Shane Oliver, Head of Investment Strategy
& Chief Economist

AMP CAPITAL

Review of 2011, outlook for 2012 – should we be scared?

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Key points

> 2011 has been a year full of disasters with floods, earthquakes, civil wars in the Middle East, and of course public debt woes in Europe and the US. Fears of another global financial crisis and a return to global recession have resulted in a rough ride for share markets.

> The shadow cast by Europe means greater uncertainty than normal. However, despite reasonable profit growth, shares have fallen suggesting they have already discounted a lot of bad news. On top of this, everyone seems to be bearish and monetary conditions are easing further. If the ECB steps up its involvement, as we expect, and monetary easing continues elsewhere, shares will ultimately have a much better year ahead.

> The main risk would be if Europe doesn't get its act together and plunges into a deep recession. Other risks relate to a Chinese hard landing and fiscal austerity triggering weaker growth in the US.

2011 – a year of disasters

2011 was to be a year in which the global recovery became more self-sustaining, underpinning further gains in investment markets. Instead it has turned out to be a year of disasters, starting with the floods in Australia, the New Zealand earthquake, the Japanese earthquake, tsunami and nuclear disaster, civil war in parts of the Middle East and North Africa resulting in a surge in oil prices, the US debt ceiling debacle and ratings downgrade, and of course the deteriorating European debt crisis. The outcome has been rather disappointing, for investors with extremely volatile investment markets and poor returns from risk assets.

Against this backdrop the key macro economic themes have been as follows. First, global growth has been fragile and sub par with another bout of double dip worries around mid year in response to the earlier surge in oil prices, Japanese supply chain disruptions, monetary tightening in emerging countries and the blow to confidence from debt debacles in the US and Europe. While the US picked up pace through the second half, Europe looks to have fallen into recession and emerging countries have slowed.

While inflation reared its head early in the year, particularly in emerging countries, it has faded into year end as growth has cooled and pressure has come off commodity prices.

The global monetary cycle has swung from tightening to combat inflation earlier in the year, though mostly in emerging countries, to easing through the second half as growth slowed and inflation came back under control. Monetary policy has eased in most countries either via interest rate cuts or quantitative easing (ie printing money).

Australia has also had a disappointing year, with disruption caused by the January floods resulting in a fall in GDP in the March quarter. Cautious household behaviour has led to constrained retail sales and weak housing related activity has offset booming mining investment. As a result inflationary pressures have receded and the RBA cut interest rates twice, in part reflecting the threat from Europe.

This has all resulted in a rather disappointing ride for investors, particularly from around April. The following table shows returns for major asset classes. (Note the 2011 returns are for year to date to December 7).

Investment returns for major asset classes

Total return %	2010 actual	2011* actual	2012 forecast
Global shares (in Aust dollars)	-2.0	-5.0	5.0
Global shares (in local currency)	10.4	-5.0	10.0
Asian shares (in local currency)	15.2	-11.0	15.0
Emerging mkt shares (local currency)	14.1	-11.0	15.0
Australian shares	1.6	-6.0	12.0
Commodities (in $US)	26.9	-4.0	15.0
Global bonds (hedged into $A)	9.3	8.0	2.0
Australian bonds	6.0	10.0	3.5
Global listed property securities	22.5	0.0	12.0
Listed property trusts	-0.4	3.0	12.0
Unlisted non-res property	10.9	8.5	9.0
Aust residential property, estimate	7.0	-1.0	2.0
Cash	4.7	4.7	4.0
Avg balanced super fund, estimate	**4.0**	**-1.0**	**8.5**

*Yr to date. Source: Thomson Reuters, Morningstar, REIA, AMP Capital

- Despite reasonable profit growth, share markets have had a rough ride, rising early in the year before falling in the September quarter on worries about a global dip back into recession, partly on sovereign debt woes.
- Within global shares, US shares have been a clear outperformer, reflecting easier US monetary conditions, the lagged impact of the weak $US and better profit growth. European shares have been amongst the worst performers. Asian and emerging market stocks have been dragged down by worries about inflation early in the year followed by concerns about Europe.
- Australian shares performed poorly (albeit between US shares and European shares) thanks to relatively higher interest rates, worries about China and the lagged impact of the strong $A, which weighed on earnings growth.
- Listed property securities had a flat to slightly up year with their greater income yields offering some protection.
- The $A met our year end target of $US1.10 early in the year but has since languished around parity.
- However, it hasn't been all doom and gloom. Unlisted non-residential property and sovereign bonds (except in troubled countries) provided solid returns. Gold made it to a new all time high of above $US1900 an ounce, and rose 22% over the year as investors sought a safe haven against falling values of major paper currencies.
- The poor returns from shares resulted in poor returns from traditional balanced superannuation funds.

Outlook for 2012 – bad then better?

Uncertainty hanging over Europe, and to a lesser degree the US and China, suggests a very uncertain outlook for the year ahead. However it's worth noting, to borrow from Paul Keating, every pet shop galah is saying the same thing –

Europe, Europe, Europe! So maybe it's all factored in and – perhaps after an initial messy period, it won't be so bad. There are several reasons for a bit of cautious optimism.

First, Europe appears to be heading towards a resolution of sorts, which is likely to involve much greater ECB intervention, helping to limit Europe's growth contraction next year to around -1%. The task is beyond the scope of various bailout funds (which aren't big enough and are under ratings pressure) & the IMF does not have enough funds. The only organisation that can bring the debt contagion under control is the ECB. Our assessment is that it is likely to move into top gear in the next six months – and buy bonds in troubled countries more aggressively. A move towards fiscal union is likely to provide it with more confidence to act, the deepening European recession provides justification for aggressive monetary easing and bond buying in order to achieve price stability, and German opposition to a more aggressive ECB is likely to fade as its economy weakens too.

Second, the US economy looks like it will continue to simply muddle along, perhaps even with another "double dip" worry around mid year, but growth being held up around the 1.5% level by more quantitative easing and solid profits supporting employment and business investment.

Third, China looks like it could slow further in the short term, possibly taking growth to a low point of 7% year on year. However, with the property market and inflation cooling and the authorities not willing to tolerate a hard landing, policy easing is likely to become aggressive, resulting in overall 2012 growth of 8% in China. This is pretty much the story in the emerging world as a whole, ie short term weakness but plenty of scope to provide policy easing as inflation subsides which should support growth.

Pulling all this together suggests:

- global growth somewhere around 2.5 to 3% next year, composed of 0.75% in advanced countries and around 5% in emerging countries, albeit looking worse earlier in the year before improving in the second half;
- falling inflation as commodity prices remain benign and spare capacity builds in advanced countries, leading to a bout of deflation in Europe;
- more monetary easing with falling interest rates in the emerging world and commodity countries, but aggressive quantitative easing in the US, UK and to a lesser degree Europe (ie just enough);
- intensifying currency wars as quantitative easing sees the $US, euro and sterling remain weak; and
- Constrained earnings growth reflecting the soft overall economic backdrop.

For Australia this means a difficult environment initially, before risks recede later in the year. Our base case is for 3% growth over the next year – ie better than the 2011 which was affected by the drought, but it probably will require more monetary easing with the cash rate expected to fall to 3.75% by end 2012 to help protect growth.

So what does this all mean for investors?

- In the short term it's hard to feel confident on shares and related risk assets, as much uncertainty hangs around Europe and global growth could first get worse before it gets better. However, against this, shares are now very cheap particularly against bonds, monetary policy is easing further and everyone is bearish. So while shares may have a rough start to the year, there is good reason to expect them to be higher by year end. That a lot of bad news is factored into share markets is indicated by forward price to earnings multiples which are now 10.2 times for global shares compared to 12.4 times a year ago. In Australia, the forward PE is now 10.9 times compared to 13 times a year ago. In the emerging world and Europe, the forward PE is now just 8.5 to 9 times.
- Share markets to focus on are those with strong fundamentals & monetary easing (Asia, emerging markets & Australia) or those with weak currencies and monetary easing (eg the US where monetary easing is likely to be more aggressive over Europe). We expect the Australian ASX 200 to rise to around 4800 by end 2012.
- Commodity prices are likely to rebound after a possible initial soft patch once it becomes clear the global economy is not going into free fall and as quantitative easing (QE) ramps up in advanced countries. Gold is likely to rise through $US2000 an ounce on QE.
- The $A is likely to have a few rough patches, but is likely to remain strong overall, ending higher in response to more QE in the US and Europe, Australia being one of the few countries with a stable AAA rating, and as investors start to anticipate better commodity prices.
- Cash and term deposits are likely to become less attractive as cash rates continue to fall, pulling down term deposit rates with them.
- Very low starting point bond yields suggest low returns from sovereign bonds, unless of course global recession looms. Australian bonds are more attractive than global bonds given higher yields and less risk if things fall apart. Corporate debt is a better bet, but favour investment grade if you are worried about equities.
- Unlisted commercial property returns are likely to remain reasonable reflecting yields around 7%, requiring only modest capital growth to generate a decent return.
- Australian house prices are likely to fall another 5% or so in the first half as buyers hold back on economic uncertainty, before rate cuts reach a critical mass and greater confidence leads to a recovery in the second half.

What are the risks?

The main risk is that Europe does not act quickly enough to prevent a major financial meltdown and deep recession. If so, this would drag the global economy back into, or very close to recession. There is also a risk in China that the leadership transition and a desire to quash property speculation sees the authorities react too slowly to the slowing economy, allowing a move to a hard landing (ie 6% growth or less) to become entrenched.

If the world really does go back into recession, fortunately Australia has plenty of ammo to fight it off – rates have a long way to go to zero, the $A will fall if things fall apart globally, there is more room for fiscal stimulus if needed, the corporate sector is cashed up, the household sector has a strong savings buffer and mining projects impart a degree of resilience. This would all suggest 1-2% growth locally, but not recession.

Conclusion

Expect a rough ride, with potential weakness in the first part of the year. Conditions are likely to improve as monetary authorities in Europe and the US step up to the plate. So overall what many fear could be a disaster could turn out to be much better than expected.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital Investors