2012 Investor News Alert

What looms for investors in 2012?

A good analysis of the external influences (ie global financial events) which will impact on Australia in 2012 (in particular with investment markets and domestic interest rates) has been recently written by Mr Saul Eslake, a program director at Melbourne's Grattan Institute and an independent economic analysis. He was formerly chief economist at ANZ Bank for 14 years. His report is re-produced here for the benefit of investors.

There are 2 particular external influences which he draws to our attention.

(1) The State of Europe

"*The first is the course of events in Europe. The Reserve Bank's working assumption is that "the European authorities do enough to avert extreme financial dislocation, but are unable to avoid periodic bouts of considerable volatility and uncertainty". That's hardly a ringing endorsement of the European authorities' ability to resolve the sovereign debt crises afflicting up to five European nations. And with each successive 'bout of considerable volatility and uncertainty', the possibility of 'extreme financial dislocation' becomes less remote.*

There is now a non-trivial possibility that Greece could default on its debts in a disorderly way, triggering payouts on credit default swaps (something which the European authorities have been especially anxious to prevent, mindful of the role which these instruments played in spreading 'contagion' in the aftermath of the collapse of Lehman Brothers). And the pressure is mounting on Italy whose sovereign debt is the third largest in the world, exceeded only by the United States and Japan.

The new head of the European Central Bank has conceded that the euro zone may have already slipped back into recession – that's why, at his first opportunity, he unwound one of the two rate increases his predecessor unwisely implemented earlier this year. The further austerity measures which Italy and France have enacted or foreshadowed in recent weeks could be enough on their own to make another euro zone recession a certainty. A disorderly Greek default could well do the same. Should Europe fall back into recession, it would likely be a long one, because the European authorities don't have the tools to respond to it in the way that central banks and governments have typically done since the 1930's, and as they did to the recession induced by the financial crisis of 2008-09. The European Central Bank can only cut interest rates by 1.25 percentage points (and its previous form suggests it won't cut them buy that much); and European governments are already committed to fiscal austerity, rather than to renewed fiscal stimulus.

Although Europe doesn't matter to Australia as much as it used to (it takes less than 7.5 per cent of our exports, half as much as at the time of our last recession in the early 1990s), an 'extreme financial dislocation' in Europe would still affect Australia through its impact on confidence, and on financial markets.

Fortunately, it now seems less likely that the US economy will slip into a second recession, although the medium-term outlook for the US economy is hardly encouraging – nor are the prospects for putting American public finances on a sustainable long-term footing in what will be a bitterly contested election year.

(2) China Slowdown

The second important external influence on the Australian economy next year will of course be what happens in China and – in consequence – the course of commodity prices.

China's economy is clearly slowing, by the official GDP data, according to which China's economy grew by 9.1 per cent over the year to the September quarter. It's important to remember, though, that the Chinese authorities have been explicitly seeking a slowdown in China's growth rate, in order to keep a lid on inflation and to reverse the build-up of potentially destabilising speculative pressures in China's urban property markets.

If commodity prices continue to decline – as they would, and more rapidly, if China were to have a 'hard landing' – then one of the most important sources of growth in Australia's national income would become significantly weaker. "

The OECD has just released its latest outlook which contained some thoughtful analysis of the situation. It projected what would happen to major global economies under three scenarios.

- Baseline: Europeans muddle through, avoiding contagion.
- Upside: Confidence building reforms are executed decisively allowing markets and banks to function reasonably well.
- Downside: Europe handles the crisis poorly, with contagion spreading throughout Europe and markets/economies reacting in a similar way to the GFC from late 2007 to early 2009.

Given the three scenarios above, pundits/economists favour the "baseline" outcome. The "upside" scenario seems unlikely because of the number of unresolved issues, as expanded by Paul Eslake above.

The "downside" scenario now seems less likely given the recently announced plans for a voluntary 50% haircut on Greek debt and leveraging the stability fund to Euros 1 trillion.

How should Australian Investors React?

In these uncertain times, Australian investors should focus on capital preservation. Conservative to balanced investors, who wish to have some exposure to the share market in readiness for a recovery (whenever that occurs), should concentrate on defensive, high-yielding (income) stocks. Typically, these stocks will have moderate debt (and higher interest cover) and the price to earnings ratio (PE) be less than the market/industry average.

As stated by independent research house Morningstar, "the worst performing sectors for 2011 had lower dividend yields despite some very strong profit growth especially in resource stocks. It highlights the role of dividends as an important component to overall returns in a risk-averse, low to falling interest rate environment." Through our sharebroker and independent research house, the investment sectors identified where such returns are largely contained are in the Consumer Staples, Financials-Banks, Financials – AREIT's/Property, Telecommunication Services and Energy Sectors.

For investors looking for wider diversification, (more than a single stock selection can give) but still having a conservative approach, a Managed Portfolio Service, also known as a "Model" portfolio, with a strong income bias, is also suitable.

For the more conservative investors, who are prepared to forego much of future growth for current income, convertible preference shares, also known as hybrids, and stocks within the Utilities and select property sectors are appropriate. These high yielding investments will be seen as alternatives to bank term deposits as interest rates fall.

The financial planning process is however not all about being a financial market forecaster nor an investment expert. Whilst this is an important part of the financial advisory service, financial planning in the broadest sense, provides a comprehensive and genuine fee-based advisory service including asset allocation, risk analysis, structuring, lifestyle cash flow analysis, tax and estate planning.

To discuss any of the issues raised above, given your own current investments, and circumstances, contact our office.