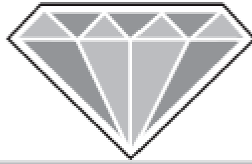


BALANCED INVESTMENT STRATEGIES

FINANCE ◆ BALANCE ◆ LIFE

Market Returns

June 2010

Balanced Investment Strategies

ABN: 33 070 860 776

AFSL: 314 365

Postal Address: PO Box 1251, Palm Beach QLD 4221

Phone: (07) 5598 3800

Fax: (07) 5598 3711

Email: info@cosgroveco.com.au

Media Noise

Investors who pay close attention to daily media headlines about the financial markets could be excused for thinking the world is coming to an end. But there's a flipside to this story.

Current concerns about sovereign debt and the damage to public sector balance sheets wrought by the financial crisis of 2008 are very real. But markets have a way of working through these risks, as we are seeing now.

In the meantime, amid all the doomsday talk, it's worth reflecting on the fact that securities markets and the real economy are different things. And on the latter front, there is much more encouraging news at the moment.

The OECD, which brings together 31 developed economies, lifted its projections for global economic growth from 3.4% to 4.6% in 2010, and from 3.7% to 4.5% in 2011. These new projections are higher than the average annual rate of growth the global economy registered in the decade before the crisis.

There are however some risks around these growth forecasts, particularly from instability in sovereign debt markets (as we are seeing now) and the risk of overheating in emerging markets.

But the overall message is one of cautious optimism. Unemployment looks to have peaked, international trade flows are rising again and many governments are beginning to repair their fiscal positions.

Outside Europe and the US, the Asia Pacific region is booming, thanks to the rapid industrialisation and modernisation of China and India. Latin America has also emerged from the global crisis in relatively good shape.

Australia has benefited from these markets with strong commodity prices underpinning incomes here. We have led the world in raising official interest rates, which has occurred six times since October.

The weaker euro is making European companies more globally competitive with carmakers Peugeot Citroën and Volkswagen starting joint ventures in China.

The international recovery is a lengthy process and will occur gradually. However it is being assisted by policies such as China's massive stimulus package geared towards reactivating internal demand, and moving away from its export model, and US consumers have started to save more.

So there are grounds for hope and that the underlying economic situation is not as bad as the financial headlines of gloom and doom might sometimes portend. Financial markets are fairly efficient in accommodating bad news, so that by the time you read about one event the markets have gone onto worrying about something else.

In the meantime, policymakers globally are working to ensure the world economy emerges from the crisis in better health. And there are indications from the economic data that the recovery is happening. While Europe and the US work through their problems, much of the rest of the world is doing relatively well, particularly the emerging markets in Asia and Latin America.

At the end of the day, sentiment is one thing, reality another.

Forecasting is still perilous

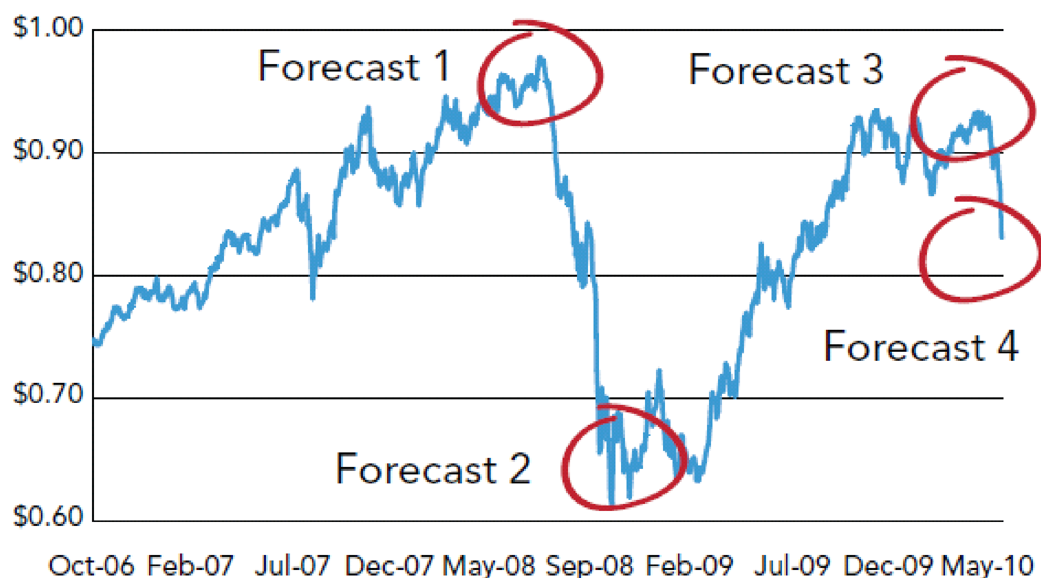
Despite the signs of recovery, anyone who still believes that you can make money consistently by forecasting market movements might want to interview clients of US investment bank Goldman Sachs.

According to Bloomberg, seven of Goldman's nine recommended top trades for 2010 had been losers for clients as of mid-May. These included 14 per cent losses by buying the Polish zloty against the Japanese yen and nearly 10 per cent trading the British pound against the Kiwi dollar.

The Australian dollar was not mentioned as a 'top trade', but judging by the recent run of media commentary, pundits trying to anticipate the Aussie's movements in the past two years might be licking their wounds as well.

Forecasts have been so bad they have almost proved to be a contrarian indicator of the currency's actual direction, as the chart below of the past three and half years of the $A's movements shows.

AUSTRALIAN DOLLAR VS US DOLLAR



Source: RBA

In mid-2008, the Australian dollar reached more than 98 US cents, its highest levels since it was floated in the mid-1980s. Economists were quoted as saying the currency would match the greenback cent-for-cent by Christmas. That is shown above as 'forecast 1'.

No sooner had the parity parties been called than the $A fell spectacularly to a five-year low just above 60 US cents. This was during the worst period of the global financial crisis when risk appetites shrank dramatically.

By October 2008 (forecast 2), economists were saying the $A was on a one-way ride to below 60 US cents and to the levels prevailing during the tech boom 10 years ago when Australia was judged to be an "old" economy.

As risk appetites revived in March 2009, the Australian exchange rate took off again and, within just over a year, had appreciated all the way back to nearly 94 US cents.

So what did the economists say this time? You guessed it: The little Aussie battler was on its way back to parity. (forecast 3)

Sure enough, no sooner had this call been made than the currency turned tail again and sank more than 10 per cent in the space of a couple of weeks. The trigger, said analysts, was a global unwinding of so-called "carry trades" as Europe's sovereign debt crisis sparked a sudden aversion to risk.

True to form, economists responded by warning of more of the same, calling for the currency to drop to 77 US cents and lower. (forecast 4)

It should be evident from all of this that pundits have a knack for turning what has already happened into a forecast. In other words, predictions of a currency's decline seem quite feasible when it has just dropped 10 per cent.

But the market tends to be always a couple of steps ahead of the professional forecasters, so that the trigger for any turnaround is the capitulation phase when everyone is jumping on the same bandwagon.

The Australian dollar is such a good example because it is often seen these days as a kind of canary in the coal mine of global investor sentiment. Despite Australia's relatively small economy (18th in the world in size), its currency is the sixth most traded globally, behind the US dollar, Euro, Japanese Yen, Pound Sterling and Swiss Franc.

Depending on circumstances, the $A is perceived as a China proxy, a commodity proxy, a signaller of market expectations for global growth and as a barometer of risk appetites.

What this means is that people who try to forecast the Aussie's movements must be able to get all of these perceived drivers right, as well as correctly anticipating the traditional currency influences of trade and investment flows.

What are the odds of them calling it all accurately?

This material is provided for general information only and has been prepared by Balanced Investment Strategies Pty Ltd (BIS) (AFSL number 314365) without taking into account any particular person's objectives, financial situation or needs. Persons should, before acting on this information, consider the appropriateness of this information having regard to their personal objectives, financial situation or needs. All due care and diligence has been taken by BIS in the preparation of the Material. BIS accepts no responsibility for any errors, inaccuracies or omissions or for loss or damage suffered by any person as a result of any errors, inaccuracies or omissions. If there is anything that you disagree with, or do not understand, please contact BIS on 07 5598 3800.