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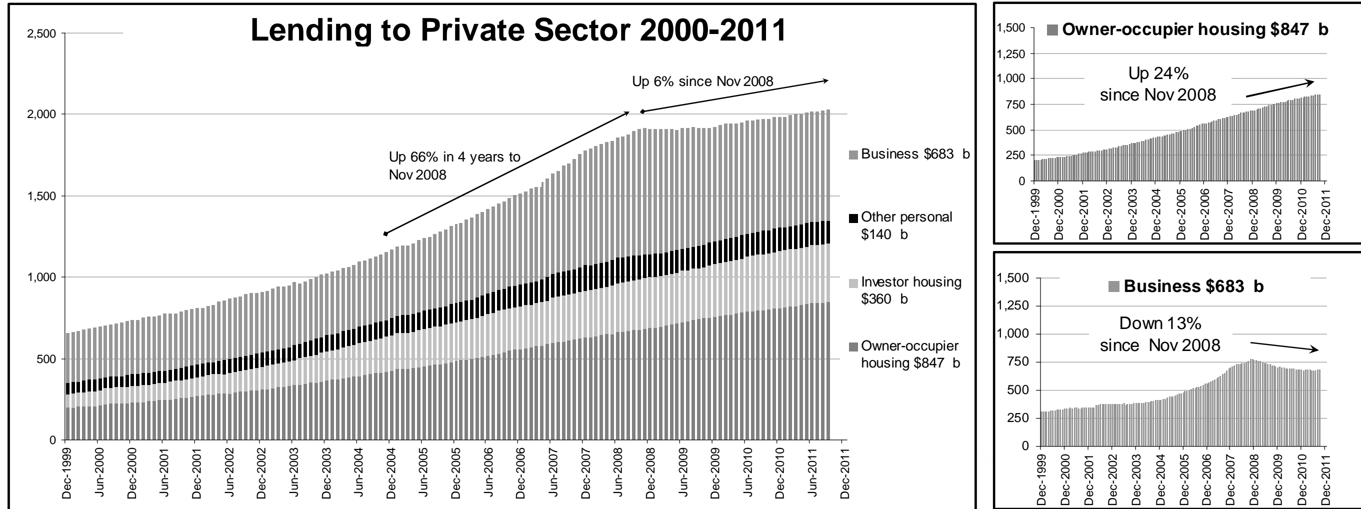
MONTHLY MARKET MONITOR – End November 2011

Chart of the month: Households aren't de-leveraging here…



While the rest of the developed world rushes to "de-leverage" (pay off debt) in the wake of the global financial crisis, Australian companies have been doing their bit to get their finances in order, but Australian households have kept borrowing like there's no tomorrow. In the 3 years since the Lehman crisis in late 2008, the level of Australian business debt has been cut by 13%, personal debt (eg credit cards) is down by 4%, but owner-occupied housing debt has increased by a staggering 24%, while investment housing debt is also up by 17%. Australian companies are in much better shape now with their lower debt levels, and an increasing number of companies can now borrow money from the capital markets at rates lower than the banks themselves pay. Banks love lending on housing because the competition is scarce and the margins are fat. But much of it still funded by foreign debt, and growth at these rates is not sustainable. The other factor helping prop up our high house prices is the plethora of middle class welfare measures aimed at home buyers and renters. These programs will come under increasing pressure as governments rush to cut spending to get their own budgets back under control.

		Economies	Current position	Current Direction/ Trend	Current pace of growth
Economies	Australia	The local economy continues to slow. Low business and consumer confidence levels are keeping consumption and investment at subdued levels (apart from the mining sector). Even miners are coming under pressure from rising wages & costs, new taxes and falling commodities prices. Recent profit results from the major banks illustrate this picture of strong results at face value, but there is trouble beneath the facade. For example: - Westpac: net profit up 10%, earnings per share up 6%, dividends up 8%; and ANZ: net profit up 19%, earnings per share up 10%, dividends up 3%. The real picture is very different – the earnings growth was almost entirely from writing back bad debt provisions from the GFC, but very weak operating earnings. Companies are paying off debt instead of borrowing, consumers are sitting on their hands, and governments are cutting back. Bond markets are pricing in a recession but unemployment remains low and the Reserve Bank is cutting rates.	Average growth rate	Growth flattening	current speed
	US	The US economy is continuing to show signs of picking up slowly. Exports and consumer spending are up, jobless claims and household savings rates are falling. But consumer confidence levels are falling, partially due to disillusionment over the lack of political leadership in tackling the budget/debt crisis. The Congressional "super-committee" failed to agree on a plan to reduce the budget deficit, and this triggers large "automatic" budget cuts. The problem is that even if the budget cuts are made, they are not enough to actually reduce debt significantly. Secondly, "automatic" turns out to not mean much – already Republicans are refusing to allow cuts to the military and Democrats are refusing to allow cuts to social programs, so they are back to square one. Meanwhile stock markets are getting excited about a possible "QE3" round of money printing that may be on the cards for January.	Below average growth rate	Recovery remaining slow	current speed
	China	The Chinese economy continues to slow. The government is expecting the economy to grow by around 9% for 2011, and 8% next year, compared to the past decade of around 10% pa. While 8% would be no disaster, policy makers are starting to worry whether the screws have been tightened too far in the battle against inflation and property price bubbles over the past couple of years. Accelerating signs of slowdown have prompted the central bank to start loosening the purse strings by cutting the bank reserve requirements, after they were raised progressively throughout 2010 and 2011 to restrict credit growth. Fears of inflation have now been overtaken by fears of a hard landing. Either way, demand for Australian iron ore and coal should still remain relatively strong because China's best defense against a hard landing would be to boost infrastructure spending, and this would benefit Australian miners.	Strong growth still	Growth slowing	current speed
	Japan	The Japanese economy is steadily improving following the tsunami/nuclear crisis in March, with rising exports and durable goods orders boosting production. The high yen is also being tackled head-on by the Bank of Japan's interventions to try to assist exporters.	Chronic recession, deflation	Remaining weak	current speed

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		Asset Classes	Current position	Long term returns (1)
Shares	Australian shares	As we opined in last month's report, the rate cut did little to help the local stock market. The overall market reflected global growth sentiments – declining in November, following the optimism of October. This was especially true for the sectors most exposed – banks (as they are heavily reliant on foreign debt markets) and miners (through commodities prices and export demand). Banks were down around 5% in November after gaining 10% in October, and the major miners lost most or all of their October gains. Iron ore and copper/gold miners were hit hardest, while most coal miners remained flat. In other sectors, mining services, transport, gambling, healthcare and utilities stocks held up well, while construction, building materials and retail stocks were mostly down, and steel makers were hammered by the slowdown in China. The local stock market as a whole remains under-valued on long term fundamentals, but remains vulnerable to further weakness in the short term in light of deteriorating global growth, new taxes, rising wages, and weak local demand.	Around fair value	Average long run returns
	Developed markets shares	The major developed markets ended up square for the month in their local currencies (with the exception of Italy, Spain & Japan which were down around 5% each). This generated a positive 2% return across the overall developed markets for un-hedged Australian investors, due to the fall in the AUD. Although most markets ended up where they started the month, it was hardly a smooth ride. Markets collapsed around 10% in the four weeks to Friday 25th November as the European debt crisis worsened, but then bounced back in the final 3 days of the month due to euphoria over the latest "quick fix" for Europe. With the US struggling and Europe heading for recession, the saving grace – buoyant demand in emerging markets – is now coming under increasing pressure, leaving major global stocks vulnerable, despite many stocks appearing cheap on the surface.	Around long run fair value	Below average long run returns (2)
	Emerging markets shares	Emerging markets as a whole ended down 4% for the month in their local currencies, but down 2% in un-hedged Australian dollars, due to the falling AUD. There were two major themes – 1) foreign investors withdrawing from "risk" markets to cover losses and/or reduce debts in their home markets, and 2) problems developing in several major emerging markets themselves. Continuing the pattern over recent months, as China slows, markets in and around China suffered (China, Hong Kong, Taiwan, Korea), while markets further removed from the north Asian production chain did better (Malaysia, Thailand, Philippines, Indonesia). India was down 10% with slowing growth, collapsing currency and even more bribery & corruption scandals. The Russian market held up well thanks to oil prices being kept high by rising tensions with Iran and increasing instability in Egypt.	Around fair value	Above average long run returns (2)
Fixed Income	Australian Gov't bonds	Bonds continue to be the best major asset class in Australia this year. Long term bonds returned 2% for investors in November as yields fell even further, bringing total returns to 10% for the year to date. Bond yields are down to levels last seen in the depths of the post-Lehman crisis in late 2008, and bond markets are now pricing in a major recession here. The only times when government bond yields were lower than current levels were in the 1890s depression and in the latter part of the 1930s depression. (During WW2, yields were kept artificially low by war-time price controls, so it was not an open market). Even in the early 1930s, bond yields were relatively high (5% to 6% during the early 1930s) because the Commonwealth government defaulted and restructured its debt – similar to the way in which yields on Italian and Spanish bonds are being kept high today by the threat of default.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	Banks have reduced rates paid on TDs but they still offer a "safe haven" guaranteed return. There is little benefit locking in for long terms. Even if rates fall further, banks will probably continue to offer good rates as their foreign funding sources dry up with the escalating crisis in Europe.	Yields above long run average	Above av. long run returns
	Global Bonds	Global government bond returns slipped slightly in November, but have returned around 6% for the year to date. Yields continued to fall in the US and the UK, despite their continuing deficit crises. Yields were flat in Japan, but crept up in Europe due to escalating default fears, even in Germany which was up until now regarded as the "safe haven" in Europe. This has finally shocked Germany into action. We expect even more tortuous attempts at a solution, while economies groan under the weight of ballooning debt levels and savage austerity measures. Increased bond buying by the ECB and IMF to prevent Lehman-style defaults, slowing economies, and falling yields - are all good for bond returns for the time being.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	The official policy cash rate was cut by 0.25% to 4.5% on the 1st November in an effort to stimulate the slowing local economy. The markets are pricing in further rate cuts and a recession next year. Australia had the highest interest rates in the developed world before the GFC, it was the slowest to cut rates during the GFC, the first to raise rates again coming out of the GFC, and still has the highest rates in the developed world today. Relatively high interest rates (which prop up the high dollar), fattening bank margins and credit rationing have been crippling Australian businesses over the past year. Markets are pricing in more rate cuts in the coming months.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	The listed property market was up 2% for the month, with nearly all of the main REITs stronger, led by Westfield Group and Stockland, compared to the overall stock market which fell 4%. REIT prices are being supported by distributions that are relatively high (at around 7%) and rising further, together with buy-backs and prospects of more take-overs and consolidations within the industry.	Around long run fair value	Around average long run returns
	Australian residential property	As expected, house prices continue to fall in most markets. We believe that housing is still too expensive on a range of measures, and prices will continue to fall in real terms (after inflation) as the economy slows further and lending margins remain high. The Labor party is now toying with introducing legislative rent controls for private rental properties, but that would be political suicide, so hopefully common sense will prevail.	Varies by market, but over-valued overall	Average long run returns
Australian Dollar		After surging from 95 US cents back to $1.05 during October, the AUD fell 5% back to parity by the end of November, with deteriorating outlooks for global growth and falling prices for most industrial commodities (except oil & zinc). The AUD is still over-valued against the major currencies and is expected to fall further in the coming months with slowing European and Chinese growth rates.	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 terms – ie hedged to AUD but excluding any profits/losses from hedging