

# International Equity Market Review and Outlook



## Economic and market review

It would appear that the rubber has, or is about to hit the road, as the saying goes. The economic stimuli and loose monetary policy have clearly helped support economic growth over the past year. The sheer scale of liquidity has been of an unprecedented level. We have written fairly extensively about this in previous quarterly commentaries. The measures were successful in what they attempted to achieve, namely to rescue the global economy from a deflationary spiral. The consequence of these measures on a medium term perspective, however, has left many countries with higher levels of debt and therefore more vulnerable. This vulnerability has been highlighted through the escalation of fear around the Euro zone this quarter. This fear has led to the so called 'bond vigilantes' pushing up the yields on these sovereigns' debt, much as the very same market players pushed down the value of the shares of companies that were considered to be overly leveraged through the end of 2008 and the beginning of 2009. The environment has therefore morphed from one where the primary concern was with regards to company insolvency, to a more worrying one of sovereign default.

In this regard the United States of America would appear to have stayed above the fray so far. President Obama and his administration have become the lone voice in their resolute stand to continue to spend their way out of their predicament. One can't help feeling however that their ability to do so has been aided by the dollar continuing to remain the reserve currency of the world. The so called 'flight to quality' through the second quarter in bond, equity and currency markets has led to the US dollar actually gaining in value, particularly against the pound and the Euro through the quarter. Ironically this is the perverse outcome of their reserve currency status, rather than a vote of confidence in the United States. We should not lose sight of the fact that the US will be going to the polls for their mid term elections, and as with many incumbent governments, the Obama administration has been suffering from an erosion in its support. This would suggest that the US will probably continue to pursue its stimulus path for some while yet. The risk of it withdrawing its stimulus policies has been laid bare by the very weak housing data reported this quarter after the end of tax incentives for first time buyers.

Much excitement was engendered around the election in the United Kingdom which eventually delivered its first peacetime coalition government since the 1930s. The coalition of the right of centre Conservatives with the left of centre Liberal Democrats would on the face of it appear to be a strange combination. Only time will tell whether or not the coalition will endure, and have the ability to implement the policies necessary to address the huge fiscal issues. The emergency budget that the new coalition government introduced six weeks after coming into power provided some visibility on some of the tax measures, but the real pressure will probably not start to build on the coalition until the autumn when further details on spending cuts will be announced. The headlines in the budget pointed to spending cuts of up to 25% in a number of government departments over the course of the parliament. Talk is cheap, but the pain that such measures will involve will undoubtedly put significant pressure on the coalition.

Just ahead of its fifteenth birthday, the euro had its first real test. We have written about the 'two speed' nature of the European Union for some time, and unfortunately the downside of monetary union without political union became all too apparent through the quarter. The catalyst was the acknowledgement by Greece that its actual level of debt was much higher than the official figures it had been publishing. It was well known that members of the monetary union had been operating outside of their agreed fiscal discipline targets, but the admission that one of the more errant members had been economical with the truth would appear to have been the proverbial straw that broke the proverbial camel's back. In reaction to the near rout in the Greek bond market, the European Central Bank in tandem with the individual member countries and the IMF,

established a € 1trillion fund to provide liquidity. The announcement of this measure helped to stabilise bond markets in the short term, but as with many measures that have been implemented over the past two years, to address the short term issues and buy time, the real underlying issues have not been addressed. Despite the backing of the European Union, the price of Greek government debt insurance continued to rise towards the end of the quarter, up to a level that implies that there is a greater than 50% chance of a default. The markets appear to have little confidence in the ability of Greece to implement its stated austerity measures.

While all the focus appears to have been on Europe through the quarter, especially with regard to its growing debt problem, the lack of focus on Japan and its debt is more a function of this not being new news. What is also not new news is that the political situation in Japan is in a state of flux. The hope that greeted the election of the first Democratic Party of Japan Government in August last year did not take long to fade. This led to Yukio Hatoyama being replaced as prime minister by Naoto Kan. The new Prime Minister carries some credibility from his previous post as the Finance Minister. It will be a tall order for the newly appointed Prime Minister to maintain that credibility in the face of the fiscal plight of the country. Each of the four previous incumbents failed to last longer than a year. While Japan participated in the global economic rebound, the pace of that rebound has clearly been slowing. Despite this rebound, Japan has not managed to get out of its deflationary hole. The national consumer price index is still down 1% through May, with the underlying rate lower still when you exclude food and energy.

It is not the fear of deflation that has been driving policy measures in Asia. In fact it is quite the reverse. In a number of the larger economies pricing pressures have actually been pushing higher. Australia and India have been two notable countries that have been increasing interest rates to try to stem these inflationary pressures. China has not moved official interest rates, but rather has increased reserve requirements for its banks, as well as suggesting that it is prepared to see its currency appreciate at a moderate pace. This announcement of Chinese acceptance to see the Renimbi appreciate was initially greeted with great enthusiasm, only for the realisation to sink in that the appreciation would be so gradual, that it was unlikely to have much of a significant impact. The timing of the announcement was interesting, coming ahead of the G20 meeting in Toronto. The liquidity that has been generated by monetary authorities around the world has in general been used to shore up balance sheets of banks in many western countries, but in Asia and much of the so called developing world it has been going into the economy, which has been the main driver of these inflationary pressures.

It has also been inflation rather than deflation that many policy makers in Latin America have been focussing on. The most notable country to increase interest rates in Latin America has been Brazil. It increased its target Selic interest rate by another 75 basis points during the quarter up to 10.25%. It is notable how proactive Brazil can be with regards to its own monetary policy, which reflects how far the country has come from its dark days in the 1990s which led to its own, as well as a number of other emerging economies experiencing currency crisis. Brazil is also starting to anticipate its upcoming general election this autumn. President Lula, having already served two terms, will be stepping down. Unlike many other elected leaders in the current environment, Lula's approval ratings have continued to remain healthy, another notable contrast to the general global trend.

## Outlook

The economic reports over most of the past year have generally been greeted positively. There has been sufficient ammunition to allow investors to continue to buy into the notion of the 'normalised recovery'. We believe that slowly but surely this 'glass half full' will ebb into a 'glass half empty' environment. We do not believe that there will be sufficient follow through from an economic perspective to maintain the momentum, once the stimulus plans have run their course. With austerity being the key watch word, we see that the ongoing trend from here will continue to be one of deleveraging, especially in many of the developed markets. The aggressiveness with which many of the emerging market countries will continue to look to attack their growing inflationary pressures is more likely to be a function of the impact on global growth of the austerity plans being implemented in the west.

This growing level of uncertainty has not been lost on equity markets. The correction through the second quarter has to some degree reflected this. Despite this correction we continue to remain generally cautious about equity markets. The scale of austerity measures so far announced, and the further measures that can be anticipated, lead us to believe that corporate earnings, particularly in the west, have not yet reflected this new environment. At the margin we have continued to be constructive on more stable growing businesses in very general terms. We will continue to look for opportunities that any ensuing market volatility may present to selectively increase existing holdings or add new ones.

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