

Economic Commentary

Inflation took centre stage during the month with the Consumer Price Index (CPI) rising 3.0% in the 12 months to 31st December 2007. Job growth continued, retail spending rose 8.1% in the 12 months to November and the unemployment rate fell back to 4.3%.

The Reserve Bank of Australia (RBA) adjusts the CPI by trimming off the items that saw the largest falls and the largest rises. This 'trimmed mean' gives the RBA a better feel for the general trend in inflation. This measure came in at 3.4% for the year and led to conjecture that the RBA may need to lift official interest rates.

Within the CPI, transport prices rose 5.6% over the year; health was up 4.1% as were education costs. Food prices rose 1.2%, communications prices were up 0.4% but the prices of household contents and services fell 1.0%.

The Australian dollar (AUD) rose 2.2% against the US dollar (USD) during January as US interest rates fell. It started the month at US 87.67 cents and ended it at US 89.61 cents. A year ago the AUD stood at US 77.38 cents. The AUD bought 0.4506 UK pounds at the end of January and 1.137 NZ dollars.

Australian shares

January 2008 will not be forgotten quickly. It saw the largest monthly fall in share prices since 1987. The S&P/ASX All Ordinaries index fell 11.3%. This compares with a 42.4% crash of October 1987 and a 10.9% fall in October 1997.

A litany of names and issues were associated with the decline. These include US recessionary fears, margin calls, sub-prime losses, emergency US rate cuts, Société General, hedge funds, Tricom and monolines (see below).

In brief, markets had been pushed up, in part, by borrowed money. When US recession loomed and risk appetites fell, the sharemarket declined at the same time as borrowing rates rose (the credit crunch). This triggered further selling via margin calls; hedge funds protecting their capital and other nervous investors worried about the impact of a US recession on profits.

The month saw 12 consecutive days of selling; culminating on 22nd January, when the All Ordinaries index fell 7.3%. To the relief of all, the market then picked up, rising 7.3% over the next three days as the US cut its official interest rates prior to its scheduled meeting time. It cut rates further at the scheduled meeting at the end of the month. The US Fed Funds rate now stands at 3.0%.

While the root economic cause of the weakness lay offshore, the debt position of many Australian investors contributed to the volatility. Press reports commented upon the number of margin calls that were made, the sheer volume of selling and the issues faced by margin lending specialist, Tricom.

After all the volatility, the final outcomes for the month were as follows. The S&P/ASX 300 Accumulation index fell 11.0% to be up 1.5% over twelve months. The resources sector was down 8.5% for the month while the traditional 'industrials' sector fell 11.9%.

In other sector breakdowns, the 'better' performing sectors included healthcare (-6.3%), materials (-7.1%) and telecommunications (-8.8%). The weaker sectors included listed property trusts (-14.3%), financials excluding property (-12.7%) and energy (-12.5%).

The property and other financials sectors were affected by concerns over debt and by the losses made by overseas investment banks. The energy sector fell on weaker oil prices.

Among the nation's top 20 companies, QBE Insurance fell 16.6% during the month. Commonwealth Bank was down 16.4% while AMP fell 15.6%. There were no positive outcomes within the top 20. The best were ANZ Banking Group which fell 5.3%, CSL (-6.1%) and Brambles (-7.5%).

Despite the turmoil of the past few months, there is hope. The Australian profit reporting season will move into full swing during February. With a strong economy, it is expected that earnings will rise, in some cases very strongly. Outlook statements will be guarded but positive. Mention will be made of higher debt costs, rising raw material costs and the 'uncertain environment' but the economy is still growing.

Of greater risk are events offshore. The sub-prime problem and its many offshoots have yet to fully unfold. Offshore banks seem likely to make more losses; some investors will see their wealth decline and the problem of high borrowing costs could spark corporate defaults. None of this is good news.

The good news is that the Australian economy is growing, demand for resources is strong, our banking system is sound and overall company earnings continue to expand.

Global shares

Major global sharemarkets took a pounding during January. All major markets were down. The MSCI World index, a broad measure of global shares, fell 7.7% in USD and was down 9.7% when measured in AUD. Over 12 months global shares were down 2.3% in USD terms but fell 15.6% in AUD terms.

While the United States was the epicenter of bad news, its sharemarkets fared better than most. The Dow fell 4.6% in January, the S&P500 was down 6.1%, and the NASDAQ fell 9.9%.

The losses of US investment banks weighed heavily on US markets as did uncertainty about the financial health of monolines. Monolines or 'wrappers' insure bonds in the hands of investors. By 'wrapping' a bond in insurance, the bond is given a better credit rating – unless the credit rating of the insurer or monoline falls.

In the US, Ambac Financial Group and MBIA, two very large bond insurers reported losses and the market was concerned that their credit ratings may slip. Had that happened, many investors would have been forced to sell their corporate bonds (since they are only allowed to hold bonds with very good credit ratings). This would have added to existing turmoil in the market. So far so good, but the 'fat lady' is yet to sing on this issue.

In Europe, the mainland losses were all in double digits. The German market was down 15.1%, France fell 13.3%, Italy was down 11.3% and the Spanish market fell 12.9%. European banks have yet to report their profits and events at Société General, where a loss, allegedly due to fraud, unsettled markets as did the unfolding US slowdown. The UK's FTSE 100 index fell 8.9% to be down 5.2% over 12 months.

In Asia, forecasts for economic growth in 2008 have been trimmed back. Japan's Nikkei index fell 11.2% in January to be down 21.8% over 12 months. Elsewhere in Asia, China's Shanghai B market fell 17.3%, Hong Kong fell 15.7% and the market in Singapore fell 4.0%.

The MSCI Emerging Markets index returned negative 14.5% in January but remains up 4.5% in AUD terms over 12 months.

As noted last month, the global economy is still growing at a solid pace but growth in 2008 is expected to moderate due to the US slowdown. The latest forecasts from the International Monetary Fund (IMF) indicate that global growth in 2008 is expected to be 4.1% - a figure above its average growth rate for the past 25 years. Growth, together with modest price to earnings ratios in the US suggests markets should find some support in 2008.

Fixed interest

The Reserve Bank of Australia (RBA) left its official cash rate at 6.75% in January but the inflation figures for the December quarter led many to speculate that the official cash rate would be lifted in early February.

In the tug-of-war over inflation, the RBA has to weigh the strength of the domestic economy against the potential problems flowing from a weakening (but still firm) global economy.

Ninety day bank bills began the month at 7.24%, fell to 7.10% in mid month before finishing January at 7.35%. Yields rose after new figures showed inflation continuing to move up. The UBSA Bank Bill index returned 0.60% in January and 6.78% over 12 months.

Credit markets remain unsettled. Companies with credit ratings in the range BBB- to BBB+ saw average yields on their corporate bonds rise from 7.24% at the end of June 2007 to 9.15% by the end of January 2008.

Ten year government bond yields fell to 5.87% in the early part of the month as funds flowed from equities to bonds. They ended the month at 6.09%, a touch lower than at the end of December. The UBSA Composite Bond index returned 1.22% in January for a return of 4.24% over the past 12 months.

Listed property

The listed property sector took a beating in December and was pushed still lower during January. The market is still coming to terms with the level and structure of debt within the sector. The S&P/ASX 200 Listed Property Accumulation index fell 13.9% in the month.

Apart from Centro Retail Trust (-51.1%) and Centro Properties Group (-34.7%) other trusts to see sharp declines in January included ING Office Fund (-21.3%), DB REEF Trust (-20.8%) and Tishman Speyer Office Fund (-19.4%).

At the end of January, the estimated distribution yield on the listed property sector was 6.7%, compared with the 6.1% yield on a 10 year government bond. Without doubt, the fall in prices has produced more attractive yields in the sector.

Global property markets were also weak in January. The S&P/Citigroup World Property index fell 4.4%. Debt and US recession fears have not helped its cause.