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Woodhall's Wrap

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The Big Picture

Just when things seemed bad - the Queensland floods and the Egypt crisis - things got considerably worse. A cyclone bigger than Katrina ripped through Northern Queensland and bush fires ran wild in WA. As the Egypt crisis got partially resolved, there was some hope but with Bahrain and then Libya, in particular, violence is spreading across the whole South Mediterranean coastline and beyond. And then there is Christchurch.

The problem with the rioting for us is not so much whether there should be a popular uprising and a new set of democracies but who will control each 'democracy' when all is said and done. It is difficult to predict what the new style of government will be. It seems that no one country - so far - on its own can bring real harm to the world economy but if collectively there is a real contagion of violence - and particularly if Saudi Arabia gets caught up in it - there could be big problems for everyone.

Surprisingly, the markets have acted calmly. Yes, most equity markets took a small hit but, so far, nothing even that could even be called a correction. Gold and Oil prices spiked up but they will probably fall as quickly if the region soon returns to calm.

The Australian economy doesn't look as strong as it did - and not just because of the natural disasters. Retail is hurting and significant retail closures have started. The February company reporting season was quite strong - particularly with big banks and big miners - but nothing exciting.

Our measures have had the market fairly priced for the last several months. The S&P/ASX 200 did rise from about 4,600 to the mid 4,900s but at a pace consistent with earnings growth. The US has been a different story. Up until the Libya revolt unfolded at the end of February, the S&P 500 was on a relentless 'straight line' march to dizzy heights (1,300+ for the S&P 500 and 12,000+ for the Dow). A few negative days were probably welcome to take the shine off what seemed like an unsustainable week-on-week ascent. Whether a correction ensues is in the hands of those nearer Africa. The Libyan uprising was only 30 miles from the capital at month end.

The Australian dollar has continued to hang around parity - mainly above - and that is at the centre of our biggest problem. The two speed economy isn't about the resources sector just growing faster than the rest, it is the impact of commodity prices on the dollar which hurts the other sectors that matters. Interest rates are also a part of the dollar story. There are signs of the UK and Europe thinking about increasing interest rates but the US isn't there yet. However, the US reporting season has been little short of spectacular - business and consumer confidence are well up, and even jobs are starting to look like being created out of a drive from the industrial sector.

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Asset Classes

Australian Equities

At last the S&P/ASX 200 seemed like attacking the 5,000 mark but the North African/Middle East crisis put paid to that. Volatility is unusually low, despite this geopolitical uncertainty. Our modelling of broker forecasts has the market growing at a little faster than 15% at the end of February compared to just over 13% at the start of the year. Earnings season has been on our side - but not too strong.

The sectoral balance has started to shift. Energy, Materials and Industrials still lead the way in predicted total returns but, when risk is taken into account, financials are coming back strongly. The volatility of the Financials-x-REITs (dominated by the big four banks) has returned to levels at the lower end of what they experienced before the GFC. So, on a risk-adjusted basis, banks are leading the pack - and that was before they reported bumper profits.

Foreign Equities

With the Bernanke 'put', a term often used to describe the Federal Reserve's intention to keep printing money for as long as it takes, putting a floor under US equities, almost everyone is optimistic about the S&P 500 for the remainder of this year. The UK, Germany, and, indeed, the MSCI World index have had pretty good runs up in the last few months The test for them will come when the Bank of England and the ECB start hitting the brakes with interest rate rises designed to contain inflation.

Bonds

Few seem to expect Government Bonds in the US and many other countries to be a good investment in the medium term. Long term yields have risen. In part these increases are a good sign as it shows increasing confidence in the world economy. There is growing optimism for investment-grade Australian corporate bonds.

Interest Rates

With the Governor of the Reserve Bank telling us he doesn't intend raising rates soon, it is a safe bet we will have a few months ahead with no increases. One or two people have suggested a cut could be on the cards but this idea looks a little far-fetched. Wage pressure is building up in some sectors - particularly in WA - but prices are seemingly well behaved - for the moment.

It still looks likely that there will be a rate rise or two later in the year. The trouble is, with only one rate to move up or down and two very separate economies in Australia, it is going to be really difficult for the RBA to get this one right. They show every sign that they understand what they are doing. What we really need is for the US to raise rates putting downward pressure on our dollar and we will all be happy. But that isn't likely until at least the end of the year.

Currency

If the dollar holds still around parity for a while, some sectors of the economy will continue to suffer. But it doesn't look likely that the $A will appreciate further. A reasonable guess is that our dollar is overvalued (compared to normal) by about 10% - 15% because of high commodity prices, and an additional 10% to 15% because of the interest rate differential between us and the US. Commodity prices look set to stay higher for longer and that benefits the resources sector. The interest rate differential with the US doesn't look like closing anytime soon - but that's all we have to hope for this year.

Oil

Because of the Libya crisis in particular, oil shot up through $100. It shouldn't have to stay high for much longer because Saudi Arabia has stated that they have the ability and the will to increase supply to replace any lost supply from Libya.

Earlier in the month, there was a massive (and atypical) differential between the WTI (West Texas Intermediate - the US price) and Brent (the Europe price). Geopolitical instability will play tricks on commodity prices for a little longer yet.

Gold

Gold got back above $1,400 at the end of February but it certainly had lost a lot of steam at the beginning of February. It looks like a little over $1,400 will be the peak for a while to come.

Regional Analysis

Australia

Unemployment stayed low but some other data will wobble for a while because of the floods and cyclones. In the case of miners not being able to ship out supplies, that will come back soon and any losses will be made up. Retailers are certainly feeling the challenge. GDP - out this week - is unlikely to be strong but longer term seems strong enough.

The combined profits of the four big banks, BHP and RIO released in February is enough to make anyone sit up and take notice. The country on average is very solid with a very strong future - but some pockets of the economy (competing with cheap imports) are going to have to rethink their business models.

China

China has again lifted interest rates - and the first reaction of our market was to pull back at the thought of the China boom going away. However, we should be happy that China is doing what it needs to do to keep its economy on a path that's not too fast and not too slow.

Interestingly, China has stopped publishing a national average house prices index. Instead, it is publishing separate indexes for dozens of major cities. That seems to make sense. The China government has lowered its 5-year target growth from 8% pa to 7% pa. That's better than boom and bust.

U.S.A.

The US economy is going from strength to strength. Even the big car manufacturers (Ford and GM) are leading the way - possibly helped by Toyota still suffering from the bad publicity it got for handling the faulty accelerator claims. Confidence is up, the $US is attractive enough to help exports but there is a big problem ahead.

It seems that both political parties are playing 'chicken' over the budget deficit and the funding of government services. Some argue that both parties are funded by big business so they are resisting 'the sensible' approach to the start of balancing their budget - and some of the rhetoric about living within their means is getting to be a bad joke. It looks like they will muddle through but without a great plan to get things going again, it could be a decade or more before they regain the relative strength the US economy had pre GFC.

Europe

Europe and the UK have taken the austerity approach to getting out of their economic messes - unlike in the US. Only time will tell which was the better approach but it has to have some impact on the relative power bases 'across the pond'. Germany is really benefiting from a low Euro. While the rest of Europe is trying to get it together, Germany powers on - exporting in particular.

Rest of World

This month, it is the 'rest of the world' that is the main focus. Many of us find it impossible to imagine what it must be like to be in Christchurch right now. Those who didn't lose loved ones must surely know plenty who have. It seems much of the city will need to be totally rebuilt. And the NZ economy wasn't in great shape before the 'quakes. With two major 'quakes in six months, will people have the confidence to rebuild? Hopefully Australia and other countries will do what they can.

Presumably nobody really knows where the unrest in North Africa and the Middle East will finish up. The middle ground seems the least likely. Either the rest of the world will be back to normal quickly while these countries work out how they want to be governed - or it could be the start of really bad times for all that will last for years. It is looking more like the African states will sort themselves out by overthrowing their rulers while the Middle East countries will hold onto their controls. That seems like the best outcome for us but it must be a wake-up call for any political leader that has great wealth while the majority of its citizens are poor.

Food prices can only get worse. It's not really anything to do with the US printing money. As China and India grow they will want more and better food. And that's why BHP tried to buy Canada's Potash (fertilizer business)!