

Market & Economics Report

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Global economy

Review: The global economy continues to recover slowly.

US economic data was more encouraging during November and at the beginning of December, suggesting the soft patch seen around mid-year may be over. Early in November, the US Federal Reserve (Fed) decided to further increase its balance sheet in a second round of quantitative easing. As part of the plan, the Fed intends to purchase an additional US\$600 billion of US Treasury bonds by June 2011. Consistent with continuing growth, key Institute for Supply Management manufacturing and services conditions indices remained solid in November and US real gross domestic product (GDP) for the September quarter was revised up to 2.5% annualised. Consumer credit rose in October, consumer confidence improved and vehicle sales and construction spending rose. Retail sales are also improving. Further, the Fed's Beige Book of anecdotal evidence pointed to improving economic activity. US payrolls increased in October and November, albeit in a weaker-than-expected rise in the latter month. Meanwhile, data from the Mortgage Bankers Association showed that the percentage of mortgage delinquencies fell to 9.1% in the September quarter. House prices fell in September; however, this largely reflects the earlier slump in housing activity after the ending of the first-time home buyer tax credit. More importantly, a surge in pending home sales and continuing improvement in weekly mortgage applications to purchase houses suggest that the housing sector is improving.

In Japan, the main news was a surprise rise in annualised GDP in the September quarter of 4.5%, driven primarily by strong consumer spending.

In China, economic indicators showed continued strong growth in November. Although China's export growth slowed, the trade surplus widened considerably to US\$27 billion. Activity indicators such as industrial production, retail sales and fixed-asset investment remained strong. However, China's annual consumer price index inflation accelerated more than expected to 4.4% year-on-year in October, influenced by sharp rises in food prices. The People's Bank of China once again raised the reserve requirement ratio by 0.5% in a move designed to counter strong loan growth and control inflation. However, with the pick-up in inflation mainly due to food prices, it's hard to see policy tightening becoming aggressive.

Concerns over the solvency of smaller European nations once again dominated headlines during November. The trigger for this latest round of concerns was Ireland's bailout of its major banks. Despite resisting initial pressure, Ireland eventually decided to accept a financial bailout package from the European Union and the International Monetary Fund. However, financial markets continue to question whether

Ireland, Greece, Portugal and Spain have the economic capability and commitment to avoid default. Despite the sovereign debt strains, business conditions surveys in the region were strong. An index of economic sentiment for consumers and business rose to a three-year high in November. The European purchasing managers' index rose to 55.5 in November and Germany's IFO Business Climate Index rose to a record high.

Outlook: Despite obvious risks, the economic outlook has improved. We expect the global recovery to continue in 2011 with growth around 4.3%.

Australian economy

Review: After showing strong momentum in the first half of the year, the Australian economy appears to have hit a soft patch with September quarter GDP growth slowing to a crawl. Data for retail sales and housing indicators have also softened. While the Reserve Bank of Australia (RBA) raised the cash rate to 4.75% in October, it has since signalled that rates will be on hold for a while. However, with mining investment set to ramp up next year and the labour market remaining strong, the soft patch in growth should prove temporary with gradual rate hikes likely to resume in the June quarter.

Outlook: We expect growth to pick up to around 3.5% over the year ahead as mining exports and investments ramp up. The RBA is likely to leave interest rates on hold for several months but we see the cash rate rising to around 5.5% by the end of 2011.

International shares

November review: The leading measure of global share market performance, the MSCI World (ex-Australia) Accumulation Index, returned -0.3% in local currencies (or +0.1% in unhedged Australian dollar [A\$] terms). The US S&P 500 Accumulation Index was flat over the month. In the European region, the Eurostoxx Accumulation Index returned -4.9% and the UK FTSE 100 Accumulation Index returned -2.3%, both in local currency terms. Shares in Asia were mixed with Japan's Topix Accumulation Index returning +6.2% and China's S&P/CITIC 300 Total Return Index returning -6.2%.

Short-term outlook [six to 12 months]: Given that shares remain cheap, global shares are likely to provide reasonable returns on a 12-month plus view as growth continues, monetary conditions remain easy, and as cashed up companies boost merger and acquisition activity, dividends and share market buy-backs. However, volatility is likely to remain high, reflecting recurring macroeconomic scares.

Medium-term outlook [five to ten years]: Constrained profit growth will see medium-term returns from mainstream global shares of around 7.0% per annum on average.

Australian shares

November review: Australian shares fell in November and again underperformed global shares, returning -1.1% as measured by the S&P/ASX 200 Accumulation Index. The RBA's tightening bias and the rising A\$ placed pressure on Australian shares.

Short-term outlook: While short-term volatility will remain high, Australian shares are likely to provide positive returns on a 12-month view. Valuations are reasonable and solid economic conditions and rising profits are supportive of further gains in shares.

Medium-term outlook: Reflecting reasonable growth prospects, medium-term returns of around 9.5% per annum are likely (or 10.5% if franking credits are allowed for).

Real estate investment trusts

November review: The Australian real estate investment trust sector underperformed the broader Australian equities market, returning -2.1% for the month of November while the S&P/ASX 200 Accumulation Index returned -1.1%.

Short-term outlook: Property stocks have recapitalised and are good value from a long-term perspective. With improved credit conditions and property transaction volumes having increased, property stocks should provide solid returns over the next 12 months.

Medium-term outlook: Solid yields and moderate growth prospects suggest medium-term returns of around 9.0% per annum are likely.

International bonds

November review: Globally, the focus during November was on the Fed's decision to implement a new phase of quantitative easing (QE2) and renewed concerns over European sovereign debt. The US bond market sold off despite the announcement of QE2 and a bailout of Ireland announced on 28 November didn't prove to be the circuit breaker policy-makers had hoped for. The US ten-year bond yield rose by 20 basis points (bps) to 2.80% and Japan's ten-year bond yield rose by 25 bps to close at 1.19%. In Europe, the UK ten-year bond yield rose by 15 bps to close the month at 3.23% and Germany's ten-year bond yield also rose by 15 bps to 2.67%.

Short-term outlook: Sovereign bond yields are likely to push higher as economic conditions continue to improve, and are likely to continue to move higher through next year as the global economic recovery continues.

Medium-term outlook: Global sovereign bonds are likely to see low returns, reflecting currently low bond yields and the likelihood of capital losses as yields rise.

Australian bonds and cash

November review: The RBA surprised markets by raising the cash rate by 0.25% to 4.75% in November. Three-year Australian government bonds opened the month of November at a yield of 4.84% and closed 14 bps higher at 4.98%. Ten-year bond yields also rose and the yield closed the month 21 bps higher at 5.41%. The three-month bank bill yield opened at 4.87% and rose 17 bps to close at 5.04%, the six-month bank bill opened at 5.07% and closed 18 bps higher at 5.25%.

Short-term outlook: Australian bond yields are likely to provide returns around current yield levels (5.5%), or a little less as yields rise.

Medium-term outlook: Returns from local sovereign bonds over the medium term are likely to be low, reflecting low yields.

Australian dollar

November review: The A\$ began November strongly, pushing decisively back above parity with the US dollar (US\$). However the A\$ drifted lower as concerns about global growth and further tightening in China caused commodities and risk assets to fall. Meanwhile, the A\$ rose slightly against the Japanese yen (JPY) and the currencies of Australia's major trading partners (as per the Trade Weighted Index [TWI]). The A\$ closed the month at 95.86 US cents (down 2.7% from 98.50 US cents) and JPY80.23 (up 1.5% from JPY79.08). The TWI closed the month at 73.0 (up 0.4% from 72.7).

Short-term outlook: Notwithstanding short-term volatility, further gains in the A\$ are likely on the back of strong demand for resources and relatively high Australian interest rates.

Medium-term outlook: High commodity prices and strong growth in China are likely to support higher levels for the A\$.

Key financial markets

	30 November 2010	Change in one month	Change in 12 months
S&P/ASX 200 Accumulation Index	33,299	-1.1%	+1.7%
MSCI World (ex-Aust Accumulation/unhedged in A\$)	3,380	+0.1%	+1.2%
US S&P 500 Accumulation Index	1,982	0.0%	+9.9%
Dow Jones Eurostoxx Accumulation	414	-4.9%	+2.8%
UK FTSE 100 Accumulation Index	3,609	-2.3%	+10.0%
Japan Topix Accumulation Index	1,079	+6.2%	+4.4%
S&P/CITIC 300 Total Return Index	2,995	-6.2%	-7.7%
S&P/ASX 200 Property Accum. Index	19,122	-2.1%	+1.7%
UBS Global Real Estate Investors Index (hedged in A\$)	1,133	-2.5%	+23.1%
Aust 90-day bank bill yield	5.04%	+17 bps	+101 bps
Aust 10-year bond yield	5.41%	+21 bps	+17 bps
US 10-year bond yield	2.80%	+20 bps	-39 bps
A\$ in US cents	95.86	-2.7%	+4.7%
Trade-weighted index	73.0	+0.4%	+5.6%

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