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Expert Update

Chris Caton (BT Chief Economist) Reports

Most investors won't be sorry to see the back of the 2007/08 financial year. Share markets weakened all over the world, with the exception of a few emerging markets. The Australian share market is down more than 14% as I write, and will almost certainly record its worst performance in 26 years. And there wasn't much, if any, money to be made in other asset classes. There was, in a sense, no place to hide, except in cash. For the year, even balanced funds are likely to show a negative return, and it's been six years since we've seen that happen.

What's past is prologue, of course. What can investors expect in the year ahead? Perhaps the first thing that we need to do is to look at the factors that made 2007/08 such a poor year, and try to figure out how important they still are.

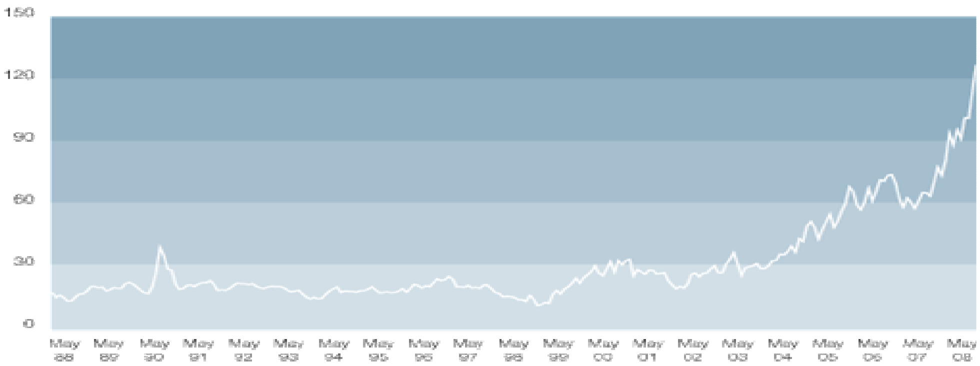
2007/08 financial markets in retrospect

In my mind, three clear problems (admittedly with some overlap) beset financial markets last year. It all began with the sub-prime mortgage crisis in the United States. This morphed into an extraordinary dislocation of credit markets, and into major problems for the US financial sector.

More recently, markets have had to grapple with the implications of the levitating price of oil, both directly and because of its effects on overall inflation (and hence potentially on interest rates).

West Texas intermediate oil price (US$ a barrel)

Thirdly, the US economy has weakened significantly, which is never good for share markets. So where do we stand on these issues? I have written about them all in the not-too-distant past, so some of this will read like revision, but what better time for that than the end of a year?



Source: Energy Information Agency

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Where to for sub-prime, oil prices and the US economy?

First, I continue to believe that the Federal Reserve is "on top" of the financial-sector issues. There will still be foreclosures and falling house prices, but the worst of this issue is past.

Second, I remain agnostic about further substantial rises in the oil price. Some of the rise in the past year must be speculative; the fundamentals of supply and demand simply haven't changed that much. So I wouldn't be surprised to see a significant fall in oil prices (and at the pump!) in the near future, although oil is unlikely ever to be cheap again. If this turns out to be correct, then inflation will eventually begin to fall, both in Australia and abroad. That said, the peak effect of oil, and food, on inflation has not yet been reached.

That leaves the state of the US economy, and that's not getting any clearer. If one looked only at the labour market (six months of falling private-sector jobs and a one percentage point rise in the unemployment rate in the past year), one would have to conclude that the world's largest economy was in recession. Other indicators such as industrial production and consumer confidence have also been at recessionary levels. But total output continues to grow, helped in part by the weakness of the US dollar, which has stimulated export growth.

The good news: markets love recoveries

For some time, I have thought that the recession in the US could well be mild ('U shaped') in which case that may well have been the low point in markets in mid-March. Note that even if this is the case, until greater clarity emerges, market volatility will continue but the trend should eventually be upwards.

I have also thought that the biggest risk to this view was that the US economy takes a further turn for the worse (the recession is V shaped), in which case the low point in share markets is probably still ahead of us.

I now think there is another risk; that the economy struggles along in a weakened state, with analysts still uncertain whether to call a recession for several months yet (a saucer shape). If this risk eventuates, then markets will continue to wander aimlessly for some months.

There is, however, some good news. Every US recession has ended (I looked that up!), and just as markets hate recessions they love recoveries. Whether it's U, V or saucer, there is almost certain to be a recovery some time in 2008/09, which augurs well **eventually** for investment returns.

In the past seven economic recoveries in the US, their share market has averaged 33% growth once the bottom has been reached, and ours has probably done about as well. For various reasons, I wouldn't be inking that sort of performance in yet, but I am reasonably confident that the second half of this New Financial Year will be better than the first half!

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