

Economics Report

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Caton's Corner February 2010

The End of the Beginning?

Global share markets are in the midst of their first major "correction" for almost a year. In January, the US share market fell by 3.7%, while the ASX200 gave up 6.1%. The Australian market thus had its worst month since November 2008, and it hasn't ended the month at a lower level since last August. Is the extraordinary run since early-March 2009 over? My humble assessment would be "no". In Churchillian terms, this looks more like the end of the beginning than the beginning of the end.

Markets suddenly have a lot to worry about. In quick succession in recent days, investors have fretted over the *possibility* of a slowdown in China, the fact that the sheen has come off the Obama administration, a new proposal for regulating the US financial sector and a possible debt default by Greece, to name just a few concerns. But none of these calls into serious question the longevity and strength of the global economic recovery, which is the most important force driving markets at the moment. It is worth pointing out (and more than once) that most of the economic surprises have been on the strong side in recent months.

Bull markets always experience periods of "backing and filling", during which the market consolidates for a while before regaining upward momentum. There is no evidence—and little likelihood—that the current episode is anything more than such a period.

That said, the best part of the market recovery is behind us. The ASX200 is still more than 45% higher than its early-March 2009 low; it is very unlikely to repeat that performance in the next 11 months! Most of the market's gain to date has been because of "re-rating", which you can think of as the removal of pessimism. From here on, market gains will come about as company earnings grow in the improving economy. My end-2010 forecast for the ASX200 remains 5000, less than 10% higher than the market is now.

The Australian economy continues to impress. In the two months since I last wrote, the most spectacular manifestation of this has been in the labour market. Australia has added 130,000 jobs in just the past four months, and the unemployment rate (now 5.5%) peaked at 5.8%. To appreciate how good a performance this is, note that the Government's Budget-time forecast, made 9 months ago, envisaged a peak unemployment rate above 8.5%.

The Outlook for Interest Rates

Every silver lining has a cloud, of course. The fact that the Australian economy is doing so well means that the focus of monetary policy has shifted quickly from limiting the damage caused by the GFC to managing the economic recovery. The Australian economy is doing well enough that it no longer needs "emergency" interest rate settings. Look forward to a steady drumbeat of rising rates for most of 2010.

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I mentioned briefly above the US proposals for regulation of its financial sector. Something different clearly has to be done; the GFC showed that the old model simply wasn't working. The world still has to address the issue of the **correct degree of regulation of the financial sector** in the post-GFC environment. Clearly, there will be more regulation than there used to be. Despite the fact that Australia did so well in relative terms, we will not (and should not) be immune from the worldwide trend to greater financial regulation. Even if this goes no further than more stringent capital requirements for financial institutions, one thing is clear: the cost of providing financial services will be driven up. Put simply, lending rates are likely to rise relative to deposit rates.

Drawing the Long Bow

Since this is the first *Caton's Corner* of 2010, permit me to engage in some longer-term rumination. After all, it is part of human nature to draw artificial lines in the sands of time. 25 years ago, at least to science-fiction fans, 2010 was going to be "the year we make contact". That now seems unlikely to happen, although there was that unidentified object that flew past the Earth in January. Now, 2010 is widely thought of as the start of a new decade. Most observers are not unhappy to see the end of the previous one. The "noughts" started out with great promise (of growing wealth for all etc) and generally disappointed. Will the "teens", or the "tens", be any better?

In December, I mentioned a recent speech by Ken Henry, the Treasury Secretary, which looked at some of the longer-term forces affecting the Australian economy. The most important of those in the decade just begun is likely to be the China/India story. While it is easy to become blasé about China, its performance has been amazing. In 2000, the Chinese economy was less than a third the size of the Japanese economy. It is now bigger than Japan. Within 10 years, China and India combined will be bigger than the US economy, and the other two "BRIC" nations (Russia and Brazil) will be moving up the ranking tables. In 2009, China surpassed Japan as our biggest export market. Japan held No 1 position for 43 years. China may well be our biggest export market for the next 43! China's presence hugely softened the blow of the GFC on Australia. In the long run, the continued dominance of world economic growth by the developing world means that the resource sector will loom ever larger in the Australian economy. This will require a long-term transfer of resources from other sectors of the economy, notable manufacturing and (other) construction. Capital spending will rise as a share of the overall GDP, and some of this will be financed from abroad. In particular, China is likely to continue to want to invest in the resource sector, and this should not be discouraged.

While increasing reliance on China in particular, and the developing world in general, is a great story for Australia, it does increasingly expose our economy to a source of potential volatility. China's story still has decades to run, but growth will not be smooth. As we were reminded in 2009, commodity prices do sometimes go down. Booms have a nasty habit of being followed by busts. Nevertheless, it is no accident that consensus forecasts for the Australian economy for the next decade are higher than for any other developed country.

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