

Market & Economics Report

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Global economy

Review: Global financial markets' primary focus during July was whether the US Congress could agree to raise the national debt ceiling limit from US\$14.3 trillion by 2 August. An eleventh hour compromise was announced on 31 July. The agreement increased the debt ceiling in return for budget savings of US\$917 billion over ten years, with a further US\$1.5 trillion in savings to be identified by a bipartisan congressional committee by late November. While the agreement headed off a government shutdown and default, it wasn't enough to head off a ratings downgrade from AAA to AA+ from Standard and Poor's. Meanwhile, US economic data released was weak. There was a sharp fall in the July Institute for Supply Management (ISM) manufacturing conditions index, a further fall in the ISM non-manufacturing conditions index, a fall in personal spending in June and a sharp rise in lay-off announcements in July. While payroll employment increased by more than expected in July, America's unemployment rate remained high at 9.1%. Retail sales were also subdued, registering only +0.1% month-on-month (mom) growth in June. Finally, the June quarter gross domestic product (GDP) data showed a sharp slowdown in US economic growth at just +1.6% over the year to June. Expect more monetary stimulus from the US Federal Reserve.

More encouraging is that Japan's economy continues to recover from the tragic earthquake and tsunami in March. Japanese industrial production has revived after March's sharp fall of -15.5% mom, with April recording +1.6% mom growth and May a further +6.2% mom growth. This recovery continued in June with a +3.9% mom rise.

Meanwhile, China's economy continued to expand at a solid pace, with real GDP growing by +9.5% year-on-year (yoy) in the June quarter. Chinese economic indicators for July showed solid growth in industrial production (+14% yoy), retail sales (+17.2% yoy) and fixed asset investment (+24.5% yoy). However, inflation remains a concern, with consumer price index data rising to +6.5% yoy in July. The People's Bank of China raised its key one-year lending rate by 0.25% to 6.56% in the third interest rate rise so far this year, but with inflation likely to have peaked monetary conditions should start to ease later this year.

Economic news from Europe was dominated by sovereign debt woes. Spanish and Italian bond yields spiked higher as fears of contagion spread. Disagreement within the European Union about how to respond to the deteriorating crisis created further uncertainty, along with news that European bank stress tests found that eight banks failed with another 16 banks needing to boost capital. European leaders announced a new bailout for Greece and enhanced support for other problem countries later

in July. The key elements of the package include: €109 billion in new financing for Greece; a €37 billion contribution from private sector investors; an extension of loans from the current 7.5 years to at least 15 years; a cut in the interest rate for Greece, Ireland and Portugal to 3.5%; and allowing the European Financial Stability Facility to buy bonds in secondary markets. The trouble is that the new measures face implementation risk, don't go far enough and raise fears investors will also suffer losses on loan to other countries.

Outlook: The global recovery is likely to continue, but the risk of renewed recession in the US and Europe is high.

Australian economy

Review: Australian economic news was weak. The labour market was flat in July and unemployment rose to 5.1%. The Westpac Melbourne Institute consumer sentiment survey for July and August showed sharp falls in confidence. The National Australia Bank business survey also showed a deterioration in business conditions during July – confidence has softened particularly in the construction and finance sectors, while mining sector confidence remains robust. In addition, there was a 8.7% fall in new home sales and a sharp slump in a manufacturing conditions index in July, a 3.5% fall building approvals and a 0.1% fall in retail sales in June, leaving them up just 1.4% yoy, and a 0.1% fall in house prices in the June quarter, leaving them down 1.9% yoy. The Reserve Bank of Australia (RBA) left interest rates on hold at 4.75% at the August meeting, with the Board meeting minutes revealing that the central bank had considered raising rates, but was held back by an "acute sense of uncertainty in global financial markets".

Outlook: Growth is expected to pick up as production returns to normal in flood-affected areas, rebuilding kicks in and mining investment surges. However, retailing, housing, manufacturing and tourism are likely to remain weak. Given global uncertainty and mixed Australian indicators, the RBA is likely to cut rates before Christmas.

International shares

July review: The leading measure of global share market performance, the MSCI World (ex-Australia) Accumulation Index, returned -2.6% in local currencies (or -4.3% in unhedged Australian dollar [A\$] terms). The US S&P 500 Accumulation Index returned -5.0% in local currency terms. In the European region, the Eurostoxx Accumulation Index returned -5.9% while the UK FTSE 100 Accumulation Index returned -2.1%, both in local currency terms. Shares in Asia were more resilient, with Japan's Topix Accumulation Index returning -0.9% and China's S&P/CITIC 300 Total Return Index returning -1.8%.

Short-term outlook [six to 12 months]: Given the uncertain global backdrop, shares are likely to remain volatile and possibly fall further in the near term. However, valuations are attractive, the global recovery should continue (although the risks in Europe and the US have increased) and monetary conditions remain easy, all pointing to gains on a 12-month horizon.

Medium-term outlook [five to ten years]: Constrained profit growth will see medium-term returns from mainstream global shares of around 7.5% per annum on average in local currency terms. Shares are likely to remain volatile.

Australian shares

July review: Australian shares underperformed global equities during July, with the S&P/ASX 200 Accumulation Index returning -4.0% for the month. Australian shares have been constrained by higher interest rates, an appreciating A\$ and analyst downgrades to company earnings outlooks.

Short-term outlook: While short-term volatility will remain high with further weakness possible, Australian shares are likely to provide positive returns on a 12-month view. The turn in the Australian interest rate cycle suggests the period of underperformance by Australian shares is over.

Medium-term outlook: Reflecting reasonable growth prospects, medium-term returns of around 10% per annum are likely (or 11% if franking credits are allowed for).

Real estate investment trusts

July review: The Australian real estate investment trust sector fell sharply over the month, with the S&P/ASX 200 Property Accumulation Index returning -6.6% during July. The sector underperformed the broader Australian share market which returned -4.0% for the month. The negative result was propelled largely by global macroeconomic concerns, including the US debt ceiling negotiations and the European debt crisis.

Short-term outlook: Property stocks have recapitalised and are good value from a long-term perspective. With improved yields, 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 9.5% per annum are likely.

International bonds

July review: International bond markets rallied during the month in response to the concern over the US debt ceiling negotiations and the European debt crisis. The US ten-year bond yield fell by 36 basis points (bps) to 2.80%, and Japan's ten-year bond yield fell by 6 bps to close at 1.08%. In Europe, the UK ten-year bond yield fell by 52 bps to close the month at 2.86% while Germany's ten-year bond yield fell by 49 bps to 2.54%.

Short-term outlook: Sovereign bonds are poor value given low yields, but are a good diversifier if the current growth scare gets worse.

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 eventually return to more normal levels.

Australian bonds and cash

July review: Australian bond markets rallied strongly in response to concern over the US debt ceiling negotiations and the European debt crisis. A weaker tone to domestic economic data also contributed to the rally, with only a surprisingly high inflation result causing a brief sell off in bond yields. Three-year Australian government bonds opened the month at a yield of 4.76% and closed 40 bps lower at 4.36%. Ten-year bond yields also fell, opening the month at 5.21% and closing 41 bps lower at 4.80%. The three-month bank bill yield opened at 4.97% and rose 4 bps to close at 5.01%, the six-month bank bill opened at 5.05% and closed only 1 bp higher at 5.06%.

Short-term outlook: Australian bonds are poor value at current yields but they are a good diversifier against global uncertainties.

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

Australian dollar

July review: During July, the A\$ rose further against the US dollar (US\$) and the currencies of Australia's major trading partners (as per the Trade Weighted Index [TWI]), but did fall against the Japanese yen (JPY). Despite general risk aversion during the month, the A\$ benefited from strong Chinese growth. The announcement of a new European debt bailout plan also gave the A\$ a boost. The A\$ closed the month at 109.93 US cents (up 2.5% from 107.24 US cents) and JPY84.40 (down 2.3% from JPY86.37). The TWI closed the month at 78.4 (up 0.8% from 77.8).

Short-term outlook: The A\$ is vulnerable to further volatility and weakness but should remain strong on the back of high 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 over the medium term.

Key financial markets

	31 July 2011	Change in one month	Change in 12 months
S&P/ASX 200 Accumulation Index	32,842	-4.0%	+2.7%
MSCI World (ex-Aust Accumulation/unhedged in A\$)	3,274	-4.3%	-2.5%
US S&P 500 Accumulation Index	2,196	-2.0%	+19.7%
Dow Jones Eurostoxx Accumulation	429	-5.9%	+3.4%
UK FTSE 100 Accumulation Index	3,874	-2.1%	+14.2%
Japan Topix Accumulation Index	1,068	-0.9%	+1.2%
S&P/CITIC 300 Total Return Index	2,843	-1.9%	+5.0%
S&P/ASX 200 Property Accum. Index	18,671	-6.6%	-2.1%
UBS Global Real Estate Investors Index (hedged in A\$)	1,301	-0.4%	+22.5%
Aust 90-day bank bill yield	5.01%	+4 bps	-1 bp
Aust 10-year bond yield	4.80%	-41 bps	-10 bps
US 10-year bond yield	2.80%	-36 bps	+6 bps
A\$ in US cents	1.0993	+2.5%	+0.2%
Trade-weighted index	78.4	+0.8%	+13.0%

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