



INVESTMENT MARKET UPDATE: State of Play; 4 January 2012

comments by Bob Miller

Welcome to 2012! Investors have sound grounds for believing this year will be better than 2011. The only obstacle looks to be **extreme** stupidity by Europe's decision makers.

Volatility (which relates to price swings of an investment) is likely to prevail in 2012. But it does not mean that the investment itself is at risk.

Risk refers to the **likelihood that an investment will lose some or all of its value**. Poor market sentiment can cause even the very best investments to lose value for a while. It is inconceivable, however, that shares associated with businesses consistently turning out **good cash flows and profits** will lose significant value for a long period.

In the 8 months from mid-2008 to 22 February 2009, the ASX 200 fell by some 33 per cent. But by the end of 2009, it was only 3 per cent below the level of mid-2008. Sadly, **some investors mistook extreme market volatility for extreme investment risk** and bailed out near the bottom of the market..... thereby crystallising their losses.

Financial markets are awash with the views of those apparently convinced that the world as we know it is pretty well shot. They are often well written by people who understand the principles of economics and investment.

Clearly such people have a financial motive in producing **scary newsletters** (which presumably work on the basis that bad news sells better than good news).

But there is also **money to be made when bad news grips investors**. As previously explained, **bond funds make money when interest rates fall**. Why wouldn't large bond fund managers talk of doom and gloom and hope that the resultant cut back in economic activity spurs governments/central banks to drop interest rates in response. It is simply **talking their book**.

And then there are the **short sellers**: those who borrow shares and sell them in the expectation they will subsequently fall in price. Shortly afterwards short sellers are obliged to buy back these shares (to replace those borrowed). If the buy-back price is lower than the sale price, the short sellers make a profit. Make no mistake, **a lot of short selling goes on**. Not many ordinary investors like it, but stockbrokers make money on it and this practice is unlikely to cease soon.

The reason for this somewhat lengthy discussion on market volatility is to emphasise that **quite often markets don't fall in line with the underlying economic fundamentals**.

I believe we are in such a time. In short, the world economic fundamentals are not nearly as bad as market prices suggest. Sooner or later market prices should more closely reflect economic fundamentals.

Let's look at those fundamentals, beginning with the most important, the US.

US industrial production continues its upwards movement. Last month's factory index expanded at its fastest pace in six months. Furthermore, **construction spending** grew at more than twice the forecast rate. After a flat start in 2011, **US retail sales have grown strongly**.

One significant economic flower yet to bloom is housing. In the US, as in Australia, **consumer confidence is closely linked to the value of houses**. It appears that in some cities, such as Atlanta and New York, prices may fall another 6-8 per cent. But in **Miami and Detroit** (two of the cities hardest hit by the subprime crisis), **prices are tipped to rise by 3 per cent in 2012**.

In the meantime, official statistics show a 9.3 per cent increase in building starts to 685,000 annually. While the pre-subprime crisis figure was some 2 million building starts, such levels were fuelled by cheap credit and lax lending standards. All in all the critical housing sector is in better shape than at the start of 2011.

Today's climb in the **Australian dollar reflects strong manufacturing data from the US and China**. Much to the chagrin of some bond fund managers, data released by China last weekend reported **an expansion in manufacturing activity in December**, after a contraction in November.

Finally, an appraisal of the **Eurozone crisis**, the thing that has the potential to unravel the orderly economic progress in the rest of the world. Let's start with Angela Merkel's claim that "2012 will be full of danger and risk". Surprising? Hardly. What else would the German Chancellor say if she wished to impose a **strict regime of belt tightening on the economically irresponsible countries of the Eurozone**.

Investors will be pleased to know that the **key troubled economies have begun to implement fundamental changes** necessary to eliminate budget deficits and begin paying down their debts. Italy is a striking example. Newly ensconced Minister Monti almost immediately announced a package of austerity measures and fundamental reforms.

Italy's problems have been somewhat exaggerated. While it has a very large debt, the problem hasn't changed much since the mid-1990's. In fact its efforts to prevent deficit budgets since the mid-1990's have been better than some other Eurozone countries. Italy is a major exporter, with excellent companies such as tyre maker Pirelli and car maker Fiat. **The problem has been overregulation and rigid labour rules**. (The President of one of Italy's largest construction companies was quoted in a recent edition of Bloomberg Business Week that "**It's easier for me to get rid of my wife than to fire an employee**")

There is no denying that labour reform and other changes are going to take time. So too will the pay down of government debt in the Eurozone. But key countries have owned up to their chronic problems and initiated appropriate programs. And with Germany cracking the whip it is unlikely there will be too much slacking off in the task ahead.

This scenario is unlikely to bring down investment markets.

Please call me if you have any questions.

Kind regards



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