

# Market & Economics Report

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## Global economy

**Review:** The US economy has generally continued to improve. The labour market showed more encouraging signs in March with 216,000 new jobs created and the unemployment rate falling to 8.8%. Personal spending was stronger than expected in February and consumer credit picked up, although consumer confidence fell in March on the back of higher gasoline prices. Industrial production recorded a marginal decline of 0.1% month-on-month (mom) in February but has maintained a recovery profile with production having risen 5.5% over the past year. US economic growth was revised upwards for the final quarter of 2010 with the National Activity Index showing 3% growth momentum. Business surveys continued to be robust with the Institute for Supply Management's (ISM) manufacturing index remaining over 61 in March and the ISM survey of non-manufacturing conditions remaining strong despite recording a fall. However, housing data remains mixed with house prices falling in January and housing starts dropping 22.5% mom in February, but pending home sales rising 2.1% in February.

In Japan, the north eastern coast was devastated by a severe earthquake and tsunami on 11 March. This was compounded by a nuclear power crisis and associated disruptions to power supply. Preliminary estimates suggested that the physical damage alone will be ¥15-20 trillion, i.e. approximately 3% to 4% of nominal gross domestic product (GDP). Overall, Japanese economic data for February was positive, but a sharp fall in manufacturing conditions for March following the earthquake points to much weaker economic data ahead.

China's economy continues to be closely watched. The official manufacturing purchasing managers index (PMI) rose in March, but is soft if seasonal influences are allowed for. Inflation was recorded at 4.9% year-on-year in February and is showing signs of peaking. The People's Bank of China announced in early April that interest rates will be raised again by another 25 basis points (bps). However, with growth cooling and inflation close to peaking, the heightening cycle is likely close to an end.

In April the European Central Bank became the first major developed country central bank to raise interest rates following the global financial crisis taking its cash rate from 1% to 1.25%. Inflation accelerated in March on higher food and fuel prices. Further, the region's manufacturing PMI fell by 1.3 points to 57.7 in March but remains close to a decade high, and a measure of services sector activity strengthened in March. In Germany, the unemployment rate fell to 7.6% in March and industrial production and factory orders rose by more than expected, highlighting the continuing strength of the German economy. Portugal became the third European country to seek

a bailout. While bond yields rose in Greece and Portugal they have been roughly flat in Spain and Italy, suggesting that a firewall has been set up around problem countries.

**Outlook:** While sovereign debt risks in Europe, the Japanese earthquake and high oil prices pose significant risks, the global economic outlook continues to improve. Global growth in 2011 should be around 4.5%. While the world could live with oil around US\$100 per barrel, a rise to US\$140 would pose a significant threat to growth.

## Australian economy

**Review:** Australian data releases remain mixed. Retail sales for February saw a solid rise, private sector credit recorded its strongest monthly growth since the global financial crisis and the unemployment rate dropped by more than expected to 4.9% in March. In contrast, consumer confidence fell in March and the housing sector struggled with housing finance falling further in February, building approvals dropping in March and housing starts falling over the December quarter. The trade balance dropped back into deficit in February on the back of weather-related weakness in iron ore exports and volatility in gold exports and fuel imports, but is likely to bounce back into surplus in the months ahead. The Reserve Bank of Australia (RBA) decided to leave the cash rate constant at 4.75% in April.

**Outlook:** While the precise impact of the Queensland floods is not yet known, it is likely to knock 1% or so off March quarter GDP before rebuilding kicks in and combines with increased mining investment to boost growth from the June quarter. Given flood-related uncertainty and benign underlying inflation, the RBA is likely to leave rates on hold until around July or August.

## International shares

**March review:** The leading measure of global share market performance, the MSCI World (ex-Australia) Accumulation Index, returned -1.4% in local currencies (or -2.6% in unhedged Australian dollar [A\$] terms). The US S&P 500 Accumulation Index was flat in local currency terms. In the European region, the Eurostoxx Accumulation Index returned -2.5% and the UK FTSE 100 Accumulation Index returned -0.9%, both in local currency terms. Japan's Topix Accumulation Index returned -7.6% and China's S&P/CITIC 300 Total Return Index returned -1.0%, while the MSCI Far East ex Japan Index returned +4.6% in local currencies.

**Short-term outlook [six to 12 months]:** Given that shares remain cheap, global shares are likely to provide good 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, recurring macroeconomic scares are likely with the main risks at present being high oil prices, European debt and emerging market inflation.

**Medium-term outlook [five to ten years]:** Constrained profit growth will see medium-term returns from mainstream global shares of around 7% per annum on average in local currency terms.

## Australian shares

**March review:** Australian shares were impacted by global weakness in the first half of March but closed the month higher. The S&P/ASX 200 Accumulation Index returned 0.7% during the month, supported by solid economic data and renewed confidence regarding the global economic outlook.

**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 underlying 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

**March review:** The Australian real estate investment trust sector underperformed the broader Australian share market, returning -1.8% for the month of March while the S&P/ASX 200 Accumulation Index returned +0.7%.

**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 8% per annum are likely.

## International bonds

**March review:** International bond markets rallied over the month buoyed by safe-haven buying and solid economic data. The US ten-year bond yield rose by 5 bps to 3.47%, whereas Japan's ten-year bond yield was flat closing at 1.26%. In Europe, the UK ten-year bond yield rose by 9 bps to close the month at 3.69% while Germany's ten-year bond yield rose by 18 bps to 3.35%.

**Short-term outlook:** Sovereign bond yields are likely to push higher as economic conditions continue to improve.

**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

**March review:** Australian bond markets rallied in March driven mostly by offshore events including the escalation of geopolitical conflict in the Middle East and the earthquake and tsunami in Japan. Three-year Australian government bonds

opened the month at a yield of 5.13% and closed 9 bps lower at 5.04%. Ten-year bond yields were flat, opening and closing the month at 5.49%. The three-month bank bill yield opened at 4.93% and closed at 4.89% while the six-month bank bill yield opened at 5.12% and closed 12 bps lower at 5.00%.

**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

**March review:** The A\$ rallied strongly during March, rising against the US dollar (US\$), 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 103.28 US cents (up 1.4% from 101.85 US cents) and JPY85.87 (up 3.1% from JPY83.29). The TWI closed the month at 76.3 (up 1.1% from 75.5). The A\$ hit a new 29-year high in the month, above US\$1.03, buoyed by further strength in commodity prices and relatively high Australian interest rates.

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

**Medium-term outlook:** High commodity prices and strong growth in China are likely to see the A\$ remain strong.

## Key financial markets

	31 March 2011	Change in one month	Change in 12 months
S&P/ASX 200 Accumulation Index	35,632	+0.7%	+3.4%
MSCI World (ex-Aust Accumulation/unhedged in A\$)	3,523	-2.6%	+0.6%
US S&P 500 Accumulation Index	2,239	flat	+15.7%
Dow Jones Eurostoxx Accumulation	454	-2.5%	+5.6%
UK FTSE 100 Accumulation Index	3,897	-0.9%	+7.4%
Japan Topix Accumulation Index	1,103	-7.6%	-9.2%
S&P/CITIC 300 Total Return Index	3,040	-1.0%	-2.3%
S&P/ASX 200 Property Accum. Index	20,089	-1.8%	+5.0%
UBS Global Real Estate Investors Index (hedged in A\$)	1,256	-0.7%	+21.2%
Aust 90-day bank bill yield	4.89%	-4 bps	+40 bps
Aust 10-year bond yield	5.49%	flat	-29 bps
US 10-year bond yield	3.47%	+5 bps	-36 bps
A\$ in US cents	1.0328	+1.4%	+12.7%
Trade-weighted index	76.3	+1.1%	+6.4%

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