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Ron's Wrap

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The Big Picture

Global attention turned back to the USA during April. Markets were knocked down on April 18th when Standard & Poor's put US debt on a 'negative watch'. S&P put a 1-in-3 chance of the US losing its AAA rating within three months. But the resilience of the US and the local markets saw a strong rally into Easter.

Ben Bernanke's press conference - the first ever by a sitting Chairman of the Federal Reserve - was the next cab off the rank. We all eagerly awaited an insight into what would follow Quantitative Easing II (QE2) - or loose monetary policy - which is due to end in June. The conference came and went on the 28th but many of us were not much wiser. We were told that there would be no QE3 - but 'just a' continued purchasing of debt rolling off! Sounds like quasi-QE3 to me. Interest rates in the USA are said, though, to remain low for an extended period of time. Questions of how USA debt will be controlled - and then cut back - was the main game in April but, being the USA, that didn't stop Donald Trump throwing his hat in the ring and demanding to see President Obama's birth certificate

USA earnings again beat analysts' expectations 75% of the time during April. Since analysts usually set the bar low enough for a result such as this, earnings weren't outstanding but definitely OK. The S&P 500, unlike Australia, reached near 3 year highs but the US dollar remains low - and too low for us. The knock-on effect is that our dollar blasted through $1.08 on the back of a higher-than-expected CPI result (27th April) and then $1.09 the next day. $1.10 and above suddenly looks a distinct possibility!

The high Aussie dollar is compounding the problems for the non-resources part of our economy. The high inflation number is reigniting talk of another rate hike in the not-too-distant-future. There seems to be little chance of the dollar getting back to parity in the next few months but we still maintain that our dollar should sink as soon as the US talks up its interest rate.

Inflation in commodity prices (food, oil, base metals, gold and the rest) is putting the world in a very uncomfortable position. Some blame the US policies but the growth (population and economic) in Asia has to also be a contributing factor. Gold broke through $US1,500 and Oil through $US110. There are plenty of people struggling with food prices around the world, and importantly in North Africa and the Middle East.

When commodity prices are translated into $A, the story is a bit of a non-event. Our dollar is climbing in synch with commodities. But for poorer nations, inability to afford food can fuel unrest. It seems that a solution to the problems in North Africa and the Middle East is a very long way off. While much of the cause of the unrest is to do with the removal, or attempted removal, of long-serving dictators, the full solution will require some sort of aid in developing these economies.

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Asset Classes

Australian Equities

Australian equities struggled to gain ground over the month - and sunk to a loss on the last day - while reasonable gains were had in the US and Europe. The question facing analysts is to what extent they need to pare back Australian earnings forecasts in the light of the high dollar. Few analysts, if any, were forecasting much above parity 6 months ago so there is likely to be some impact for retailers, tourism operators and education providers. However, given the extreme volatility of the dollar, there is no incentive to revise earnings' forecasts down until the last minute. For the moment, earnings prospects - as reported - remain very strong.

The China-dependent resources economy looks solid in spite of China's moves to keep inflation under control. The nuclear disaster in Japan put the spotlight on LNG and the premature news of BHP taking over Woodside Petroleum certainly fuelled that part of the market.

Until our dollar stops rising, the overnight gains in the US are not going to translate into gains within our market. The higher the dollar rises, the more turbulence we expect when the currency market turns around.

Foreign Equities

The US market goes from strength to strength. While our market is about equal to where it was at the start of 2010, the S&P500 is up by about 22%. In that period the German DAX is up over 26% and even the FTSE is up 12%. Foreign investors in Australian companies have to take the foreign exchange risk into account.

Not only has the US market improved in returns, the VIX, which is a measure of how confident investors are of the market staying up, has fallen to under 15% at the end of April from an average of 21.5% since the start of 2010.

Bonds

The possibility of US Treasury bonds being downgraded caused a very big stir in April but the issue was quickly brushed aside. PIMCO, the world's biggest bond fund manager, reportedly sold all of its US Treasury holdings before the negative alert by S&P. However, the results of the Federal Reserve's FOMC and related press conference allayed investor fears about the Fed not providing at least support to that debt which is to be rolled over during the rest of 2011.

Interest Rates

The view that interest rates might not rise this year was gaining traction until the Q1 CPI result was released at the end of April. Some analysts are now re-iterating their expectation of a rate rise by August. It is this buoyancy in our rates that is providing much of the unwanted support for our dollar.

Inflation, while remaining within the band considered acceptable by the RBA, was higher than expected but a lot of the discussion was about which measure of inflation to use. Besides the headline measure, there is another that strips out some of the more volatile measures. Most analysts think the RBA will have to wait for the Q2 number to be released in three months before its next move

We maintain our less-specific forecast of one or two increases by the end of the year.

Currency

The currency is mainly affected by commodity prices and the interest-rate differential with the USA. While commodity prices are high in US dollars, they are not much more so than in their 2008 peaks. That alone does not justify a dollar at $US1.10. We think the more important current driver is the expected interest-rate differential. With the US affirming continued rates of 0% - 0.25%, and our Reserve bank looking a little twitchy about raising them, the expected differential looks stronger for longer. But when that expected gap falls - watch out for the currency to snap back. The question is when?

Oil

With oil blasting through $110, the US is talking about the flow on to US gasoline prices stifling its economic growth. There seems to be little progress in bringing order to the S/E coasts of the Mediterranean. Without that, oil prices seem unlikely to come down.

Gold

$US1,500 was breached in April but gold was flat during the month when measured in $A!

Regional Analysis

Australia

The latest employment data was strong but we feel that it might be masking some problems in the slower half of the two-speed economy. Q1 growth may turn out badly because of the floods and cyclones. Not only were domestic businesses thwarted, resource companies have been reporting lost output in recent times. Since we will recover from lost output, and gain from the rebuilding problem, the economic scars - but not the human ones - will quickly heal.

A simple read of the economic announcements in April look quite good but not great. But with the promise of a tough budget on May 10th, and little consensus on the carbon tax, we are not out of the woods yet. The government and Reserve Bank can do little to realign the two-speed economy in the short-run. The longer-run need for action depends upon how the US handles its growth and debt. It's complicated stuff!

China

With more monetary tightening over April - even by targeting specific banks - no one can claim China is not acting to control inflation. One or two are suggesting they might be 'too successful' and cause a hard landing in a year or two. We still believe the Chinese authorities are nimble and willing enough to move levers back and forth as necessary.

Prime Minister Gillard visited China, Japan and South Korea with a view to improve relations. There has certainly been no bad news coming out as a result and some good might well flow.

U.S.A.

The Democrats and Republicans are going at it hammer and tongs on how to face up to the size of their deficit and how to reduce it. Politicians will be politicians and the next presidential election is creeping up on them.

There is little to deny that there is some economic strength bubbling under in the USA but the question is whether that will continue when the loose monetary policy comes to an end. With some analysts claiming QE2 did nothing for the real economy, it seems that market wants it both ways.

The problem facing the US from my regular watching of US TV is that 'Main St', if not more, does not realise other that countries do not 'take their jobs'. There is a natural process of jobs moving to cheaper labour sources. No one owns the jobs. The developed world has to continually develop a smarter workforce and the jobs that go with them.

The second tech wreck seems to be getting closer with strong downward revisions to the astronomical valuations of Facebook and the like. But the big scam is the property spruiker selling 'cheap' US residential property. Many are finding they paid too much for seriously damaged housing located in slums with little chance of getting a tenant or your money back! A cheap lemon is still a lemon!

Europe

The last business day of April was crowned with a Royal Wedding and the revelation our budget deficit has blown out to $50m (from a $41m forecast 12 months ago). And Britain loves nothing like a good royal party. Bad news seems rare from the UK these days but not so for the fringe European countries like Portugal and Ireland. Portugal just came out - rather late - with the revelation that their debt situation is worse than first assessed!

Tussles still exist between Germany - as the big, strong stable power house - and those countries that have been riding its coat tails.

Rest of World

Japan's latest monthly Industrial Production report showed a fall of 15% for the month. Their ability to get the nuclear reactor in a stable position seems no closer to being resolved. Fortunately for us, we are not economically much affected by this disaster. In fact, our energy sector - with an emphasis on LNG - could do quite well as LNG is chosen over nuclear power for 'slightly clean' power.