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The Big Issues for 2011

BIG ISSUES FOR 2011

Has consumer spending fundamentally changed?
Is the US economy about to take off?
Will China continue to dominate?
Will the Aussie dollar be stronger for longer?
How high will interest rates go?
Is there a housing bubble?
What we will be the impact of climate change policies?
Will inflation or deflation rule?
How long before shares return to record highs?
How tight is the job market?

First a recap

- If there were one word to sum up 2010 it would be "recovery". Not that recovery occurred at the same pace in every industry and region. It certainly didn't. But rebuilding is like that. Sometimes there are fundamental issues that need to be addressed and navigated. And that has been the case with the budget deficits and debt loads in the Euro area. And in the US the issues have included the weakness of the job market, the high budget deficit, deflationary risks and over-supply of housing.
- But in Australia and Asia the issues have been different. Our region was dragged down by the problems in Europe and the US, but fundamentally there were few concerns. So recovery has been swift – with many economies notching up fabled 'V-shaped' recoveries. But entering 2011 the issues are different. It is all about sustainability. That is, maintaining solid economic growth without letting the inflation genie out of the bottle.
- China has certainly dominated the radar screen over 2010. Get used to it. The biggest ever industrialisation in world history has really only just begun – 1.3 trillion people aspiring to the standard of living that we enjoy in the West. And when the next 5-year plan is handed down in early 2011 expect the Chinese consumer to be the centre of attention. The aim will be to continue to improve the lot of the Chinese people.
- Last year when we compiled the Big Issues for 2010 we outlined our forecasts for the Australian economy. And we can claim a

FORECASTS

Economic growth	2.75% in 2010 3.50% in 2011
Inflation	2.75% in 2010 3.00% in 2011
Unemployment	5.00% mid-2011 4.50% end-2011
Cash rate	5.00% mid-2011 5.50% end-2011
Sharemarket	5,100 points mid-2011 5,400 points end-2011
Australian dollar	US99c in mid-2011 US92c in end-2011

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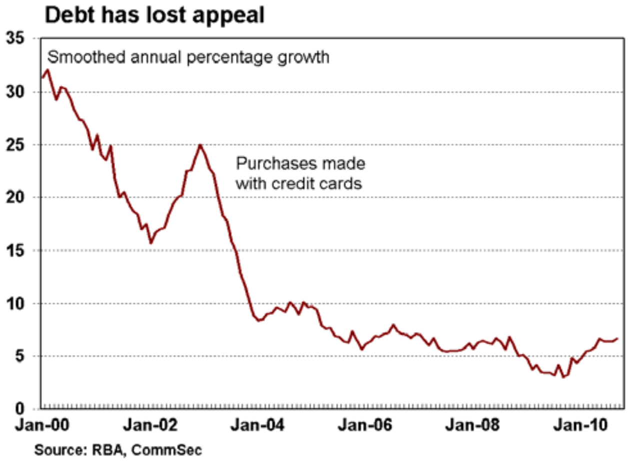
measure of success.

- Inflation was tipped at 2.75 per cent, unemployment at 5.25 per cent and the cash rate at 4.75 per cent. The final figures won't be available for a few months but the estimates were pretty much spot on. That is the good news. We also tipped the sharemarket to reach 5,600 and economic growth to be 3.25 per cent. These forecasts have turned out to be too optimistic. The sharemarket will finish near 4,800 points and economic growth will be around 2.75 per cent.

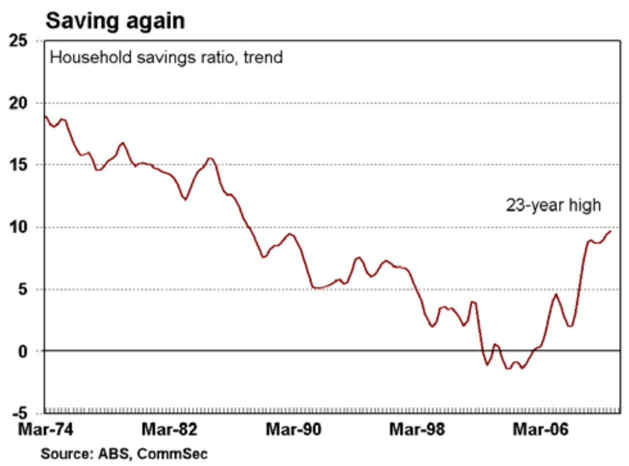


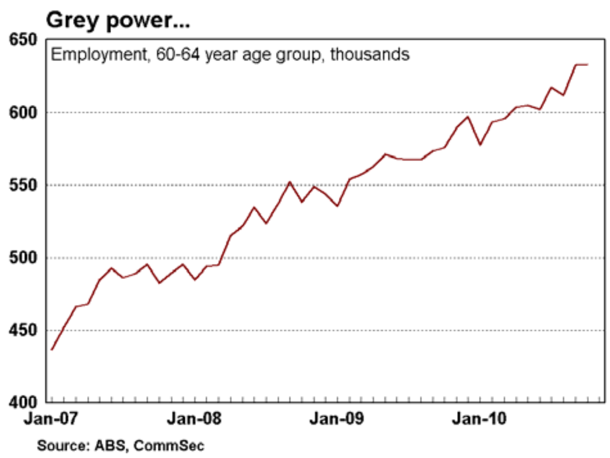
- The Aussie dollar was tipped at US98c in June and US90c in December. Both forecasts weren't bad but not spot on. A fundamental assumption was that the US economic recovery would be further advanced by now. In fact we think that this will prove to be the main disappointment of most forecasters – that the US recovery has lacked momentum. We blame confidence in large part – cashed-up businesses haven't had the confidence to invest, employ and grow again.
- At this time last year we suggested that the Shape of Economic Recovery would be amongst the key issues for 2010. Certainly that was indeed the preoccupation for investors and policymakers alike. We also noted China, India, Taxation, Superannuation, Commodity Boom and Housing Cost & Supply as key issues. Superannuation didn't feature as much as we thought but the other issues were very much in focus over the year.
- On our "What's Out" list for 2010 there were the no-brainers: Recession, GFC, Rate cuts & Debt. But we also thought that the US wouldn't hog the spotlight as much, and volatility would ease. While on balance that did occur, some would doubt the extent of the moves.
- Our left-field issue was the 9-5 workday. We felt that the workplace flexibility demonstrated in 2009 would continue in 2010. The evidence coming through now shows that this flexibility is certainly being embraced. It may not have dominated consciousness but it is where we start off our look at 2011.

The Big Issues for 2011

Has consumer spending fundamentally changed?

- One issue that began to grab more attention as 2010 progressed was the weakness of consumer spending. Even the Reserve Bank has spent more time in the past few months focussing on the changes underway in consumer land.
- There certainly have been fundamental changes to consumer attitudes. In part these changes were prompted by the global financial crisis (GFC). But the changes have also been coming for some time. Over the past seven years Aussie consumers have been making more purchases with debit cards rather than credit cards. And people have been adding less to credit card balances. During 2009 growth in credit card debt turned negative. It currently is up just 3.3 per cent on a year ago. Further, over the past four months, the average credit card balance has been slashed by $39.10. Apart from the GFC period in early 2009 this is the biggest reduction in credit card debt for over 15 years.
- The warnings about the risk of high debt loads have been getting through and the messages were reinforced during the GFC. Consumers are now more likely to pay off debt with extra savings or put it in the bank. And while





the Bureau of Statistics has recently revised up the estimates of the household saving ratio, it has merely brought it into line with other indicators. In trend terms the household saving ratio is at 23-year highs but it's been rising for the past five years in line with the slowdown in the growth rate of credit card debt.

- Certainly household debt is much higher than in the past (but then again so is wealth) but small changes in interest rates do have a much bigger impact on behaviour. Reserve Bank Assistant Governor Philip Lowe suggests that this may mean that rates don't have to rise too much in the future. We'll see.
- There is also the issue of on-line shopping. Effectively this has provided more competition for Australian retailers, thus keeping downward pressure on prices. And certainly the higher Australian dollar has also influenced consumers to shop overseas websites as well as reducing prices for imported goods.
- Over the past two years changes in employment patterns have also led to changes in consumer spending. The job market peaked during 2007 and 2008, weakened in 2009, before turning higher in 2010. And there have been some major changes. Employment for those between 15-19 years peaked in December 2007 and job numbers haven't recovered – there are over 105,000 less young people with jobs compared with the peak. And for those between 20-24 years, employment is only 13,000 higher than the December 2007 peak.

Job market winners & losers

Age group	Change in jobs ('000) past 2 years*
25-34	111.3
60-64	95.0
45-54	84.6
55-59	74.3
65+	66.7
35-44	32.6
20-24	27.8
15-19	-57.5
TOTAL	***434.7***

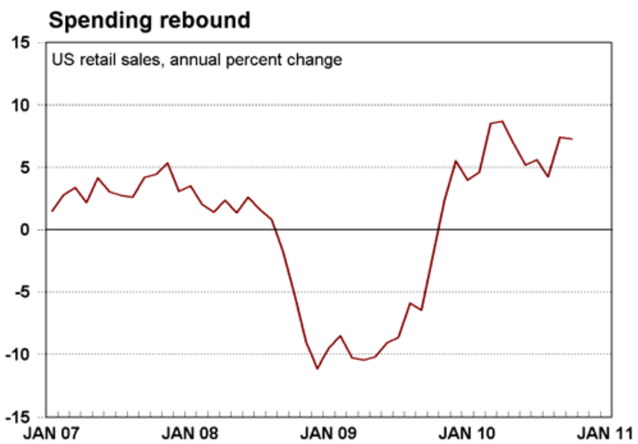
Source: ABS, CommSec
* to October 2010

- So who has been getting all the jobs? Amazingly, over the past two years 75 per cent of all the jobs created have been taken but those over the age of 45. In fact almost 162,000 positions have been created for those over 60 years.
- No doubt the GFC caused a big dent in the incomes and saving levels of senior Australians, prompting them to either stay in jobs longer or return to the workforce. But older Australians are also adjusting attitudes to retirement, staying in the job market longer. And employers would also have played a role in older workers finding and retaining jobs, selecting them for positions ahead of younger workers.
- Whatever the case, more seniors have been employed in recent years, and they have decidedly different spending habits than Gen Y or Gen X workers and they are more likely to save rather than spend. Perhaps what we have been getting is a glimpse of some of the changes that are associated with an ageing population. And that represents a wake-up call for retailers.
- So has consumer spending fundamentally changed? The short answer is that consumer spending patterns are always changing with societal changes, demographics and 'big picture' events like the GFC. Consumers are currently focussed on saving rather than spending and have more conservative spending preferences. But with wealth levels rebounding, the job market strengthening and provided there is an extended period of interest rate stability, then consumers will indeed spend again. But conspicuous consumption is not ready for a comeback any time soon.

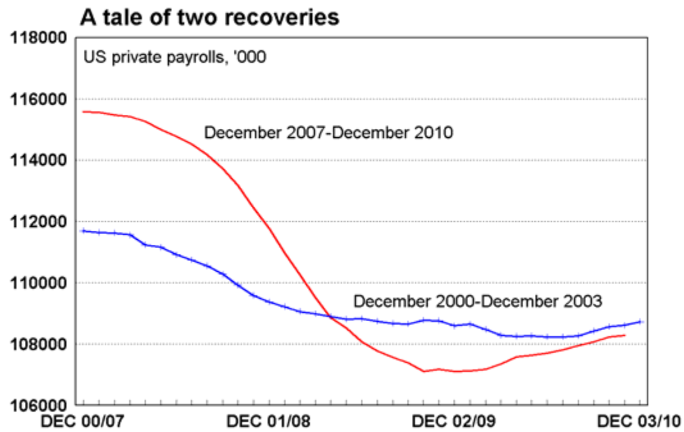
So What? Australian retailers will gradually see an improvement in fortunes over 2011 as consumer attitudes thaw and the job market continues to tighten.

Is the US economy about to take off?

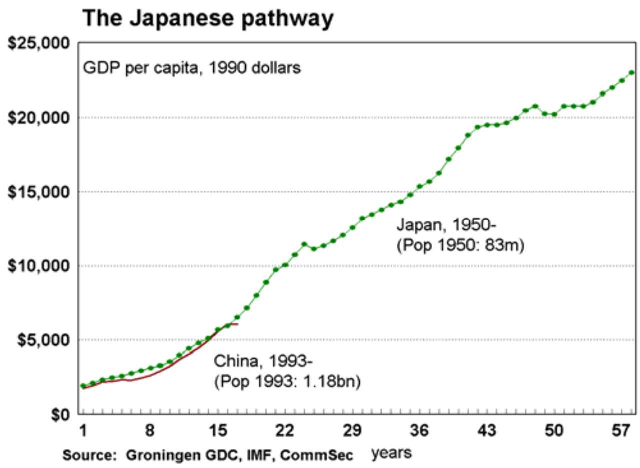
- Certainly analysts are getting more positive about prospects for 2011. And with good reason. The federal funds



Source: US Federal Reserve, CommSec



Source: US Federal Reserve, CommSec



rate is close to zero; the Federal Reserve has embarked on another round of quantitative easing (buying bonds in exchange for cash); and Congress appears poised to extend Bush-era tax cuts. This tax cut package also involves a temporary cut in payroll tax and extension of unemployment benefits. And the federal government is ramping up spending on infrastructure. In short there is not much more stimulus that could be applied.

- And still there are factors like the low US dollar, boosting exports. And the strength of Asian economies, providing a spur to growth in other parts of the globe. Company balance sheets are also in good shape and private companies are sitting on US$2 trillion of cash.
- So what are the factors holding back the US economy? The housing market is still over-supplied with stock, constraining new building. Unemployment stands at 9.8 per cent. State government finances are in bad shape. And the federal budget deficit is near 10 per cent of GDP.
- Overall though the economic indicators have been improving, even retail sales have increased despite an unemployment rate near 10 per cent. Job growth has been an Achilles heel for the economy but that is largely because businesses haven't had the confidence to grow. Once the animal spirits do turn more positive – and indeed there is evidence that this is happening – the US economy could indeed accelerate.

So What? If the US economy does take off there is a raft of implications. A stronger US economy may lead to a stronger US dollar and that would provide headwinds for the Aussie dollar. A pick-up in the US would also be positive for US-reliant stocks like Westfield, News Corp, James Hardie, Billabong and CSL.

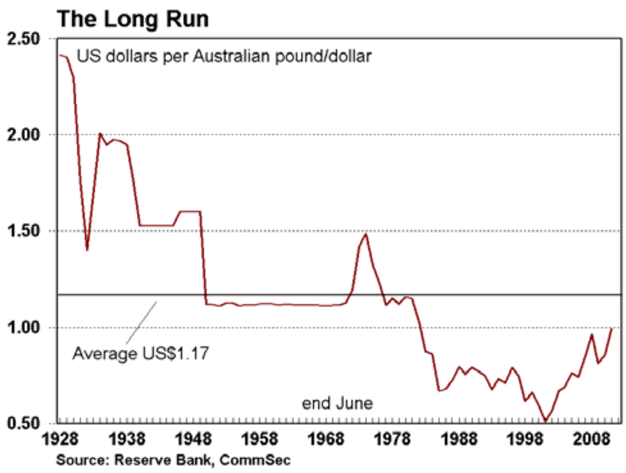
Will China continue to dominate?

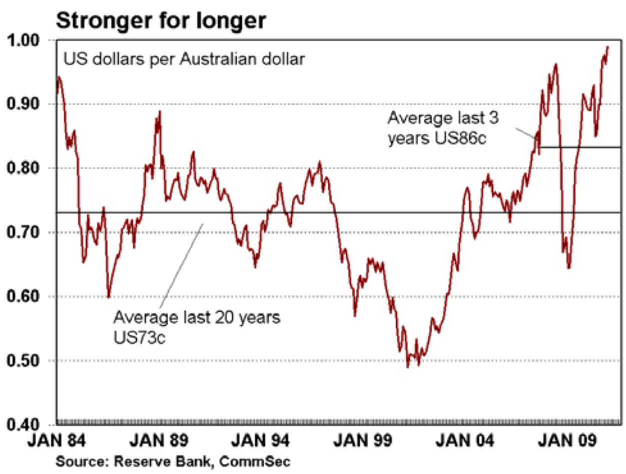
- The short answer is yes. When measured in terms of GDP per capita, China is at the same point that Japan was in the early 1970s. Japan continued to industrialise and expand through to the late 1980s, at which time economic growth slowed to rates that were more consistent with other so-called advanced nations.
- Despite strong economic growth over the past decade and the emergence of impressive global cities like Shanghai and Beijing, China still has more in common with developing nations than advanced nations. China is the world's biggest car buyer but only 1 in 50 people own a car rather than 1 in 2 people in countries like Australia and the US.
- Given the fact that China is continuing to expand at a near 10 per cent annual rate, there will always be risks for the authorities in sustaining the expansion without imbalances developing such as high rates of inflation or a housing bubble.

So What? Australia has already become very reliant on the Chinese economy and this reliance is set to extend further in coming years. At its height in 1995, Japan took 25.1 per cent of Australian exports. China now accounts for 24.4 per cent of exports and its importance continues to grow strongly. Reliance on China provides significant opportunities for the Australian economy but also poses significant risks.

Will the Australian dollar be stronger for longer?

- Since the Australian dollar was floated in 1983, it has averaged US73 cents. But over the past three years it has

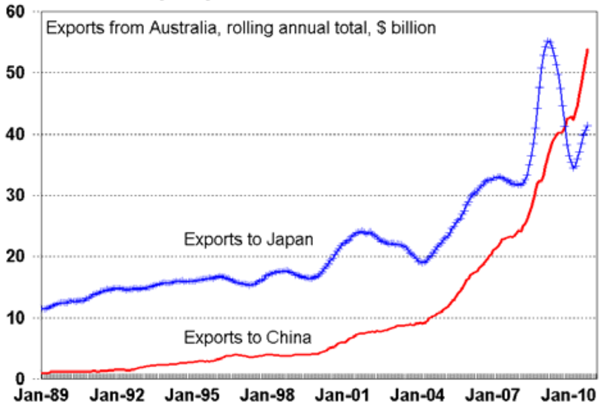




averaged US86 cents. And currently the Aussie is not far off the highest levels recorded in 28 years.

- Part of the lift of the Aussie dollar can be explained by the growth of China, reflected in rising demand and higher prices for commodities. The 'China effect' has served to keep the Australian economy strong and caused the Reserve Bank to lift interest rates.
- But the other side to Aussie dollar strength is US dollar weakness. US official rates are close to zero and the economy has been struggling for momentum. But that could be all about to change. Longer-term US bond yields are rising on expectation of stronger economic growth in 2011.
- Chinese industrialisation has much further to go. And the resource demands are huge, keeping upward pressure on commodity prices. So while a resurgent US dollar would provide headwinds for the Aussie dollar, the 'China effect' should keep the Aussie dollar stronger for longer.

China is top export destination



Source: ABS, CommSec

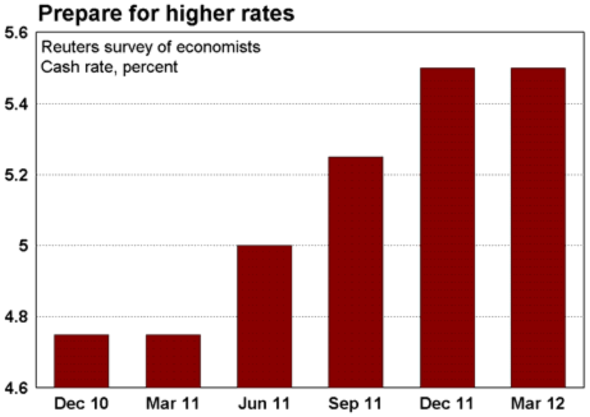
- It's interesting to note that the Aussie dollar held above parity with the greenback until July 1982. But the long-term decline in world commodity prices dragged the Aussie lower over time, culminating with the low point of US47.73 cents in April 2001. It has been the industrialisation of China that has been responsible for arresting the long-term decline of both commodity prices and the Australian dollar.
- Our currency strategists believe that the Aussie could lift to US$1.02 in March 2011 but retreat to US92c by December 2011. In 2012 our strategists expect the Aussie dollar to ease to US85c in the September economy and find a new base at these levels.

<u>So What?</u> Exporters and importers can't take their eyes off the currency for a second. Just when you think a new paradigm is emerging, something can come from left field. Note that the Aussie was heading for parity in mid 2008 before the GFC emerged and dragged the Aussie to US61 cents in October 2008. If the US economy was to rebound markedly in 2011 and the Chinese economy over-heated, then the Aussie would quickly lose altitude.

How high will interest rates go?

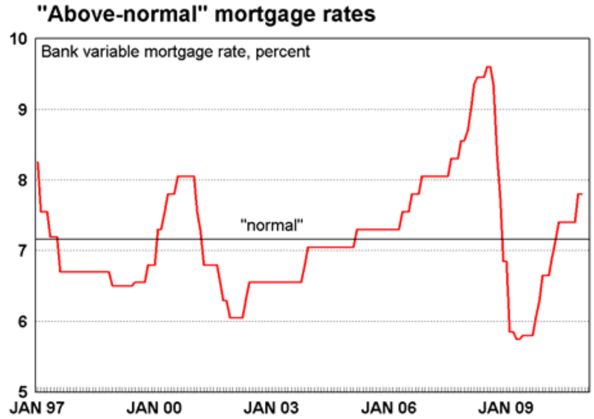
- The Reserve Bank never used to comment directly on the level of interest rates. But some subtle shifts have occurred. In recent testimony, the Reserve Bank Governor did give views on where rates were headed and how high rates could go – at least in the short-term.
- *"At the moment, most commentators do not anticipate and market pricing does not anticipate any further near-term change by us for quite some time. I think that is probably a reasonable position for them to have based on the information we have now*."
- *"We may need some more (rate hikes) than we have at the moment at some point, but at this stage the expectations are for only fairly gradual and not very close together increases. At this point, I certainly do not want to steer people away from that today."*
- Even RBA Assistant Governor Philip Lowe weighed in, claiming that Aussie consumers may continue with their conservative habits "for quite a while yet", thus capping inflationary pressures and interest rates.
- The Reserve Bank appears to be working on the assumption of around two rate hikes in 2011. Economists

Prepare for higher rates



Source: Reuters, CommSec

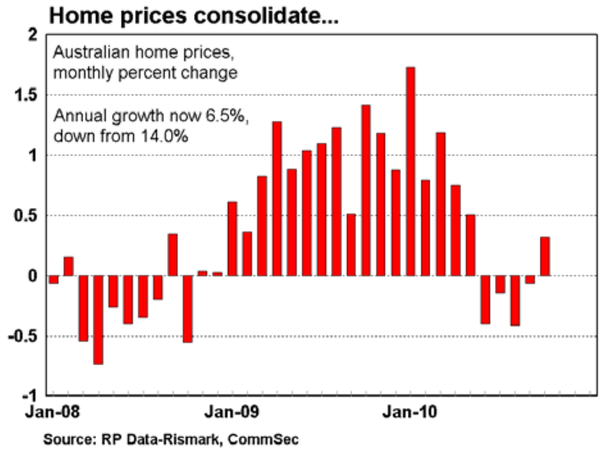
"Above-normal" mortgage rates



Source: Reserve Bank, CommSec

assume three rate hikes. But it's important to note that the RBA is already maintaining tight monetary policy and that small changes in rates have a big impact on consumer spending because debt levels are much higher than in the past.

So What? We expect cash rates to peak at 5.75 per cent in 2012. Much will depend on the migration policies of the Federal Government. If the Government continues to restrict migration and limit business and working holiday visas then labour supply may not be allowed to adjust to meet higher demand. Clearly a tight job market increases the risk of higher wages, prices and interest rates.



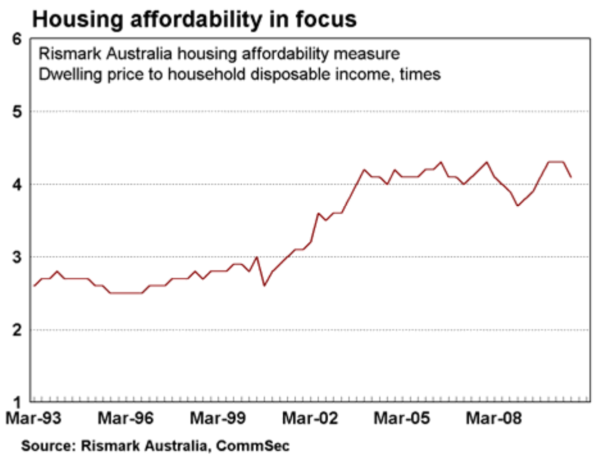
Is there a housing bubble?

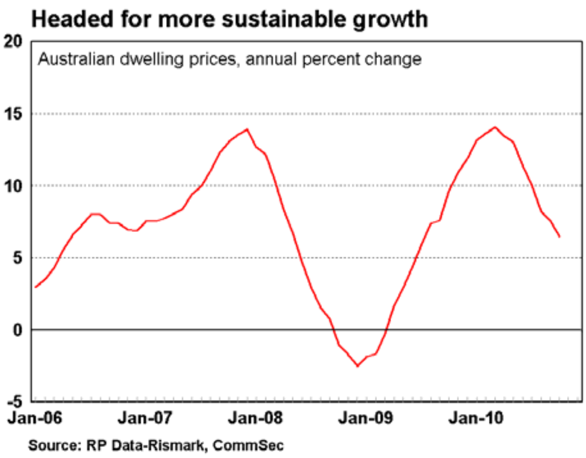
- A housing 'bubble' refers to a situation when there is an unsustainable lift in housing prices. And because it is unsustainable, eventually prices plunge back to more appropriate levels.
- Australian home prices lifted sharply in 2007 and 2008 because population growth was outpacing supply of new homes. Interest rates rose to choke off some of the demand and dwelling starts rose. Again in late 2009/early 2010 there were double-digit gains in home prices. Super-low interest rates and government grants fed the lift in prices but they have since come back to earth in response to higher interest rates.
- While there have been ebbs and flows over time, over the past five years annual growth of home prices averaged 7.3 per cent – slightly below the long-term average growth rate. There hasn't been any excessive home building, as reflected in tight rental markets across the country. In short there hasn't been any evidence that there has been a housing bubble and none to suggest that one is likely.
- Property markets are adjusting to reflect their relative supply/demand balances. Nationally home prices are up 6.5 per cent on a year ago. But while Melbourne prices are up 10.7 per cent and Sydney prices are up 8.4 per cent, Brisbane prices are down 0.7 per cent and Perth prices are down 1.8 per cent.

So What? There is so much misinformation on home prices. Some commentators and journalists make inaccurate and damaging comments about housing 'bubbles' and affordability without facing any consequences. While it may make an emotive story, inaccuracies can limit housing investment and prevent supply from adjusting to higher demand.

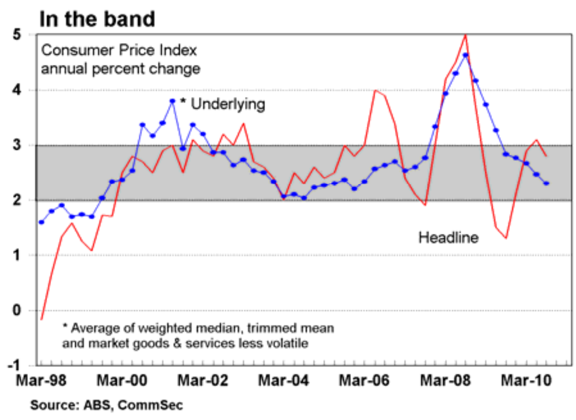
What will be the impact of climate change policies?

- This issue can be summed up as 'watch this space'. The Federal Government has in effect buried this issue until well into 2011. The Productivity Commission is examining carbon pricing policies in other countries but won't report until May 2011. Similarly Ross Garnaut has been asked to update his report on climate change and carbon pricing policies, again by May 2011.
- Clearly it's impossible for businesses to factor in potential carbon pricing issues into medium-term strategic plans. Still all businesses are already coping with a 'greener' landscape with policies affecting new building, renovations and maintenance issues. While strict carbon pricing doesn't currently exist, clearly greener practices are a common feature of the operating environment and serving to lift costs.





So What? Carbon pricing and climate change issues are likely return to the spotlight in the second half of 2011. It's not possible to make a judgement on likely effects. But any changes that do occur will have long phase-in times. Still it's important to note that environmental issues are already serving to affect business decisions and costs by stealth.



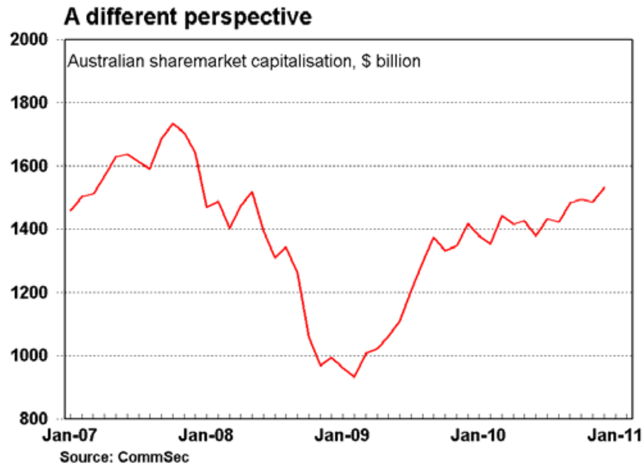
Will inflation or deflation rule?

- In Australia, the inflation rate sits comfortable inside the Reserve Bank's 2-3 per cent target band. The RBA assumes that inflation will remain in the band over 2011 but could lift to the top end of the band in 2012.
- At present a higher Australian dollar is pushing down prices of imported goods. On-line shopping is also serving to boost competitive pressures in the retail sector and keep prices low. Consumer conservatism is also an influence keeping prices low as consumers shop around for the best deal and retailers are forced to discount heavily. Even supermarkets are feeling the cool winds of deflation, rather than inflation.
- But prices of services are still rising, not falling. Workers are in demand, keeping upward pressure on wages and prices.
- In the US, the concern is still with deflation rather than inflation. In October, core consumer prices grew at 0.6 per cent annual rate – the lowest reading on record. But with all the stimulus being applied to the economy, inflation is seen as a greater risk in 2011.
- In China, food inflation has been soaring but non-food inflation has been contained. In November, China's inflation rate lifted to 5.1 per cent – the highest in 28 months. But while food inflation lifted to 11.7 per cent, non-food inflation stood at just 1.9 per cent.

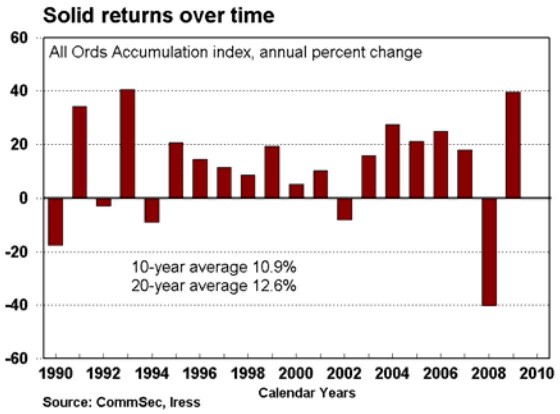
So What? Inflation remains the greater risk in 2011, not deflation. With a few notable exceptions, central banks are maintaining exceptionally loose monetary policies. Strong growth in China, and Asia more broadly, continues to put upward pressure on commodity prices. The risk is that if central banks make policy mistakes – that is, they are not sufficiently alert and forward-looking and delay tightening monetary policies – this could allow inflation to take root.

How long before shares return to record highs?

- On November 1 2007 the All Ordinaries index hit record highs of 6,853.6. On the same day the ASX 200 hit highs of 6,828.7. On Friday, the All Ords stood at 4,830 and the ASX 200 at 4,745.9. So broadly the sharemarket would need to lift just over 2,000 points or over 40 per cent to return to the highs.
- No doubt most observers would estimate that it would take another 3-4 years for the sharemarket to return to record levels – or at least six years after the levels were originally reached. Certainly we don't expect the highs to be reached any time soon – we tip the All Ords/ASX 200 to be at 5,400 at the end of 2011. It's also worth noting that it took a similarly long period to return to record levels after the 1987 sharemarket crash. The market peaked on September 21 1987 and didn't again hit record levels until February 3 1994.
- However the current situation is a little different. In 2009 companies were active in raising capital at the same time as shares were recovering from lows. So it's worth looking at the overall value of the sharemarket over time. Sharemarket capitalisation peaked at $1.73 trillion in late 2007 and now stands at $1.53 trillion. So it would only take a 13 per cent lift for sharemarket capitalisation – the broad value of the sharemarket – to reach new highs.



- The other important point is that investors are fundamentally interested in the return on shares (dividends and capital appreciation). While the sharemarket may end 2010 reasonably flat, over the past decade total returns on shares have averaged 10.9 per cent. And over the past 20 years returns have averaged 12.6 per cent a year.



So What? While it may make a good headline, record highs for the sharemarket mean little for investors. More important is the return on shares over time. And the old adage applies. It is time in the market that matters, not market timing.

How tight is the job market?

- An issue that should regularly feature over 2011 is the state of the job market. Whenever a strong employment figure is announced, commentators waste no time warning that a lift in interest rates won't be far away. In most other countries a strong lift in jobs is celebrated but in Australia it tends to be commiserated.
- The concern of course is that if the job market is tight, employers may be forced to bid for the available workers. And if wages rise, employers may be forced to lift prices. But the job market is always about demand and supply. If labour supply is increased to meet the higher demand then there is less risk of inflationary pressures are emerging.
- The Federal Government clearly has a role here. In 2009 the Government cut the migrant intake target and tightened up on visa requirements. This may have been appropriate in 2009 but less appropriate in 2010. Employers are crying out for staff but fewer migrants are coming to our shores.
- In fact net permanent and long-term arrivals to Australia fell to 210,420 people in the year to October, down a record 35.2 per cent or 114,300 people on a year ago. Departures from Australia rose by 43,500 while arrivals plunged by 70,800. The number of permanent settlers entering Australia in October stood at 9,370 – the lowest monthly total in 6½ years.
- If the migrant intake is lifted over the coming year then there will be less risk of the job market tightening too rapidly.
- There are other factors to consider as well. More people are finding work but average hours worked in the economy are falling not rising. In addition productivity growth is poor. And then there is the under-utilisation rate. In November the under-utilisation rate stood at 12.4 per cent. While down from the high of 13.6 per cent in August, it is well up from 10.7 per cent in November last year. In short, the job market is not as tight as it seems.
- This is also the conclusion of the Reserve Bank. More people are getting jobs and the jobless rate is low, but the job market is nowhere near as tight as in 2007 and 2008.

So What? Clearly the tightness of the job market will be a big issue for 2011. But it will be important to look at the trends more closely before jumping to conclusions.

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