

Investments

Setting a course

A guide to investment markets



redefining / investments

A guide to investment markets

2010 delivered mixed results on the markets as wary investors continued to exercise caution in the wake of the global financial crisis (GFC).

Despite developing countries driving global economic growth higher than expected, investment returns stuttered as markets became distracted by wider economic concerns such as sovereign debt in Europe, fears of a double-dip recession in the US and a managed slowdown in China's growth rate.

But at the individual level companies are starting to post decent profits. When the markets start to fully factor in positive company earnings, returns should improve but we are still likely to see periodic disruption that will test the patience of investors.

Now more than ever the key to unlocking value is diversifying investments across asset classes, industries and regions.

We have developed this guide to help you make sense of the investment markets and navigate your way through the noise and confusion of conflicting market signals with the help of your financial adviser.

Where are we now? /

Back on track

Last year the global economy exceeded expectations, delivering 5 per cent growth in overall gross domestic product (GDP). The International Monetary Fund (IMF) is forecasting 4.4 per cent growth for 2011, with developing countries powering ahead. Emerging economies are predicted to improve their collective GDP by 6.4 per cent this year, easily outstripping a more modest 2.2 per cent increase in their advanced counterparts (see figure 1). Emerging markets now account for two-thirds of global growth and almost 40 per cent of global consumption.*

The reciprocal trade relationship between China and Australia is a classic example of demand for commodities from the developing world fuelling growth in resource-rich developed countries.

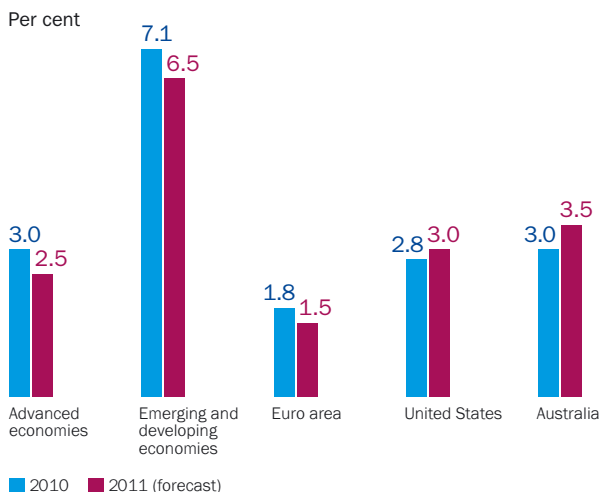
* Source: International Monetary Fund, World Economic Outlook Update, January 2011.

In the US, fears of falling back into recession have abated. The ground lost during the GFC has now been recovered and the economy is tracking well, driven by strong export figures, with developing countries now accounting for the lion's share of US manufacturing exports (see figure 2).

But unemployment remains stubbornly high in some countries and governments continue to grapple with the challenge of high levels of public debt, particularly in Europe.

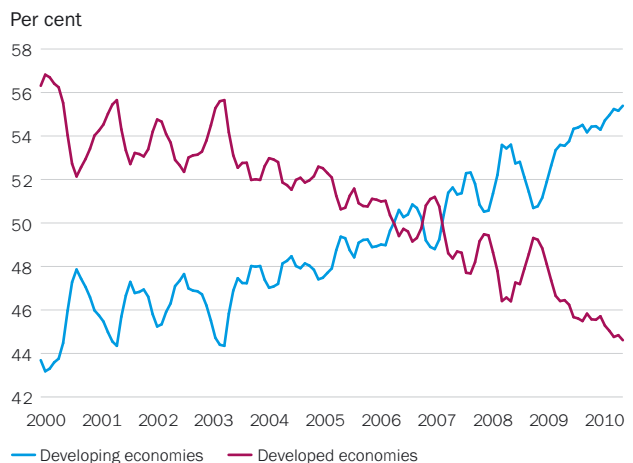
The need to balance the books continues to constrain growth and provide a continuing source of uncertainty for investors.

Figure 1 **Gross domestic product forecasts 2010 – 2011**



Source: International Monetary Fund (IMF), World Economic Data Base, October 2010 and January 2011. Percentage change from previous period.

Figure 2 **Destination of US manufacturing exports 2010 – 2011**



Source: Three month moving average. Source: AllianceBernstein. Census Bureau and Haver Analytics. Data as of November 2010.

Balancing the books

Sovereign debt concerns put the brakes on market growth in 2010 and the fight to contain debt and deficit levels remains a top priority for many governments in the developed world.

Debt is the total amount of money owed by a government, while the overall budget deficit is the difference between the amount of money the government spends and receives each year.

Advanced economies are dealing with debt and deficit levels in very different ways.

For example, the US and Japanese governments passed further stimulus packages in late 2010 to boost their respective job markets.

US fiscal debt is now forecast to reach almost 11 per cent in 2011 – more than double that in the Euro area – and government debt is expected to exceed 110 per cent of GDP in five years time.* The key risk in the US is the lack of a credible exit plan to bring debt down over the medium to long term.

Across the pond in the Eurozone it's a different story. Following the bailouts to Greece and Ireland, Euro member countries continue to tighten their fiscal belts, even though domestic demand is weak. Continuing high debt levels and related risks to the banking sector make Europe more of a worry to the markets in the short term.

* Source: International Monetary Fund, World Economic Outlook Update, January 2011.

Up, down, sideways?

One thing most developed economies have in common is near zero interest rates, which removes a key monetary policy lever to control inflation (see figure 3).

Overall the IMF is predicting a global inflation rate of 1 per cent. But this masks a diverse picture. Managing inflation is another area in which there is a stark divide between advanced and emerging economies.

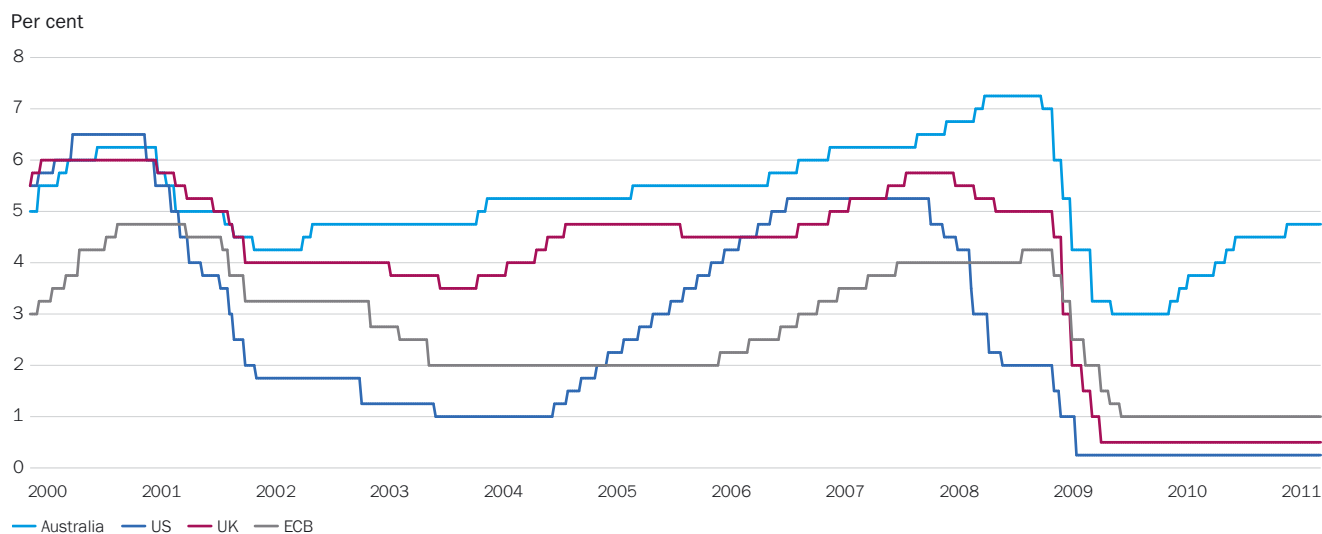
In developing countries, the key risk relates to over-heating economies and rapid price rises, or inflation. Indeed, the Chinese government spent much of last year taking the pressure out of their overheating economy by implementing a managed slowdown.

In contrast, advanced economies are facing the opposite problem. Persistently high levels of unemployment, coupled with spare capacity in the economy, is making deflation, or falling prices, more of a concern.

With interest rates already at rock bottom levels, US authorities have turned to the exotically named quantitative easing as a solution. In plain terms, this means the US government has started printing money in an attempt to jump-start the economy by injecting massive amounts of liquidity into the system.

It remains to be seen how successful this policy will be. While much of the new money has yet to make its way through the system, it's already causing the currencies in some developing countries to appreciate, contributing to short-term inflationary pressures.

Figure 3 Official cash rates 2000 – 2011



Source: Bloomberg. Official cash rates used: Reserve Bank of Australia Cash Rate Target, US Federal Funds Target Rate, UK Bank of England Official Rate, European Central Bank Minimum Bid Refinancing Rate 1 Week. Data through to 11 February.

Knocked off course

Back home, the start to the year has been dominated by a series of devastating natural disasters.

First floods devastated large areas of southern Queensland, northern New South Wales and Victoria, causing tragic loss of life and serious damage to infrastructure.

Then Cyclone Yasi hit northern Queensland, causing widespread damage to homes and crops. It's still too early to gauge the full extent of the disruption to supply chains but among the industries likely to feel a short-term impact are mining and tourism.

One of the most immediate and obvious effects of the disasters will be higher prices for fruit and vegetables on supermarket shelves. The Reserve Bank of Australia estimates inflation will be up 0.5 per cent or so to about 3 per cent – the higher end of its preferred band.

In terms of overall economic impact, Australia is expected to shed 1 per cent of GDP. In fact, we may even experience a technical recession – two quarters of negative growth – although this would be largely a result of the natural disasters rather than any serious underlying structural problems.

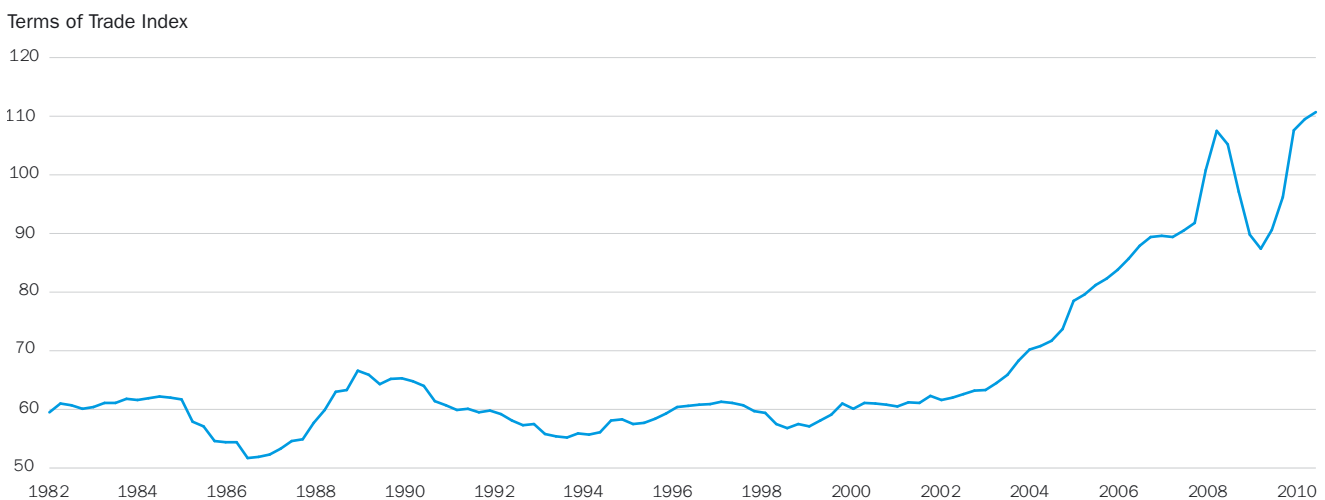
Two-speed economy

The inflationary and economic effects of the natural disasters are expected to be temporary. While the pace of recovery will vary among different industries, the RBA reckons that Australia's overall level of economic growth is likely to recover close to where it would have been without the disasters by the middle of the year.

Australia will continue to benefit from growth in developing markets for our commodities, particularly from China and India. Historically, high terms of trade mean that essentially we've been able to charge more for our raw materials, adding \$25 billion to our bottom line over the past year (see figure 4).

The signs of a two-speed economy continue to emerge, with strong growth in key sectors such as mining and energy and significantly lower growth in other sectors such as retail. Although we are enjoying full employment and strong wage growth, cost of living pressures are prompting households to exercise more caution in their finances, particularly in relation to borrowing and spending.

Figure 4 Australian Terms of Trade



Source: Reserve Bank of Australia. Data through to December 2010.

What does this mean for investment markets?

Brick by brick

So what does all this mean for investors?

After cutting their costs during the GFC, many companies have repaired their balance sheets and have a lot of cash on their books which they can use to fund expansion plans or pass out as dividends.

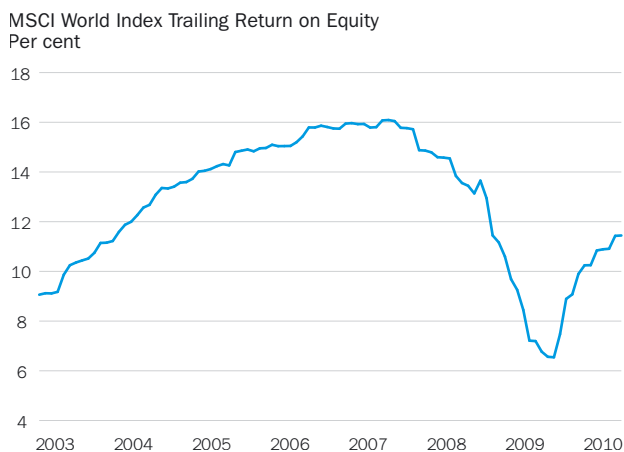
One measure that reflects rising profitability is return on equity, which calculates how much profit a company generates with the money shareholders have invested. As you'd expect, return on equity took a big hit during the GFC but is now climbing back up to more historically acceptable levels (see figure 5).

Improving corporate balance sheets and profits is likely to flow through to investment markets as investors focus more closely on individual companies and industries.

Markets will eventually start pricing in good company earnings and these growth assets will drive returns.

Over the short term, however, sovereign debt concerns could very well trigger another round of nervousness and market volatility before government approaches to reducing debt and deficits to more manageable levels begin to bear fruit.

Figure 5 Global sharemarket profitability 2003 – 2010



Source: Consensus Economics, FactSet, MSCI, national accounts and AllianceBernstein. Data through to 31 December 2010.

Double-edged sword

The Australian dollar has recently been trading at or near parity with the US dollar (see figure 6). This is partly due to Australia's relatively healthy economy, high commodity prices and high interest rates compared with the rest of the world, as well as the weakness in some overseas currencies.

The strong local dollar is good news for Australian-based investors purchasing overseas investments but not so good for investors already holding overseas assets, as it can reduce returns.

It's worth bearing in mind that currencies are notoriously unpredictable and can reverse course quickly, as was the case during the onset of the GFC.

Diversifying your investments across different regions can help reduce the effects of currency movements on your overall returns.

Figure 6 Australian dollar versus US dollar 1983 – 2011



Source: Bloomberg. Data through to 11 February 2011.

So what can I expect for the rest of 2011 and beyond?

Untapped potential

The global sharemarket has improved by an impressive 82 per cent since reaching its lowest point during the GFC, but still needs to rise 16 per cent to get back to its previous high (see figure 7).

There is still a lot of potential in the sharemarket to deliver returns and keep you several steps ahead of inflation, both through regular dividend payments and capital growth.

Figure 7 Global sharemarket return 2007 – 2011



Source: Datastream. Data through to 11 February 2011.

Keeping your head, in good times as well as bad

It's important not to lose sight of your long-term investment goals and saving for your retirement, regardless of whether markets are moving up, down or sideways.

In bad times, it's tempting to make a swift exit from growth assets, crystallise your losses and move lock, stock and barrel to the safe haven of cash, riding out the turbulence but potentially missing out on the rebound.

And in good times, it's tempting to chase 'quick wins', over-commit to the best performing asset classes and change well-laid plans.

But markets remain unpredictable in the short term and modifying your investments based on the previous year's results rarely proves successful.

Persevering with a diversified long-term strategy pays off, regardless of whether it's a bull or a bear market. Retaining quality, secure assets managed by experienced financial professionals will put you in the best position to benefit from the market recovery.

It's important to hold fast to the fundamental principles of investing:

- diversify across a variety of asset classes
- invest for the long term
- take advantage of tax-effective superannuation
- seek quality financial advice.

Important information

This information has been prepared to provide you with general information only. It is not intended to take the place of professional advice and you should not take action on specific issues in reliance on this information. In preparing this information, we did not take into account the investment objectives, financial situation or particular needs of any particular person. Before making an investment decision, you need to consider (with or without the assistance of an adviser) whether this information is appropriate to your needs, objectives and circumstances. You should obtain a copy of the relevant Product Disclosure Statement (PDS) before making a decision to invest in any financial product. Copies of our PDSs can be obtained from your adviser or by calling 137 292. Applications for investment in AXA Australia products will only be accepted on receipt of an application form accompanying a current PDS. Detailed information about the product is contained in the PDS. The National Mutual Life Association of Australasia Limited and its associates derive income from issuing interests in the products, full details of which are contained in the PDSs. Unless specifically stated, the repayment of capital or performance of our products is not guaranteed. This information is provided for persons in Australia only and is not provided for the use of any person who is in any other country. Past performance is not necessarily indicative of future performance.

AXA Australia Customer Service GPO Box 2780 Melbourne VIC 3001
Telephone: 1800 780 085 Facsimile: (03) 8688 5796
Responsible Entity: National Mutual Funds Management Ltd
ABN 32 006 787 720 AFS Licence No. 234652

