Market & Economics Report

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Global economy

Review: In the US, the labour market appears to be gradually healing, with the unemployment rate falling sharply by 0.4% to 9.0% in January and then further to 8.9% in February. US business surveys are also showing positive growth prospects. The Institute for Supply Management manufacturing and services indices both rose to strong levels in February. Retail sales rose by 4.2% year-on-year (yoy) in February and consumer credit gained US$5 billion in January. Pending home sales and construction spending in January were soft, but consumer sentiment and vehicle sales improved. The US Federal Reserve's (Fed) Beige Book of anecdotal evidence showed a continued strengthening and the Fed also revised its forecast for US economic growth during 2011 from 3.4% to 3.9%. The only negative news was continued weakness in the US housing sector as the Case Shiller Major 10 Cities Index showed house prices fell by 3% in the six months to December.

In Japan, Tokyo's annual inflation rate was flat in February, compared with -1.8% a year earlier, indicating that deflation has moderated in response to the economic recovery and higher commodity prices. Japan also became the latest major advanced economy to see its sovereign debt rating downgraded in February due to its adverse public debt outlook. Vehicle sales and construction orders were soft, but there was good news in terms of industrial production, manufacturing conditions, small business confidence and retail sales.

China's economy continues to be the focus of much scrutiny. China's purchasing managers index fell for the third consecutive month in February, indicating that Chinese industrial activity is growing at a more sustainable pace than previously. The People's Bank of China raised the benchmark lending and deposit rates by 25 basis points (bps) each as well as raising the reserve requirement ratio for banks once again, reflecting the central bank's continued efforts to moderate credit growth.

European economic data was generally positive. Business conditions indicators rose in both January and February to reach their highest reading since June 2000. The region's unemployment rate also fell to 9.9% in January, its lowest level since March last year. Germany's IFO Business Climate Index is similarly robust, reaching its highest point since German reunification in 1990. Overall, Europe's economic recovery appears to be solid. With headline inflation being boosted by higher food and fuel prices, the European Central Bank has signalled a possible interest rate rise for April.

Outlook: While sovereign debt risks in Europe remain a concern, the global economic outlook continues to improve. Global growth in 2011 should be around 4.5%. Rising oil prices on the back of Middle East unrest are a risk though. While the world could live with oil at US$100 per barrel, a rise to US$140 would pose a significant threat to growth.

Australian economy

Review: Australian economic data continues to be generally positive. House prices and building approvals fell in January but are likely to have been affected by the floods. The Australian labour market remains robust, with job advertisements rising 1.2% in February to 19.3% yoy and the unemployment rate remaining low at 5.0%. Meanwhile, the wage cost index data for the December quarter showed that wages appear to be in line with core inflation, suggesting little urgency to raise interest rates. The National Australia Bank business survey showed that business confidence jumped to 14 points in February from 4 points in January. New home sales also rose slightly in January and retail sales were stronger than expected. Further, the January trade surplus fell by less than expected and December quarter gross domestic product (GDP) growth was a respectable 0.7%. Were it not for the floods, growth would have been around 1.1%. The Reserve Bank of Australia (RBA) decided to leave interest rates on hold at 4.75% at its March meeting.

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 mid-year.

International shares

February review: The leading measure of global share market performance, the MSCI World (ex-Australia) Accumulation Index, returned +2.9% in local currencies (or +1.3% in unhedged Australian dollar terms). The US S&P 500 Accumulation Index returned +3.4% in local currency terms. In the European region, the Eurostoxx Accumulation Index returned +1.9% while the UK FTSE 100 Accumulation Index returned +2.6%, both in local currency terms. Shares in Asia were also stronger, with Japan's Topix Accumulation Index returning +4.6% and China's S&P/CITIC 300 Total Return Index returning +5.5%.

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.

Australian shares

February review: Australian shares closed February higher but once again underperformed global shares. The S&P/ASX 200 Accumulation Index returned 2.3% during the month. After a very strong start to the month, Australian shares followed their global counterparts lower as turmoil spread across the Middle East and North Africa and surging oil prices triggered a correction.

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

February review: The Australian real estate investment trust sector outperformed the broader Australian share market, returning +3.2% for the month of February while the S&P/ASX 200 Accumulation Index returned +2.3%.

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% per annum are likely.

International bonds

February review: International bond markets were volatile in February, selling off initially in response to stronger global economic data. However, increasing civil unrest in the Middle East and the resulting spike in oil prices caused equity markets to pull back and bond markets to rally. The US ten-year bond yield rose by 4 bps to 3.42%, and Japan's ten-year bond yield also rose by 4 bps to close at 1.26%. In Europe, the UK ten-year bond yield fell by 6 bps to close the month at 3.60% while Germany's ten-year bond yield rose by 1 bp to 3.17%.

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

February review: Following the lead from their global counterparts, Australian bond markets were volatile in February, selling off initially in response to stronger global economic data. However, increasing civil unrest in the Middle East and the resulting spike in oil prices caused equity markets to pull back and bond markets to rally. Three-year Australian government bonds opened the month at a yield of 5.05% and closed 8 bps higher at 5.13%. Meanwhile, ten-year bond yields fell, opening the month at 5.51% and closing 2 bps lower at 5.49%. The three-month bank bill yield opened at 4.92% and rose 1 bp to close at 4.93%, the six-month bank bill opened at 5.08% and closed 4 bps higher at 5.12%.

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

February review: During February, the Australian dollar (A$) rose against the US dollar (US$), 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 101.85 US cents (up 2.1% from 99.71 US cents) and JPY83.29 (up 1.8% from JPY81.82). The TWI closed the month at 75.5 (up 1.5% from 74). Strong commodity prices saw the A$ push back above parity with the US$ early in the month. The A$ also benefited from strong domestic wages and business investment data, adding to confidence that the RBA will raise interest rates later this year.

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

	28 February 2011	Change in one month	Change in 12 months
S&P/ASX 200 Accumulation Index	35,395	+2.4%	+8.7%
MSCI World (ex-Aust Accumulation/ unhedged in A$)	3,618	+1.3%	+7.0%
US S&P 500 Accumulation Index	2,239	+3.4%	+22.6%
Dow Jones Eurostoxx Accumulation	466	+1.9%	+16.9%
UK FTSE 100 Accumulation Index	3,934	+2.6%	+15.5%
Japan Topix Accumulation Index	1,194	+4.6%	+8.5%
S&P/CITIC 300 Total Return Index	3,071	+5.5%	+0.8%
S&P/ASX 200 Property Accum. Index	20,462	+3.2%	+6.9%
UBS Global Real Estate Investors Index (hedged in A$)	1,265	+3.7%	+30.8%
Aust 90-day bank bill yield	4.93%	+1 bp	+80 bps
Aust 10-year bond yield	5.49%	-2 bps	+8 bps
US 10-year bond yield	3.42%	+4 bps	-19 bps
A$ in US cents	1.0185	+2.1%	+13.7%
Trade-weighted index	75.5	+2.0%	+8.6%

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