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Woodhall's Wrap

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The Big Picture

After a year and a half delaying a decision on how to manage the euro zone debt crisis, the European leaders seemed to have agreed on enough for world markets to have rallied sharply. Indeed, the S&P 500 had its best month in October since 1974. The Australian market was not as strong but the 7% rise in the ASX 200 was a welcome relief.

Since the details of the euro solution are far from complete, volatility may continue throughout much of November. Perhaps this October 'relief rally' is merely a statement that the end of the world was priced in. The world - having not ended - has re-priced markets to 'bad'. When and if more detailed solutions are tabled, markets could rally much harder.

The Reserve Bank of Australia (RBA) makes its monthly decision on interest rates today. Analysts are split between a decrease and an 'on hold' at 4.75%. We believe September's and October's labour market data were poor enough to warrant an immediate cut with possibly more to follow.

It is not surprising that commodities and currencies were extremely volatile throughout October. The Australian dollar ended September at 97.8 (US cents) fell to 95.0 and broke through 1.07 before the end of October to finish the month at 1.055

The latest GDP data for the US certainly countered the view that the US was going into a double dip recession. At 2.5% (annualised) that is not a bad GDP growth number. US unemployment remains high but the situation is not getting worse. Indeed, consumer confidence and spending did well during the month as well.

Obama's *American Jobs Act* has not yet got anywhere in Congress but with an election 12 months away, some 'pump priming' is bound to be around the corner. There is talk of QE3 and that would help stimulate global stock markets.

Australia needs a rate cut to avert half of the economy going into a 'recession'. But, on average, we can muddle along while the world sorts itself out.

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Asset Classes

Australian Equities

Our market started October badly - like the rest of the world - but a 9% or so rally got us back to about where we were at the beginning of August. Our sector forecasts clearly delineate between the powerful sectors - Resources and Industrials, on the one hand - and the rest. The rally has put the Financials sector back to 'fair pricing' and capital gains are not expected to be strong over the next 12 months.

Overall, we measure the market to be underpriced by about 5% with a 10% capital gain expected over the coming 12 months. Our fear measure got back into the normal range during parts of October but jumped higher after the market surged in response to Europe. All is not quiet but we are much better off than if Europe had failed completely to reach a conclusion.

Foreign Equities

The German DAX had a very strong October - around 15% - but then again they did suffer a fall of 19% in August. The US indices grew by around 11%.

The US Q3 reporting season was mixed. Some stocks - like Caterpillar - kicked the lights out but a number missed estimates. The accompanying outlook statements are so important. With politicians around the world struggling for credibility, it is little wonder that companies have an uncertain future. If QE3 (printing money) is soon announced - as many expect - a big Santa rally and beyond should follow.

At the end of 2007, the All Ordinaries and the UK index, the FTSE, were level pegging at about 6,400. The FTSE is now over 5,700 while our All Ordinaries languishes in the low 4,000s. Our dollar appreciation has a lot to answer for.

Bonds

Bonds around the world have been impacted by the chance of a Greek default - or even worse, a spread of lost confidence to Italy. The end of the month agreement by the 17 euro zone countries should stabilise the area - and the possible contagion. Private investors have been forced to take a 50% haircut (or capital loss) as part of the deal to save the banks. More than a decade of living off and amassing cheap debt (through the EU) came home to roost for Greece and its creditors. Greece does not have a rosy future.

If Europe does tack a back seat soon, then focus should return to how the US is handling (or not!) its debt problems.

Importantly, Fitch's estimated 5-year probability of default for all regions of the world have started to fall back.

Interest Rates

The all-important rate decision is announced today at 2:30 (November 1). There seems to be no chance of a rate hike but the RBA might keep rates on hold. They did have a great inflation number last week - underlying inflation for the quarter was only 0.3% - which would support a much needed cut but waiting another month isn't going to cripple the economy - but why wait? The unemployment rate might only be 5.2% but it has started to rise and 5.9% was the worst result during the GFC - in a period in which rates were falling. It is generally accepted that a rate cut takes 12 - 18 months to flow through to the real economy.

Currency

Just when things looked brighter - with our dollar in the nineties - it shot up nearly 12 cents to over $1.07. It is not clear whether a rate cut has been priced in. Hopefully, a cut will return the dollar back to near parity. If it doesn't, we might need a few cuts - say back to 4% to put our whole economy in a position to prosper.

Oil

Oil, like most commodities, has been on the roller coaster ride too. Back above $90, old memories have been quickly restored.

Gold

The price of gold climbed about 8% over the month but it is still about $200 off its peak. It would appear that investors and traders are buying and selling all sorts of assets to rebalance their portfolios and margin calls. Gold doesn't look very 'safe' at the moment.

Regional Analysis

Australia

With Qantas grounding its fleet at the end of October - the mood at home is not good. Fair Work Australia has placed a 21 day no-go-zone on industrial action while all parties have the chance negotiate in good faith. Also, political sides seem to be switching over the mining tax but a Carbon Tax is on the way.

The two-speed economy has a growing gap in its component's directions. Part of the problem is due to a lack of confidence and that might take a while to fix. The RBA, until recently, was threatening us with future rate rises and the lack of a strong political direction dampens investment psychology for business and consumers. The only positive on that front is that a rate cut now might get translated into a happy holiday season.

We didn't win the Rugby World Cup but at least our team didn't disgrace itself as the England players did. Four years to prepare for the next.

China

After months of some commentators talking about a hard landing for China, good data is starting to come though. Inflation is well off its peak but growth is holding up nicely. Commodity prices fell on the hard-landing speculation but they have already started to bounce back nicely. Unfortunately that takes our dollar with them.

The really interesting thing about China is the possibility that they will help in the Europe bailout. That would be a rise in power and status for China with the big G-20 meeting only around the corner (3^{rd} and 4^{th} November).

U.S.A.

Europe dominated the business news in October while the US slipped in some quite good data - on GDP growth and consumer confidence. Almost nobody sensible is now calling for a double dip recession but - as we have been writing about for some time - we don't expect strong growth and low unemployment anytime soon. The US too has a debt mountain to climb and seemingly little more political will to solve their crisis than their European counterparts.

Europe

It is amazing that 17 nations could get together and agree on some sort of policy that will hurt most of them! I guess it was the alternative that would bring down the EU that spirited them along.

In hindsight, this problem should have been self-evident and solved years ago. Isn't it anybody's responsibility to check what the member countries are up to? Perhaps there now are some eurocrats with a real job to do.

Rest of World

India became the third largest nation in the world - by GDP - during October. How the world is changing. Two of the top three countries are now BRIC nations (Brazil, Russia, India and China) and the fourth in the world rankings, Japan, followed the same path half a century ago. That wasn't the case before the GFC. Thankfully, Australia - the Lucky Country - is aligned with the growth engine of the future.

Of course with this prosperity will come pluses and minuses for Australia. Asia will buy more of our exports but they will also replace more of our jobs. The world keeps evolving so our training and education must react. When I came to this country in the seventies, our School of Economics at UNSW had half a dozen typists (pre-golf ball). Now everybody does their own typing. Any country that tries to swim against the tide will get carried out to sea. And what about Qantas?

Japan caused a storm on the last day of the month by intervening in the currency market. The yen pulled back 4% in a flash and Japan has hinted at more to follow.