

Investment update – January 2012

2012 – Proceed with caution

We entered the New Year experiencing the second round of the global financial crisis – where uncertainty surrounds the value of eurozone sovereign debt, an asset with a critical role as a supposedly risk-free asset in the global banking system.

With these challenges, the optimistic case for 2012 rests on a US-led economic upswing that is strong enough to offset anticipated weakness in the European economy while assuming that the worst-case scenario of a messy euro break-up can be avoided. US data has been resilient but, as things stand, its doubtful financial contagion from Europe can be avoided.

Global economic growth is slowing and a peak in inflation will enable central banks to ease policy with force. However, it will be hard to offset a synchronised slowdown in the EU, an economic area larger than the US or China. At the same time, the ability of the US to underpin global activity is constrained by political deadlock over fiscal policy and China is unlikely to fill the gap. China's exports to the developed world are slowing and monetary easing is likely to be incremental as inflation is still an issue.

One of the key reasons for investor caution is that policy responses are making the European debt crisis worse. Europe's problems stem from a lack of competitiveness in the peripheral economies resulting in large trade deficits with the core that investors are no longer willing to finance. Policy makers are addressing the crisis by insisting on ever-deeper austerity, by threatening banks with injections of public capital and by hinting that countries that don't follow the rules can leave the euro. These policies may do more harm than good.

A solution to the problem could come from a policy to rebalance the European economies with the European Central Bank intervening to maintain market discipline in the meantime but Germany opposes such a move.

For Germany's opposition to become exhausted, we may need to see contagion spread to its financial sector and economy. This still seems some way off. The German unemployment rate is at a post-unification low of less than 7%; compare this with 23% unemployment in Spain and it is clear the German economy is simply not feeling the pain of its neighbours.

Once the crisis reaches Germany, the choices could become binary. A eurozone break-up is something that Europe's premier manufacturing export base wants to avoid at almost all costs. Monetary and fiscal easing to inflate the German economy and make it less competitive relative to the periphery may, ultimately, be a solution that Germany is prepared to stomach.

A recession in Europe will hamper emerging markets through trade and financial channels. European banks are the dominant lenders into Asia where credit growth has been a key driver of economic activity. Emerging markets will probably not be spared from volatility but a weak global economy in 2012 could provide a good long-term buying opportunity in much the same way as it did in 2008-09.

When global growth starts to recover, emerging markets are likely to outperform developed markets by some margin. It's likely that investment conditions will remain difficult. We expect short violent economic cycles, driven by bouts of unprecedented fiscal and monetary stimulus. Diversification across a range of asset classes will remain an attractive proposition.

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