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Market Update – 8 August 2011

Last week saw sharp falls in sharemarkets around the globe, leaving many investors feeling nervous or unsure. What happened last week, and what is the outlook going forward?

The falls of last week, particularly on Friday 5 August (Thursday in the US), were a culmination of a series of broad global concerns that have existed since 2010. Importantly, they were not a result of any new piece of data or isolated significant event. Around the world, investors were suddenly gripped by fears about slowing growth in Europe and the US. At the same time, people seemed to realise that these governments still don't have effective long-term solutions to their well-publicised debt problems.

The world waited anxiously last week to see whether the US would lift its debt ceiling, avoiding a possible debt default. Congress required it to negotiate to increase its 'debt ceiling', or the maximum amount that it can borrow and with this budget cuts to match. A political impasse contributed to market uncertainty. As markets waited for a result, some negative economic data was released, indicating that the country is not in ideal shape in some areas, particularly weaker economic growth figures. At the same time, trouble was brewing in Europe with concerns continuing around debt levels, particularly those of Spain and Italy, where concerns where expressed in higher bond yields.

The sovereign debt concerns in Europe can now be split into two complex and related issues – solvency and liquidity – affecting different countries within the area. Greece is effectively insolvent, with Portugal and Ireland not far behind. However, the European Union and the European Central Bank have provided Greece with a new bailout package. This package extends current loan terms and lowers the associated interest rates. These measures were also extended to Ireland and Portugal to some degree. The most recent market and media attention has been around the sovereign debt liquidity crisis affecting larger European countries like Italy and Spain. Whilst these two countries are solvent for the time being, they are susceptible to future woes, brought on by market movements that have increased bond yields.

As a result of all this concurrent uncertainty and negativity, Wall Street had its worst trading day since the global financial crisis (GFC). Gross domestic product (GDP) growth for the US has now been revised down from forecasts made early this year and expectations for the remainder of 2011 and 2012 are being downgraded. There is talk of further action required by the US Federal Reserve (the Fed) to assist economic growth. This includes rumours of a third round of 'quantitative easing'; this involves the Fed finding ways to get cash, or liquidity into the American economy to encourage spending and promote growth.

In Australia, share markets showed a significant decline. The Reserve Bank of Australia (RBA) cut its economic growth forecast for Australia in 2011 to an average of 2%. Just three months ago, the RBA expected growth of 3.25%, although this was no surprise given the slow recovery from natural disasters and weaker consumer spending. The Australian dollar also fell, from buying 1.11 USD early last week to 1.04 USD by Friday on global uncertainty. Sharemarkets across the region also tumbled with Hong Kong, Japan and China all suffering.

However, all of this selling appears to be a fear-driven knee-jerk reaction to the issues around worldwide growth and debt. Several key events were occurring at once, culminating in widespread selling across the globe. Whilst the power of investor sentiment is not to be dismissed given large market moves and high trading volumes, it is important to remember that sentiment alone does not govern markets. Days like those just past are actually extremely likely to occur given the number of issues facing international markets.

The US market actually closed slightly higher on Friday. However this was before a major announcement from ratings agency Standard & Poor's (S&P). S&P downgraded the US as a nation from a AAA rating to a rating of AA+, with a negative outlook. This is the first time the US has been downgraded since it originally received its AAA rating from Moody's (another ratings agency) in 1917. It has held the S&P AAA rating since 1941. This, and the ongoing debate about the appropriateness of S&P's actions, is expected to result in more market volatility over the next few days. It is important to remember that a AA+ credit rating is still extremely high and over time it could lead to higher borrowing costs for the US, from a very low base.

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As previously mentioned, Australia is not immune from the many issues facing international markets. We are also currently experiencing a 'multi-speed' economy. This is where parts of an economy are thriving whilst others are flailing. This paradox is gaining pace with retail sales and personal and business lending at low levels. On the flip side, the resources boom is continuing with some force. This is resulting in skills shortages in some parts of the country and wage pressures, keeping our already low unemployment rate down. Inflation is now above the RBA's comfort zone and looks like it will rise further over the medium term. This is due to increases across the board, particularly fruit prices after the natural disasters and ongoing increases in utility prices, education and health care prices. The RBA strives to keep inflation in a comfortable 'band' of 2-3% which it manages by the official cash rate. Its quandary now is that raising rates will hamper the parts of economy that are already suffering. Given global issues, there is a chance the RBA could leave interest rates on hold for longer than originally anticipated.

While the magnitude of last week's one-day fall, following a week of continuous daily falls, has struck fear into markets globally. Share markets have fallen given the weaker outlook but this can often increase valuations. Balance sheets of companies around the world are in decent shape, a contrast to government balance sheets in the US and Europe. Also, it can be argued that these kind of events actually present opportunities for buying for those who are prepared to encounter short-term volatility.

This is no doubt a challenging time. As the countries that are under debt stress continue to work on solutions, economic growth will continue to be limited. We expect that news from Europe and the US will continue to impact financial markets for some time. It is important to remember that when investing in growth assets such as shares, a five-to-ten year timeframe is recommended. Ups and downs, even those as extreme as last week's, are to be expected.

Speak to us if you would like to learn more about market volatility.

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