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An Update on News at Home and Abroad November 2011

Throughout the world, a problem for investors is the many mixed signals. There are plenty of reasons to be cautious, but valuations for share and property assets also appear attractive on some traditional measures.

Japan has chronic economic and political issues no closer to any resolution. The continuing "fallout" from the nuclear incident last year adds to ongoing instability, high currency, high savings and virtually no growth.

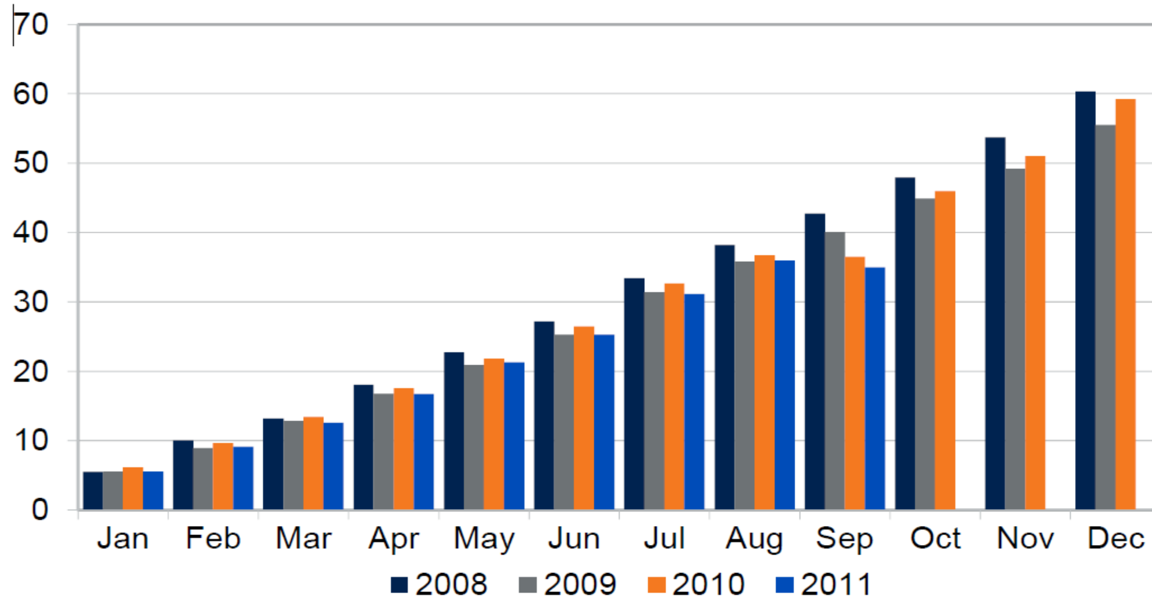
The **European debt situation** is a very difficult problem: the issues include not just money, but also politics and honesty. We saw last week the announcement of terms of a "rescue package", which included banks taking a "haircut" of 50% on Greek government debt, recapitalisation of European banks, and an increased bailout fund. The announcement was greeted with relief by markets. This is typical when politicians effectively pronounce "we will do whatever it takes".

The devil is always in the detail – and the ability to actually deliver on the promises made. Sure enough, Greek Prime Minister Papandreou announced this week that he will take the bailout measures to a referendum – which would almost certainly be defeated. Markets fell accordingly. The next steps will see an emergency meeting with French and Italian leaders, trying to "persuade" the Greeks to get on with action. Overnight, we hear there may not be a referendum. What will tomorrow bring?

This is symptomatic: many of the measures required to manage the global debt situation are not popular. They involve things such as tax increases, job losses, later retirement and lower pensions. Fundamentally, they amount to lowering living standards and expectations. For politicians, the electoral implications are obvious.

The graph on the following page illustrates the real difficulty for the Greeks and many others – despite increasing tax rates, overall tax revenue is lower than it was a year ago. Simply slashing spending may actually make the problem worse. There need to be offsetting programmes such as infrastructure spending to create jobs and improve future productivity.

Cumulative Greek Government Tax Revenues in Euro



Source: Greek Ministry of Finance, Thompson Datastream, Schroders. Updated 28 October 2011.

A concern for commentators and investors is really about the **"domino effects"** if Greece cannot be helped: what will the impact be for other European countries? Will European banks survive? Will these things also slow growth in the developing world?

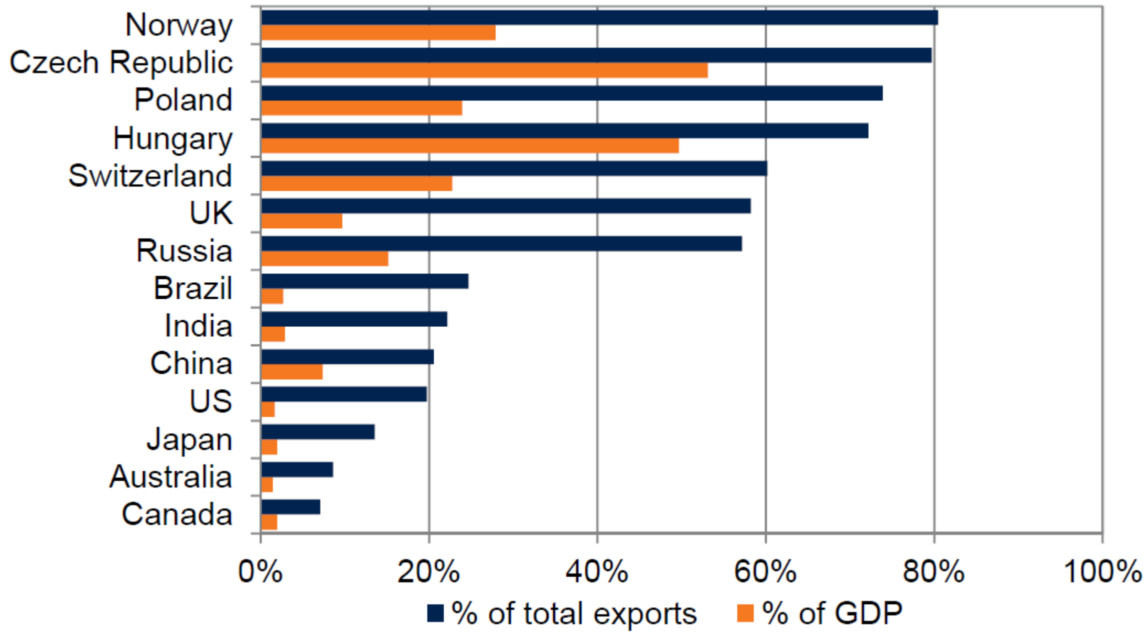
These issues will continue to dominate discussion, and changing newsflows will explain some of the ongoing volatility in investment markets. However, the chart below provides some comfort.

The clear implication of this is that economic prosperity in countries such as China, India, US or Australia is unlikely to receive a major negative impact from ongoing problems in Europe. However, the fact that there would be some impact could actually be a positive in galvanising collective action.

Meanwhile, **the US** is already moving into election mode for the Presidential election next year. The political deadlock there is making it difficult to implement any genuine economic recovery approaches. However, recent US economic data has been relatively positive, suggesting that some slow growth is happening.

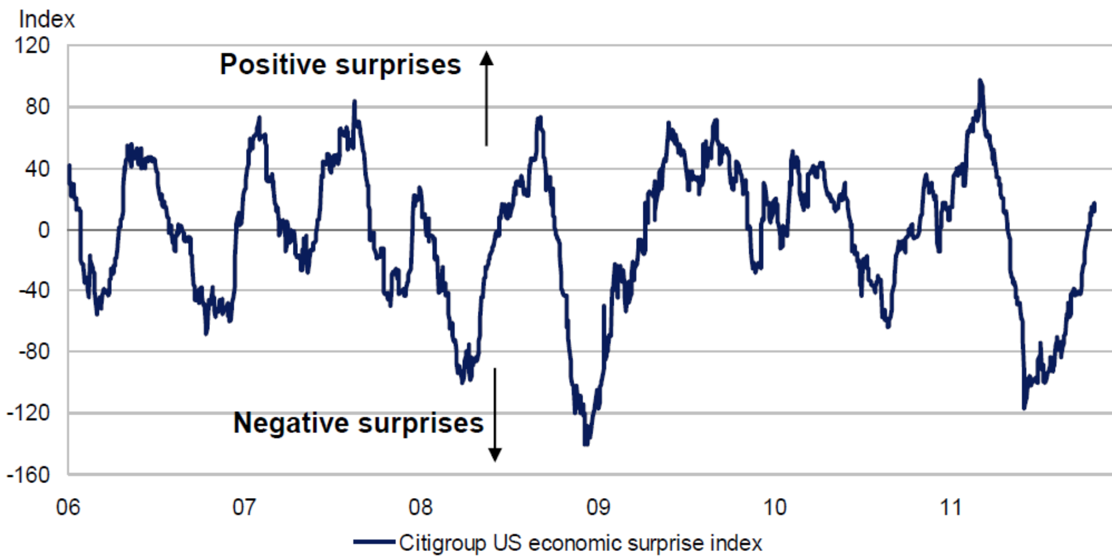
There also some early indications the housing starts have bottomed in the US, while house prices are 40% below their peak – similar to Japan, but over 5 years instead of the 20 years it took in Japan. Many major US companies (examples include Apple, Johnson & Johnson) are also in very strong positions, with cash and strong cashflows. Recent economic data has tended to be slightly better than expectations (see graph below). The difficulty is that there remain about 20 million people unemployed in the US. That is a massive drain on the economy, and potential cause for civil unrest.

Trade Links with the Euro Zone



Source: Schroders, Thomson Datastream, 27 October 2011.

US Economic Surprise Index Turns Up



Source: Citigroup, Bloomberg, 27 October 2011.

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In **Australia**, we continue to have low unemployment, inflation is moderating, and there is some uneven economic growth. On Melbourne Cup Day, our Reserve Bank announced a cut in interest rates of 0.25%. That is not very meaningful, but is a big change from earlier this year when expectations were for further increases. Largely due to global economic considerations, the Reserve "concluded that a more neutral stance of monetary policy" would now be appropriate.

The Reserve are less concerned about inflation, and see weakness in consumer spending and house prices in recent months. While significant cuts in interest rates are unlikely immediately, the message is clear: the Reserve Bank sees that there could be a need to give a boost to the local economy.

Our banks appear to be very strong, and we have a strong pipeline of major resources project developments to underwrite growth and employment. We should be in no doubt about the importance of continuing growth in emerging economies for us. However, we suffer from some political uncertainty with some significant new taxes mooted. Also, the QANTAS lockout this week seems to herald the start of industrial relations problems over the next 12 months.

While we often pride ourselves in being much better placed than our global peers, it is still worth noting that Australian household debt to disposable income ratio at 160% is four times what it was in 1990, and the highest ratio in the Western world – the US is 120% for example.

What Does It All Mean and What Do We Do?

Overall, the world economy will continue to show growth in the next few years, underwritten by the emerging economies. In developed economies, the process of debt reduction for both Governments and households will continue. That is necessary, but reduces growth potential in the short-term.

Around the world, the debt problem has been shifted from companies to Governments. The answers will be difficult, painful and time-consuming.

Investors in global markets are well aware of the issues: they explain why bonds are very expensive globally, and shares offer what would normally be very attractive dividend yields. There will be more volatility in markets, as data and events produce news that is different to expectations. However, with massive amounts of cash around the world, and very low interest rates, money is likely to gradually move back towards equities as the "wall of worry" is scaled over the next few years.

Within our portfolios, our approach is to act for you as follows:

- Remain cautious. Capital preservation remains a key objective. This requires patience, diversification, less growth asset exposure, and more careful choice of growth assets.

- In shares, take a "value" bias. This implies a target of higher income yields, and seeking companies whose prices are low compared to their fundamental value.

- Retaining some international exposure remains important. We continue to see that the $A falls against major currencies when markets are worried – this helps to hold up the value of those investments.

- In defensive assets, long-term government bonds are expensive. As the world economy recovers and/or confidence improves, the price of these bonds will fall in the next few years. Therefore, we prefer quality corporate debt and shorter timeframes.

- Continue to seek investments that provide the potential for returns above inflation but do not necessarily rely on growth in prices of shares or property.

- Do not become too interested in daily volatility, which is inevitable and largely meaningless.

- Being careful to continually review your objectives, timeframes and the resulting portfolio.

- Guarding against making decisions based on short-term emotional considerations.

We hope this update has been helpful. Please don't hesitate to contact the Hub team if you would like to discuss your own circumstances and portfolio with us.

With very best wishes

Hub Wealth Management

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