Stock Market & Economic Update

As June commenced we saw an intensification of the 'sell Australia' trade driven by further rises in global bond yields. All else being equal, rising bond yields make Australian shares less attractive to investors. This is because it narrows the differential (or benefit) of holding high dividend yielding Australian stocks versus Government bonds.

We suspect foreign investors, many of whom established positions to capture this 'yield premium' and who do not receive a taxation benefit from dividend franking have been large sellers of Australian shares in recent weeks. After all, how many domestic investors are willing to sell our major banking stocks down to a 6% fully franked dividend yield?

It is worth noting that while bond markets are beginning to factor in future interest rate increases - from a very low base - the key Central Banks in the US and Europe are yet to raise official interest rates. But as economic data continues to improve it is becoming increasingly apparent that the point of lowest interest rates and maximum quantitative easing (QE) may be behind us.

For example, the strengthening US jobs market is one factor which has heightened expectations that the US Federal Reserve may increase interest rates later this year. In Europe, a rebound in economic activity has led the European Central Bank (ECB) to raise its Eurozone inflation forecast, suggesting that Europe may eventually follow the US's path and reduce QE as their economy improves.

Having said this, a stronger global economy is the objective of a low interest rate environment and inherently good news for stock markets. It is likely that financial markets will react in some form to the initial and inevitable interest rate rises, but once comfortable with this new setting, we expect stock markets to be net beneficiaries of improving economic conditions.

Domestically, two interest rate cuts and a supposedly friendly Federal Budget has done little to kick-start the Australian economy. With an unsustainable, debt driven, East Coast housing boom currently offsetting a structural slowdown in commodities demand we expect a prolonged period of weak Australian economic activity and correspondingly low interest rates.

While low interest rates continue to fuel domestic buying in our high yielding stocks, the degree to which sluggish economic conditions are impacting company profits – and to what extent these have been factored into current share prices - is more difficult to read.

August is clearly an important month for our stock market with most of our leading companies due to report profits, declare dividends and release outlook statements. Some good news and a lift in stock market sentiment is sorely needed, with Australian being a huge underperformer compared to almost every other major international stock market this quarter.

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