

International Equity Market Review and Outlook



Economic and market review

What a difference a year makes and we ask ourselves what has really changed? As we look back over the past quarter and indeed past 12 months, had you gone on vacation for 12 months, isolated from media, you would be forgiven for thinking nothing had actually happened. However, as we are all too aware, nothing could be further from the truth. At the end of 2008, government bond prices were soaring, stock markets were collapsing, credit spreads were widening and banks were going out of business. Twelve months on from arguably the worst financial crisis in history (the cost of which, in terms of banking writedowns and losses globally now stands at US\$ 1.7tn), we find the exact opposite occurring: governments bonds have fallen, credit spreads have narrowed, stock markets have soared and banks are paying big bonuses on the back of bumper profits.

The question we ask ourselves constantly is, "what is sustainable"? In asking this question we attempt to deal with the cyclical aspects of economies, corporate profits and stock markets. Sustainability comes from long term economic policy to create jobs and wealth; or in the case of corporates, by reinvesting in their business year in year in order to generate new products and profits.

Current economic policy in the Western hemisphere has been focused on monetary measures to stimulate growth or indeed avert depression. Interest rates remain at record low levels and central banks in countries such as the USA and the UK continue quantitative easing programmes to buy back government debt, issued to pay for the clean up of the financial crisis. This policy is unsustainable in the medium to longer term and it is not a question of if this stops, but when. Most market participants believe that interest rates will remain low for the foreseeable future and central banks will remain "accommodative", we will err on the side of caution and would prefer to factor in the inevitable now, rather than predict when it might actually happen. Economic data in the most troubled financial systems remains mixed though the trend is one of positive improvement. Therefore, corporate profits should continue to recover on the back of increased demand for goods and products as economies "normalise". Profits could also be boosted by a continuation of the rebuilding of inventories which were decimated at the height of the crises. Given the huge rises in stock markets in 2009, albeit from low levels, some of this is certainly already reflected in valuations.

The US remains the single biggest economy in the world and of course was the epicentre of the recent financial crisis. Whatever happens in the US, still has a large bearing on the rest of the world and although the unemployment rate remains stubbornly high at around 10%, recent economic releases regarding unemployment, such as the initial jobless claims and continuing claims have shown a continued fall from the highs seen in mid 2009. All this is heartening, yet we remain convinced from our visits to companies that there will not be a hiring spree any time soon, nonetheless, the signs are encouraging that at least things are not getting any worse.

Historically, unemployment indicators have been a keen focus for the Federal Reserve when it comes to interest rate rises and they have not raised rates in the past until they see a significant improvement with regard to these data points. However, the Federal Reserve may not have as much control of the future direction of interest rates as they have in the past. Yields on US 10-year treasuries spiked sharply higher in the fourth quarter, from 3.3% at end September to 3.8% at the end of the year, yet the FED funds rate remained the same. As a result of the crises, we expect economic and monetary policy to remain challenging in the USA with large deficits remaining for the foreseeable future. For this reason we retain a negative view on the US dollar in the medium to longer term. Anecdotally, it has been estimated that for each 1% rise in interest rates, increases the tax burden on US tax payers by US\$80 to US\$100bn.

If things are showing modest improvement in the United States but with significant challenges remaining ahead, then policymakers in the UK must look on with envy at the fact the United States have the reserve currency of the world, providing them with the ammunition to keep the printing presses rolling, as they print more and more money. However, this has not stopped the Bank of England or the UK government from following exactly the same policies with one notable difference: the UK government has started to raise taxes, increasing the higher rate income tax band to 50%. It is ironic that the UK government at a time that they want to kick start the economy raises taxes which will reduce consumption. However, faced with one of the largest budget and fiscal deficits as a percentage of GDP within the developed world, they (the UK government) have little choice. With an election coming in 2010, politicians are far too preoccupied with electioneering to come up with meaningful economic policy for a route back to growth. They must content themselves for now in buying up the bad banks and flooding the system with money. The election will also make it difficult for the central bank to change anything in terms of monetary policy for fear of "interfering" with the election result.

Of course, poor fundamentals for economic growth does not necessarily mean that there will not be any opportunities in the stockmarket. Over the years some of our best investments have been in areas such as Europe, where economic growth has been relatively muted. Europe has been slowly emerging from recession, but the issue of the 'one size fits all' interest rate policy continues to be apparent. Ireland and Greece find themselves forced into some quite stringent austerity measures, as a function of previous periods when interest rates were clearly too low for their economies. Core Europe, and Germany in particular, has been benefiting recently from the improved outlook in the export market. It is likely however that core European growth will continue to be capped by the structural lack of growth in domestic demand. In addition, the other downside is the upward pressure on the euro is that in an environment of the 'beggar thy neighbour' policies being adopted by many countries to try to push their exchange rates down to more competitive levels, the strength of the euro has been a stand-out. Further strength could well undermine the very export markets that core Europe is reliant upon.

The Latin American region once again provided the best returns in US\$ for the calendar year, the 7th time this has happened in the last decade. However, The MSCI Latin American index is dominated by the Brazilian market which accounts for around 70% of the index weight. Indeed, Latin America was also the single best performing region in the fourth quarter, largely due to Brazil. As Western central banks pumped money into their ailing and floundering financial systems, "riskier" assets have been beneficiaries of this money creation. With strong reserves of most commodities including oil and a banking system that has been relatively unscathed by the global financial crisis, the longer term outlook for Brazil has probably never looked better. Nevertheless, these underlying strong fundamentals have not been lost on investors as both currency and stock market had a fantastic year and valuations on both are now starting to look a little less appealing in a global context. Moreover, Brazil is not merely a commodity export play, but also has a strong underlying domestic consumption and strong industrial production, supported by falling unemployment, approaching decade lows at around 7.4%, the future is more in their control than it has ever been.

The great hopes for the new administration in Japan did not take long to flounder. It would seem that the scope to improve the ailing economy that is Japan would appear to be very limited. Japan may well be providing a salutary lesson to the potential pitfalls that can come from a zero interest rate policy. Japan would now appear to be unable to 'normalise' interest rates as the impact that such rises would have on their debt servicing costs would be severe. To add insult to injury, the elderly Japanese finance minister, who carried the most credibility within the new administration, has been forced to step down due to ill health, a change that Japan could have done without!

The rest of Asia has been benefiting from the improved export environment, helped in no small part by the stimulus provided through 2009 by the Chinese government. It is difficult to know how sustainable 30%+ growth in fixed asset investment can be in China, or the real consequences of the spike in lending that the Chinese banks were encouraged to undertake through the first half of 2009. What is clear about the most of Asia, however, is that the structural positioning is more positive from an economic perspective, than for most of the Western world, with debt levels low both at the consumer and government levels.

Outlook

Looking back at our outlook statement made at the end of December 2008, for calendar year 2009, we were cautious with an optimistic tone: cautious due to the uncertainty surrounding world economic growth and the collateral damage inflicted from the sub prime and financial crisis, yet optimistic that governments would enact policy responses, that would fend off recessionary conditions and install confidence back in the system.

Abraham Lincoln once said "With high hope for the future, no prediction is ventured." It is with these words in mind that we predict 2010 and 2011 will hold plenty of surprises and will probably not play out the way most market participants envisage.

Fortunately, due to the way we manage money, we focus on the individual prospects for each corporate we look at, with a preference for good franchises and strong balance sheets in the belief that they will survive any downturns and prosper and participate in the good times. It is for these reasons we have a longer investment time horizon. We will be looking to take advantage of any wobbles in economic recovery or indeed any "aftershocks" from the global financial crisis in 2010 and beyond and that we hope we get the opportunities, but will venture little to predict what may happen.

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