# 2011

## THE YEAR AHEAD | ECONOMISTS' OUTLOOK

In this article, AMP's Shane Oliver, BT's Chris Caton, MLC's Brian Parker, Praemiums Don Stammer and HSBC's Paul Bloxham share their outlook for the year ahead, with each economist individually analysing what could transpire for the Australian share market, domestic economy, interest rates, currency and global economies.

## The Australian economy

Chris Caton, BT Australia

The Australian economy begins 2011 with a fair head of steam. Employment has increased by 3.7 per cent in the past 12 months, and the mining investment boom still has a long way to run.

Given that we are starting from a low 5.2 per cent unemployment rate, this boom can be accommodated only if growth elsewhere is restrained. The best forecast is, therefore, that the economy will continue to do well, but with interest rates rising further again.

Reserve Bank of Australia (RBA) governor Glenn Stevens has hinted strongly that the central bank still has a bias to raise rates further, but that it is in no hurry. It would be prudent to assume perhaps two more rate increases in 2011. Incidentally, the RBA is well aware consumers and businesses do not borrow at the official cash rate.

So when we get so-called out-of-cycle increases in the variable mortgage rate, as occurred in early-November, what this almost certainly means is that the RBA will need to increase the cash rate one fewer time than it otherwise would.

Of course, as always, there are risks. The international ones remain the same as in 2010: the possibility of a slowdown in China, the chance of a double-dip recession in the United States and some event emerging from the continuing debt problems in the eurozone.

It is my view that all three of these risks have been overstated. While there is always a chance of a slowdown in China, the authorities there have proved remarkably adept at getting that economy going again should it falter.

There was never much prospect of a double dip in the US, and the Fed's new program of quantitative easing should help that economy. And the euro-debt issue is very unlikely to morph into global financial crisis (GFC) mark two.

There are important differences from late-2008, when the full severity of the GFC struck. Back then, no-one know who was holding what on their balance sheets or what the 'assets' were worth.

Now at least not only is the problem smaller but it is far more transparent. A default, full or partial, would hurt, but it would be a clearly survivable event.

The new domestic risk is, of course, the widespread flooding. As serious an event as this is, history suggests economists tend to overestimate the economy-wide effects of disasters, whether natural or manmade. There is no question the flooding will impede mining production and other economic activity, and it will clearly drive up the prices of many fruits and vegetables. However, the water will eventually recede, and production will resume. Indeed, reconstruction will add to measured gross domestic product. Importantly, the RBA will look through the extra inflation, which means the floods have probably postponed the next rate rise. And that leaves the exchange rate. Australia is caught up in a currency skirmish going on around the world. Currency volatility will go on for some time yet. However, we all know the Australian dollar is currently overvalued and is likely to come down at some stage. By my reckoning, fair value is about 85 US cents, so that seems as good a forecast as any for end-2011.

At the moment, however, the rest of the world is on sale for Australians, be they travellers, on-line shoppers or investors.

## The Australian share market

Shane Oliver, AMP

The second year after a major bear market ends often sees volatile trading and poor returns from shares as investors are fearful of either a double dip back into recession or the removal of stimulus measures.

Over 2010, Australian shares were arguably hit by both with double-dip worries at various points in time in Europe and the United States, but monetary tightening in China, Asia and Australia.

However, the experience of past cycles points to the resumption of better returns in the third year and we expect this to play out in the year ahead. There are several reasons for optimism. **First**, Australian shares are starting the year reasonably

cheap. The forward price-to-earnings multiple coming into the new year is around 12.8 times, which is below its longer-term average of 14.5 times and well below its level of a year ago when it was 15.2 times.

This suggests that risks are better allowed for and provides greater scope for a rise as investor confidence gradually improves.

**Second**, the continuing economic recovery both globally and in Australia should underpin further gains in profits. We expect profit growth of around 12 per cent over the year ahead.

**Third**, the global monetary and liquidity backdrop is very stimulatory, underpinned by very low interest rates and quantitative easing in some countries with the likelihood that some of this cash sloshing around globally will find its way into share markets, including the Australian share market.

Related to this, the corporate section in the US, Australia and in other major countries is cashed up, which is likely to result in a further pick-up in merger and acquisition activity, share buybacks and dividends, all of which are positive for shares.

**Fourth**, while investor caution has seen poor inflows into share funds and strong inflows into bond funds in recent years, there is a good chance fund flows could reverse in favour of shares in the year ahead as investors realise the global and Australian economic recovery is continuing.

**Finally**, 2011 is also the third year in the US presidential cycle, which usually sees above average share market gains as economic policy becomes stimulatory in order to help the incumbent president.

Since 1927, the average return from US shares in the third year of the presidential cycle has been 19.4 per cent a year, compared to an average return across all years of 11.8 per cent a year. Solid gains in US shares should augur well for the Australian share market.

To be sure there are plenty of potential threats to keep an eye on, including recurring sovereign debt crises in Europe, another bout of house price weakness in the US, monetary tightening in China and Australia and the risk of a sharp rise in bond yields.

However, while some of these are likely to cause ongoing volatility, they are unlikely to be significant enough to derail the ongoing recovery in the share market. By year end we expect the Australian ASX 200 Index to have risen to around **5500**.

# Interest rates

Don Stammer, Praemium

Around the world, 2011 is likely to be a challenging year for everyone affected by interest rates.

Recall the good and the bad for interest rates over 2010. Reflecting the two-paced world economy, official cash rates were left unchanged (and extremely low) in the United States, the eurozone, Japan and Britain, but raised in Australia, China and India.

In the US, government bond yields fell to multi-year (and even record) lows during August, when fears developed that low inflation would morph into deflation, but on several occasions during 2010 bond yields soared in some European countries because of sovereign debt problems. The big influences on interest rates in 2011 are likely to be growth rates in the US and China, and inflation fears in Australia.

My guess is the US economy will exceed consensus growth expectations, with each of consumer spending, exports and business capital spending contributing.

In the second half of the year, the Fed could contemplate its first step towards normalising the cash rate – leading, perhaps, to a sharp sell-off in bonds and a stronger US dollar.

There are many uncertainties in the outlook for China, where monetary policy has been tightened to restrain inflation and property speculation while encouraging consumer spending as one way of rebalancing the economy.

The safest assumption, perhaps, is that China's growth will slow modestly in the second half of the year, reducing the boost to commodity prices and our economy generally.

When the Reserve Bank of Australia (RBA) last raised our cash rate (to 4.75 per cent in November), its move was pre-emptive: prospective inflation was within the target range and consumer spending was a little soft.

My guess is the cash rate will remain unchanged until the June quarter. However, over the second half of the year, the deteriorating outlook for inflation – as wages pressures build up while productivity growth is near zero – could see the cash rate raised progressively to 5.5-5.75 per cent, with the variable interest rate charged to borrowers increasing by an equivalent amount. Over much of 2010, Australian 10-year bond yields traded mostly within the range of 2-2.5 percentage points above US yields.

I suggest this spread will narrow in 2011 as US growth speeds up; even then, our yields could move higher on the back of rising

US bond yields. And Australians are likely to continue enjoying attractive returns on at-call money and term deposits.

Of course, 2011 will have its share of surprises for interest rates (and investment markets more generally). The major economies all have big budget deficits to finance. China may make mistakes in its efforts to cool inflation and property speculation. Europe's debt problems could take a new twist.

My major concern is that, by end-2011, the RBA will be concerned by the outlook for inflation.

## Currency

Brian Parker, MLC/NAB

Most of the world's major economies have emerged (cautiously) from the biggest recession in decades, but growth remains fragile.

In such an environment, most of the major economies of the world would rather avoid, of at all possible, having their currencies appreciate, and the efforts of several countries, including the United States, Japan and United Kingdom, at quantitative easing, seem designed at least in part to bring about a lower exchange rate. However, clearly not every country can have a weaker currency. In the past year or so, if you wanted to own a floating currency where the central bank was not actively debasing its value, your list of options was pretty short: Canada, New Zealand and Australia, and if you didn't want any of those, there was always gold.

Forecasting exchange rates over the short term is fraught with danger: a mug's game some would say. With that caveat in place, let's have a go.

In 2011, there's a decent chance that many of the trends and themes that have dominated currency markets over the past year or more will reverse.

The tone of the economic data coming from the US has improved markedly of late. Fears of a renewed recession have abated.

True, the US housing market remains depressed and over time the government still needs to de-lever. However, household incomes are rising, the private section is hiring, and key business surveys are at levels consistent with reasonable economic growth.

This is not to say the US is firing on all cylinders – it is not, but over the year ahead it is likely to become clear that of the major economies the US is performing reasonably well, and the broad downtrend in the US dollar over recent years is likely to reverse.

Japanese growth is likely to remain subdued and the economy remains mired in deflation. In Europe, the problems on the European periphery are truly massive, and there is little sign of a

decent resolution emerging any time soon. Among the majors, the US economy is the best of a mediocre bunch.

Over the past couple of years there have been plenty of reasons to love the Australian dollar: the soaring terms of trade, widening interest rate differentials as the Reserve Bank of Australia raised interest rates earlier and faster than virtually everybody else, healthy public finances, and a strong economy.

However, the currency is now significantly overvalued on traditional measures such as purchasing power parity. For those sectors not exposed to the resources boom, such as inbound tourism, education and manufacturing, the level of the currency is becoming problematic.

The reasons to love the Australian dollar are now well known to all and sundry. It wouldn't take much to go wrong here (or right for the rest of the world) for the currency to fall significantly. Enjoy the overseas shopping while you can, but it probably won't last.

One of the things that would go wrong for Australia would be a sharpish slowdown in Chinese growth or a significant change in the composition of that growth.

Given the deft management of their economy the Chinese authorities have demonstrated in recent years (one of the benefits of in many ways still being a command economy) such a slowdown in unlikely, but it can't be entirely ruled out. The Chinese authorities have continued to resist international pressure to allow their currency to appreciate at a faster rate, fearing an adverse impact on their export growth.

While they are most unlikely to agree to such pressure, the year ahead is likely to see further modest increases in the value of the renminbi.

## Global economies

Paul Bloxham, HSBC

Globally, conditions have improved in recent months, largely driven by strong growth in Asia, which is particularly important for Australia.

In the emerging markets, economic conditions are strong and indeed the bigger threat now is that demand exceeds supply capacity and puts upward pressure on inflation. Commodity markets are already showing strong signs of growing inflationary problems, with food and energy prices rising significantly, partly due to loose monetary policy in Asia and western countries. There has also been a general reluctance among policy makers in emerging nations to lift interest rates significantly, as this would attract even greater capital inflows and put unwanted upward pressure on their currencies.

A key risk for 2011 is that policy makers are unable to adequately contain inflation, which

could threaten to derail the global recovery sometime later in the year or in 2012.

There are also some recent signs of improvements in conditions in the western economies. Recent data suggest a double dip in the United States is unlikely, and while it looks as though the US recovery will continue to be a long slow grind, as household balance sheets are repaired, the outlook has generally become more positive. In particular, inflation expectations seem to be rising and US bond yields have increased in recent months in anticipation of better economic conditions.

Conditions in Europe have improved, driven by strength in Germany, and exports in particular. A strong outlook for demand for capital goods from the emerging world is expected to see Germany continue to grow more quickly than the eurozone, which should also support demand for intermediate goods from other smaller European nations. Of course, there remains significant risk that the sovereign debt issue in some of the peripheral countries once again rears its ugly head.

Inflation has picked up in Asia and authorities are trying to slow it down, while in contrast growth has been anaemic in the western countries and authorities have been doing what they can to boost it. For Australia, the Asian story is the one having the most effect on local conditions. The Australian economy is already operating at close to capacity, the outlook for mining investment is very strong, and the high level of commodity prices is boosting incomes substantially. Indeed, with inflation starting the next upswing in the middle of the target band – not below the band, as might be preferred – interest rates will probably need to rise to keep inflation in check.

We expect the Reserve Bank of Australia to lift the cash rate by a further 75 basis points over 2011 in order to contain inflationary pressures.



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