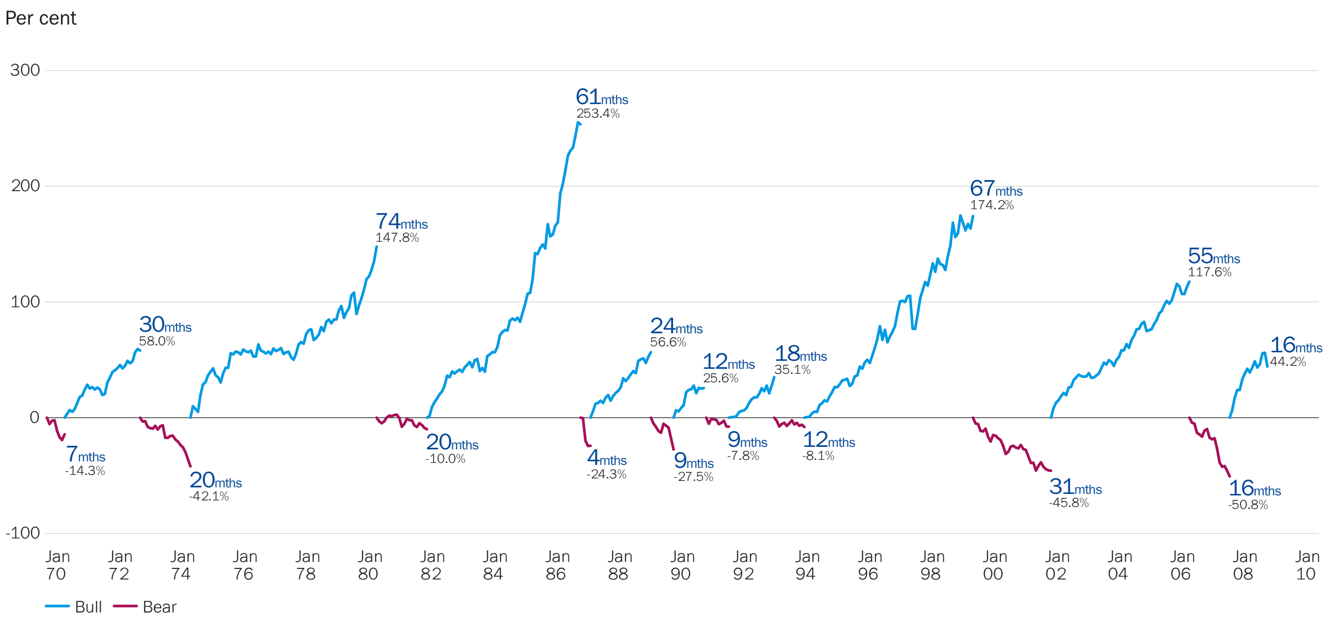
Figure 6 **Volatility – 1996 to 2010**

Number of ‘big move days’ (Market up or down by more than 2 per cent)



Source: Bloomberg. FactSet, MSCI, Standard and Poor’s, Datastream and AllianceBernstein. S&P 500, All Ordinaries Index. Data from 1 January 1996 to 30 June 2010.

Figure 7 **Global sharemarket: Previous bull and bear markets 1970 to 2010**



Source: Datastream, MSCI World Index (net dividends reinvested) in local currency. Data from December 1969 through to 30 May 2010.

History lessons: The bulls and the bears

After the considerable gains over the past year, many investors will naturally be asking whether we've reached the end of the road.

The good news is that, looking at previous bull and bear markets, there is still considerable potential for share prices to rise (see figure 7).

So far in this recovery, stocks have gained about as much as they lost during the downturn. But on average over the past four decades, sharemarket rallies outperform their respective downturns by a ratio of about 2.5 to 1. On that basis, we have some potential for future growth.

Furthermore, this recovery has been on the go since the markets bottomed out in early March 2009. The average bull market lasts two to three years, also suggesting that we have longer to run.

It's all about the research

All this adds up to a busy investment environment that's tailor made for active fund managers with experience in selecting the right shares.

Passive fund managers who rely on geographical location or share price index movements when choosing stocks are less likely to prosper in the present climate.

The current environment best suits active investment managers who can identify industries and companies that will benefit from structural shifts in the economy and growth in developing markets.

So what can I expect for the rest of 2010 and beyond?

Untapped potential

As we have seen, this market cycle, while extreme, has followed the traditional pattern of bust and boom.

Even if it takes seven years for the Australian sharemarket to recover lost ground, this equates to an average annual return of seven per cent – 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.

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 when 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.

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
- seek quality financial advice.

For further information, please contact your financial adviser or visit axa.com.au/investmentmarkets

axa.com.au

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