

Here we go again – another round of global growth worries

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Key points

- Shares and other growth-related investments are going through another rough patch due to renewed fears about the global growth outlook. Given the unusually long worry list facing investors, this could persist for several months.
- However, this should give way to good buying opportunities in the months (or weeks) ahead, as the cyclical recovery in the global economy and shares is likely to continue, albeit remaining constrained and fragile.

Introduction

I am getting a sense of déjà vu all over again. Or is it Groundhog Day? Here we are in May and global share markets, after a reasonable start to the year, are fretting again about global growth due to worries about Greece, China, and softer global data generally. Just like May last year! Does this mean the global economic recovery is over and shares are heading off the precipice again? Or is it just another correction, as it was a year ago?

The long and widening worry list

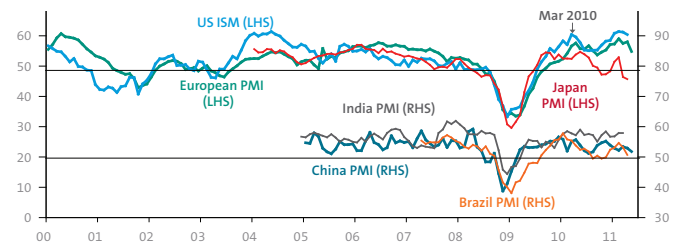
After rallying into April, global share markets hit an air pocket over the last month. From their April highs, US shares have fallen 3%, global shares have fallen 4%, Asian shares have fallen 5% and Australian shares have fallen 7%. What's more, commodity prices have fallen nearly 10% on average and the growth sensitive Australian dollar has fallen 4% from its recent 29-year high of US\$1.10.

It's little wonder investors are concerned again. While shares often climb a wall of worry, in the last few weeks the list of worries has become more worrying.

- The European sovereign debt crisis has not gone away. Greece is ultimately heading towards some form of default, leaving policy makers unclear as to what to do. There are ongoing strains in Portugal and Ireland, and a combination of soft growth and political problems is causing investors concern about Spain and Italy
- The European Central Bank appears eager to raise interest rates again to combat rising inflation
- Japan has slipped back into recession – its sixth in 18 years – and the associated disruption to production is affecting global production chains
- Chinese growth is slowing but policy makers are not yet prepared to signal easing, as inflation is yet to peak. This has added to fears of a Chinese hard landing

- Global business conditions indicators (such as the US Institute for Supply Management [ISM] index and so called purchasing managers indices [PMIs] in other countries) are rolling over, albeit from quite high levels, just as they did through the June quarter last year

Global business conditions starting to roll over



Source: Bloomberg, AMP Capital

- There is concern that just as the ending of the first round of quantitative easing in the US in March last year was followed by turmoil in the June quarter, the same will occur with the ending of QE2 at the end of next month
- The US housing sector remains chronically weak
- The pace of US growth slowed to 2% in the March quarter and this quarter doesn't look much stronger, and
- The US Government is up against its debt ceiling and the debate with Republicans in Congress about increasing it could become acrimonious and lead to worries that next year's fiscal cutbacks will become even more severe.

For good measure, another Icelandic volcano is affecting north Atlantic/European air travel yet again, as it did last year. Australia-based investors also have to contend with talk of more interest rate rises when much of the economy outside mining is struggling.

After sharp falls in recent days, shares, particularly in Australia, are oversold and due for a bounce. But until many of these issues are resolved or start to recede, it's likely share markets and other risky assets will remain volatile and at risk of a further correction.

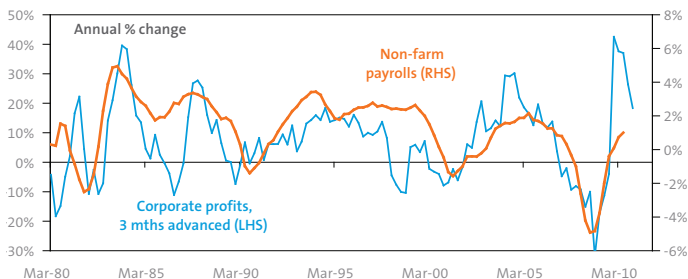
Reasons this is just another soft patch

The key question is whether the long list of worries will lead to a return to recession and a new global bear market, or just another soft patch and correction in shares in the context of an ongoing recovery. This is exactly the same issue as a year ago when a 'double dip' became the big concern. Our view back then was that the risks had increased but ultimately the recovery would continue, and it did. The same is likely this time around, with the latest correction likely giving way to renewed strength by year end.

- Global monetary policy remains very easy and will now likely remain easy for longer. The current soft patch, if anything, will ensure that the US Federal Reserve keeps interest rates near zero for longer. If it intensifies, it may also result in another round of quantitative easing (QE3). Increasing uncertainty will also help prevent or delay further tightening by the European Central Bank.

- It's quite normal for business conditions indicators to roll over after rising to high levels. This is part of the normal ebb and flow of economic data. For example, after peaking in May 2004, the US ISM indicator moderated for four years, without being associated with recession.
- The strong US corporate sector is likely to underpin further gains in US employment and business investment, both of which are critical in sustaining the US economic recovery.

Strong profit growth is now driving higher US employment

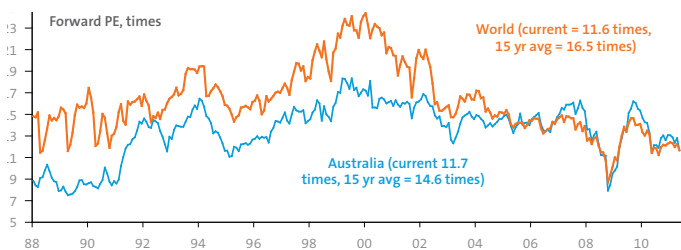


Source: Bloomberg, AMP Capital

- Recovery in Japan is likely to get underway from mid year as Japanese production returns to normal and rebuilding kicks in. This will also see a reversal of the supply chain disruptions globally that are now hampering automobile production.
- The correction should be self limiting to some degree, as lower bond yields as a result of safe haven buying will help the US housing market by reducing mortgage rates, and lower food and fuel prices will take pressure off headline inflation and consumer spending.
- While China is uncertain, reflecting still high inflation and slowing growth, a peak in inflation around mid year should lead to an easing of China's policy tightening stance some time in the September quarter. We continue to expect China to grow 9% this year.
- In Australia, growth is likely to accelerate later this year as flood related rebuilding kicks in, coal production returns to normal and mining investment ramps up.
- Finally, while the situation regarding Greece remains uncertain, the most likely scenario is some sort of muddling through. This will likely involve an enhanced European Union (EU) support package, ahead of an eventual restructuring at a time when the EU is better able to protect other countries and recapitalise affected banks.

So, while there are reasons for short-term concern and we may not know the answer for a few more months, there is good reason to see the latest setback in the global growth outlook as just another soft spot, and the fall back in shares as just another correction. Continued global recovery should ensure profit momentum will remain positive, albeit slower than it was, and with share valuations looking attractive once again, shares should have more upside by year end, particularly in the December quarter.

Shares getting very cheap again



Source: Bloomberg, AMP Capital

What about Australian shares

As is usually the case, Australian shares will take their lead from global markets and the US in particular. Along with global influences, Australian shares have been struggling under the impact of relatively high interest rates, with the threat of more increases to come, the strong Australian dollar (A\$), worries about a collapse in house prices and a less favourable political environment than in the past. Until some of these negatives are resolved, Australian shares are likely to continue to lag their global counterparts.

However, while the next few months are likely to remain volatile, if as expected global shares recover by later this year, then Australian shares are likely to rebound as well, ultimately breaking through the 5000 level for the ASX 200. Note, however, our year end target for the ASX200 has been revised down to 5200, reflecting the tougher environment in Australia.

What to watch?

Given the length of the worry list, the risks remain high, but several things are worth keeping an eye on. These include:

- Credit and money market spreads for signs the problems in Europe are leading to a renewed global credit crunch, as well as Spanish and Italian bond yields for signs of contagion. So far so good.
- Signs global business conditions indicators are turning down sharply or the US labour market is faltering.
- Signs Japan is starting to bounce back.
- Signs Chinese inflation is peaking and/or the official rhetoric in China is moving away from more tightening.
- And for Australian shares, a weaker A\$ or signs the Reserve Bank of Australia is abandoning its tightening bias.

Concluding comments

This year is feeling a lot like last year. Given the long list of worries confronting investors, we could go through more short-term volatility and weakness in shares and other growth trades. That said, there are good reasons to be confident that, like last year, the current tough patch will pass, giving way to better conditions in share markets and continued recovery.

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