



Overcoming the wall of worry

2009 was a remarkably good year for investment markets, but many investors missed the opportunities. In this Point of View, AXA's Chief Investment Officer Mark Dutton explores the 'wall of worry' that investors currently face and the associated investment opportunities.

Entering the scepticism phase

Legendary investor Sir John Templeton once said that bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria.

As we have seen so often in the past the turnaround in global sharemarkets commenced early in 2009 at a time of extreme pessimism and fear.

Investors were facing a shortage of liquidity, heightened volatility, falling markets and the onset of global recession.

For many, the 'wall of worry' was just too high and they choose to exit the market, or suspend investing in line with their strategy.

As discussed in the December 2009 Point of View, markets typically move early. The forward looking aspect of investment markets meant that 2009 ended up being a very good year for most investment returns.

Global sharemarkets in their local currencies increased by 26 per cent, the Australian sharemarket by 37 per cent, global bond markets by 8 per cent and Australian property trusts by 10 per cent.

We are now transitioning from a period of pessimism to a phase marked by scepticism. While each phase creates investment opportunities, the 'wall of worry' still seems unbearably high for many investors.

Growth concerns

Markets are currently fluctuating on concerns that the economic recovery might falter.

Without doubt, we are experiencing a strong economic turnaround. Even the most conservative forecasts suggest that 2010 will see positive growth in all major developed economies.

A reversal from negative 2.2 per cent global growth in 2009 to 3.5 per cent in 2010 is a massive shift in momentum, even if the total rate of growth is fairly modest. This shift is enough to drive significant earnings reversals and help markets rise further.

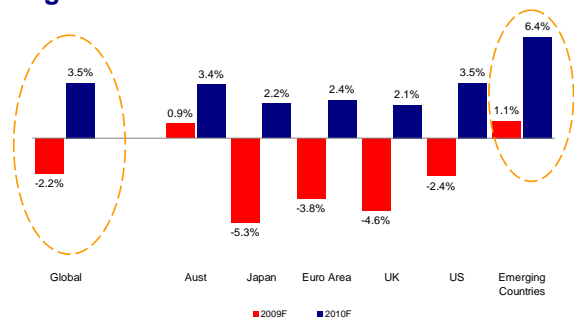
Underpinning this turnaround are massive global stimulus measures, which have begun to positively impact global trade and manufacturing activity. Global production levels are up 8 per cent for the past 3 months and US manufacturing increased by around 20 per cent over the past quarter.

It's unlikely that economic growth will falter in the near term. So far the US has only deployed one third of its total spending stimulus spending and China has only implemented half of its planned stimulus spending – there is still more in the pipeline.

The biggest contributors to global economic growth are emerging markets economies. These countries experienced the least number of banking crises, carry the lowest portion of debt and are undergoing the largest shifts in demographics.

The rise of the emerging market middle class is taking some pressure off the US consumer, which in recent years has accounted for 70 per cent of US GDP.

Figure 1: 2010 GDP forecasts



Source: AllianceBernstein. Forecasts may not be achieved. Data as of 20 January 2010



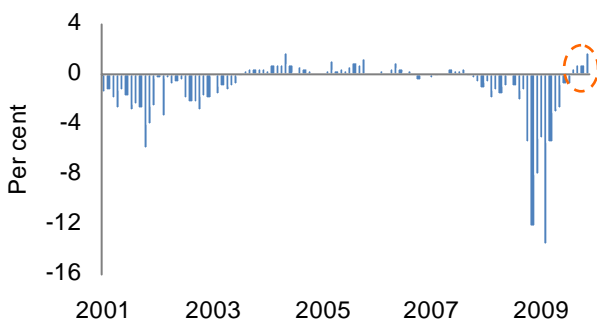
Earnings concerns

Some investors are nervous about the possibility that the upcoming earnings reporting season will disappoint.

Based on 2009 earnings, global equities are now reasonably valued – around 18 times current earnings as of year end. On other measurements, such as price to book and price to sales global equities are still cheap.

The consensus now expects earnings growth of around 30 per cent in 2010, but there is a lot of disagreement about which companies will be the winners and losers.

Figure 2: Global earning revisions turning positive



Source: AllianceBernstein and MSCI. Based on aggregate estimates and represents change from previous month in estimates for next 12 months

In contrast, Australia's forecasts are more moderate. The consensus expects earnings growth of around 11 per cent in 2010. Analysts have more recently started revising their forecasts down.

The wide level of dispersion (disagreement among analysts as to which stocks will perform) means that research will play an important role in identifying stocks that out perform.

Sovereign sector debt concerns

Investors are becoming increasingly concerned about rising public debt levels, particularly in Europe, where worries over the ability of Greece, Portugal and Spain to meet debt obligations precipitated a move from stocks to the perceived safe haven of the US dollar.

Sovereign credit ratings aren't set in stone, and markets are likely to remain jittery until confidence is restored.

Investors are also uneasy that the eventual repayment of public debt will lead to lower levels of future economic growth.

Leading global investment management firm PIMCO calls this 'the new normal.'

These concerns are valid. Developed market public debt as a percentage of GDP is forecast to reach a high of 118 per cent by 2014.

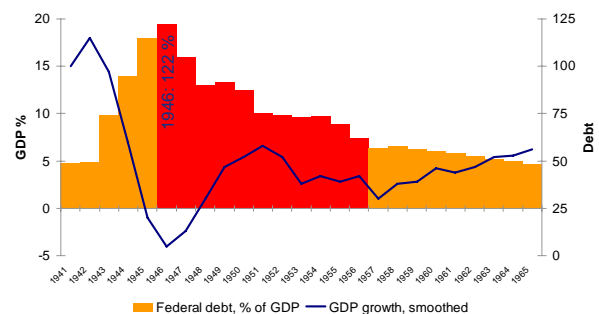
However, it's worth reminding ourselves that we have been here before.

History shows that unusually large public debt levels can be progressively wound down without adversely impacting economic growth.

For example, Post WWII US public debt soared as high as 122 per cent of GDP as shown by figure 3.

Although it took an entire decade to scale this debt down to around 50 per cent of GDP, economic growth averaged 3.6 per cent and inflation averaged 3.3 per cent over this period.

Figure 3: US Post WWII debt



Source: AXA, BEA, OMB, AXA IM Research.

What this means for investors?

Opportunities are shifting. The changing composition of economic growth and underlying debt levels will impact investment opportunities.



As the gap in economic growth between Australia and other overseas nations narrows, rising overseas interest rates and the reversal of other policy measures means tailwinds for the \$A are likely to become headwinds.

This is good news for Australian investors in unhedged global shares. In 2008, the falling \$A cushioned losses during the worst of the GFC, but the sharp correction of the \$A detracted from gains in 2009.

The global financial system is still under repair itself. The deteriorating budget position of Greece, Portugal and Spain has caused panic in the markets, even though the EU union can 'afford' to assist Greece. At this point, it is unlikely that we will experience major country contagion.

Fixed income markets are experiencing a large issuance of government bonds and are characterised by low but rising short term rates and relatively high long rates.

The risk is that yields will rise further. Portfolios will require careful management to capitalise on relatively high risk premiums on non-government credit securities.

Scepticism in markets means uncertainty, anxiety and controversy. This environment creates above average investment opportunities. To participate investors need to overcome the wall of worry and continue with long-term investment strategies.

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