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Market Update

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Throughout the first quarter of 2012, investors put European debt concerns on the backburner as the US recovery picked up momentum, resulting in impressive returns for equity markets. Whilst it is clear that challenges remain for the global economy, perhaps there is finally some light at the end of the tunnel.

What is happening in the U.S?

It was only late last year that grave fears were held by many that the world's largest economy may be slipping into a dreaded double dip recession. Fast forward six months and a string of positive economic and corporate earnings surprises later and this fear seems to be a distant memory. Whilst the US is far from booming, the recovery seems to be ticking along at an acceptable pace, albeit with a little help from the Federal Reserve (The US version of the RBA).

Along the road to recovery hiccups are inevitable, and the lacklustre March US jobs report would appear to fall into this category. With consumer spending accounting for around 70% of the US economy, it is imperative for the recovery that consumers have confidence in the security of their jobs and comfort in their ability to find a new one if need be. With this in mind, it is worthwhile paying close attention to upcoming labour market releases to determine whether this weakness was an anomaly, or the beginning of a broader weakening.

What is happening in Europe?

While immediate concerns about the European debt crises have subsided, the structural issues at the heart of the problem remain. The Long-Term Refinancing Operation (LTRO) from the European Central Bank has alleviated much of the short-term pressure by pumping more than €1 trillion of liquidity into the financial system. This should buy the banks enough time to sufficiently rebuild their balance sheets and remove much of the contagion fear associated with a potential sovereign default. Whilst the structural issues will not be solved over night, attractive equity valuations suggest these risks have been mostly priced in. Developments in the Spanish bond market should be closely watched as they appear the most likely candidate to come under pressure next.

What is happening in China?

After a successful effort from the Chinese authorities to tackle inflationary pressures throughout 2011, the stage is set for policy settings that may prove more accommodative of growth moving forward. Whilst China is certainly capable of growth, this must be finely balanced with the need to make genuine improvements to the quality of life of its citizens.

The Chinese Government is clearly entering a phase where they are placing more emphasis on the quality of growth rather than simply focussing on growing the headline GDP number. The outcome of such focus should hopefully be a smoother growth cycle; a clear positive for the long-term sustainability of Chinese growth, and Australia's place within that story.

What does all this mean for Australia?

Domestically, we continue to grapple with a two-speed economy. The emerging market demand for our natural resources is providing some strong economic data points, whilst the non-resource areas of the economy are burdened by sluggish demand and a general lack of confidence.

The high Australian dollar has had a major impact on many sectors of the Australian economy. Tourism has suffered as it becomes more expensive for international travellers to visit, whilst our exporters have lost competitiveness as their goods become more expensive in international markets. Whilst cheaper imports are clearly a positive for the consumer, this has eroded margins for many domestic retailers who are forced to lower prices in order to compete. Any meaningful pullback in the Australian dollar relative to our major trading partners would be a clear positive for the prospects of the Australian economy.

What will happen to interest rates?

The RBA uses interest rates as a tool to influence inflation rates and broader economic activity in Australia. Changes in the official RBA rate tend to be mirrored in variable mortgage rates charged by the banks to their customers. By lowering the official rate, the RBA can effectively leave more money in consumers' pockets for discretionary spending, which stimulates economic activity.

Whilst the RBA has left rates on hold for the past three monthly meetings, they have made their intentions clear that should inflation figures remain subdued and demand conditions remain weak they would not hesitate in cutting rates. Markets are now pricing in the prospect of numerous cuts to the official rates over the next 12 months.

Due to cost pressures in international funding markets, Australian banks are facing increased costs. As we have seen in recent times, the banks may decide to only pass on a portion, or not pass on rate cuts at all in an attempt to maintain their margins. This limits the RBA's ability to directly stimulate consumer spending.