The slow motion recovery

March 2011 // Market commentary

The New Year has delivered a range of bullish share markets forecasts from sell-side investment houses. The most optimistic are for year-end targets of around 1,500 for the S&P500 and 5,500 for the S&P/ASX 200. These index targets imply share market returns of over 20% this year. Our views are more measured. We expect that share markets can deliver returns in the high single to low double digit range. We look for the S&P500 to finish the year at around 1,350 to 1,400 and for the S&P/ASX 200 to reach 5,000 to 5,200.

Volatility is likely to be an ongoing theme of 2011. There are no easy solutions to the European debt crisis and more bail-outs seem likely. Our main concern is that the policy response in Europe seems reactive rather than proactive – policy makers seem to act only when under threat of a crisis. We expect the euro to survive, but it is likely to be a messy and protracted affair as the highly indebted countries struggle with internal devaluation (i.e. wage cuts) and Germany counts the costs of financial rescues. Geo-politics also seem to be heating up with last November's North Korean missile tests and this year's uprisings across the Middle East a foretaste of what could be an eventful year. One of the challenges this year will be to differentiate between events that have a transitory impact on investor risk aversion and those that will reduce economic and profit growth.

Central to our cautiously optimistic share market view is that the US economy will achieve growth of 3-3.5% this year – close to the long-term trend but not enough to make sustained inroads into the unemployment rate. This should deliver reasonable growth in earnings per share (EPS). The amount of spare capacity in the US means that the risks around our growth forecast are skewed to the upside (4.5% growth is more likely than 1.5%), but the US still faces plenty of headwinds in terms of de-leveraging, mortgage foreclosures and government spending cutbacks.

Our theme last year for the Australian share market was 'less pain means less gain'. This certainly played out with the S&P/ASX 200 eking out a 2% return for the year compared to 13% for the MSCI World index. We're less cautious this year on local shares relative to the rest of the world. Australian shares face the headwinds of the high Australian dollar, a sluggish economy outside of the mining sector, the potential for more RBA tightening and the flow-on effects to the resource sector of a slowdown in China. They will, however, benefit from the mining-led investment boom and the income gains being delivered by high commodity prices (nominal GDP increased by 9.6% in the year to September).

Emerging markets shares ran hard during 2010, with the MSCI Emerging Markets index delivering a 19% return for the year, after the 79% gain achieved in 2009. Valuations are no longer supportive (although not yet dangerously high) but the biggest issue is likely to be inflation pressures across many emerging market economies. This is likely to trigger policy tightening across a range of countries with China at the head of the queue.

Global fixed income remains a two part story – high yield and investment grade credit are relatively attractive while global government bonds appear expensive. US 10-year government yields at around 3.6% currently are less overvalued than last October when yields fell to 2.4%. There are still upside risks and our US strategists expect the 10-year yield to reach 4.0% this year. Near term, there appears no catalyst for a significant further sell-off with the Fed undertaking quantitative easing and inflation pressures still moderate. Australian government bonds, with 10-year yields at 5.6%, look more fairly valued.

US outlook – from double dip to potential boom

Last August the talk was of a potential US double dip as economic indicators faltered and the Fed moved towards a second phase of quantitative easing. Now, analysts are upgrading forecasts following a run of strong manufacturing data and improving labour market news. The forecast for 2011 economic growth from the Blue Chip panel of economic forecasters has been revised up from 2.4% last September to 3.2% in January.

Russell's chief economist for North America, Mike Dueker, is wary about extrapolating the current run of positive economic indicators into booming growth. Mike expects the monthly payrolls figures to average around 220,000 by mid-year – enough to start making gradual inroads into unemployment – but he thinks this will be as good as it gets. The recovery from the financial crisis is likely to be drawn out and moderate as households continue to pay down debt and banks work through mortgage foreclosures.

The issue for share market returns is how much more profit growth is left in the US recovery and can the price to earnings ratio increase? EPS for the S&P500 rebounded by nearly 40% in 2010. One of our favourite indicators of the US profit cycle, the Conference Board's quarterly survey of CEO confidence, bounced back in the December quarter and suggests reasonable EPS gains are possible.

Australia – the two speeds diverge further

The mining boom continues to drive divergent outcomes in the Australian economy. The income gains from the rise in the terms of trade caused nominal GDP to rise by 9.6% in the year to September, well above the 2.4% gain in real GDP. Mining investment is at a historically high level and is likely to increase further given the substantial number of large resource projects now underway.

It's a different story outside of the mining sector. Firms are cautious about investment spending, the high Australian dollar is taking a toll and households are paying down debt instead of spending. The tourism industry has been hard hit – short term overseas departures exceeded visitor arrivals by 1.2 million last year as Australians took advantage of the low relative cost of overseas holidays.

The household savings ratio has increased sharply over the past three years. Higher savings imply weaker spending growth out of rising incomes. Retail spending has been surprisingly weak despite strong jobs growth, wage gains and rising household wealth.

Most forecasters anticipate that the mining boom will continue and that households will eventually lose their caution and start spending again. This view is behind the RBA's relatively hawkish forecast of GDP growth in a 3.75-4.0% range over the next two years. The latest Bloomberg survey of market economists has the RBA's cash rate at 5.50% by the end of the year, implying three more 25bp tightenings.

Our view is more measured. The lower-than-expected December quarter inflation figures and weak trends in retail spending and housing activity are pushing the next tightening further into the future. Our suspicion is that the pace of RBA tightening might be more gradual than the market expects. We may see only one or possibly two 25bp rate rises this year.

China – slow motion slowdown

The long-awaited China slowdown is yet to materialise. There were signs in mid 2010 that the economy was cooling as money supply growth slowed from its stimulus-driven peak in 2009. The economy, however, accelerated over the final quarter of 2010 as exports strengthened and industrial production picked up. Inflation also stayed high, ending the year at 4.6% and is expected to accelerate further in early 2011.

The debate on China is largely around whether the spike in inflation is temporary and will subside when food prices return to normal, or a sign of an overheating economy that will force more aggressive tightening measures and the risk of a sharp economic slowdown.

Right now, the consensus seems to favour the more bullish view that inflation will moderate and there will be only gradual further tightening. The inflation trend over the first half of the year is going to be important. A continuing upward path could see investors start to worry about aggressive tightening and the risk of an economic slowdown later in the year.

Conclusion: upside remains in ageing recovery

The pessimism of mid-2010 has given way to a strong sense of optimism as economists upgrade global growth forecasts and post bullish targets for share markets. We agree that share markets have upside, but we're wary of some of the more bullish forecasts. In the same way that investors became too gloomy mid last year, there is a risk that positive economic news is being over-extrapolated.

Our expectation for a continuation of the moderate US economic recovery combined with reasonable, but not cheap, valuations leads us to a modest bias towards global share market exposure.

Volatility is likely to be an ongoing theme in 2011, generated by market events such as government debt concerns and shifting views about monetary policy, and by geo-politics. The challenge once again this year will be to maintain discipline amid potentially large swings in market sentiment.

Issued by Russell Investment Management Ltd ABN 53 068 338 974, AFS Licence 247185 ("RIM"). This document provides general information only and has not been prepared having regard to your objectives, financial situation or needs. Before making an investment decision, you need to consider whether this information is appropriate to your objectives, financial situation and needs. This information has been compiled from sources considered to be reliable, but is not guaranteed. Past performance is not a reliable indicator of future performance. Any potential investor should consider the latest Product Disclosure Statement ("PDS") in deciding whether to acquire, or to continue to hold, an investment in any Russell product. The PDS can be obtained by visiting www.russell.com.au or by phoning (02) 9229 5111. RIM is part of Russell Investments ("Russell"). Russell or its associates, officers or employees may have interests in the financial products referred to in this information by acting in various roles including broker or adviser, and may receive fees, brokerage or commissions for acting in these capacities. In addition, Russell or its associates, officers or employees may buy or sell the financial products as principal or agent.
R_MKT_Commentary_SlowMoRec_V1FF_1103 MKT/2852/0311