Point of view

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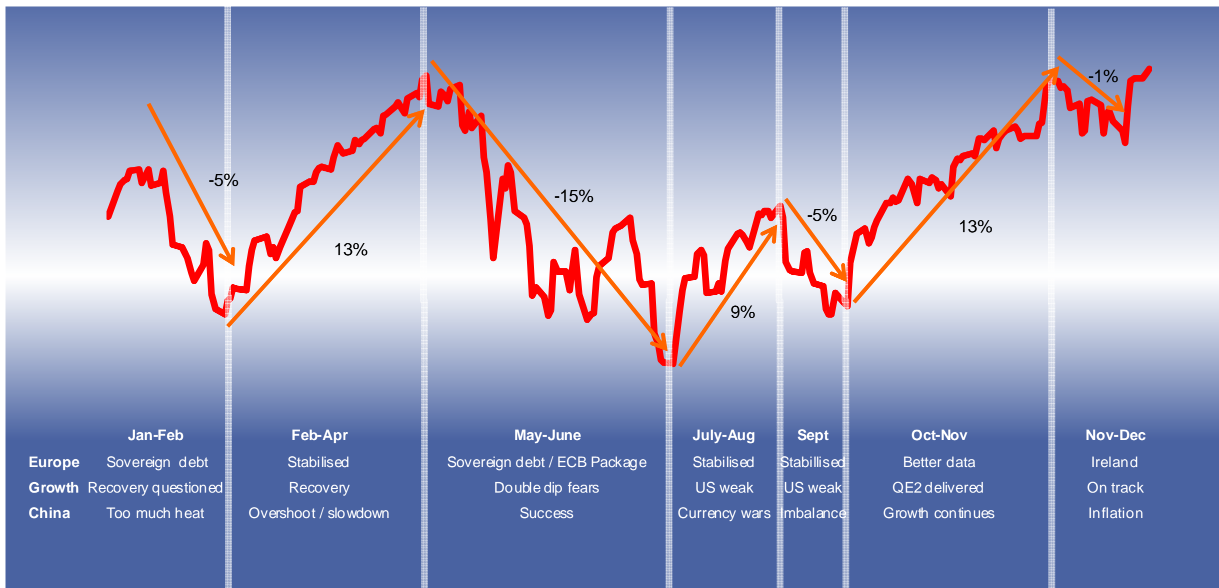
2010 – The year that was – The year that wasn't

2010 was the year investors hoped would confirm that we were past the worst, but it turned out that there was still plenty to worry about. In this Point of View, AXA's Chief Investment Officer Mark Dutton considers the three big issues that made for a rough ride and provides an overview of what happened in investment markets.

Figure 1: Global sharemarket returns – 1 January 2010 to 8 December 2010



Source: Datastream. MSCI World Index (net dividends reinvested) in local currency.

The big 3

2010 was the year that promised good returns after markets rebounded from the collapse of the GFC, but it didn't deliver. Share market fundamentals improved, but overall returns were barely positive.

It was the year that serious concerns arose about new issues. While none of them turned into a crisis, the sheer number of problems, rescue packages, policy changes and general noise, seemed overwhelming for many investors.

But stepping back from the noise, there were really three big issues that made for a tough ride – the threat of contagion from Euro area debt concerns, fears of a double dip recession, and a possible slowdown in China.

Sovereign debt concerns

2010 was the year that we were reminded that governments can default. Investor concerns about rising public debt levels turned to reality. The true picture of Greece's finances emerged. Its public debt was larger than the total size of its economy.

The possibility that Greece would default spooked already nervous capital markets. To contain the immediate problem and remove the threat of contagion, Europe's leaders surprised the markets by creating a €750 billion stabilisation package.

The strings attached included the requirement that Greece get its financial house in order and bring its budget deficit down to 3 per cent of GDP over the next four years.

The stabilisation package was viewed as large enough to also help other troubled Euro area countries – including Portugal, Ireland and Spain.

Later in the year the economic boom in Ireland turned to bust. The reasons were different to those of Greece, but the result was similar - a rescue package with tough conditions attached.

The massive build up of public debt for many developed countries was largely the result of government measures to stimulate the economy during the GFC.

While the situation was effectively contained in 2010, it isn't resolved. Large public deficits will continue to be an important issue for many developed countries to address and wind down over the next few years.

Fears of a double dip recession

2010 was also the year that saw the shift of economic power from west to east accelerate. Developing countries surged ahead, while fears arose that parts of Europe and the US would experience a double dip recession.

It wasn't the year of the double dip, but many European countries face tough challenges ahead in meeting European Central Bank (ECB) requirements to reduce debt levels to 3 per cent of GDP.

It is likely that some countries will have to deal with subdued growth rates and social disruption for some time.

It was the year, the US took the unconventional path of implementing a second round of quantitative easing (QE2), which is effectively creating money.

The aim is to avoid deflation and provide a further boost for the economy.

It's too early to see how this policy measure will play out. Banks are still hoarding record amounts of cash with the Federal Reserve, which means that much of the 'additional' liquidity isn't yet making its way through the system.

There is a risk in the future that the US Federal Reserve will overshoot, and generate an adverse amount of inflation and the formation of 'new' asset bubbles.

Doubts about China managing its slowdown

With China largely viewed as the world's growth engine, the possibility of an abrupt slow down spooked already nervous markets.

It was the year that Chinese policy makers took action to curb bank lending and take the heat out of the property market.

China's central bank raised banks' reserve requirements three times, coordinated a marked deceleration in money and credit growth and raised interest rates towards the end of the year.

At this stage, there is little sign that China is slowing too quickly and market concerns have abated on this front.

Rather, tensions are brewing between China and the US over trade imbalances that are heightened by currency manipulation.

Both countries are relying on exports to stimulate their economies, and a weaker currency helps competitiveness.

The market remains nervous about the possibility of the introduction of trade barriers and other protectionist measures.

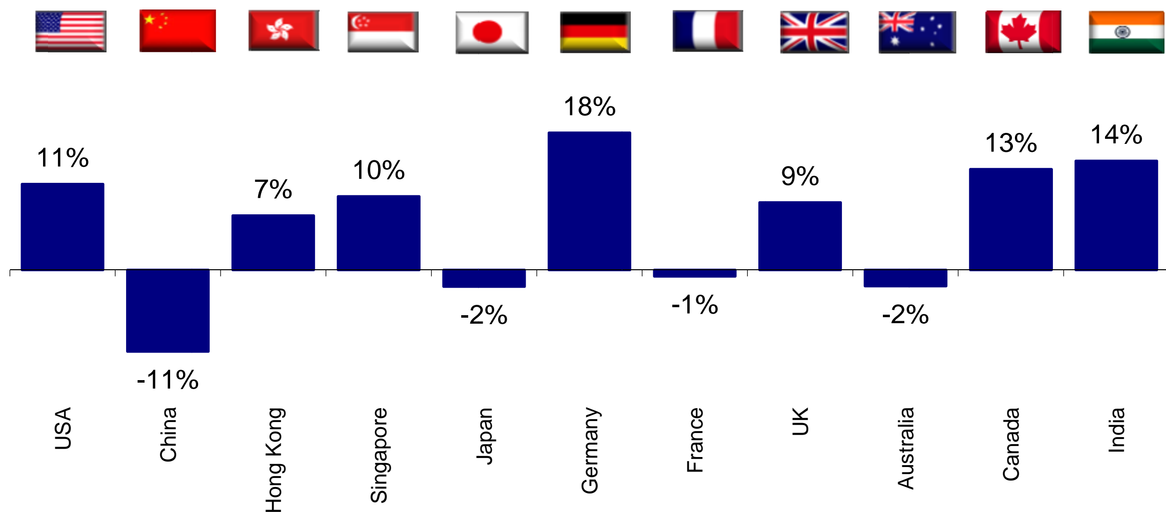
Australian dollar hits parity

2010 was the year that the Australian dollar reached parity with the US dollar on 6 occasions.

This was partly due to Australia's healthy economy, high commodity prices and relatively high interest rate differentials. Our current official cash rate of 4.75 per cent is the highest among developed economies.

The strong Australian dollar is good news for savers with some online savings accounts paying interest of around 6 per cent (other countries are as low as 0.5 per cent). But not so good for borrowers, especially with the banks raising rates by more than the official cash rate.

Figure 2: Global sharemarket indices – 1 January 2010 to 14 December 2010



Indices: S&P 500; Shanghai Composite; Hang Seng; Straits Times; Nikkei 225; DAX; CAC 40; FTSE 100; S&P/ASX 200, S&P/TSX Composite; BSE Sensex 30
Source: Data stream. Data from 1 January to 15 December 2010

It's also good for Australian based investors purchasing overseas investments, but can detract from returns on unhedged portfolios that were purchased previously.

It's worth bearing in mind that currencies are notoriously unpredictable, and can reverse course quickly. Because this movement is often in the opposite direction to market changes, some currency exposure can help reduce volatility and stabilise a portfolio, particularly in falling markets.

Equities - 'fundamentals' starting to improve

It's been a mixed bag for equity markets, as shown by figure 2 above.

Some of the countries with the biggest problems ended the year with the highest share market gains, while those with roaring economies delivered negative returns.

For example, over the course of the year, the US share market is up by 11 per cent, while China's share market is down by 11 per cent.

The Australian sharemarket is down by 2 per cent, but when you account for dividends it is up by almost 2 per cent.

There is a wide divergence in sector returns, with the materials sector, which includes mining and resource stocks, benefiting from the commodities boom, enjoying gains of around 20 per cent. In contrast, the telecomunnications sector fell by almost 19 per cent.

Against the back ground of all this noise, company fundamentals have generally started to improve.

Companies are delivering good profits. In the most recent reporting season 75 per cent of US companies that reported met or beat earning expectations. Of the Australian companies that reported 77 per cent met or exceeded their profit expectations.

Cost cutting and debt reduction measures mean that corporate balance sheets are now generally stronger than before the GFC, and companies are sitting with strong cash flow positions.

Many Australian and US based companies are also benefiting from exposure to some of the world's fastest growing economies.

For example, activity generated by US companies in overseas markets now account for around 35 per cent of overall US corporate profits.

What this means for investors

As we head into 2011 there is still plenty to worry about. The big issues that drove the 'risk on, risk off' nature of market behaviour in 2010 have been contained, but not resolved. They are likely to take on a different dimension in 2011, as governments and policy makers' work through potential solutions.

In this kind of environment, diversification is an important aspect of capturing return and managing risk. Cash rates are relatively high, Australian shares deliver tax attractive dividends, and global markets offer strong potential returns.

It will take time, but when the markets' fixation with bigger picture 'macro' events starts to abate, shares with attractive valuations and under-appreciated earnings potential will perform.

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