

Economic Insights – if the shoe fits

with **Stewart Brentnall,** **Chief Investment Officer (CIO), OnePath**

Stewart discusses his thoughts on how current themes in economies and markets will play out over the next year and beyond.

Rarely, in recent times, have we had such a disparity of views from respected economic and market commentators, over which direction, and by how much, markets are going to move in the next year and beyond. Currently these include a 'Japan 90s style' gradual decline, a volatile and unpredictable climate, a 'muddle through sideways' model and a 'she'll be all right' upward trend. So which one is most likely and how can we plan ahead?

Diversification – how does it all fit together?

Rational thinking and accepted wisdom teaches us that we should build an investment portfolio that contains a mixture of asset classes, fund managers and securities that will help meet our investment goals while also protecting us against the unwanted impacts of as many economic and market shocks as possible.

However, careless diversification will not protect us when we need it most and over diversification will probably result in higher costs and may rob us of some intended portfolio characteristics.

We should be thinking that each component of our investment portfolio has a clearly intended purpose and that each part should complement the other parts. Thinking about it, this sounds scarily like conversations I have with my wife, from time to time, about the contents of her shoe cupboard!

So let's think about what's happening around the world and how we can build an investment portfolio to suit these conditions.

What is happening in the global economy?

Three things currently strike me about the global economy:

The different speeds of emerging and developed economies

China and India's Gross Domestic Product (GDP) continues to grow at almost 10% per annum whereas the developed world struggles to manage only about 2% GDP growth per annum. House prices and building levels are largely anaemic across the western world, but building is rampant in emerging economies (with city skylines packed with cranes) and inflation of essential goods (food prices and energy) is rising sharply around the world.

Excessive levels of government debt

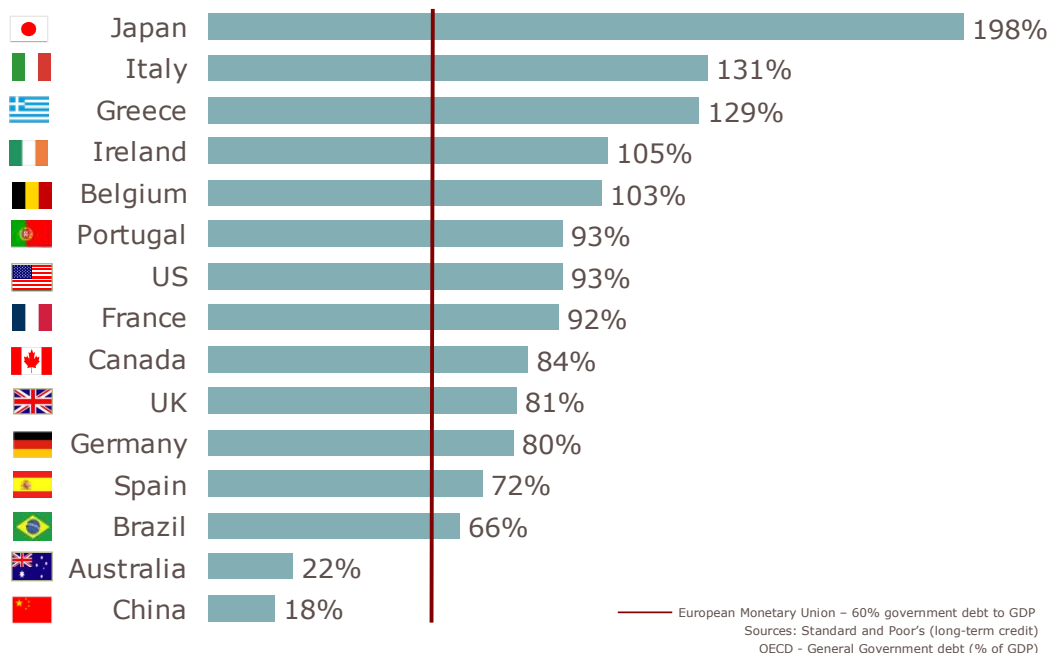
European countries average over 90% of government debt to GDP (ranging from 72% to 131%). The United States, by comparison, is currently 93% and Japan 198% of government debt to GDP. Interestingly, in 1992 when the European Monetary Union was set up, joining countries were required to have no more than 60% government debt to GDP.

As simple as it might sound, there are only three ways for governments to reduce debt – pay it back, cause a reduction in its real value through inflation, or default.

While borrowing to stimulate consumption and investment keeps economies moving, it also defers longer term recovery, as interest payments get higher and higher and ultimately consumption has to be reduced in order to pay back debt.

I expect that a number of European countries may default in the next year. This is because the austerity measures and belt-tightening required to enable repayment of high levels of debt and reduction of crippling interest payments are simply too high and politically unacceptable. Default will inevitably be painful and cause losses.

Gross government debt as a percentage of GDP, 2010



The ongoing strength of commodities and precious metals

Since the Global Financial Crisis (GFC), two factors have been notable in the commodities and precious metals sectors. Firstly, the combination of credit tightening and continuing strong demand for commodities from emerging economies has meant prices for iron ore, coal and base metals have been driven up. Very limited new production capacity has been financed and built which has kept these prices high.

Secondly, views that inflation may rise and the declining reputation of bank and government debt as quality investments, has meant that the demand for gold and silver (as a store of safe value) has gone through the roof. In less than three years, the US dollar price of gold has almost doubled and the price of silver has risen almost six-fold! Can this performance continue and can these prices last? I think not and I am worried by the influx of retail investors' money as investment in gold and silver has become more easily available.

To me, these prices are in part the result of herd behaviour – where we all like the sound of what our neighbour has, and would like to have some of it, without giving proper consideration to investment merits (or the lack of them).

Putting these factors together, we can see pockets of growth, some potential bubbles and some worrying longer term impacts of excessive debt. Too many eggs in any one of these baskets may lead to 'portfolio pain' and we need to carefully build a diversified set of investment exposures into a robust investment portfolio.

What does this all mean for sharemarkets?

Despite growing views of a global economic recovery, we should be wary of placing too much optimism on sharemarket performance also lifting sharply. Local and overseas shares have fallen, mainly by between 5% to 10% in the two months leading up to 30 June 2011, as investors have worried about slowing economic growth, debt and sluggish US and European housing markets.

For **developed sharemarkets**, I see a period of sideways movement for some time, as economies digest current imbalances of high levels of debt to GDP and investors remain conservatively placed in cash and liquid assets on the sideline. Higher recent savings rates (as a proportion of disposable income), in place of spending, are also holding back sharemarkets – although the longer term impacts of this extra saving will be positive for equities.

Emerging sharemarkets will, I think, continue to perform well, as they enjoy the ongoing stimulus of capital investment (especially China) and gradually increasing levels of domestic wealth and consumption. China may have an overheated, high-end apartment market, but its broader economy is being managed diligently, even if

one day, current levels of production and investment in it decline. Such decline would also impact those who rely on supplying China, including Australia.

Australian shares continue to operate at two distinctly different speeds in earnings terms. Resources stocks and companies which export to Asia and the emerging markets continue to have a bright earnings outlook.

On the other hand, much of the domestic facing industry and services sector are lumbering along more slowly. The financial sector is also feeling the bite of declining rates of demand for loans, especially in the commercial sector. Overall, resources share prices may already fully reflect the better outlook for the export and investment sectors.

What are current views on the Australian dollar?

The Australian dollar is still worth more than 1 US dollar and remains strong against most currencies. I remain of the belief that this is the result of three factors – strong commodity prices, relatively high Australian interest rates and an apparently safe home for currency traders.

I still think that our dollar may slip back below parity with the US dollar over the next year, but the timing and mechanism for this is very hard to call. One thing that concerns me is the amount of advertising one now sees, inviting retail investors to think they can become currency trading experts suddenly, and speculate for gain. We don't become qualified electricians, so why should we become currency experts as quickly? Beware – the shocks from mistakes can be equally painful in both cases!

So, where to next?

Investment goals and portfolio planning should be approached as long-term exercises. Investment portfolios should be built to include multiple asset classes which will allow reasonable performance in as many market conditions as possible. This should include defensive assets such as bonds, which will perform better in times of flat or slowing growth – as they have done over the last year. Adding to the mix some cash, as well as commodities, currencies and other forms of less traditional assets, will allow us to access new investment opportunities.

As I finish, I am recalling looking into a cupboard containing shoes of a multiplicity of colours, shapes and styles that can be mixed and matched to complement any outfit and suit any occasion. I can hear my wife's words – and the analogy with investments is an excellent one!

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