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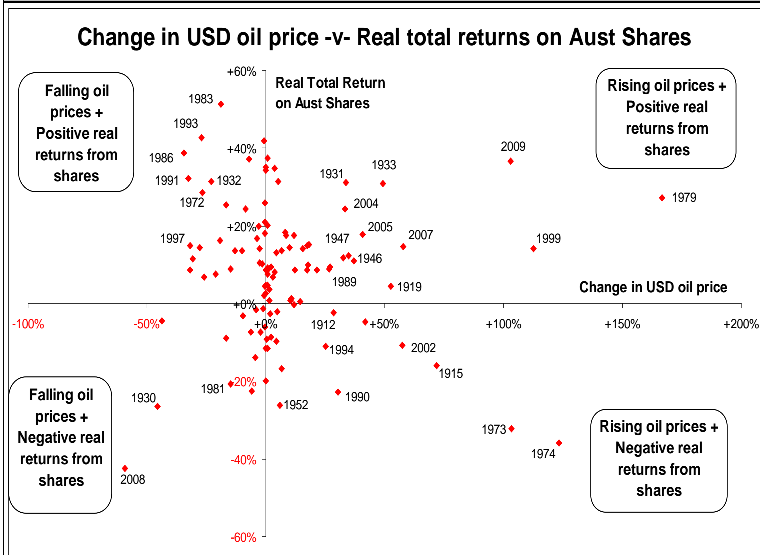
MONTHLY MARKET MONITOR – End February 2011

Chart of the Month: Oil prices & Returns from Shares



The recent rises in oil prices have been driven by rising demand from emerging markets and from the recovering US and UK/Europe markets, together with supply disruptions as the "Jasmine Revolution" sweeps across the Middle East. So far, disruptions have been relatively minor, and the spikes in prices of oil and gold reflecting more fear than reality. Tunisia, Egypt and Libya are relatively minor oil producers, but Saudi Arabia and Iran are the critical players to watch.

Saudi Arabia produces 10% of world oil supplies and has spare capacity to increase production to cover disruptions in the smaller markets, but civil unrest there is gathering pace. Also, Iran is looking menacing, and it can close the Strait of Hormuz to oil traffic very quickly – cutting off 25% of world supply (whereas only 4% passes through the Suez Canal and pipeline). If either Saudi Arabian or Hormuz supplies are disrupted, oil prices could spike up to $200 or even higher very quickly. Higher oil prices would threaten the weak economic recoveries in the US, UK and Europe.

However, oil price spikes don't necessarily result in lower returns from shares in Australia. Oil prices more than doubled in 1973, 1974, 1979, 1999 and 2009. Real returns from Australian shares were -32% in 1973 and -36% in 1974, but at that time the Australian economy was already in recession and inflation rates were above 10%. In the other years in which oil prices more than doubled, Australian shares generated very strong real returns: +27% in 1979 (with the Iranian revolution), +14% in 1999 and +37% in 2009. In fact many of the best years for Australian shares have been years in which oil prices have been rising sharply, including: 1924, 1925, 1931, 1933, 1945, 1946, 1947, 1978, 1979, 1989, 1996, 1999, 2004, 2005, 2007 and 2009.

		Economies	Current position	Current Direction/ Trend	Current pace of growth
Economies	Australia	The local economy is still expanding, primarily driven by the mining boom that goes from strength to strength and looks like continuing for as long as China manages to hold its boom together. Inflationary pressures continue to build – prices are rising, but wages are rising at an even quicker pace, as employment is tight and skills are scarce. Interest rates will probably need to keep rising to prevent an inflationary break-out. The Gillard government's new plan to introduce a carbon tax by July of next year has everybody scrambling to work out what it will mean. The final package (if any is implemented at all) will probably look very different from the media release – once all the loop-holes, exemptions, subsidies and compensation hand-outs are factored in.	Average growth rate	Improving	current speed
	US	The US economy continues to improve slowly. Companies are slow to re-hire but revenues and earnings are growing strongly, which means US productivity is improving for those employed, while unemployment levels remain near 10%. Unemployment is being hit further as governments at all levels (Federal, State and municipal) continue to lay off staff and cut services in their efforts to balance their budgets. The low US dollar and continuing strength of emerging markets are helping to revive exports and manufacturing.	Below average growth rate	Recovery remaining slow	current speed
	China	So far China has managed to put down early signs of protests inspired by the popular uprisings in the Arab world. Chinese workers supply the world with phones, laptops, i-pads, and network equipment that played a key role in the spread of information that fed the popular uprisings in the Middle East, but the Chinese government bans the workers from using these same devices in their own country to access basic information about what's going on in the rest of the world. Meanwhile, the National People's Congress meets to approve China's 12th Five Year Plan, which is targeting slower economic growth rates (7% pa growth instead of 8%), and a shift in focus from exporting to domestic consumption. This may not be enough to satisfy 1.3 billion people who are being hit with rising prices of fuel, food and housing, but have no political voice.	Strong growth	Growth slowing	current speed
	Japan	The Japanese economy is still moribund – with slow consumer spending, rising government debt and falling prices, despite stronger business investment and exports, particularly cars. In yet another grand plan destined for the dust-bin of history, PM Naoto Kan is attempting major reforms which are urgently needed but will be very difficult to implement in practice – including radical reform of agriculture and pensions, plus a plan to boost tax revenues by raising sales taxes.	Chronic recession, deflation	Remaining weak	current speed

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		Asset Classes	Current position	Long term returns (1)
Shares	Australian Shares	The local stock market continues to rise, with the overall market index up another 1.5% in January, making it up 14% since last June. Mining stocks continue to do well on the back of soaring prices – led by BHP (with its purchase of major shale gas operations in the US, and its buyback program) and Fortescue (with new iron ore deposits, and now paying its first dividend). The main losers were the coal miners who were generally down after strong recent rises and the flow-on effects of the Qld floods. Aside from the miners and banks, other companies were slowed by rising wages and fuel prices, and non-mining exporters hit by the high dollar, especially healthcare companies like CSL, Resmed and Sonic. The big banks continue to do well, with strong earnings driven by healthy margins thanks to their cartel-like pricing power. We remain over-weight Australian Equities in our Model Portfolios as earnings outlooks remain strong and current pricing levels are not stretched.	Around fair value	Average long run returns
	US shares	February was another strong month, with shares up around 3% across the broad market, following another very strong reporting season. More than two thirds of companies beat their earnings expectations, boosted by strong sales (particularly in foreign markets). Profit margins benefited from low interest rates and productivity improvements, as the corporate sector is producing more with fewer staff. We remain of the view that US stocks hold good prospects in the current year, but are still over-valued on longer term indicators, as the current strong results are being largely supported by unsustainable levels of household debt, government deficits, artificially low interest rates and artificial government stimulus. None of these are sustainable in the long term.	Above long run fair value	Below average long run returns (2)
	Emerging markets	In Asia, Chinese markets recovered slightly in February but the advanced "tigers" (Hong Kong, Korea, Taiwan and Singapore) continued to slide. Middle Eastern stock markets were hit hard by the revolutionary wave sweeping the region, although the impact on the overall emerging markets index is minor as the markets are relatively small. In Latin America the two big markets – Brazil and Mexico – remained flat, while Russian and Eastern European markets were relatively strong, led by the big Russian gas exporters.	Around fair value	Above average long run returns (2)
Fixed Income	Australian Gov't bonds	Yields on Australian long term government bonds remained steady in February as future inflationary expectations remain high despite negative flow-on effects of the high dollar and higher oil prices affecting the broader economy. We expect yields in Australia to continue to rise over the medium term, so investors would generally stay at the short end of the yield curve.	Yields below (prices above) long run av level	Below average long run returns
	Bank Term Deposits	Term deposit rates remain very attractive relative to traditional bonds, and TDs remain our preferred way of investing in the domestic fixed income sector. However TDs are not a substitute for long term investments – they offer no inflation hedge, no growth and no tax advantages.	Yields above long run average	Above average long run returns
	Global Bonds	Yields on long term government bonds in major markets continued to edge up slowly in February - including US, UK, Germany, Switzerland and Japan – as their fragile economies continue to edge forward. The pace of rises in recent months has slowed significantly as the energy and food price spikes threaten recoveries. We remain significantly under-weight global bonds in our Model Portfolios, as the potential downside risk to returns of higher inflation and widening credit spreads out-weighs any potential upside to returns of double-dip recessions. Yields on Irish, Portuguese and Greek bonds have shot up even further in the past month, despite buying from the European Central Bank in an effort to create artificial price support to lure in other buyers.	Yields below long run average level	Below average long run returns (2)
	Credit Spreads	Corporate credit spreads in Australia are still higher than the economic conditions appear to warrant. Corporate profitability is rising, balance sheets are strong, debt levels are low, the risk of a double-dip recession here appears remote, and there is a shortage of quality issues in the market. These factors would point to a potential to profit from good quality issues as spreads tighten further.	Spreads above average	Above average long run returns in Australia
Cash	Australian target cash rate	Cash rates remain at 4.75%. Our view is still that rates will need to be raised to at least a "neutral" setting soon to slow rising prices and wages. So far the high dollar has slowed non-mining exports, and rising lending margins and oil prices have slowed consumer spending, so the Reserve Bank has not had to turn off the tap as quickly as it may have had to in the absence of these factors.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	Listed property trusts had a solid reporting season and another strong month of unit price rises in most trusts. The sector is increasingly being seen as a defensive play – even at the expense of the traditional defensive sectors like consumer staples, healthcare, telcos and utilities (all of which were down) to offset uncertainty caused by the uprisings in the Arab world. The office market continues to lead the recovery in rents and capital values, and the outlook for this year remains positive. We remain slightly over-weight Australian listed property in our Model Portfolios.	Around long run fair value	Around average long run returns
	Australian residential	Construction activity is slow, due to a weak first home buyer market (put off by high interest rates and the scaling back of hand-outs), and also by a very constrained funding for developers. These factors should be good for prices of existing houses over the medium term because of the continued pressures from population growth and the flow of money from the mining boom.	Varies by market	Average long run returns
Australian Dollar		The Australian dollar did the reverse of what it did in January – recovering against virtually all other currencies, and up 2% against our Trade Weighted Index of trading partner currencies. Rising oil prices are putting pressure on the Fed to keep interest rates at zero for even longer, and to print even more money, making our relatively high interest rates even more attractive for foreign investors and speculators. We remain of the view that the AUD is fundamentally over-valued.	AUD Above fair value	Below average long run returns

(1) Expected "long term" returns refers to periods of 10+ years (looking through economic cycles) starting from the current position
(2) Returns for non-Australian assets are in local (foreign) currency – hedged to AUD