



A hung parliament not necessarily a hung market

For the first time since 1940, Australia has a hung parliament. In this Point of View AXA's Chief Investment Officer Mark Dutton points out that this is not necessarily negative and looks at the implications for investment markets.

In brief

- A hung parliament is not necessarily a negative outcome even though it is currently generating much uncertainty. Minorities can form a stable government.
- The Australian dollar is susceptible to an environment of additional uncertainty because it is at the high end of its valuation range.
- In contrast the Australian sharemarket is at the low end of its valuation range, but is unlikely to make much headway until there is more clarity as to how the situation will play out.

Another dose of uncertainty

After five weeks of campaigning and 14 million votes, there is no clear winner from the federal election.

This situation is adding another dose of uncertainty to markets that are already reflecting above average levels of risk aversion.

There are really three possible outcomes: either the Labor party, or the Coalition parties form a minority government, or we face a fresh election.

The most likely outcome looks to be the formation of a minority government. If this is the case, agreement will need to be reached, at the latest, by the time parliament next sits in November.

Hung parliaments can have happy endings

A hung parliament is not necessarily a negative outcome, providing the leading minority party has genuine support from additional members, guaranteeing the confidence of the house and supporting supply.

While unusual for Australia, it is not rare for minority governments to be formed in western democracies.

For example, Canada has had thirteen minority governments over the past 140 years, including their current federal parliament.

While Canada has generally prospered through most periods of these governments, there is a clue to a possible risk for Australia.

Only one of Canada's thirteen minority governments have lasted a full term. On average, the other twelve minority governments lasted less than two years.

The UK election in May this year resulted in a hung parliament, and further demonstrates that a minority government can be a stable government.

The UK's new 'coalition' government' is proving to be an initial success, and has just managed to pass a budget which doesn't pull punches on tough issues such as spending cuts or tax increases.

Closer to home, hung parliaments are nothing new for Australia's States and Territories.

Over the past 20 years there have been more than 10 occasions where Australia's states and territories have had hung parliaments. In most cases initial uncertainty was replaced by stable government.

The Australian dollar is vulnerable

The Australian dollar is vulnerable to an environment of additional uncertainty because it is already at the high end of its valuation range.

While there are still a number of positives supporting the currency – wide interest-rate differentials, strong commodity prices and an improving trade balance – the Australian dollar

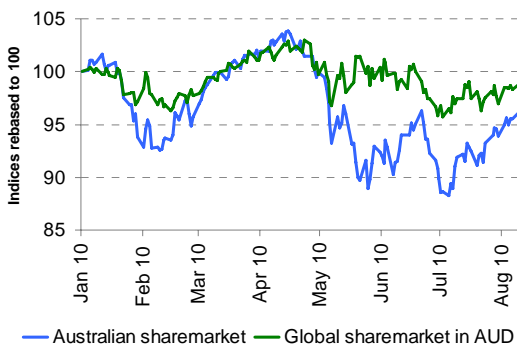
is overvalued on most longer-term valuation metrics.

For example, the OECD's purchasing power parity measure suggests the AUD/USD fair value is around 0.68, which indicates that the Australian dollar is overvalued by around 34 per cent.

Increased uncertainty and risk aversion typically results in the Australian dollar falling against the US dollar.

Investments in unhedged overseas equities benefit from this trend. Figure 1 below shows returns from the global sharemarket in Australian dollars have been better and less volatile than returns from the Australian sharemarket over the course of this year.

Figure 1 – Australian versus global sharemarket in AUD



Source: Bloomberg. S&P ASX300 Total Return Index and MSCI World Index ex Australia (net dividends reinvested) in AUD. Data through to 10 August 2010

Difficult environment for the markets to make any headway

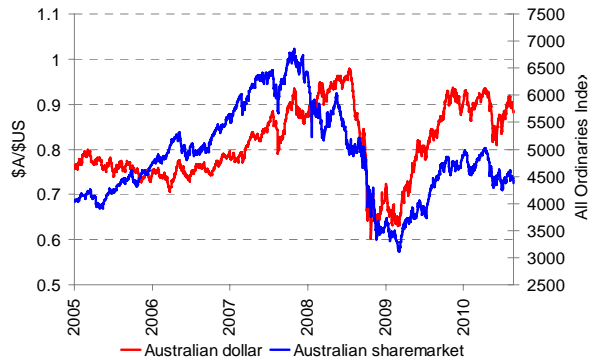
The Australian dollar and the Australian sharemarket share a close relationship. In times of stress, they generally move in tandem as shown by figure 2.

In contrast to the Australian dollar's position, the Australian sharemarket is valued near the low end of its range.

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On a price to earnings ratio basis, the Australian sharemarket is currently trading at 12x forward earnings, which is 20 per cent below its 10 year average.

Figure 2 – Australian dollar versus Australian sharemarket



Source: Bloomberg. Data through to 23 August 2010

Elections in Australia don't usually have a marked impact on the broad sharemarket. However, a minority government formed with either of the major parties will not necessarily enact all of the pre-election policies of that major party.

A number of individual stocks and sectors will be looking for early clarity on key issues such as the proposed resources tax, financial industry reforms, the national broadband network and carbon trading policies.

Collectively, these issues impact around 75 per cent of the Australian market because of the high weighting of the financial, energy and materials sectors in our market.

A minority government is not necessarily a bad thing for the markets, but a protracted period of uncertainty would be a problem.

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