Investments

Understanding the ups and downs

A guide to investment markets

June 2011

redefining / investments

A guide to investment markets

So far 2011 has seen the global economy continue to grow, albeit at a slower pace. Developed countries have started to make headway. However, they continue to lag behind developing countries that remain firmly in the driver's seat, leading the way in global economic growth.

In Australia, it remains a tale of two economies. Key sectors such as mining and energy are performing strongly, predominately due to surging commodity prices. Other areas such as retail and tourism are facing the brunt of the high Australian dollar and subdued consumer spending.

The first half of this calendar year has seen new challenges for investors. Adding to the concerns of sovereign debt and a possible adverse slowdown in China's economic growth, there have been a spate of natural disasters and political unrest in the Middle East and North Africa (MENA). While these large-scale events continue to unnerve investors, markets are showing more resilience in absorbing these kinds of shocks.

At the individual level, companies are starting to post decent profits based on the cost-cutting measures taken during the global financial crisis (GFC) as well as growth strategies. Markets are slowly starting to factor in positive company earnings and improving returns.

As the recovery continues on its path to pre-GFC levels, investment expertise and research are important elements in unlocking value and finding market opportunities. Diversifying investments across asset classes, industries and regions is also a key component.

We have developed this guide to help you make sense of the investment markets and navigate your way through the noise and conflicting market signals, with the help of your financial adviser.

Where are we now?

A world of difference

The first half of this year has seen the global economic recovery slow down a little.

The International Monetary Fund (IMF) is forecasting 4.4 per cent growth in overall gross domestic product (GDP) for 2011, slightly lower than 5.0 per cent in 2010 (see figure 1). The world economy continues to be fuelled by developing countries that are expected to grow by 6.5 per cent compared to 2.4 per cent for advanced economies.

We're seeing many different stories emerge across the globe. The US and Euro area are now in positive territory. However, they still face high unemployment and significant challenges in getting their economies in order to reduce their high levels of public debt.

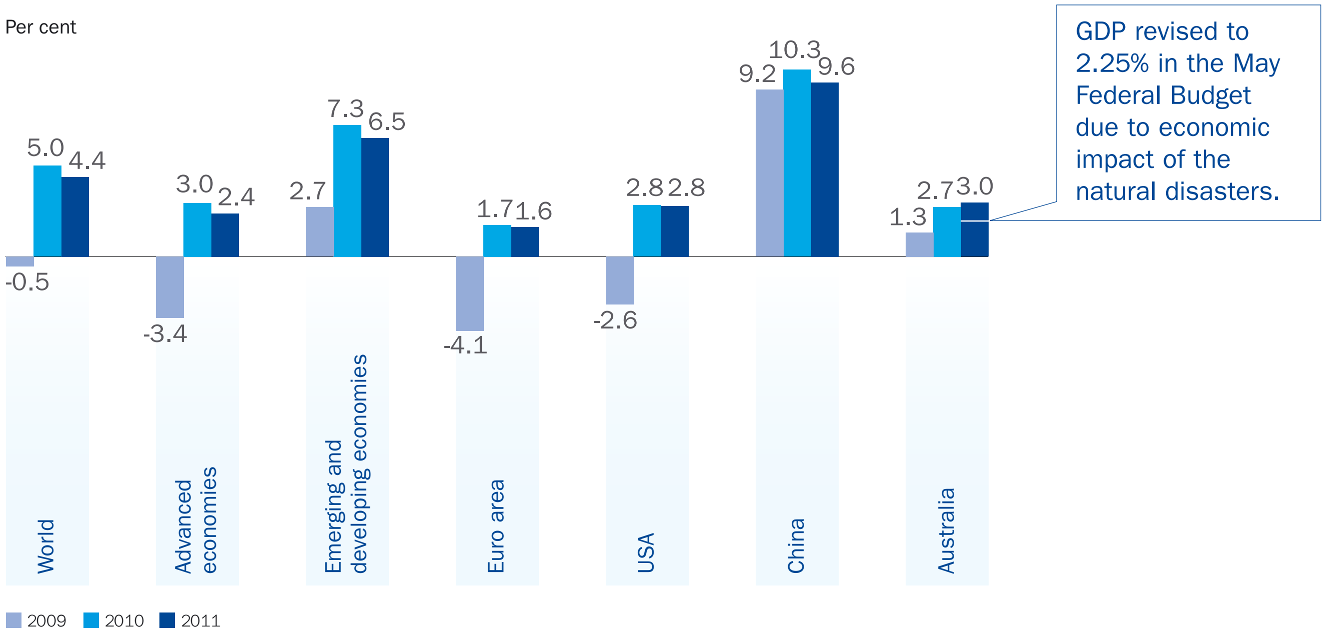
In contrast, emerging and developing countries are in relatively strong economic positions and face low unemployment levels. However, these countries have different concerns with capacity constraints and signs of overheating starting to emerge.

In Australia, the economic impact from the floods and cyclone has seen our GDP figure revised down (in the May Federal Budget) from 3.0 per cent to 2.25. While the effects of the natural disasters are expected to be temporary, signs of a two-speed economy are still present.

GDP refers to the market value of all goods and services produced over a given period, and is often used to gauge an economy's health.

Global economic recovery slowing a little

Figure 1 **Gross domestic product (GDP)**



Source: International Monetary Fund (IMF), World Economic Data Base, April 2011. Constant prices percentage change from previous period. Australia's revised GDP: 2011-12 Budget Papers, Statement Nos. 1, 2 and 3.

Sharemarkets continue their climb

The start of 2011 certainly has been a testing period for markets, given the extreme weather events and political unrest in the MENA. Investors remain cautious in the face of these events and how they may impact markets, which has been characteristic of market behaviour since the GFC.

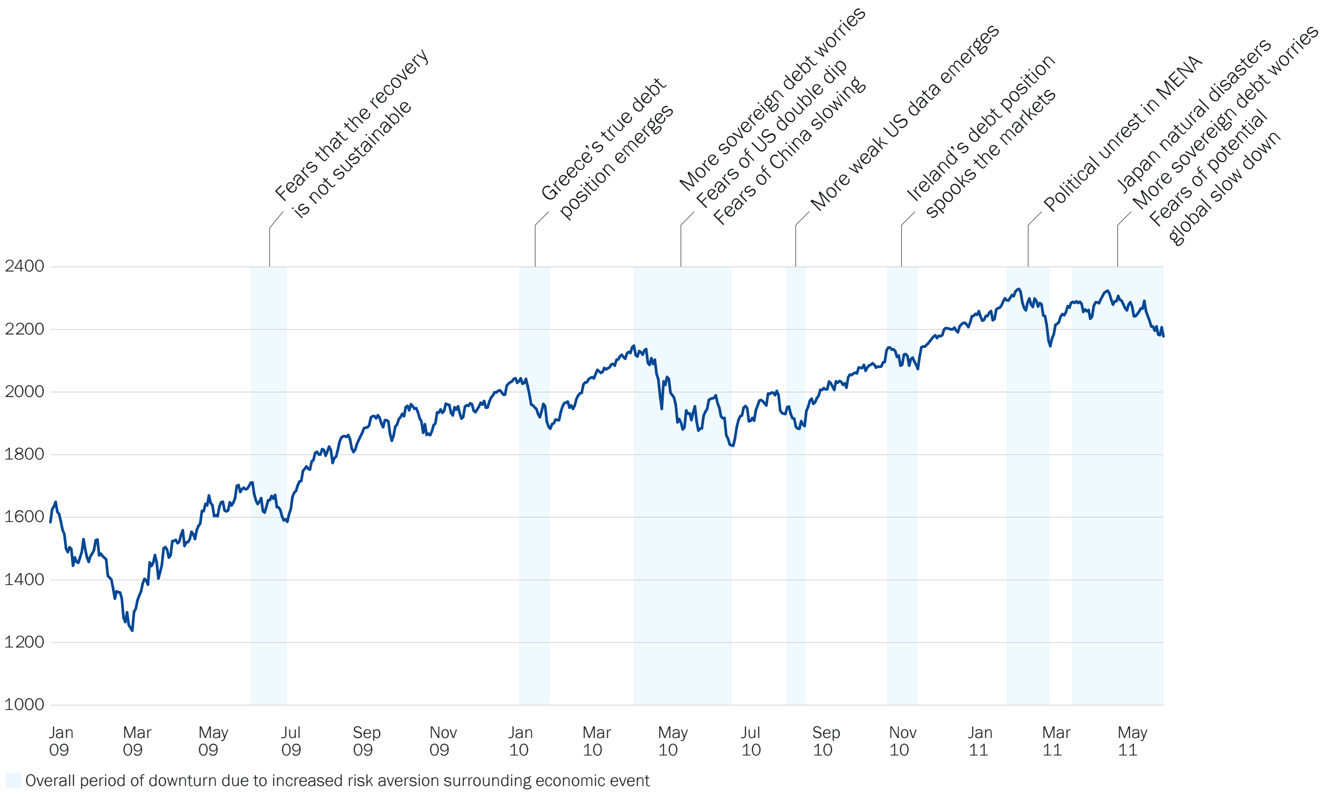
By nature there will always be ups and downs, however markets are currently showing resilience in absorbing these kinds of shocks. Volatility has declined a long way and the global sharemarket has continued its climb (see figure 2), albeit at a slower pace.

Behind all the noise, company fundamentals are improving with positive earnings coming through; reinforcing potential value in the markets.

Global sharemarket still climbing through the noise

Figure 2 **Global sharemarket returns**

MSCI World Index (net dividends reinvested) in local currency



Source: Datastream, data from 1 January 2009 through to 15 June 2011.

Keeping a lid on debt

The fight to contain rising sovereign debt and deficit levels is still an issue that needs to be addressed by many governments in the developed world (see figure 3). And they continue to deal with these challenges in varying ways.

During the good times Greece, Ireland, Italy, Portugal and Spain spent years building up deficits. For most of 2010, these countries were in the spotlight as their true debt positions and their struggle to refinance them (via capital markets) emerged. To remain solvent they sought support from European agencies.

In exchange for this support, these countries agreed to tighten their fiscal belts further, even though domestic demand is weak. Depreciating their currency has not been an option for these Euro-member countries as they share the single Euro currency.

Greece remains in a critical position because it's becoming clear that it cannot meet its commitments set out under last year's budget and needs further support. European leaders are working hard to construct a solution that will help prevent Greece's problems spreading to other European economies.

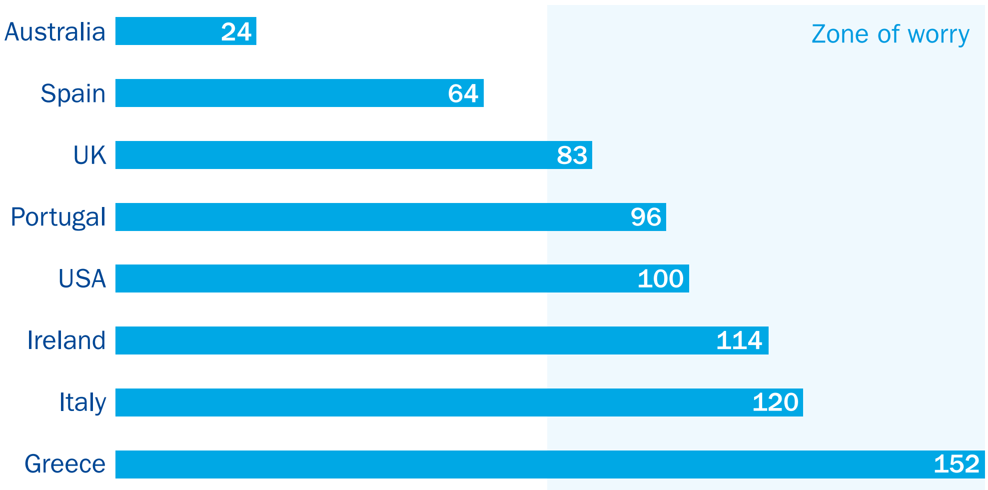
The US implemented historic stimulus measures at the onset of the GFC, in an attempt to soften the impending global recession. While not as bad as Greece and Ireland, America's budget deficit and sovereign debt levels are now larger than Portugal and Spain. And with the impending presidential election next year, markets are becoming increasingly concerned as to when the US will outline credible exit strategies to reduce both its deficit and sovereign debt over the medium-to-long term.

Sovereign debt represents 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.

Public sector debt: repair work needed

Figure 3 **Gross public sector debt**

Per cent of GDP



Source: International Monetary Fund. AMP Capital Investors. As of May 2011.

Surging commodity prices – a threat to inflation

A strong theme in 2011 has been a surge in global commodity prices mainly due to rapid growth in emerging and developing economies. We've seen food prices exacerbated by natural disasters with the IMF Food Price Index up by almost 30 per cent over the past year (slightly higher than previous peaks reached mid 2008). In the case of oil, political unrest in the MENA has also caused more volatility in energy prices.

The inflationary pressures felt by some countries, however, have been vastly different to others.

The threat of inflation is less of a problem for major developed economies because they still have a fair amount of spare capacity. These countries are maintaining very low (near to zero) interest rates, and in the case of the US has implemented additional measures, such as quantitative easing, in an attempt to further stimulate the economy (see figure 4).

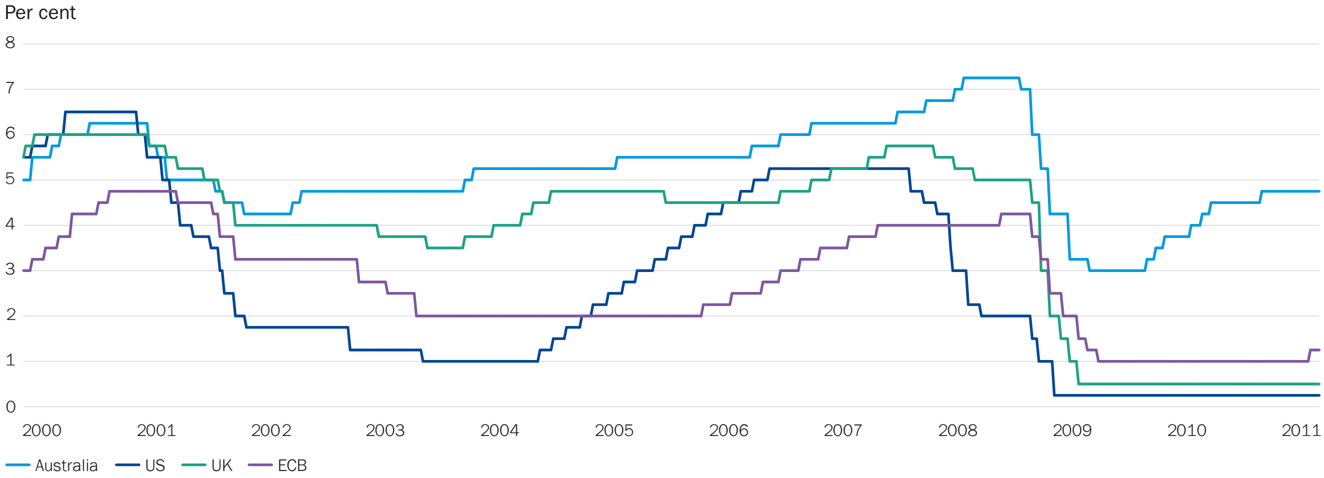
In emerging and developing economies, particularly those with limited spare capacity, signs of inflationary pressures are building. On the whole, these countries are more susceptible to food and energy shocks because these components tend to have a much higher weighting in their consumer price indices than in developed markets.

Policy makers are responding to inflationary pressures with a number of measures, including currency appreciation, higher interest rates and credit rationing. A prime example of this is China, where policy makers have spent much of the past year taking pressure out of its economy by implementing a managed slowdown.

Quantitative easing is a policy measure used by central banks to increase the money supply by purchasing government (and other) securities from the market. This in turn provides the economy with more liquidity and lending potential.

Interest rates favour Australia

Figure 4 **Official cash rates**



Source: Bloomberg. Official cash rates used: Reserve Bank of Australia Cash Rate Target, US Federal Funds Target Rate, UK Bank of England Official Rate, European Central Bank Minimum Bid Refinancing Rate 1 Week. Data through to May 2011.

Australia – a tale of two economies

The rise in commodity prices globally is providing a significant lift to Australia's real national income. The RBA Index of Commodity Prices has risen by around 75 per cent over the past 12 months (see figure 5), and has surpassed its previous high by around 15 per cent. The demand for our commodities and their rising prices are driving up Australia's terms of trade to almost record levels (see figure 6), adding $25 billion to our bottom line over the past year.

This increase in national wealth is continuing to impact Australia's two-speed economy. Some key sectors such as mining and energy are expected to remain strong on the back of rising commodity prices and demand from China. Other areas such as retail and tourism are facing the brunt of the high Australian dollar and subdued consumer spending, with the household saving ratio at its highest level since the late 1980s.

Effects of natural disasters have shaved 1.2 per cent off Australia's economic growth for the first three months of this year. They have caused inflation to rise by 1.6 per cent in the March quarter (3.3 per cent higher over the year) to be slightly outside the RBA target zone of 2 to 3 per cent per annum. The inflationary and economic effects of the natural disasters are expected to be temporary.

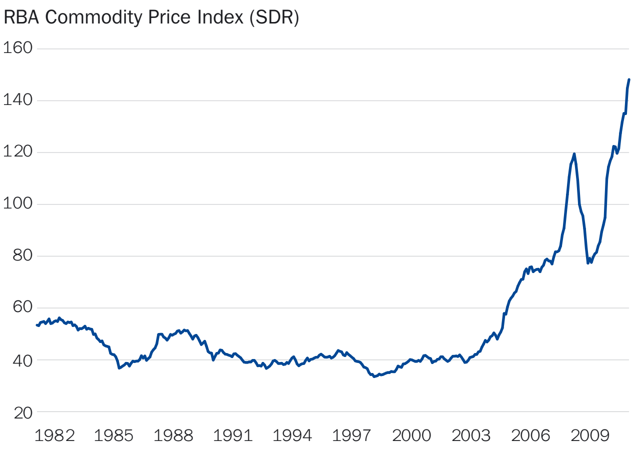
The RBA has a tough job ahead in setting appropriate policies for an economy that is growing strongly in some sectors, but remains subdued in others.

Real national income is the total of all income earned in a country, adjusted for inflation.

Terms of trade measures the price of a country's exports relative to the price of its imports.

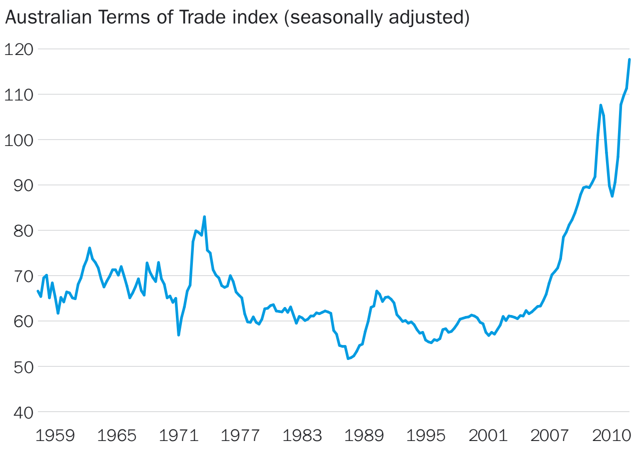
Commodity prices rising: feeding through to Australia's terms of trade

Figure 5 **RBA Index of Commodity Prices**



Source: Reserve Bank of Australia. 2008/09 average = 100, SDR.
Data through to May 2011.

Figure 6 **Australian Terms of Trade index**



Source: Reserve Bank of Australia
Data through to March 2011.

The Aussie dollar – positives and negatives

The Australian dollar has surged above the greenback to record a new post-float high of 1.1012, having broken beyond the psychological parity barrier (where one Australian dollar can be exchanged for one US dollar). It's also risen strongly against other currencies, such as the euro and the pound.

The main reasons for the rapid rise of our dollar are:

- Australia's relatively healthy economy has outperformed other developed markets
- strong terms of trade (particularly with developing countries like China and India), boosted by demand for our commodities and their rising prices
- our official interest rates are higher than most other countries, and this has attracted foreign investment as it provides a good investment return
- weakness in some overseas currencies, such as the US dollar.

The strong local dollar is good news as it has lowered the cost of overseas travel and the price for imported goods for consumers and businesses. It's also been a positive for Australian-based investors purchasing overseas investments.

By contrast the strong dollar has adversely affected the competitive position of other industries, especially manufacturing and tourism. It has also hurt investors already holding overseas assets, as it can reduce returns (see figure 7).

It's worth bearing in mind that currency movements are notoriously difficult to predict. They can reverse course quickly and can substantially impact investment performance. Diversifying your investments across different regions can help reduce the effects of currency movements on your overall returns.

Rise in the Aussie dollar detracting from overseas sharemarket returns*

Figure 7 **Global sharemarket: returns in local currency versus returns in Australian dollars**

* Unhedged

Source: Datastream. MSCI World Index (net dividends reinvested) in local currency and Australian dollars. Data from 1 January 2009 through to 15 June 2011.

What does this mean for investment markets?

Good value amid the recovery

So what does this all mean for investors?

The global economy is solidly in its recovery phase. And while it's still expected to grow, it won't be plain sailing for investors. Over the short term, wider economic issues such as sovereign debt could very well trigger another round of nervousness and market volatility.

The global investment market has enjoyed substantial gains since it bottomed out in early March 2009. For investors who feel they may have missed the boat, markets continue to present opportunities:

- the global sharemarket still has some way to go to get back to pre-GFC levels (see figure 8)
- companies are starting to report strong profits, expansion plans, increased dividend payments and positive outlooks
- companies are continuing to grow profits with the return on equity climbing back to more historically acceptable levels
- global sharemarket's 12-month forward price-to-earnings (p/e) ratio reflects that shares, compared to earnings, show good value and are still relatively cheap (below their long-term average, see figure 9).

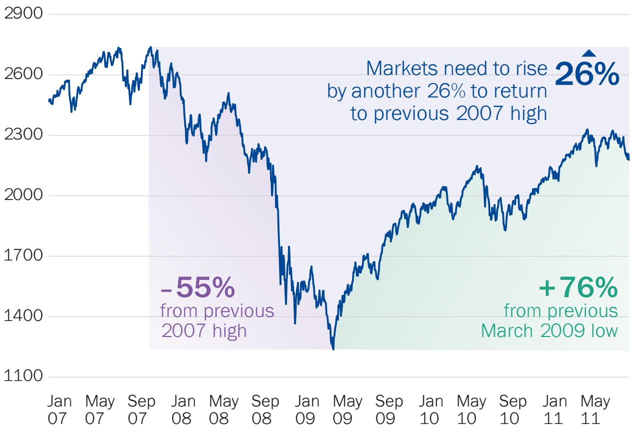
Return on equity calculates how much profit a company generates with the money shareholders have invested.

Forward price-to-earnings (p/e) ratio measures the price paid for a share relative to forecasted earnings.

Markets still not back to pre-GFC levels

Figure 8 **Global sharemarket returns**

MSCI World Index (net dividends reinvested) in local currency

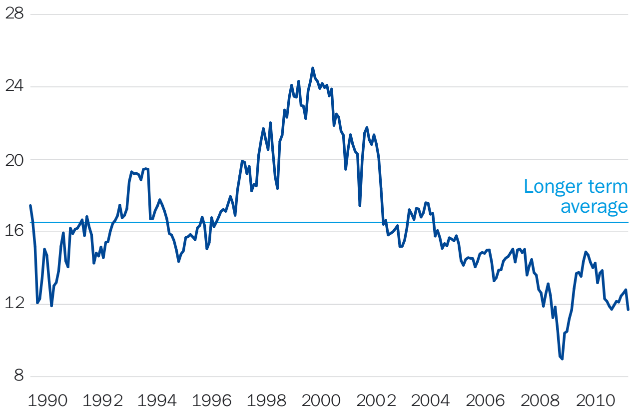


Source: Datastream, data from 1 January 2007 through to 15 June 2011.

Share valuations are attractive

Figure 9 **Global sharemarket 12 month forward p/e**

MSCI World Index 12 month forward p/e



Source: Factset, MSCI and AllianceBernstein.
MSCI World 12 month forward p/e.
Data from January 1990 through to 31 May 2011.

So what can I expect for the rest of 2011 and beyond?

Companies, not countries generating returns

In today's environment, we're seeing changing composition of global growth and consumption creating many investment opportunities for longer-term investors.

But it's companies, not countries, generating these returns.

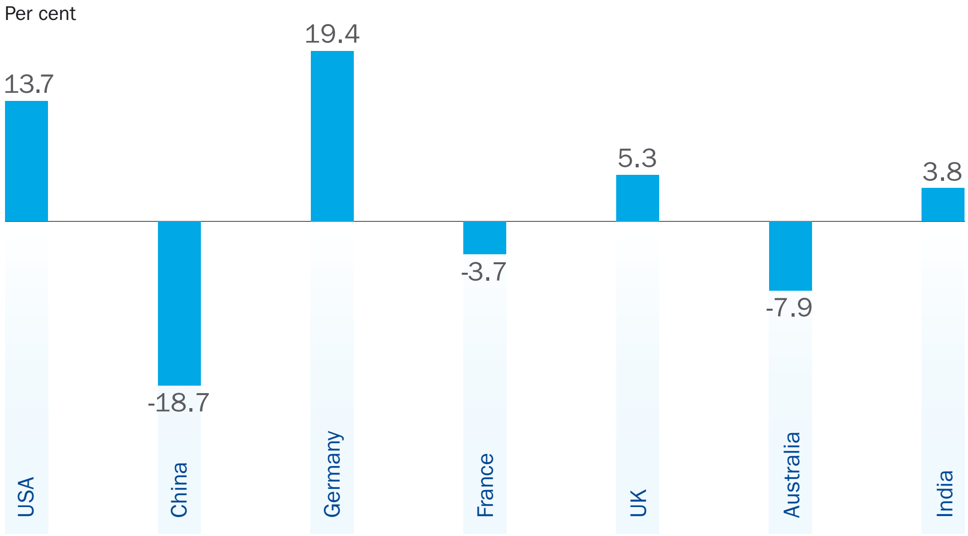
Intuitively, it may seem like a good idea to invest in a region, or country, where economic growth prospects look the strongest, and to avoid those that appear the weakest. But we don't need to look too far back to see that this doesn't always work (see figure 10).

Since the start of 2010 to mid-June 2011, China's sharemarket has gone backwards by more than 18 per cent despite its roaring economy. By contrast, the US economy has experienced a patchy and largely jobless recovery, but its sharemarket has proved to be one of the more robust in the world, rising by 13.7 per cent over the same period.

In the current environment, there is value in investment expertise and research when deciphering the companies that are well priced and positioned to benefit from structural shifts in the economy and growth in developing markets.

Companies, not countries

Figure 10 **Sharemarket index returns since January 2010**



Source: AXA, Datastream. Indices: S&P 500, Shanghai Composite, Nikkei 22, DAX, CAC 4, FTSE 100, S&P/ASX 200. Data from 1 January 2010 through to 16 June 2011.

Finding the untapped potential

While the global economic recovery continues, volatility will remain part of the journey. Market corrections will understandably be unnerving, however overreacting on short-term price movements at the expense of the overall trend can see investors potentially miss out on any rebound.

There's still considerable potential in the global sharemarket. Companies are reflecting good value and positioned to deliver strong returns (through dividends payments and capital growth). In seeking these opportunities, it's now more important to seek quality investment advice that will put you in the best position to benefit from the market recovery.

Whether markets are moving up, down or sideways, it's important not to lose sight of your long-term investment goals and saving for your retirement. And it's key 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
- retain quality, secure assets managed by experienced financial professionals
- seek quality financial advice.

axa.com.au

Important information

This information has been prepared to provide you with general information only. It is not intended to take the place of professional advice and you should not take action on specific issues in reliance on this information. In preparing this information, we did not take into account the investment objectives, financial situation or particular needs of any particular person. Before making an investment decision, you need to consider (with or without the assistance of an adviser) whether this information is appropriate to your needs, objectives and circumstances. You should obtain a copy of the relevant Product Disclosure Statement (PDS) before making a decision to invest in any financial product. Copies of our PDSs can be obtained from your adviser or by calling 137 292. Applications for investment in AXA Australia products will only be accepted on receipt of an application form accompanying a current PDS. Detailed information about the product is contained in the PDS. The National Mutual Life Association of Australasia Limited and its associates derive income from issuing interests in the products, full details of which are contained in the PDSs. Unless specifically stated, the repayment of capital or performance of our products is not guaranteed. This information is provided for persons in Australia only and is not provided for the use of any person who is in any other country. Past performance is not necessarily indicative of future performance.

09938-06-11S

AXA Australia Customer Service GPO Box 2780 Melbourne VIC 3001
Telephone: 1800 780 085 Facsimile: (03) 8688 5796
Responsible Entity: National Mutual Funds Management Ltd
ABN 32 006 787 720 AFS Licence No. 234652

Partner

redefining / investments