Don’t ignore key US themes for shares, bonds

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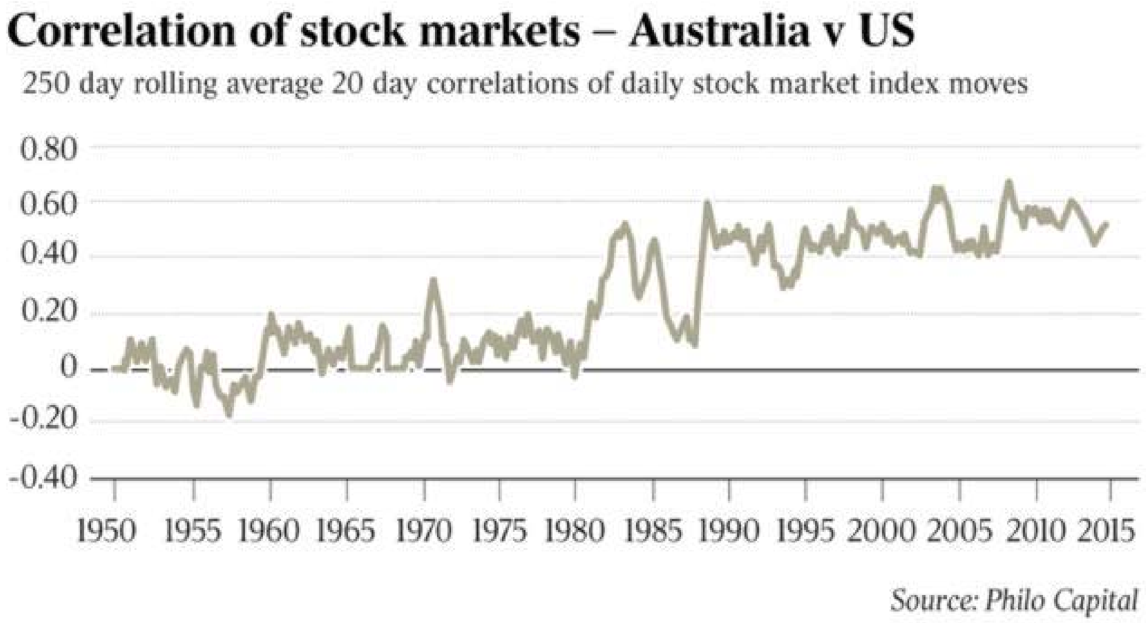

Correlation of stock markets. *Source:* TheAustralian

IN Australia, presentations on the investment outlook usually start with an update on economic prospects in the big economies. And that’s fair enough: we’re a small commodity exporting country.

But investor sentiment on growth in the big economies seems to be turning too negative.

Economic activity in our major trading partner, China, is slowing — just as the global surge in iron ore production would, in any event, have lowered the price we receive for our major export — and the eurozone and Japanese economies have been stalling.

China is selectively easing credit to support its stressed property market and is boosting demand by speeding up the program of urbanisation. The US forward-looking indicators for manufacturing and consumer spending are positive.

Times are tough in Japan and the eurozone, but much will depend on how determinedly their two central banks go about delivering the monetary easings they’ve committed to.

In my view, investors can reasonably expect global growth of 3 per cent to 4 per cent this year and next — but growth will be very uneven across the major economic blocs. US growth is likely to be strong enough (at 3 per cent plus) to require early moves to normalise monetary policy and, as a side-effect, to support a strengthening dollar.

In Australia, real GDP seems likely to grow by a modest 2 per cent to 2.5 per cent this financial year, even with stronger house construction and some recovery in retail sales; with the terms of trade in decline, real national income will contract a little.

Will these macro numbers have much direct effect on our investment markets in the year ahead? I think not.

Investment presentations too often underplay the extent to which Australian shares and longer-dated bonds follow what's happening in the US. In contrast, our cash rate, prices of short-dated bonds and average house prices mainly affect Australian influences.

The correlation between the US and Australian sharemarkets has been high and rising since the 1980s — despite wide divergences in the timing and amplitude of their economic cycles and big differences in industry representation in the share indexes.

Correlation is not causation; but the high degree of linkage is more likely to run from the US to Australia than the other way.

The correlation of yields on long-dated bonds in the two countries is quite high, though at times changes in the spread between Australian and US yields create slippage.

In the past nine months, the yield on US 10-year bonds has fallen from 3 per cent to 2.64 per cent while our yield has dropped from 4.2 per cent to 3.64 per cent.

Shares and longer-dated bonds in Australia (and in most other wealthy economies) follow US leads for these reasons: the dominant scale of the US economy and investment markets; the globalisation of each of investment flows, investor sentiment and information; the central role of the US dollar; and the global reach of US companies.

By contrast, our cash rate (and yields on short-dated bonds, which are driven by the cash rate) usually remains independent of the US. With our economy soft, but the Reserve Bank wanting to avoid fuelling a house price bubble, our cash rate seems likely to be left unchanged in the next 12 months, even if the US rate is raised.

In my view, presentations to Australian investors need to include the key themes for the outlook for US shares and bonds, because our shares and bonds are likely to move similarly to those in the US.

Those US themes might be as follows: the US economic recovery could soon cause bond yields, here and in the US, to rise. At first, higher bond yields would likely be negative for shares. But with sharemarkets having been less overpriced than bonds, prospects of a rebound in shares might appeal to investors.