

## Review of 2010 and outlook for 2011



### Key points

- 2010 has been somewhat disappointing for investors, with a continuing economic recovery but various macro scares resulting in a constrained and volatile ride for share markets and other related investments.
- 2011 is likely to see global growth continue and this, combined with attractive valuations and easy money, is likely to underpin renewed acceleration in the recovery in shares and other growth-oriented investments.
- Key risks relate to the US housing market, sovereign debt in advanced countries and emerging market inflation. However, with shares cheap and so much liquidity around it's also possible that returns surprise on the upside after the consolidation of 2010.

### 2010 consolidating the recovery

The key global themes of 2010 were continued global economic recovery, benign inflation and easy global money, yet all against a backdrop of periodic macro threats resulting in a mixed and perhaps disappointing ride for investors. **Global growth in 2010 has actually turned out a little better than expected**, coming in at around 4.7%, with emerging countries leading the charge. Even advanced countries with growth of around 2.8% have come in a bit better than we expected. Despite fears of a global dip back into recession, the recovery has continued.

While inflation has been a bit of a concern in emerging countries, this has mainly been due to higher food prices. **In advanced countries, underlying inflation has fallen**, with the US coming close to joining Japan in deflation.

**Global monetary conditions as a whole have remained very easy** as advanced countries have kept interest rates near zero and the US and Japan have embarked on more quantitative easing. While there has been some monetary tightening in emerging countries, this has arguably just offset capital inflows, which have resulted from resistance to upward pressure on their currencies.

Contrary to the global experience, **Australian economic growth has come in a little less than expected** as housing construction has rolled over, rate hikes and greater caution with respect to debt have weighed on consumer spending, public sector stimulus has come to an end, and mining exports and investment are yet to fully ramp up. Nevertheless, the labour market has been very strong with unemployment falling to 5.2%.

However, despite a solid economic growth backdrop, investment returns have generally been sub-par. All was fine up until mid April, but the June quarter saw macro worries return in a big way, led by the European sovereign debt crisis, worries about a 'double dip' in the US on renewed housing sector weakness, and concerns that Chinese policy tightening would crash its economy. This all weighed on returns for listed growth assets. Returns for major asset classes are shown in the following table.

### Investment returns for major asset classes

Total return (%)	2009 actual	2010 actual	2011 forecast
Global shares (in A\$)	-0.3	-2.0	13.5
Global shares (in local currency)	25.4	10.4	18.5
Asian shares (in local currency)	64.1	15.2	25.0
Emerging market shares (in local currency)	62.3	14.1	25.0
Australian shares	37.0	1.6	18.5
Commodities (in US\$)	38.8	26.9	20.0
Global bonds (hedged into A\$)	8.1	9.3	3.0
Australian bonds	1.7	6.0	4.5
Global listed property securities	27.4	22.5	15.0
Listed property trusts	7.9	-0.4	18.0
Unlisted non-residential property	-8.1	9.8	9.0
Australian residential property (estimate)	18.0	5.0	2.0
Cash	3.5	4.7	5.0
<b>Average balanced super fund</b>	<b>12.8</b>	<b>5.0</b>	<b>13.5</b>

Source: Datastream, Intech, REIA, AMP Capital Investors

While returns are well down on 2009, **the key winners in 2010 were commodity prices, global listed property, and Asian and emerging shares.**

Global bonds have also had solid returns as government bond yields fell on growth worries and deflation concerns, and credit rallied.

Returns from global shares were reasonable but turned into losses once the rise in the Australian dollar (A\$) is allowed for.

Australian shares were also a disappointment, with global macro worries made worse by Australia's exposure to China (Chinese A shares were one of the world's worst performers in 2010), domestic monetary tightening and the rise in the A\$.

Australian unlisted commercial property provided good returns as investors took advantage of attractive yields. By contrast, Australian housing was subdued as poor affordability in response to last year's price surge and higher mortgage rates flattened sales and house prices.

The subdued and mixed experience across asset classes saw positive returns from super funds.

## Outlook for 2011

While aftershocks from the global financial crisis will continue to cause volatility, 2011 is likely to be a year of continuing global recovery. The key themes of relevance for investors for 2011 are likely to be:

- 1. Continuing solid global growth.** Business conditions indicators remain at levels consistent with solid growth ahead. There remains plenty of pent-up demand globally and while fiscal conditions are tightening, monetary conditions remain very easy. In the US, strength in the corporate sector is driving a pick-up in employment and capital spending, housing indicators appear to have found a floor and retail sales growth is improving. In Europe, strength in Germany has offset weakness in debt impaired countries. 2011 is likely to see global growth of around 4.3%.
- 2. Emerging world to remain stronger, but gap to narrow.** Thanks to stronger domestic demand, growth in the emerging world is likely to remain stronger than in the advanced world. However, reflecting relatively tighter monetary conditions, the gap between the two is likely to narrow with emerging country growth of 6.5% versus 2.5% in advanced countries. China is likely to grow by 9.5%, India by 8.0% and Brazil by 4.5%.
- 3. Essentially benign inflation.** Excess capacity is likely to ensure inflation remains low in advanced countries. Less spare capacity is likely to see inflation stay somewhat higher in emerging countries, but declining food prices, including those in China, are likely to remove upward pressure.
- 4. Fiscal tightening, but easy money.** Fiscal tightening is already in train and likely to be the equivalent of one percentage point of GDP in 2011 in advanced countries and somewhat less in emerging countries. However, the negative effect will be offset by continued easy monetary conditions with still high unemployment ensuring monetary tightening will be unlikely before 2012. While emerging countries will likely be tightening to keep inflation under control, this is unlikely to be aggressive, especially with food prices likely to fall, and will continue to be offset by a reluctance to allow faster currency appreciation, resulting in capital inflows.
- 5. Solid earnings growth.** As economic growth continues, earnings growth will likely remain solid. Profit growth is likely to be in the order of 10-15% in the US and Australia, and 20% in emerging countries.
- 6. Solid, but two speed, Australian economic growth.** Growth in Australia is likely to be around 3.5% through 2011. However, this will mask huge strength in the mining sector as a 50% boost in mining investment adds 2% to GDP growth, and tougher conditions elsewhere. The overall growth backdrop will probably be enough to push unemployment down to 4.75% by the end of 2011, but for home builders and manufacturers it may feel pretty tough. Inflation is likely to be benign initially but start to rise toward 3% later in the year as growth constraints start to impact. While the Reserve Bank of Australia (RBA) will leave rates on hold until the June quarter, we expect more hikes designed to contain inflation, ultimately taking the cash rate to 5.50% by the end of 2011. Soft non-mining growth will likely head off the need for a more aggressive rise.

Looking at the major asset classes in 2011:

- **After undergoing a decent correction in 2010, shares are well placed to put in strong gains in 2011.** Shares are cheap (with

forward price to earnings multiples around 12.5 times compared to longer-term averages around 14.5 times), suggesting risks are well allowed for. In addition, the continuing economic recovery should underpin further gains in profits, the global liquidity backdrop is positive (underpinned by very low interest rates and quantitative easing in some countries), and the corporate sector is cashed up, which is likely to result in a further pick up in merger and acquisition activity, share buybacks and dividends. 2011 is also the third year in the US presidential cycle, which usually sees above-average share market gains. The Australian ASX 200 Index is expected to rise to around 5,500 by the end of 2011. Strength in the A\$ is likely to see unhedged international shares underperform Australian shares.

- Key sector outperformers in Australia are likely to be resources, cyclicals such as media and undervalued retailers, and telcos.
- **Asian and emerging markets are likely to remain outperformers**, reflecting similar valuations to Australian and global shares but better growth prospects, lower debt-related risks and likely strong capital inflows from traditional advanced countries.
- **Commodity prices are likely to remain strong** with the oil price likely to breach US\$100 a barrel in 2011.
- **Commodity strength is likely to push the A\$ to US\$1.10** by the end of 2011, but expect occasional sharp corrections as US growth strengthens.
- **Cash remains unattractive, reflecting low interest rates.** Cash returns are likely to be around 5%.
- **Low starting point bond yields and a rising trend in yields as the global economic recovery continues is likely to result in poor returns from international government bonds.** Corporate debt remains far more attractive with higher yields.
- **Unlisted non-residential property is likely to see good returns** on the back of yields around 7% and modest capital growth thanks to favourable space demand/supply fundamentals and investor demand.
- **Australian house prices are likely to flatten** due to poor affordability and the threat of more rate hikes.

Our return expectations imply that most super funds should see a return to solid gains after the soft returns of 2010.

## What are the risks?

The main risks are recurring sovereign debt crises in Europe and possibly also in other advanced countries, another bout of US house price weakness, and a more persistent rise in inflation in emerging countries, leading to a sharper than expected tightening in China. In Australia, it's worth keeping an eye on the RBA as excessive tightening could threaten the Australian housing market.

## Conclusion

The second year after a bear market ends often sees volatile trading and poor returns as share markets are constrained by worries about a double dip back into recession or concerns about the removal of stimulus measures. This has certainly been the case in 2010. However, the experience of past cycles points to the resumption of better returns in the third year and we expect this to play out in 2011.

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