



The Past, the Future, the Present and the Long Run

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The Past

Obviously, both economies and markets have done better than seemed likely at the start of the year. At end-November, the S&P500 index in the US is up by 21.3% year-to-date, while the ASX200 index has risen by 26.3%. By comparison, these two indexes fell by 36.3% and 41.3% respectively in 2008.

Regular readers will know that I have thought all along that the turnaround in markets was a "no-brainer". It was always going to happen. Cheap markets can get cheaper, but they don't stay cheap forever. The only (very important) questions were: when was the correction going to start? And from how low a level? We now know the answers.

The Future

The questions for 2010 are the usual ones: **how much more do markets have to gain, and how strong will the world economies be?**

There is certainly no shortage of naysayers about the world economies there are so many analysts who believe that the recoveries are not sustainable simply because the economic problems have not gone away completely. While the doubters are ruminating about W-, L- or square-root shaped recoveries, the world economies are recovering as they usually do, with more upside surprises than downside. Since early in 2009, forecasters have been raising their estimates of how much growth is likely in 2010. There is no reason to think this process is over yet.

Just one example in May this year, the consensus forecast for growth in the Australian economy in 2001 was 1.5% that figure is now 2.8%, and it is almost certain to be exceeded.

When forecasters are raising their sights, earnings tend to improve faster than anticipated earlier, and share markets thrive. But they won't do as well in the next twelve months as they have in the past nine. The recovery to date has been primarily because stocks have been "re-rated". The price/earnings ratio for the Australian market has gone from a bargain-basement level to close to the long-run average. Re-rating is the only way that you can ever get close-to-50% increases in a short period of time. From now on, the market will need to be fuelled by earnings growth. That should happen, but the pace of appreciation of the market will almost certainly be much slower. A 10% gain over the course of 2010 would be a good result.

The Present

Of course, even before we get to 2010, there are hazards to be negotiated. The latest has emanated from Dubai—the Iceland of the Middle East. Dubai World, a government-owned body responsible for financing much of the emirate's spectacular growth in recent years, has requested a six-month postponement of debt repayments. Given the massive real estate crash in Dubai in recent months, it is hardly surprising that Dubai World has run into trouble. But the explicit recognition of the issue has led to a decline in investor confidence, and fears that there is still more damage to come from the GFC. It has raised questions as to the extent

of exposure of the international banks to Dubai World and other troubled enterprises in the Gulf region. It has also raised concerns that Arab investors (and others) may engage in substantial repatriation of funds, thus weakening major share markets.

While this latest announcement is clearly a major credit event, it is salient to recall that there are almost always some credit-related "accidents" during recoveries. If the names Worldcom (2002) and Parmalat (2003) are relatively unfamiliar to you, this only establishes that the world generally moves on. Right now, it is unlikely that the Dubai issue is a major game-changer. The behaviour of the Australian share market to date supports this view the first day losses after Dubai was known about were reversed the very next trading day.

On 1 December, the Reserve Bank did something that it has never done before. It raised rates for the third month in a row. The accompanying Statement was very similar to its predecessors renewed financial market volatility did not even rate a mention.

Look for interest rates to rise by about another 1.5 percentage points over the course of 2010.

The Long Run

On a longer-term note, the Treasury Secretary, Ken Henry, gave a thoughtful speech in late-October, in which he looked at some of the long-term forces facing Australia. The four forces he identified were 1) population aging 2) climate change and efforts to offset it 3) the information and technological revolution and 4) the ongoing China/India story.

Population Aging: within 40 years, more the one in five Australians will be 65 and over, and one in 20 will be 85 and over. A smaller proportion of the total population will be working, and the calls on the public purse for health spending, aged care and pension payments will expand enormously. The total population will increase by about 60% (13 million) in that time, raising questions about the future of our cities, environmental sustainability, the demand for infrastructure etc.

Climate Change etc: the issue is about both adaptation and mitigation. To achieve the latter, the cost of energy intensive activities has to be raised. Decisions about land use and the energy efficiency of urban infrastructure will also have to be made.

The ICT Revolution: we all now take for granted so many aspects of everyday life that the ICT revolution has brought us. There is no reason to think it's over, but for Australia to stay at the forefront will require significant and intelligent investment.

China/India: this year, China surpassed Japan as our biggest export market. Japan held No 1 position for 43 years. China may well be our biggest export market for the next 43! China's presence softened the blow of the GFC on Australia this year. In the long run, the continued dominance of world economic growth by the developing world means that the resource sector will loom ever larger in the Australian economy. This will require a long-term transferral of resources from other sectors of the economy, notable manufacturing and (other) construction.

All of these are slow-burning, but long-lasting stories. They will have significant implications for many sectors of the economy, and for investment markets. Something to think about over Christmas!

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