

# An improving economy amid investor caution

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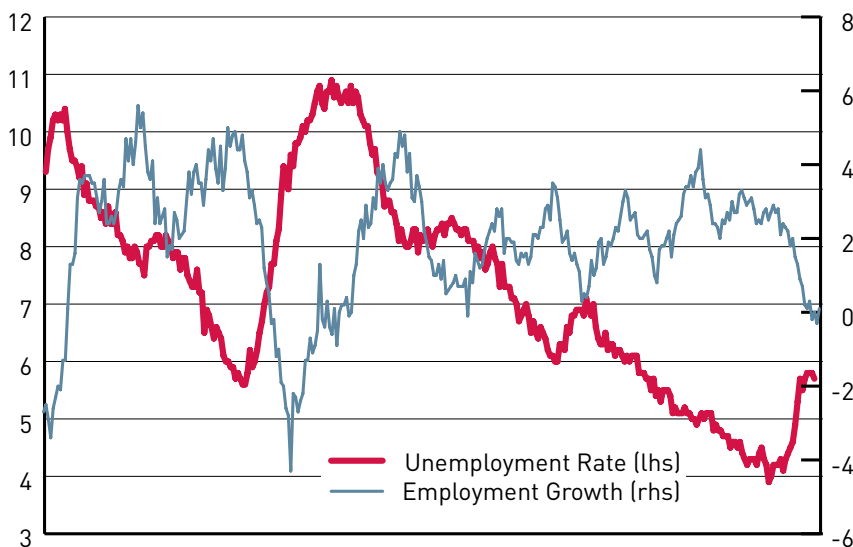
The Australian labour market has shown strong signs of recovery over the past few months, do you expect this to continue?

The Australian labour market showed continuing signs of improvement in September 2009 and the latest data as shown in the chart below, is certainly very strong. Total employment rose by 40.6K in September, well above market expectations of -10K. This is the strongest monthly gain since November 2007, and follows a 26.1K fall in August. Full-time employment rebounded by 35.4K, after a 30.5k fall in the previous month. Part-time employment rose by 5.2K. The unemployment rate unexpectedly fell to 5.7% from 5.8% previously. Also quite encouraging was the news that aggregate hours worked increased by 0.9% during the month, the first rise in several months. If hours worked continues to rise in the next few months, it would be a clear signal that labour demand is picking up, and would be a precursor to more solid growth in employment numbers.

Global equity markets fell in October in spite of an earnings season, which ran ahead of expectations as mixed economic signals unsettled confidence. We speak with Felix Stephen, Manager Research and Strategy at Advance Investment Solutions for his insights.

% AUSTRALIA: THE LABOUR MARKET

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Source: Datastream & Advance Investment Solutions

Leading indicators for the labour market suggest further improvement in conditions in the months ahead. The ANZ Job Ads series has shown a rise for the past two consecutive months and suggests the labour market is entering an early recovery phase. We note however, that job ads are still 44.9% lower than levels a year earlier. Nevertheless, the rises in recent months are promising. Business surveys are also pointing to a pick up in the labour market. The NAB Business Survey showed a solid gain in the employment component from -11 in August to -1 in September. Similarly, the Westpac-ACCI Manufacturing Survey labour market composite index rose 13 points to its highest level since 2008Q3.

## How are labour markets in the rest of the world fairing?

Globally, labour markets are very much a mixed bag. In the US, job creation is now becoming a key objective of the Obama administration, with the unemployment rate at a 26-year high of 9.8% in September 2009. In Japan the unemployment rate fell to 5.3% in September 2009, the second consecutive monthly decline. Whilst promising, one month's data is not reliable and we will need to see further improvements in coming months to become more optimistic on the labour market. Consumer confidence in China continues to rise, with improving labour markets.

The unemployment rate in Europe edged up to 9.7% in August 2009, which is its highest level in over a decade, suggesting a subdued employment outlook. This is also true of the UK labour market with the unemployment rate at 7.9% in July 2009, its highest level in over a decade.

There is very little doubt that steady employment growth is absolutely essential if we are to have any hope of a sustained economic recovery because consumer spending, just like corporate investment, government spending and net exports, is an important piece of the final aggregate demand puzzle.

Although on the face of it the employment data in Australia looks good, I treat it with a lot of caution as I suspect that the real unemployment rate is yet to be captured given that since the global economic turnaround most employees work part time, staggered days or hours. These statistics have not been captured by the data collectors and would indicate that household consumption could remain subdued for time yet.

## The Australian equity market was particularly volatile in October, what happened?

October proved to be a more volatile month for equity markets as investors began to assess the current valuations in light of increasing interest rates and a potentially prolonged period before any earnings recovery emerges. The Australian equity market began the month on positive momentum reaching new 12 month highs before profit taking

saw the market finish lower (S&P/ASX 200 Accumulation Index -2.1%), the first negative return in the last eight months. The S&P/ASX 200 Accumulation Index is now 48% up off of its March lows but remains 32% down from its pre-credit crisis high in November 2007.

Interest rates and currency were a major focus for investors. The RBA added another rate increase of 0.25% in early November, which saw the AUD/USD rise quickly above 90cents and hit a high of 93cents. Reporting season continued with most companies indicating the negative impact that a strong AUD would have on earnings. Economic data was positive justifying the large increase in consensus expectations for 2010 GDP, however, the decline in unemployment figures was the standout, and provided the RBA with the evidence that the low interest rates setting was no longer appropriate.

Investors remain focused on the length and duration of the recovery phase with a focus on earnings will emerge in FY11 and how much is already priced into shares. The outperformance of cyclical stocks has now resulted in the majority of them exhibiting a premium, which requires surprises on the upside to justify any further outperformance. Overall equity market valuations remain attractive particularly with respect to the earnings expected in FY11, however, a prudent investor is now focusing on identifying earnings risk and investigating attractively priced defensive stocks.

## The rally in global equity markets lost steam in October, down for only the second time since the trough in March. Is this slow-down expected to continue?

Patchy economic data left market participants increasingly cautious about the sustainability of the economic recovery and whether it has been outpaced by the strength of the market rally. October was a tale of two halves. Equity markets rose strongly during the first half of the month on a better than expected US reporting season, and then fell back in the latter half of the month on rising risk aversion, finishing the month in the red. Consequently, rising uncertainty and risk aversion

caused market volatility to jump sharply towards month-end with the US VIX Index (volatility index) ending the month above 30, up 19.8%. Not surprisingly, risk trades generally underperformed over the month, with large caps outperforming small caps and growth outperforming value.

However, the inconsistency came with the continued outperformance of emerging markets over the developed world with Argentina, China and Poland being the best performing countries. Notably, Brazil held up well despite the country implementing a 2% tax on speculative inflows aimed to curb currency appreciation. At the regional level European markets particularly those included in the Eurozone fell the most, whereas the Asia Pacific countries fared best.

Sector relative performance was mixed although it reflected the risk aversion swing with consumer staples and energy the best performing sectors, while utilities, financials and industrials were the sectors with the largest declines.

From a short to medium term standpoint, we favour growth assets because defensive assets now offer a very poor risk/return trade-off. Assets such as commodities offer good protection against political risk and unexpected inflation risk. They hedge against macroeconomic risk while also being a great portfolio risk/return diversifier. With corporate credit yields on offer now being more attractive relative to yields that prevailed prior to the financial market meltdown and corporate default risk gradually abating, investors have an opportunity to accumulate risky assets that have a sound risk/return trade off via global debt markets.



















We suspect that equity market returns will be modest once the earnings growth expansion is over because of headwinds that will keep global growth below trend and equity earnings at historical averages.

To clarify, economic headwinds and tailwinds are;

Economic headwinds – What prevents global growth from accelerating higher? These factors include: high unemployment which directly impacts consumer spending, investor risk aversion, negative consumer and corporate confidence, sharp liquidation of business inventories leading to a sharp fall in industrial production & resource utilisation and dysfunctional credit markets.

Economic tailwinds – What helps the global economy to gain traction and then move ahead? These factors include: industrial production increases following sharp liquidation activity, a global reduction in official interest rates & and coordinated fiscal policy and global shipping costs begin to rise as industrial production increases.

**FINANCIAL ASSET MARKET OUTLOOK (TOTAL RETURNS)**

Asset Class	Ultra Short Term (1-6mths)	Short Term (6-12mths)	Medium Term (1 yr – 3yrs)
Equities			
Government Bonds			
Credit			
Currency A\$			
Commodities			
Listed Property			

Source: Advance Investment Solutions November 2009.

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