

**Shane Oliver, Head of Investment Strategy
& Chief Economist**

How vulnerable is the Australian economy and investment markets?

EDITION 25 – 23 AUGUST 2011



Key points

- The risk of recession in the US and Europe is high. Australia is not immune, but is well placed to withstand a renewed global slump. The initial line of defence includes interest rate cuts from the Reserve Bank of Australia (RBA), which we expect to commence possibly as early as October.
- Australian assets are better placed than was the case prior to the Global Financial Crisis (GFC), with cheaper valuations for shares and commercial property. Housing is a bit vulnerable in the short term, but should benefit from lower interest rates from around mid 2012. The Australian dollar (A\$) is vulnerable to global growth concerns in the short term, but is likely to continue trending higher as major global central banks continue to debase their currencies.

Introduction

The combination of European and US debt problems, softer economic data and share market falls are all feeding on themselves, resulting in a significantly increased risk of recession in the US and Europe, particularly in the latter. Signs of rising stress in European interbank lending markets are also adding to fears of a re-run of the GFC. Our assessment is that growth in advanced countries over the year ahead will be a paltry 1% and global growth will be around 3.25%, well below trend and consensus. There is significant downside risk to this, particularly in Europe and the US.

During the GFC, as a result of the impact on confidence, loss of share market wealth, disruptions to lending markets and reduced demand for our exports, Australia wasn't left unscathed. However, thanks to a combination of rapid monetary and fiscal stimulus, a strong financial system, resilient Chinese export demand and a bit of good luck, Australia got by with only a slowdown in growth. It was the only advanced country to avoid recession. But would we be so lucky this time around?

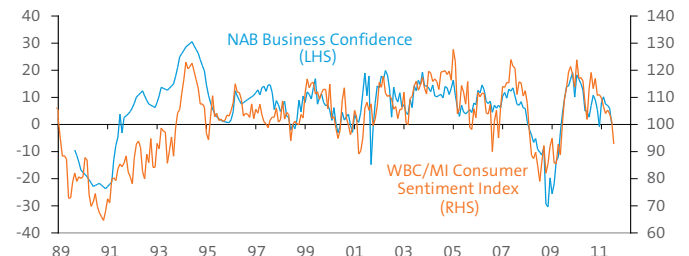
How vulnerable is the Australian economy?

Australia is not immune to any renewed global economic slump. Business and consumer confidence have already been hit hard (see the next chart), the fall in share markets has resulted in a renewed loss of wealth, another global credit crunch will adversely affect lending and exports will be impacted if economic weakness in the US and Europe drags down our key trading partners in Asia.

What's more, the renewed threat to global growth is occurring at a time when household demand in Australia is weak on the back of consumer caution and the global turmoil may only reinforce this. Announced job layoffs are rising – totalling around 9000 so far – and are likely to increase further as companies revise down the demand expectations that underpinned last year's employment surge. By year end unemployment is likely to rise to 5.5%.

Australia's high house prices relative to income levels and associated high level of household debt is an added source of vulnerability should an economic downturn threaten the ability of Australians to service their mortgages.

Australian consumer & business confidence have fallen sharply



Source: AMP Capital Investors

However, notwithstanding these risk points, Australia is reasonably well placed to withstand a possible return to recession in the US and Europe.

- As in 2008, interest rates have a long way to fall if need be. While it may take a month or so for the RBA to change its thinking from rate hikes to rate cuts, we expect the combination of increased global risks and rising unemployment to convince the RBA to start cutting interest rates by year end, possibly as early as October. With 85% of Australian mortgagees on floating rate loans, as we saw in 2009, slashing them has a powerful impact on demand.
- While the scope for fiscal stimulus is less than it was in 2008 as the budget is now in deficit, Australia's trivial level of net public debt (i.e. 8% of GDP compared to 72% in the US) suggests there is room for targeted, timely and temporary fiscal stimulus if needed.
- Gearing and financial leverage is low compared to the situation prior to the GFC. Corporate gearing is well below long-term average levels in contrast to 2007, margin lending is low, and private credit growth is running around its lowest level since the early 1990's recession. In fact, the Australian corporate sector as a whole is cashed up, having gone from a borrowing sector of the economy in 2007 to a net lender now.
- In the event of a sharp fall in commodity prices, the A\$ would likely fall sharply, just as it fell nearly 40% in second half 2008 – providing a huge boost to competitiveness and thus acting as a buffer.
- Banks are less dependent on global markets for funding than in 2007, with 50% of funding coming from deposits compared to less than 40% at the time of the GFC, and are far less dependent on short-term funding. In fact, banks are now starting to cut deposit rates as they are awash with cash at a time when credit growth is weak.
- While households are cautious, they have built up a large savings buffer which they are likely to eat into if unemployment rises and interest rates fall.
- While the mining sector is not immune to lower commodity prices, the huge pipeline of work in mining projects provides a degree of resilience that wasn't there in 2008.
- Finally, our key export markets in Asia are more secure than those in Europe and the US and may prove more resilient this time around. A big factor behind the transmission of the GFC to emerging countries in 2008 was a drying up in trade finance. That is less likely to occur this time. In the meantime, credit growth in emerging countries has been much more constrained this time around, China has become slightly less dependent on exports and public debt levels in Asia are still very low. While inflation worries have seen most Asian countries in monetary tightening cycles lately, inflationary pressures have been showing signs of peaking, providing scope to ease if need be.

As a result of these considerations we believe that – providing the RBA acts swiftly – the risk of a recession in Australia is low, at less than 20%. While non-mining demand in the economy is

likely to take a hit in the short term from reduced business and consumer confidence, the loss of share market wealth and rising unemployment, growth is likely to receive a boost from monetary and potentially fiscal stimulus through next year.

But how are Australian assets placed?

Shares

Our assessment remains that Australian shares are good value for long-term investors (particularly given grossed up dividend yields are over 6%, bond yields are just 4.3% and bank deposit rates are now falling rapidly). Nevertheless, just because shares are good value doesn't mean they have bottomed.¹ However, the starting point for recent weakness is more favourable than it was in 2007:

- When Australian (and global) share markets topped in 2007, it came after a long cyclical bull market which had left forward price to earnings (forward P/E) multiples at 15 times for global shares and 16 times for Australian shares. Earlier this year when shares peaked, the forward P/E was just 12.4 times for global shares and 13 times for Australian shares. So shares have commenced the recent slump at relatively modest valuations, implying more limited downside.
- The level of gearing in the share market is far less than it was four years ago given a sharp decline in margin lending and reduced levels of corporate gearing.

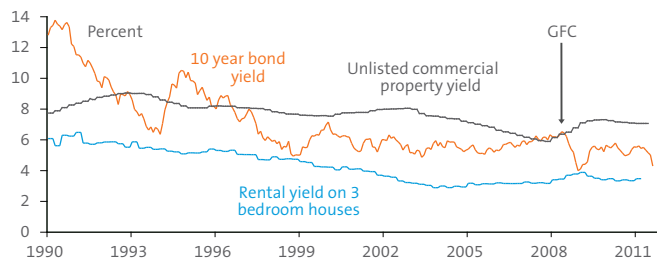
This suggests the downside potential for shares should be less than was the case in the GFC which saw Australian shares fall 55% and global shares fall 56%.

Commercial property

Commercial property values fell around 20% over 2008 and 2009, reflecting forced selling by listed property trusts in an effort to reduce gearing levels and pressure on investment funds to sell direct property as the fall in share markets had pushed property weightings to excessive levels. However, there are several differences this time around.

- Listed property trusts have substantially reduced their level of gearing. So the risk of refinancing problems, and hence forced selling, is low.
- Average commercial property yields are well up from the record lows that prevailed in late 2007. In late 2007, average commercial property yields were around 5.9% compared to bond yields of around 6.3%. Now property yields are around 7.1%, compared to bond yields of just 4.3%. In other words commercial property valuations provide a far more attractive buffer this time around.

Commercial property yields are much higher relative to bond yields than was the case before the GFC



Source: REIA, Bloomberg, AMP Capital Investors

So while commercial property is at risk from slower space demand and rental growth, a sharp 2008-09 style spike in property yields (and associated loss of value) is less likely.

Residential property

Australian residential property has been softening over the last year on the back of poor affordability and buyer caution. Average house prices are off by around 2-3%. Further weakness is likely over the next six to nine months as buyers remain cautious in the face of economic uncertainty, investors stay away given low yields (see the previous chart) and rising unemployment puts upward pressure on the supply of property on the market. However, in the absence of a serious recession it's hard to see prices falling much (maybe another 5% or so) and falling interest rates (and maybe another round of first home owner boosts) will likely start to result in rising prices from around mid next year.

The Australian dollar

The Australian dollar is caught between two conflicting forces. On the one hand, a downturn in the global economy that results in a sharp fall in commodity prices will put more downward pressure on the Australian dollar. This is arguably the key risk in the short term now that the global growth outlook has become much more uncertain. As such, a fall below parity cannot be ruled out, particularly if the RBA cuts interest rates as we expect.

However, against this the US dollar, the euro, the British pound and even the Japanese yen all look to be in a race to the bottom on the back of a combination of long-term debt problems, more quantitative easing and more interest rate cuts (in the case of the European Central Bank). Against this backdrop, investor demand for hedges against ongoing weakness in major currencies will likely remain strong.

Gold is likely to remain a key beneficiary, with US\$2,000 an ounce set to be breached soon and much higher levels likely over time. Emerging market currencies are also likely to be key beneficiaries but they suffer from intervention to limit their gains. This leaves the commodity currencies such as the Australian dollar and the Canadian dollar, which are likely to benefit as long-term commodity demand remains strong, and these don't have the structural problems faced by the US, Europe, Japan and the UK.

While the RBA is likely to start cutting interest rates soon, Australian interest rates are likely to remain well above US levels and over time the impact is likely to be swamped by more quantitative easing in the US which has the effect of increasing the supply of US dollars.

So while the short-term outlook for the A\$ is uncertain, longer term, the outlook is likely to remain up.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital Investors

¹ See "The share market panic", Oliver's Insights, # 24, August 2011.

Contact us

If you would like to know more about how AMP Capital can help you, please visit ampcapital.com.au, or contact one of the following:

Financial Advisers

Your Business Development
Manager or call 1300 139 267

Personal Investors

Your Financial Adviser or call
us on 1800 188 013

Wholesale Investors

AMP Capital's Client Services
Team on 1800 658 404

Important note: While every care has been taken in the preparation of this document, AMP Capital Investors Limited (ABN 59 001 777 591) (AFSL 232497) makes no representation or warranty as to the accuracy or completeness of any statement in it including, without limitation, any forecasts. Past performance is not a reliable indicator of future performance. This document has been prepared for the purpose of providing general information, without taking account of any particular investor's objectives, financial situation or needs. An investor should, before making any investment decisions, consider the appropriateness of the information in this document, and seek professional advice, having regard to the investor's objectives, financial situation and needs. This document is solely for the use of the party to whom it is provided.