



Positive outlook for Australian equities

Christine St Anne | 10 Dec 2010 | *Christine St Anne is Morningstar's online funds editor.*

Developed economies around the world face some significant economic challenges next year. For Australia, however, its economy faces a brighter future in 2011.

Some fund managers reckon the growth in the Australian economy will outpace that of the rest of the developed world.

"We expect the Australian economy to grow more strongly than the rest of the developed world in 2011," ING Investment Management head of Australian equities James Wright says.

For UBS head of investment strategy and consulting, George Boubouras, Australia's ability to outpace the rest of the developed world will continue.

"The performance of the Australian economy has been very strong versus the major OECD economies over the past two years and this looks set to continue in 2011," Boubouras says.

Boubouras also said consumer confidence is higher in Australia than in other developed economies, and importantly, Australia's terms of trade remain strong on the back of demand for commodities from emerging markets.

A stronger economy means brighter prospects for Australian equities. Boubouras predicts the ASX 200 will reach 5600 by 2011 year-end as earnings continue to be delivered.

AMP Capital Investors senior portfolio manager Greg Barnes believes the ASX 200 will rise above 5500.

Wright says solid population growth and the demand for raw materials, as well as robust employment, will be positive for Australian equities.

"Strong business investment, rising commodity exports and robust income growth supporting household consumption will continue in 2011, which will support local markets," he says.

Support from mining

The mining sector in particular has buoyed the Australian equity markets and will continue to do so in the future due to sustained demand from emerging markets.

Boubouras says while there have been many factors underpinning the local economy, one of the primary drivers has been the contribution the emerging world makes to the local economy in general.

"This has driven the extraordinarily large capex (capital expenditure) flows into our mining and energy sector, driving economic activity," he says.

Not surprisingly, the mining and resources sector remains a favoured industry among a number of fund managers.

Barnes, Wright and Boubouras all favour mining stocks and believe the sector is well placed to capitalise on opportunities in 2011.

Perennial Growth Management investment manager Lee Mickelborough also favours the mining sector as well as energy stocks.

However, both Mickelborough and Barnes prefer to invest in the big mining conglomerates including [BHP Billion \(BHP\)](#) and [Rio Tinto \(RIO\)](#) rather than the smaller mining companies.

"We prefer to invest in the major diversified businesses in the mining sector," Mickelborough says.

Barnes prefers to invest in companies that have broad exposure to the mining sector, including developers and contractors.

Going beyond the resources sector, Wright is optimistic about the banking sector and consumer stocks [Woolworths \(WOW\)](#) and [Coca Cola Amatil \(CCL\)](#).

Wright notes that the banks' earnings remain reasonable and they continue to successfully pass on their margins.

He sees [Woolworths \(WOW\)](#) as a good growth stock, and although [Coca Cola Amatil \(CCL\)](#) has underperformed the market over the past few months, Wright is confident in the long-term performance of the firm, saying it is "a good place to park some money".

Wright is also optimistic about the real estate investment trust (REIT) market, saying the new [Westfield \(WDC\)](#) REIT is trading at a reasonable discount to its expected net tangible assets (NTA).

The US story

The energy sector is not just tied to the growth in emerging markets. The sector is also set to benefit from the predicted recovery in the US economy.

Mickelborough believes economic traction is starting to show in the US, particularly with lower interest rates and a pick-up in the confidence of the US consumer.

Similarly, Barnes is also optimistic about the economic future of the US.

"The efforts to address the problems in the US economy have been positive. The economic recovery in the US is now starting to grow," Barnes says.

As such, both Mickelborough and Barnes are eyeing Australian companies that can take advantage of the US recovery. For Mickelborough, oil companies in particular will gain from a positive US economic environment.

Non-resource stocks that will also benefit from the US recovery include [Brambles \(BXB\)](#) and media firm [News Corp \(NWS\)](#), according to Mickelborough.

Barnes also pointed to an increase in the level of business travel and says he will be looking at potentially investing in companies that can profit from overseas travel.

Banking on regionals

The end of the year marked a tumultuous time for Australia's four major banks. The banks came under political fire following their decision to hike interest rates over and above the Reserve Bank of Australia's 25 basis point cash rate increase last month.

The banks say higher funding costs were behind the interest rate hike.

While the banking sector does face some challenges UBS is more optimistic, removing its underweight position on the sector and increasing it to a neutral position. Mickelborough actually now sees value in the regional banking sector. He believes the regional banks have now been able to re-establish their margins.

Barnes also acknowledges that regional banks have benefited from a strong deposit base and competitive position, but will still struggle against the major banks.

"Regional banks will struggle because they don't have the same scale as major banks nor the same ability to access wholesale funding," he says.

"Treasurer Wayne Swan has announced that there could be potential policy measures allowing regional banks access to funding. This will help the regional banks. It remains a challenging environment for them."

Risky business

Any risks impacting Australian equities appear to be global.

According to a UBS strategy statement, local equities have retreated 4 to 5 per cent in recent weeks due principally to a combination of Eurozone debt concerns and Chinese inflation worries.

"While the implications for Australia are somewhat indirect, investors remain alert to the possibility of larger and more systematically important countries, for example Spain, being forced into a bailout scenario," the UBS strategy statement said.

However, given the Eurozone sovereign debt situation has been widely appreciated for a year now, and combined with the relatively orderly playing out of the Ireland bailout, UBS believes the situation is manageable.

Similarly, the UBS strategists believe China's inflation woes are also manageable, and are confident in the policy measures undertaken by the Chinese government.

"Fears of aggressive macro and monetary tightening are overdone in our view. We believe the policy response will be both measured and targeted," the UBS strategy statement said. Barnes is also cautious about European sovereign risk.

He also points out that while Australia's export partners India and China will continue on their growth path, Australia's other major export partner Japan is now only just recovering - and at a slow rate. Regulation is one domestic risk identified by Wright.

"We have seen a suite of regulation in the Australian market. Telecommunications, gaming, healthcare, banking and mining have all come under regulatory pressure," he says. "We are particularly focused on regulation in 2011, when governments may put more onerous conditions on companies."

While there are some sectors in the Australian economy positioned for growth and while others may still need to overcome a number of challenges, Australian equities overall face sustainable valuations in 2011. "There remains some very good upside in equities in Australia," Boubouras says.

"While we expect volatility to persist, it will be at levels well below what we have experienced over the past year and half."