



INVESTMENT MARKET UPDATE: State of Play; 7 December 2011

comments by Bob Miller

Yesterday's two biggest news stories, the Eurozone crisis and the Reserve Bank's decision to cut the official cash rate are obviously linked. The Eurozone saga has raised the fear of scarcer (and therefore **more expensive**) **loan funds for Australian banks**. This, on top of relatively subdued spending by Australian consumers, forced the Reserve Bank's hand. While there is no guarantee our banks will pass on all of the 0.25 per cent rate cut to borrowers, it should please retailers, householders with debt and upset those with funds on deposit.

In the meantime, ahead of Friday's summit meeting, financial markets have rallied since the beginning of last week on hopes that **Germany's Merkel and France's Sarkozy** can agree on a plan to achieve two things.

First, impose **budgetary discipline** on the European Union's 27 members, or if that can't be done, at least the 17 members of the Eurozone.

Second, persuade the European Central Bank (ECB) to engage in a sustained program of buying the bonds of stressed members. Like the US's Federal Reserve (or any other central bank), **the ECB can literally create money out of nothing**. Such a program would cause boundless **joy to bond dealers** (as bond prices rise and interest rates fall). Pity about the risk to **inflation**. German agreement to this program seems most unlikely.

Let's go back to last Monday's meeting between Angela Merkel and Nicolas Sarkozy. While France is the Eurozone's second biggest economy and doubtless believes it is entitled to sit next to Germany, the reality is that Germany's Merkel is calling the shots. Essentially, **Germany** would like to **impose fiscal (budgetary) discipline upon all 27 members of the European Union**.

Under this proposal individual governments would effectively **give up some of their sovereignty** to German control. It's unlikely that the UK and the other nine EU members who do not use the euro as their currency will all agree. But Eurozone members who wish to remain (and countries like Poland who wish to join) have little choice but to adhere to Germany's demand for a more stringent economic environment.

One of the buzz words in recent weeks has been **austerity**. Severe restrictions on government spending will ease pressure on interest rates, but alone they will not solve Europe's crisis. You could argue that, on its own, reduced spending will simply lead to reduced income and subsequent lower output (the downward spiral). **It has to be accompanied by reforms** (The buzz phrase is **structural change**).

Here, the early signs are good. **Italy's new Prime Minister** has just announced new measures to save \$32 billion, including the structural measure of **raising the retirement age**. Such measures appear infectious. Yesterday **Ireland** outlined a quite brutal program of spending cuts (to meet targets set by its bailout leaders).

You could argue that the party is over for the high spending ways of Europe's centre-left governments, as rulers in Spain, Portugal and Greece have been given the flick. **Bond markets created chaos for them (by selling off bonds, which push up interest rates)**. The leftist legacy is **debt**, which is now a really dirty word.

In a rapidly evolving Europe, even Germany has been forced to alter its course by the all-powerful bond market. Until very recently the German stance was "bad luck if private holders of government bonds get burnt" (as they did with Greek bonds). The Merkel line now is "Sorry about Greece folks. It won't happen again".

Merkel's apology was music to the ears of participants in **bond markets**. Love them or loathe them, these people have enormous influence. **Effectively they are blackmailing governments to come up with their demands or face a bond crisis**. Given that a bond crisis would invariably **threaten the financial stability of some banks** holding such bonds, it's clear that a bond crisis could lead to an out and out financial crisis.

Best to keep these Genghis Khan-type bond hordes happy! Right now they are happier than they were a fortnight ago (which explains the **share market rally since Monday 28 November**).

Keeping the bond market happy won't solve Europe's economic woes on its own. But it will serve to **keep interest rates down**, which definitely helps. Each European country in a mess has to come up with its own plan to lift its economic performance. **That's going to take time**. But it does appear that Europe's leaders have at last realised the seriousness of the situation and set their ships on a different, less dangerous course.

Until very recently investors were not convinced that Europe's leaders had the **will or clout to push through very tough budgetary adjustments**. Fortunately, that appears to be changing.

What about the world's most significant economy? While Wall Street was also shaken by events or perhaps more accurately 'non-events' in Europe, the **real US economy is progressing rather well**. Sure, it's going to take a long time before unemployment falls from its current high level, but the private sector continues to add jobs at a steady rate. Look at indicators such as the traffic carried by US rail companies and you will see an economy decidedly on the rise. Furthermore, **key US business firms tend to be sitting on a pile of cash and have excellent balance sheets**. The US economy will be much better off, however, when firms decide to spend some of that cash on **investment and hiring new labour**.

Meanwhile in China, the leaders of the Communist Party have engaged in **deliberate economic slowdown**. Some investors have foolishly concluded that the slowdown was the result of woes in Europe. Such a conclusion caused further worry in already stressed markets.

The Chinese slowdown (achieved via **restrictions on bank lending**) was designed to do two things: One; **reduce inflationary pressures** overall (to retain competitiveness of Chinese products and preserve the spending power of consumers). Two; **take the sting out of property prices**. Such was the build-up of property prices induced by a supply of relatively cheap and easy loan funds, that a **property bubble was on the cards**. Investors get hurt when bubbles are burst. Furthermore, soaring property prices were making life harder for the millions moving into the cities from rural areas.

The Chinese authorities are very well placed to handle things if events in Europe do happen to get out of hand and economic panic spreads. **They can spend more and they can reverse the recent credit squeeze and lower interest rates**.

China should really not be a source of worry to Australian investors.

Given this is the final planned State of Play for 2011, I'd like to wish you all the very best for Christmas and New Year and advise you that our office will be closed between Christmas and New Year.

Kind regards



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