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SnellemanTom

Consulting Accountants and Financial Planners

Australia: shaken but not stirred

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2011 Year in Review

Some years drift by without incident, but 2011 was not one of them. The year began with natural disasters in Brisbane, Christchurch and Fukushima, continued with the toppling of dictators across the Middle East, and culminated with European debt levels at crisis point.

All of this grim news had an impact on share markets during the year. As the table shows, the US market was a strong performer as signs of growth and future earnings began to emerge while the market in China, the world's boom economy, slumped with worries about slow downs and recession in Europe, a major export market for China.

Comparative Share Market Performance, 2011

Country (Index)	At Dec 31, 2011	Change over 12 months (%)
Australia (S&P/ASX 200)	4056.60	–14.51
US (Dow Jones)	12217.56	5.53
Japan (Nikkei)	8455.35	–17.34
UK (FTSE)	5572.30	–5.55
China (Shanghai Composite)	2199.42	–21.67

And it is Europe that is on every investor's mind. Just as households and businesses had begun to reduce borrowings, debt resurfaced with a vengeance in 2011. But this time it threatened to sink European governments rather than major banks and corporations.

The seriousness of the European debt crisis highlighted the fragility of the global economy, as each 'solution' to the crisis faltered, sending fresh shockwaves through financial markets.

Australia did not emerge unscathed but the soaring dollar and high interest rates provide a testament to our resilience.

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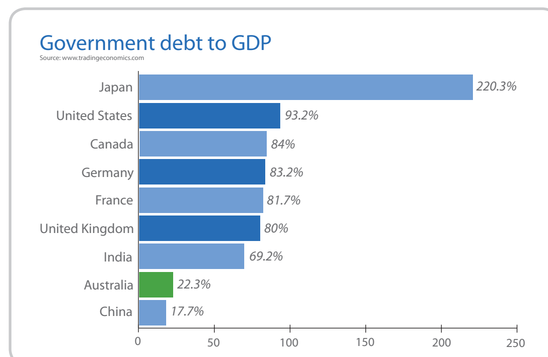
A mountain of debt

As most investors and householders know well, debt is not a problem when you have the cash flow to service it. The problem some governments now face is that they owe more than they are earning. The clearest indication of this is the level of government debt to gross domestic product (GDP), which measures the value of all goods and services a nation produces.

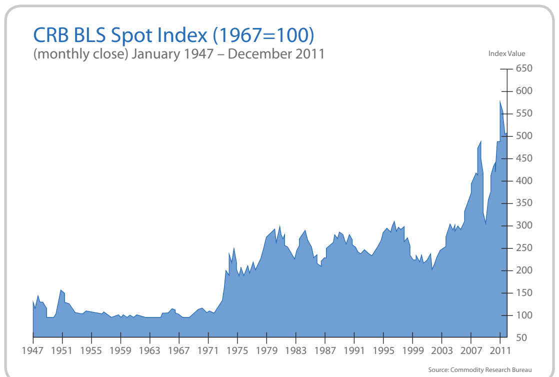


By the end of 2011, government debt averaged 85 per cent of GDP across Europe but was higher in Greece (143 per cent), Italy (119 per cent), Ireland (96 per cent) and Portugal (93 per cent). In short, the so-called PIIGs of Europe were living beyond their means and taking the rest of Europe down with them.

But as the bar chart shows, the issue of unsustainable government debt is not confined to Europe. In the US debt is more than 93 per cent of GDP while in Japan it is a whopping 220 per cent as the nation rebuilds in the wake of the Fukushima disaster. By comparison, Australia stands out like a beacon with government debt at just 22 per cent of GDP.

Commodities take a breather

Australia's economy continued to be bolstered by demand from the fast-growing Asian region, but it fell short of official government forecasts. Commodity prices tell part of the story. The CRB Commodities Index, which tracks a basket of mining and agricultural commodities, fell more than 8 per cent last year. But as the graph shows, this fall is a hiccup in a prolonged period of steep price increases.



Our economy expanded at an annual rate of 2.1 per cent last year, which might be down from the long-term average of 3.25 per cent but it was still an international success story. Economic growth slowed to 1.5 per cent in the US, 0.5 per cent in the UK and just 0.7 per cent in Japan. And despite fears that China's rapid development (and Australia's dream run) might be stalling, China still grew a phenomenal 9.1 per cent.

Interest rates fall

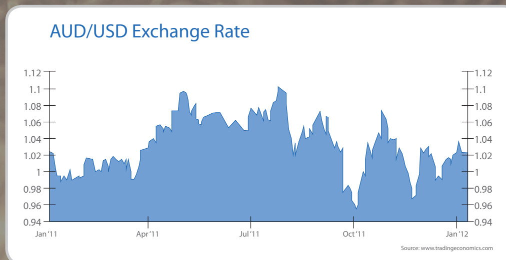
As the year progressed, global growth forecasts were hit by the European debt crisis, continued weakness in the US and fears of a slowdown in China. These factors dampened local growth and the confidence of local business and consumers. Inflation fell to 3.5 per cent, closer to the Reserve Bank's 2–3 per cent target band, and the unemployment rate lifted slightly to 5.3 per cent, easing wage pressures.

So, after seven increases in official interest rates post-GFC, the Reserve Bank finally felt relaxed enough about inflation to cut rates by 25 basis points, or one quarter of a per cent, in both November and December. This took the official cash rate to 4.25 per cent. Yields on 10-year government bonds also fell from highs of 5.72 per cent to finish the year at 3.8 per cent.

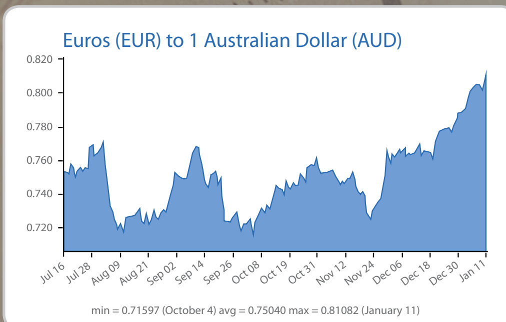
Despite the fall in local interest rates, they still remain the highest in the developed world. Rates are at 1 per cent in Europe, 0 per cent in Japan and close to zero in the US and the UK.

The dollar dazzles

The Australian dollar benefited from Australia's safe-haven status and relatively high interest rates in 2011. It hit a 29-year high of US$1.10 against the greenback in May (see graph, $A vs $US), before weakening slightly as the Greek debt crisis began to peak.



The Aussie dollar hit a 26-year high of 67.74 pence against the British pound in July and finished the year at a 22-year high against the Euro of 78.52 euro cents.



The strong currency is great news for travellers heading overseas and online shoppers hunting for bargain-priced European and American goods, but bad news for local exporters and companies competing with cheaper imports.

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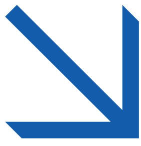

Investment fluctuations

Markets and investors hate risk and uncertainty but that is what was dished up in 2011. As assets such as shares and property fell, some investors took evasive action and kept their money in cash and conservative fixed interest.

Only eight of the 73 sharemarkets tracked by CommSec rose in 2011 and the only major market to do so was Wall Street with a gain of 5.5 per cent. Australian shares fell by 14.5 per cent, but taking dividends into account, the total return from shares fell 10.5 per cent. Telecommunications was the best performing market sector, and the materials sector (which includes mining), the worst.

For the second year running, bonds outperformed shares. The UBS Government Bond Index rose by 13.4 per cent in 2011, hot on the heels of a 4.8 per cent gain the previous year.

Interest rate cuts came too late to save the residential property market. According to RP Data, capital city residential property fell 3.6 per cent in the first 11 months of the year. Sydney and Canberra were the most resilient markets while Melbourne and flood-ravaged Brisbane were weakest. When you take rental income into account, the total investment return on capital city residential property was just 1.2 per cent.

Market outlook

As long as debt and risk remain global preoccupations, local markets will be volatile, but with risk comes opportunity. Lower interest rates and the prospect of further rate cuts ahead are welcome news for property investors. They should also provide a boost for local company profits and may tempt investors to shift some funds out of cash and into shares.

At the end of 2011 shares were attractively priced at 12 times last year's earnings, below the long-term average of 15 times earnings, which is a good indication of value for money.

The Aussie dollar has come out of the starting blocks strongly in 2012 and will continue to be a drag on some sectors of the market. The good news is that it has never been a better time to plan an overseas holiday.

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