Key influences on the financial markets outlook for 2007-01-08

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2006 was an outstanding year for share investors, with Australian equities recording double-digit gains for the fourth consecutive year, the US market emerging from a two-year slumber to post a double-digit return for the first time since 2003, and emerging markets rising on average by close to 30% for the second year in a row. Fixed income investors didn't fare so well, with 10-year Australian government bond yields rising by nearly 70 basis points over the course of the year – more than in most other markets – and little further compression in the already narrow spreads between corporate and government bond yields.

The global economic environment should again provide a benign backdrop for Australian investors. Growth in the world economy is slowing – but from just over 5% last year to an expected 4½% in 2007. 2007 will be the fifth year in succession in which global growth has exceeded 4% - the longest such run since 1969-73. Signs of slower growth will be concentrated in the United States, where they will be welcomed by the Federal Reserve, providing (along with evidence that 'core' inflation is moving back towards the Fed's 'comfort zone') grounds for the Fed to drop its 'tightening bias' and, eventually, to begin lowering US interest rates.

Prices of most commodities will ease through 2007, reflecting a combination of slower growth in demand (including from China, which last year began promoting growth in domestic commodity production) and (for some commodities) modest increases in supply (including from Australia). But the emphasis, in talking about changes in demand, supply or prices, is on the word 'modest' – and prices are likely to remain high by the standards of all but the past six months.

Global liquidity conditions are likely to remain conducive to rising asset prices. The large current account surpluses accruing in East Asia and in oil-producing nations will continue to be recycled back to more mature markets, maintaining premiums on riskier assets at very narrow levels and encouraging investors to keep moving out along the risk curve in pursuit of higher returns – including through 'private equity' deals of the sort which came to prominence in Australia during 2006.

Domestically, the Australian economy should grow by about 2½% in 2007, the same as last year. Although the drought will again subtract nearly a quarter of a percentage point from growth this year, as it did in 2006, 2007 will be the third consecutive year in which non-farm growth has fallen short of 3%. Although the rapid growth in investment spending in recent years should by now be lifting at some of the physical capacity constraints on increased output, businesses are likely to continue to face shortages of skilled labour and, outside of the resources sector, the on-going threat to international competitiveness posed by a strong exchange rate. Businesses operating outside the resources sector – or in areas not benefiting from the expansion of the resources sector – may thus struggle to achieve significant earnings growth.

'Headline' inflation will fall sharply over the first three quarters of this year, and there's a good chance that 'core' inflation will have moved back into the Reserve Bank's target range by the time the June quarter figures are released in late July. As a result, another increase in the cash rate is now looking less probable.

On the other hand, the Bank will be reluctant to give the Government a tacit green light for another round of pre-election spending increases or tax cuts, by cutting rates ahead of the poll due in the second half of the year. So the most plausible scenario for Australian interest rates in 2007 may well be one in which, like 2004 (the last election year), eleven RBA Board meetings pass with no change in the cash rate.

The election itself may represent a source of uncertainty to investors as the year unfolds, although with the notable exception of industrial relations there appear (at this stage) to be few significant differences between the Government and the Opposition regarding the key elements of macro-economic policy. In particular, both support the independence of the Reserve Bank in setting monetary policy; a predominant but not exclusive role for market forces in allocating resources; and modest budget surpluses while the economy continues to grow (with the word 'modest' here implying that both parties will spend, or give away, any 'windfalls' that drop into Treasury's coffers from year to year).

From a longer-term perspective investors in Australian financial markets will need to be conscious of two key trends which have become apparent over the past couple of years.

The first is the re-leveraging of the Australian business sector. During 2006, for the first time in over a decade, borrowing by Australian businesses grew more rapidly than borrowing by households. For the moment, this presents little cause for concern, because the financial position of Australian businesses is, at least in aggregate, stronger than it has been for more than two decades. But that would change if business borrowing continued to grow at in excess of 16% pa (as it did in 2006) for, say, another five years (as it did over the second half of the 1980s).

The Australian economy would be much less resilient to external financial shocks by the end of this decade if both the corporate and household sectors were heavily geared.

The second key trend is the slowdown in productivity growth. Over the past four years, trend growth in output per hour worked in the 'market sector' of the Australian economy has averaged just 1.2% per annum, the slowest over any four year period since the latter part of the 1980s and less than half the rate attained during the 1990s. All of the improvement in Australian productivity relative to the US during the 1990s has now been lost.

The productivity slowdown – which was quietly acknowledged in the form of another downward revision to the Government's longer-term economic growth projections in the pre-Christmas Mid-Year Economic and Fiscal Outlook – reflects the deluge of productivity-stifling legislation and regulation which has been imposed in the name of 'national security' and corporate governance since the early years of this decade.

Ideally, the 2007 election will provide those seeking high office with an opportunity to demonstrate to investors as well as voters how they propose to reverse this trend.

With so much 'good news' already factored into Australian asset prices it's difficult to see how 2007 could provide share investors with returns as spectacular as those of recent years. That's not to say that 2007 will be a 'bad' year either. But there won't be many easy pickings.