

Local hopes up despite Europe's Pisa condition

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Europe is taking way too long to get on top of its massive sovereign debt problems.

We've just been through a year to forget, will 2012 be any better?

THE tone on sharemarkets tomorrow morning will be governed by news in Europe over the weekend - and that tone will again be decidedly negative.

In the latest news, international ratings agency Fitch said a comprehensive solution to the European crisis was technically and politically beyond reach.

It put Belgium, Spain, Italy, Slovenia, Ireland and Cyprus on negative ratings watch, and it placed France, and its AAA rating, on the slightly less negative outlook, the second-to-last step before being downgraded.

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Standard & Poor's downgraded six Portuguese banks to junk status, while Moody's took an axe to Belgium's credit rating, demoting it two notches to Aa3 (the fourth highest rating). Elsewhere, we learnt

the Irish economy had contracted 1.9 per cent in the September quarter alone, the fastest decline in two years.

It's bleak, and we also had International Monetary Fund head Christine Lagarde warning that the world could slump into a 1930s-style depression unless countries worked together on the European situation.

Next year will be all about what happens in Europe, according to market watchers.

Nothing's changed.

Yet, despite all of this, the prospects are reasonably good for the Australian economy and sharemarket in 2012. Even the residential property market is expected to muddle through next year after remaining weak for the first half.

Estimates for GDP growth range from 3 per cent to 4.2 per cent for the year, well up from the flood-affected 2.1 per cent likely to be achieved this year. Not too shabby.

Unemployment is likely to edge up though - to just below 6 per cent, according to St George Bank chief economist Besa Deda - after what has been a poor year for jobs.

Just 45,000 jobs have been added in the Australian economy so far this year, a little more than a 10th of the number added in the first 11 months of 2010, according to CommSec. Job advertisements are still falling and companies are nervously holding back on recruitment.

But 6 per cent unemployment is no disaster, and interest rates are predicted to continue to fall, with most economists expecting at least two cuts early next year. This would take the cash rate to 3.75 per cent.

But this is where the problems start locally. The major banks have been telling all and sundry at their annual meetings last week the local cash rate has only a small impact on the cost of providing residential mortgages - about a fifth of the cost, they say.

The rest of their costs have been rising, particularly offshore financing costs because of the European banking and sovereign debt crisis - and that's if they can secure money overseas at all, according to ANZ.

They clearly are preparing customers for the likelihood they will not match further cuts to the cash rate by the Reserve Bank. They may even begin to lift mortgage rates ahead of the February meeting.

There's more to worry about, too. As St George's Deda points out, there are some big European hurdles early next year that are going to test financial market resolve as the balloon deflates again on the latest resolution to the European problems.

"In January and February, Italy has something like €80 billion (\$A103 billion) it needs to refinance," she says. "That's going to be a big test. Last week the Spanish debt auction went reasonably well [for €6 billion], but an earlier auction of German debt didn't."

Deda says Europe is taking way too long to get on top of its massive sovereign debt problems. "They are still tinkering around the edges and the longer they take to come up with a quick and effective

solution, the further behind the curve they get, and that's why I'm increasingly pessimistic about the outlook there."

Deutsche Bank senior economist Phil O'Donoghoe says there is considerable fatigue about the European situation everywhere around the globe.

"It's been an incredibly difficult year, but it's hard to be overly optimistic about 2012," he says. "Europe is the epicentre of the story right now and whether that will be any different in 2012 is very hard to predict. The only solution in Europe is time. Financial markets are looking for a discrete resolution, such as the Lehman collapse gave the US, but the nature of this problem means they are not likely to get it."

In a new Deutsche Bank report on the global economy titled *Between soft patch and recession*, the bank's economics team downgraded its global forecast for growth next year, predicting recession in Europe, with the euro-zone economies contracting 0.5 per cent on average.

The bank trimmed its global growth forecast from 3.5 to 3.2 per cent, as the European recession and problems in its banking sector take their toll on activity and confidence elsewhere, too.

It also forecast that euro-zone sovereign debt won't peak until 2013 even without a major catastrophe from here - and at an average of 92.5 per cent of GDP per country.

But will even the current situation last in Europe? There have also been reports of unrest in Portugal as workers realise the austerity measures being imposed on the country in return for bailout money were making it even harder for Portugal to meet its existing debt repayments.

On the positive side for Australia though, Deutsche Bank says the concern over a hard landing in China is overdone - Chinese shares fell 6 per cent last week on weak economic news, posting their biggest weekly fall in a long while and taking the Chinese sharemarket down to levels not seen since March 2009.

The US is also a bright spot, says O'Donoghoe. "The US economic data has been much better than it was in the middle of the year."

So what to do? Austock senior client adviser Michael Heffernan says that if you can remove Europe from the equation, local shares are primed to roar.

"I think we are looking at a potentially big year for shares," he says. "It's like a smorgasbord of delights, there's so much value around. Right now, you can go anywhere along the dining table and pick up a tasty morsel. If we can just get beyond Europe, we may be looking at a 15 to 20 per cent gain from here."

But it's the getting beyond Europe and its uncertainty that is the difficulty, according to financial planning group [WLM Financial Services](#) director [Laura Menschik](#).

"We are cautiously, slightly optimistic about 2012, but the volatility will continue to increase, and that's something we maybe need to learn to live with," she says.