



THE LULL AFTER THE STORM

Many were surprised the Australian share market had a quiet 2010, finishing the year just below where it started, especially when considering the local economy came through the crisis of 2008–09 better than most.

But a sound economy does not guarantee a lift in share prices. Despite the powerhouse Chinese economy, there was a 14.31 per cent fall on the Shanghai Composite index during 2010. In stark contrast, the US and UK economies may still be struggling but their share markets jumped 11.02 per cent and 9 per cent respectively.

Table 1: Comparative Share Market Performance for 2010

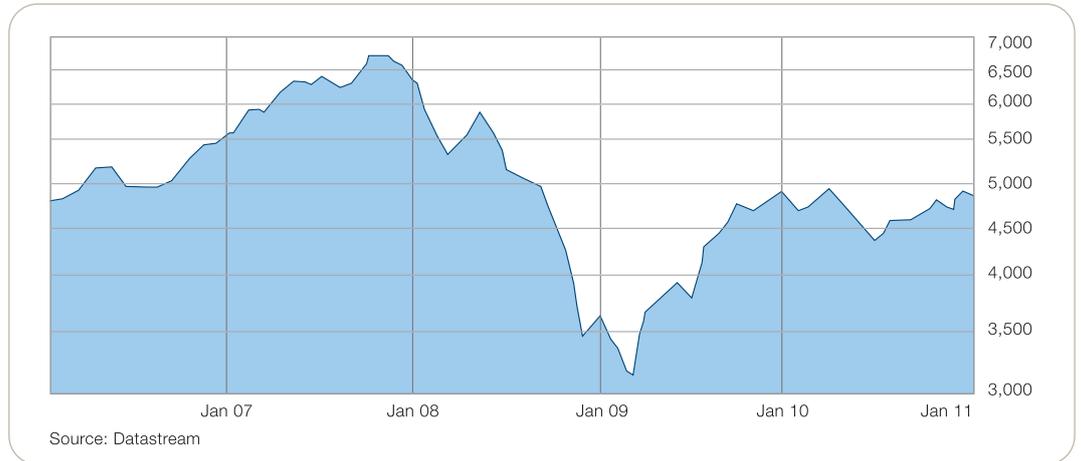
Country (Index)	Actual (31 Dec 10)	Change (%)
Australia (S&P/ASX200)	4,754	-2.56
US (Dow Jones)	11,578	+11.02
Japan (Nikkei)	10,266	+3.01
UK (FTSE)	5,886	+9.00
China (Shanghai Composite)	2,851	-14.31

Source: tradingeconomics.com

A key reason for this pattern is that share markets tend to reflect future earnings rather than past and both the US and UK economies have plenty of room for recovery. The strong Aussie dollar and interest rates mean the local market loses some appeal, especially to the significant number of global investors. A 6 per cent return on fixed interest is less risky and more attractive than a share market going sideways for 12 months, although this conclusion is only valid with hindsight.



Graph 1: S&P/ASX200 – 5 Years

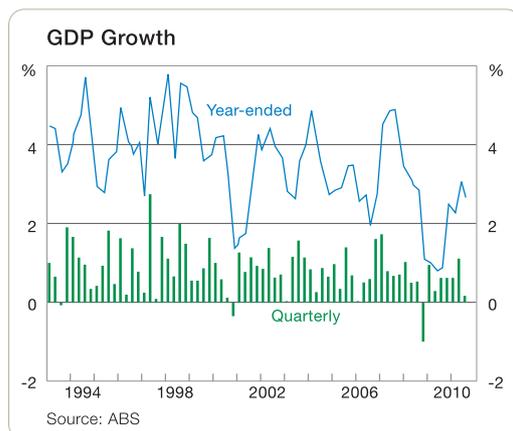


It is worth remembering our market has recovered a long way from 6 March 2009 when the S&P/ASX200 bottomed at 3,145 to its 31 Dec 2010 close of 4,754. There is a further journey to get back to the market levels of late 2007 when the index reached 6,800. While no one expects this level any time soon, the outlook for 2011 may be rosier with many analysts tipping double-digit growth, pushing the S&P/ASX200 up to somewhere between 5,000 and 5,500.

Economic Health Report

These predictions are based on the health of key indicators which show Australia's economy was in reasonably good shape at year's end: low unemployment (5 per cent), low inflation (2.8 per cent), and GDP growth of 2.7 per cent in line with expectations of flat annualised growth. But there were signs the economy was slowing when GDP rose only 0.2 per cent in the September quarter.

Graph 2: Growth in Australian GDP



Australia's GDP growth can be compared with GDP growth of 2.6 per cent and 1.7 per cent respectively for the US and UK as they emerge from the economic doldrums. In contrast, China continues to perform strongly with GDP growth at 9.6 per cent, followed by India with 8.9 per cent growth. Both countries are major trading partners with Australia.

Rising interest rates may have been the key reason for a slowdown in the Australian economy in the last quarter of the year. Housing, for instance, came under pressure towards the end of the year as the interest rate hikes by the RBA and banks started to bite. The number of home loans in November showed an 8.8 per cent decrease year-on-year.

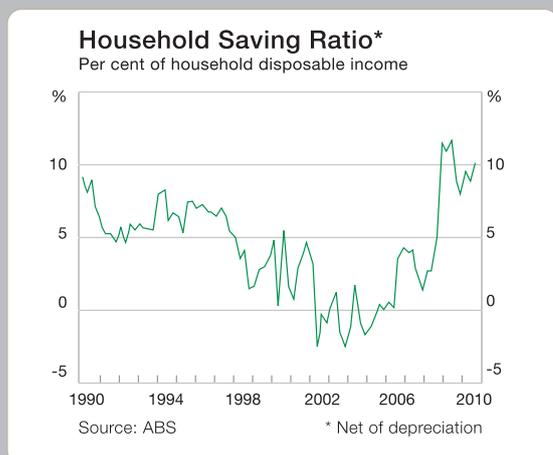
Debate about Australia's two-speed economy was a feature of economic commentary during the year as the resources sector continued to flourish while other currency-sensitive industries such as tourism, retail and education struggled.

Demand from both China and India for Australian resources underpinned much of the strength in the economy. Strong commodity prices also helped: gold, for instance, rose 29.44 per cent to \$US1,420 and copper 31.4 per cent to over \$US91.

Another important trend in 2010 was the growth in household savings. The GFC, increases in domestic interest rates, and attractive deposit terms from local banks put downward pressure on spending levels. In the 2010 September quarter, savings rose to 10.2 per cent of disposable income from 8.9 per cent in the previous quarter.

While this may not be good news for retailers hungry for the consumer dollar, it can be positive for other parts of the economy. The latest retail sales figures show only a 0.3 per cent rise in November sales after a 0.8 per cent drop in October. While the December figures are not out yet, the consensus is that pre-Christmas trading was subdued.

Graph 3: Household Savings Ratio*, Australia (1990–2010)



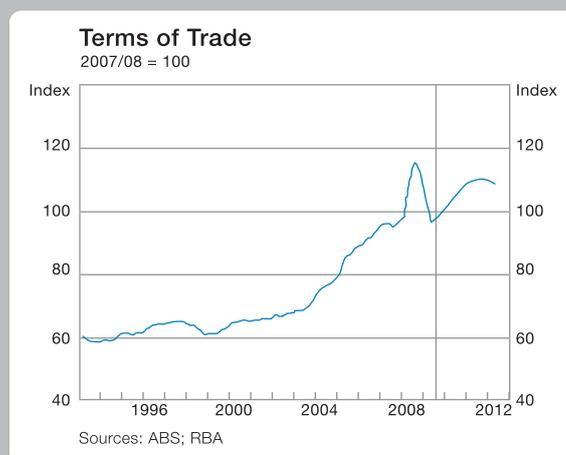
What's in store for 2011

Locally, the Reserve Bank expects the Australian economy to grow by just over 3.5 per cent in the current calendar year and the OECD is predicting a similar growth rate of 3.6 per cent.

Globally, the World Bank recently warned there could be some trying times in light of slowing growth, the Euro zone debt crisis, and rising commodity prices.

A lift in the price of gold and copper, along with bulk commodities such as iron ore and hard coking coal, all favour commodity-exporting countries like Australia. This has led to the terms of trade - the relative price we receive for exports compared to the price we pay for imports - remaining strong for Australia. So strong, in fact, the RBA has pointed to the potential for 'upside risk' and the need for policy settings to manage the strong economy.

Graph 4: Australia's Terms of Trade (with projections to 2012)



While our trade surplus narrowed in November on the back of the strong Australian dollar, the surpluses with both China and India still stand at high levels.

However, there is likely to be a short-term negative impact from the recent Queensland floods with early estimates cutting up to 1 per cent from national GDP. Further impact from floods in other states is expected. While prices for fruit and vegetables are likely to rise in the short term, the necessary reconstruction work should help bolster economic activity by the second half of the year. Given Queensland is a key player in the resources boom, the full extent to which coal exports have been compromised is still somewhat unknown.



Interest rates on centre stage

Interest rates remain central to the outlook for the year. Before the floods, most economists expected a rate increase by April or May with a year-end prediction of around 5.5 per cent. The recent floods have caused a reassessment, and interest rate increases may be set back until the second half of the year or even 2012.

Table 2: Comparative Official Interest Rates, December 2010

Country	Official interest rate (%)
Australia	4.75
China	5.56
Germany	1.00
UK	0.50
US	0.25
Japan	0.00

Source: tradingeconomics.com

As Table 2 shows, the stronger economies of China and Australia have much higher official interest rates than major trading partners whose economies are struggling. In both cases, central banks want to keep a lid on interest rates in 2011.

In Australia, the higher savings levels are a positive (Graph 3). RBA Governor Stevens has said increased savings could help stop inflationary pressures building. As long as inflation stays in the 2–3 per cent range, this should help keep the lid on interest rates. In the months ahead, governments and the RBA will no doubt continue to be tested by the resources boom, and by wage

and price pressures linked to flood damage and reconstruction activity.

Despite the fall in unemployment levels to 5 per cent at the end of 2010, some economists say the figure reflects more the drop in numbers of people looking for employment rather than increasing demand for labour. Certainly the recently released December job advertisement figures point to a slowdown in demand. While adverts dropped 2.3 per cent in December, year on year they were up 22 per cent.

Most currency watchers believe the Aussie dollar will continue to gain strength through the year with some forecasts of \$US1.05 and even \$US1.10. But others say parity won't be sustained and the dollar may end the year in the low US90c range. On the flip side, a weaker dollar would be good news for those in industries feeling the pain of a booming currency.

While we may have a two-speed economy, the strength of the resources sector should still flow through to the rest of the economy over the course of the year as demand for services filters down. So while there are some clouds on the horizon, generally the economy should deliver a reasonable performance in 2011.