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Executive summary. The eurozone sovereign debt issues continued to dominate financial markets and economies during the fourth quarter of 2011. Economic data suggests the eurozone is heading into a recession in 2012 following softer growth particularly in the major European economies of Germany and France. The US has seen some strength in GDP growth but there is concern that this has come at the expense of savings, which is unsustainable, and also as a result of a falling unemployment rate due to the 'discouraged worker effect'.

Australia's GDP growth for the third quarter, released in December, was 1.0% which was above consensus forecasts – but a slowing Chinese economy and lower commodity prices may have a negative impact in the future. The Reserve Bank implemented counter-cyclical policy, by easing interest rates, in an effort to avoid the global slowdown flow-on impact on the Australian economy.

Equity markets recovered some of the lost ground during the last quarter for 2011 with the S&P500 in the US outperforming most other markets for the year.

The global economy

The US economy recorded stronger GDP growth than expected with encouraging news from manufacturing surveys, wholesale inventories and the construction industry; and below-forecast jobless claims. Vanguard's US chief economist believes that private sector resilience is the main indicator of how the US economy will progress. Corporate profits have been strong and consumers have been spending – although prudently and at the expense of savings. The unemployment rate rose from 8.6% to 9.0% in November but this was largely due to job seekers leaving the labour force – not because more jobs became available. The US economy's strengths are manufacturing, exports, business investment and high-end consumption – its weaknesses, housing and housing finance, and government retrenchments.

The outlook for the eurozone economy remains uncertain with the major economies, Germany and France, starting to see slower economic growth. Even though the eurozone accounts for only 17 countries out of the 27 in the European Union, the impact from the eurozone is being felt widely. Growth is likely to be held back in the European Union by the difficult financial conditions and ongoing deleveraging and sectoral adjustment. Although the European Commission is factoring in slower growth for Europe, a recession in 2012 for the European Union may be likely if the downside risks from debt concerns, unemployment and weak banks worsen.[1]

Emerging economies are at risk of a hard landing as the global demand for exports to the developed world has seen a sharp slowdown. There are concerns about an asset price bubble in countries such as China due to the increasing numbers of non-performing housing loans. The overriding factor that could affect economic growth in the emerging markets is the global slowdown. Any impact on growth in the Chinese economy has ramifications for other emerging markets such as Brazil, which is closely tied to Chinese demand for commodity imports which, in turn, depends on Brazil's level of economic activity.

The Australian economy

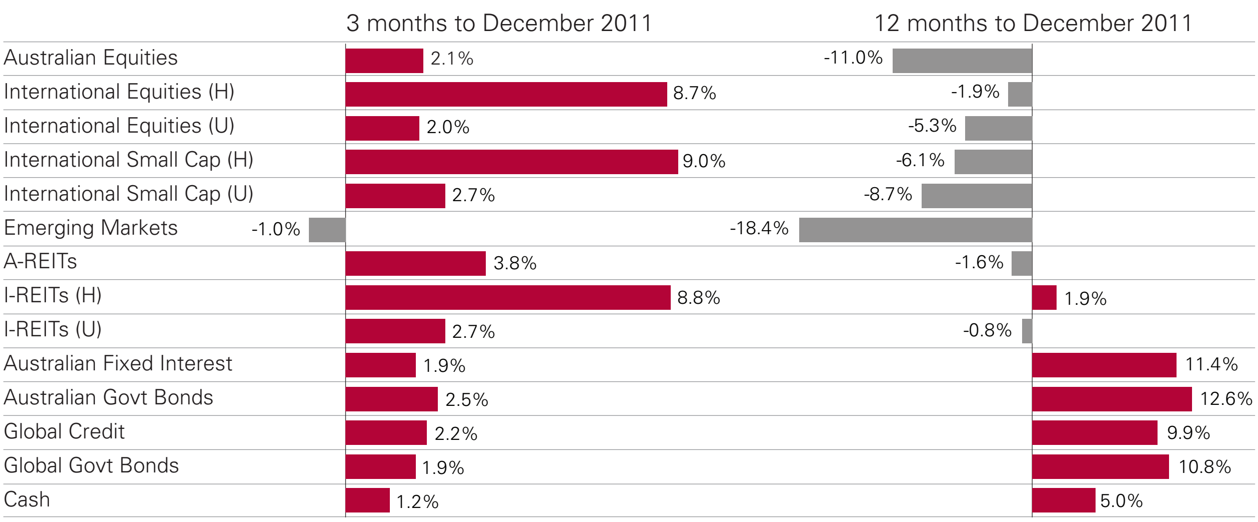
Data released in December showed the Australian economy rose 1% in the third quarter above forecasts, and 2.5% year on year. Household spending was up 1.2% in the third quarter adding 0.7% to GDP growth. The terms of trade have been driven to a record high by China's demand for iron ore, coal and energy – but that may be peaking as China's commodity demand is softer, although recent manufacturing activity in China showed some positive growth. The domestic household savings ratio rose to 10.1% for the third quarter from 9.1% in the second quarter, not quite to the high levels during the global financial crisis when the savings ratio was over 12% due to weak consumer sentiment, but still relatively high compared with previous periods.

Commodity prices had started to fall which may mean further falls in export growth, which will affect mining-related profits and public sector revenue.[2] Uneven growth is evident across sectors with an increasing mining contribution to GDP of about 9% (the second largest sector after banking and finance), while non-mining related sectors such as manufacturing have seen falling contributions to GDP as consumers become cautious and reluctant to spend.

Market summary

The major factors that impacted global markets in 2011 included the Eurozone debt crisis and the congressional debate on raising the US debt ceiling. Equity asset classes were weaker for the year ended 31 December 2011, although all asset classes were up for the last quarter, except for Emerging markets. The US equity market was one of the strongest markets for 2011 ending in positive territory, being the exception

Chart 1 Asset class performance



Source: Factset

Chart 2 Australian Equity Index industry level performance

	3 months to December 2011	12 months to December 2011
S&P ASX 300 Accum Index	2.1%	-11.0%
Consumer Discretionary	-0.6%	-17.1%
Consumer Staples	-2.9%	-0.4%
Energy	1.9%	-20.8%
Financials	5.5%	-5.0%
Financials Ex Property Trusts	5.3%	-4.4%
Health Care	5.1%	-9.1%
Industrials	6.4%	-7.8%
Information Technology	0.9%	-24.9%
Materials	-2.9%	-24.1%
Property Trusts	3.8%	-1.6%
Telecommunications	7.0%	29.2%
Utilities	8.3%	9.5%

Source: Factset

relative to most other markets, due to the stabilisation of economic indicators, such as employment and GDP growth. Domestic and International government bond and fixed interest asset classes finished up strongly for the year due to investors seeking defensive investments.

Emerging markets have struggled as they try to balance growth and inflation and avoid contagion from the weak economic growth in the Eurozone. Increasing concerns about a hard landing exist in some emerging economies, with China's banks in particular seeing a growing number of non-performing housing loans.

The Australian market ended up 2.1% for the last quarter of 2011, although was down 11.0% for 2011. The best performing sectors for the quarter were telecommunications and utilities; the worst performing were consumer staples and materials.

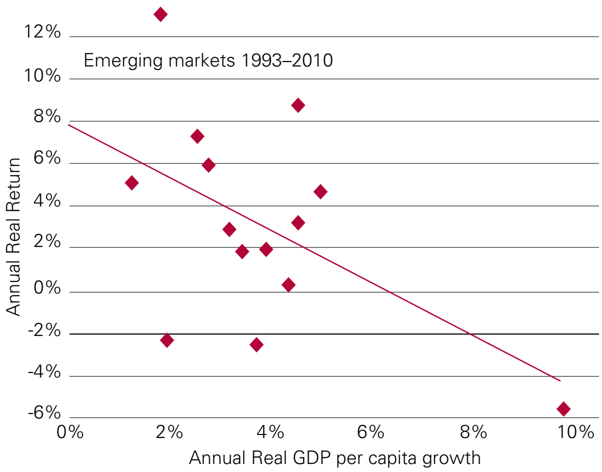
Global markets – converging valuations

In recent times we have seen a convergence of the valuation of the global stock markets, especially since the early 2000's when emerging markets traded at a discount to developed markets (chart 3). Due to expectations of relatively stronger economic growth in emerging markets, investors seeking higher returns in a low yielding environment may view emerging markets as an opportunity to achieve some future outperformance. Despite our research that has shown that both the price you pay for your investment is important over the longer term, and that lower P/E ratios now may indicate stronger long-term returns[3], this may not be the case for emerging markets. Our research found that the significant outperformance of emerging markets during the last decade is due to systematic tightening of valuations between developed and emerging markets – emerging markets were

Chart 3 MSCI World ex. Australia, MSCI Emerging Markets and S&P ASX 300 stocks: the valuation gap has narrowed

Source: Vanguard Investments Australia Limited, Factset

Chart 4 Relationship between GDP growth and market returns



Notes: Sample includes the 14 Emerging markets that had both economic and market return data available back to 1993. If we remove the outliers, Brazil and China, the correlation becomes zero.
Sources: Vanguard Investments Australia Limited, International Monetary Fund, Factset

undervalued in the 2000's but are more similarly valued today.[4]

Although a strategic allocation to emerging markets in a global equity portfolio is a sound investment strategy, (based on the principle of diversification), investors should not significantly overweight emerging markets on the basis of the belief that they will grow faster than developed economies over the next few years. While economic growth has been stronger in emerging markets than in developed in 2011, equity market performance in emerging markets has been relatively a lot weaker. Our research has shown that over the longer term there is no relationship between GDP growth and market returns (see chart 4).[5]

Emerging market equities over the next decade may do better than other markets not due to high economic growth, but partly in compensation for higher expected investment risk. ■

References

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2 Morgan Stanley Research, Dec 2011
3 Davis, Joseph H. et al, *Investing in Emerging Markets; Evaluation the Allure of Rapid Economic Growth*, The Vanguard Group, 2010
4 Philips, Christopher B, et al, *Are investors truly embracing international diversification?*, The Vanguard Group, 2010
5 The result in Figure 4 was first documented in the book *Triumph of the Optimists: 101 Years of Global Investment Returns* by Elroy Dimson, Paul Marsh, and Mike Staunton, of the London Business School (Princeton University Press, 2002).
See also Davis et al. (2010) *Investing in Emerging Markets: Evaluating the Allure of Rapid Economic Growth*. The Vanguard Group. for an in-depth analysis of this result

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