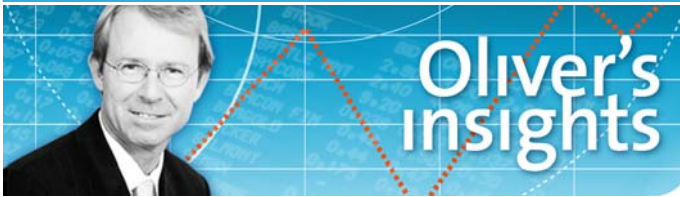


Slumping global share markets and debt debacles

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Key points

- The fall in share markets has accelerated on signs the global economic outlook is faltering badly. The squabbles over debt problems in the US and Europe have probably made the global growth slowdown worse.
- The US has avoided a default but still faces a likely downgrade from Standard & Poors and fiscal austerity far earlier than desired. Meanwhile, European sovereign debt problems are getting worse.
- This all means the ride for share markets and other growth assets is likely to remain rough in the months ahead.
- Shares are cheap, but with the worry list remaining long could still get cheaper until the US undergoes another round of quantitative easing later this year.
- Unlike the US, Australia still has plenty of firepower to stimulate growth if need be, particularly by cutting interest rates.

Introduction

The last few weeks have seen investors transfixed, first on Europe as it belatedly introduced another package of measures to deal with its sovereign debt problem, and then the US, which in the nick of time agreed to increase its debt ceiling and thereby avoid a partial shutdown and default. Markets, which enjoyed brief relief rallies in response to both - very brief in the case of the US! - have continued to weaken. The real issue has been the deteriorating global growth outlook, with the political bun fights in Europe and the US just making it worse. Global shares are now down 13% from their high earlier this year, Australian shares are down around 17% and Asian shares are down around 10%.

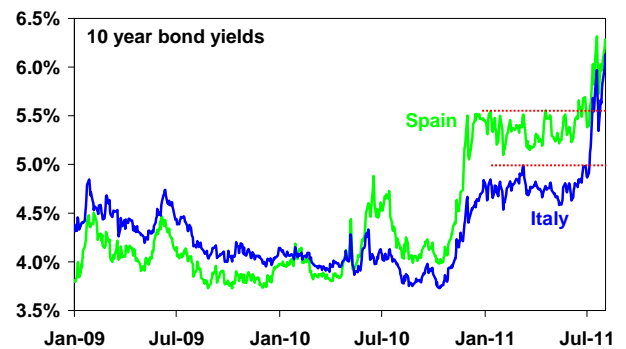
The US and European debt debacle

The good news of course is well known. Europe has expanded its support for problem debt countries and America, by raising its debt ceiling, has avoided a partial government shutdown which would have almost certainly plunged the US back into recession.

However, the European debt problems are still getting worse. The bailout fund (the EFSF) is not big enough, it's unlikely Spain and Italy will be able to make their share of contributions to it, investors now worry they will be forced to share in the pain of bailing out other countries as they have with Greece, political squabbling amongst European leaders is continuing, the ECB is still holding back from providing more aggressive support and intensifying fiscal austerity will make the debt problems worse.

Reflecting this, Italian and Spanish bond yields have broken to new highs. Italy and Spain account for around 30% of Euro-zone GDP and a third of its debt, so a spiral of ever tougher fiscal austerity forced by rising bond yields in these two countries (as has occurred in Greece, Ireland and Portugal) would be a major concern.

Spanish and Italian bond yields pushing higher



Source: Bloomberg, AMP Capital Investors

Meanwhile, **the intense political debate in the US has drawn world wide attention to the scale of its debt problem, brought forward the timing of fiscal austerity and left the door wide open for a sovereign debt downgrade** from ratings agency Standard & Poors. Back in April, when S&P put the US' AAA sovereign rating on negative outlook, it appeared to be giving it until 2013 to act to lower its deficit. In mid-July, it indicated the politics were such that if the US didn't move now the odds of doing so later were low, indicating \$US4 trillion in savings over ten years would be expected. In fact, only \$US2.4 trillion in savings at most have been agreed to. So if S&P is true to its word, a downgrade is likely in the next few months. The other ratings agencies, Moody's and Fitch, have retained America's AAA sovereign rating but have warned it could still be downgraded.

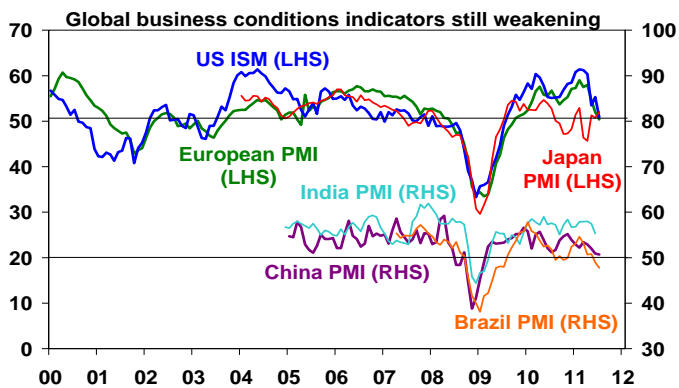
A ratings downgrade would probably have less impact on US borrowing costs than feared. The experience of other countries downgraded from AAA to AA suggests just a 0.2% rise in long term bond yields; forced selling of US bonds is likely to be limited as most investors can still hold AA rated debt as it's still investment grade; the uncertainty involved in the economic outlook would likely see continued safe haven buying of bonds; and if US bond yields do back up too much it's likely the Fed will start buying them again (via QE3). Certainly, talk of a downgrade is not presently worrying bond investors as US 10 year bond yields have fallen to just 2.6% from 3.7% in February.

While a ratings downgrade may not be a disaster for the US, **the debt ceiling debate and talk of a downgrade has focused attention on America's public debt problems and brought forward momentum for fiscal austerity at a time when the US economy is fragile.** This in turn has adversely affected business and consumer confidence.

The real problem – the slowing global economy

This brings us to the real problem - the recent slowing in the global economy. We have been of the view the soft patch in global, notably US, growth during the first six months of this year was largely due to adverse weather, Japanese supply chain disruptions and the surge in oil prices, and that growth

would pick up in the current half. However, the recent deterioration in key economic indicators suggests more may be involved than temporary factors. While business conditions indicators (or PMIs) in Japan have recovered, the US and Europe have continued to deteriorate and PMIs in India, China and Brazil have also slowed.



Source: Bloomberg, AMP Capital Investors

While some sort of bounce is still likely in the US in the current half year as auto production returns to normal, it is looking much weaker than we previously assumed. Revisions to US GDP data and the soft first half of the year have also pushed US year ended economic growth to just 1.6%, which is below its so called stall speed. In six of the last seven times US year ended GDP growth slipped below 2% since 1970, it has kept falling into recession.

Our base case is that the global recovery will continue:

- The slowing in US growth increases the chance the Fed will undertake another round of monetary stimulus via quantitative easing (ie QE3). While higher inflation means the hurdle to doing more quantitative easing is higher than it was a year ago, a further increase in unemployment is likely to spur the Fed into action. The Swiss and Japanese central banks have already stepped up monetary easing. The European Central Bank may also at some stage be ultimately forced into quantitative easing.
- While growth in the emerging world is slowing from excessively strong levels, there is no evidence of a sharp decline indicative of recession and so overall it should remain reasonably strong. Emerging countries now account for more than 50% of world economic activity. Japan also appears to have recovered from its recession earlier this year.
- The fall back in global oil and food prices should help relieve household budgets.

However, **with fiscal austerity starting to kick in next year in the US and set to knock up to 2% from growth as GFC stimulus programs wind down, and fiscal austerity continuing in Europe, growth in advanced countries is likely to be pretty sluggish.** In other words, it's hard to see the 4% or so global growth the IMF and others including the Reserve Bank of Australia have been assuming for this year and next.

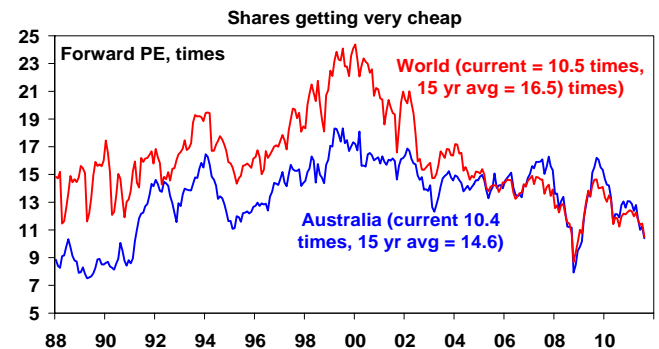
Implications for Australia

The global malaise affects Australia via three key channels: the direct impact on business and consumer confidence (both of which are depressed), financial markets (eg the loss of wealth as the share market falls) and trade. While demand for Australian exports remains strong, the risk is the weakness in Europe and the US adversely affects growth in China and Asia which then reduces demand for Australian exports. So far there is no clear evidence of this, but it is worth keeping an eye on. The bottom line though is **the global outlook is looking softer than the RBA has been assuming and this, combined with a continuing run of**

very weak economic indicators in Australia, highlights why it would be a major mistake to raise interest rates any time soon. In fact, the next move in Australian interest rates is now likely to be down. On this front its noteworthy that while Australia is highly vulnerable to a return to global recession at least it has plenty of fire power with the RBA being able to slash interest rates if need be and public debt still relatively low by global standards.

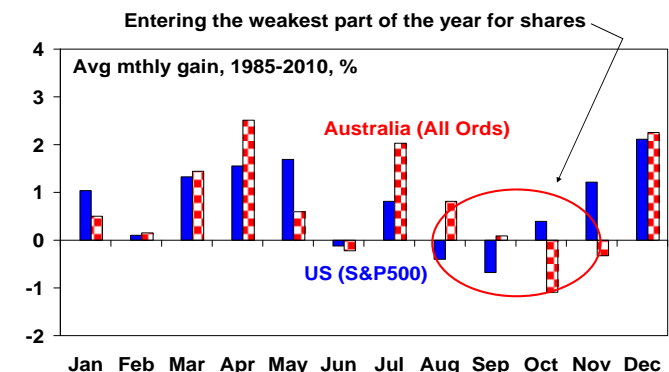
Implications for investors

The fall in share markets has left shares cheap. The forward prices to earnings ratio for Australian and global shares have fallen back to early 2009 levels.



Source: Thomson Reuters, AMP Capital Investors

However, just because shares are cheap doesn't mean they can't get any cheaper, particularly with earnings expectations being revised down. The September quarter and into October is normally the weakest time of the year for shares, and ongoing worries about European debt, the slowdown in the US and uncertainty about whether China will have a hard landing could push shares even lower in the months ahead. Investor sentiment and positioning is also not as washed out as normally occurs at market bottoms.



Source: Bloomberg, AMP Capital Investors

However, on a six to 12 month horizon shares are likely to be supported by attractive valuations, another round of US quantitative easing, greater certainty that China will avoid a hard landing and improved confidence global growth will remain positive (albeit weak and fragile).

Of course, for longer term investors this is all noise and they should stick to their agreed long strategy. But for shorter term investors there is a case to remain cautious for the next few months.

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