Market & Economics Report

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Global economy

Review: Global economic data was subdued during May. Most US economic data released during the past month confirmed that the economic recovery has slowed. In nominal terms, US retail sales rose solidly in April. However, some of this strength was due to price rises for food and energy, with these increases also visible in inflation readings. America's industrial sector stalled in April, with industrial production flat for the month. In particular, US automobile production slumped by -8.9% during the month due to shortages of parts as a result of the earthquake in Japan. The ISM manufacturing conditions index also slowed sharply in May. On top of this, employment growth slowed in May pushing unemployment up to 9.1%.

Meanwhile, Japan's economy has fallen into recession once again, recording two consecutive quarters of declining activity. Japanese GDP fell by 0.9% for the March quarter. The Bank of Japan conceded that "Japan's economy faces strong downward pressure, mainly on the production side, due to the effects of the earthquake disaster."

China's economic activity indicators suggested moderating growth momentum, but still elevated inflation. Growth in industrial production and retail sales slowed more than expected in April, but fixed asset investment was slightly higher than expected. China's annual CPI inflation exceeded market expectations at 5.3% in April, as food prices remained elevated.

European bond markets continued to be plagued with default concerns during May despite the financial bail out packages for Greece, Ireland and Portugal. Greece, in particular, is under severe pressure due to the perception that the scale of its government debt is too high to ever be repaid. As a result, the yield on Greek 10-year sovereign bonds rose to approximately 16% reflecting the market view that default is looming. Despite the lingering sovereign debt issues, Europe recorded a surprisingly strong economic growth result for the March quarter, with GDP expanding by +0.8%. However, there remains a dramatic divergence in country performance across Europe, with Germany and France continuing to perform strongly while other countries struggle. However, Europe's purchasing managers index (PMI) shows a more cautious manufacturing sector. The European Central Bank (ECB) kept its policy interest rates on hold at 1.25% at its May and June meetings after raising interest rates by 0.25% in April but signalled a tightening in July.

Outlook: While sovereign debt risks in Europe, the Japanese earthquake and high oil prices pose significant risks, the global recovery is continuing albeit in a constrained and fragile fashion.

Australian economy

Review: Australian economic data has been somewhat mixed in May, confirming the 'multi-speed' growth path of the Australian economy, with the boom in the mining sector contrasting with softness in other sectors. The Reserve Bank of Australia (RBA) left interest rates on hold at 4.75% noting that the current mildly restrictive stance of monetary policy remained appropriate but also acknowledged they would closely monitor the outlook for growth and inflation. March quarter GDP contracted 1.2%, reflecting the impact of the floods, despite strong domestic demand. Capital spending was strong in the March quarter and plans point to very strong growth ahead driven by the mining sector. Other indicators are mixed. Retail sales rose in April but this followed a fall in March. Housing finance rose in March after months of falls but other housing indicators are weak. Worryingly, the labour market is showing signs of softening with nearly 80,000 full-time jobs lost over April and May.

Outlook: Growth is expected to rebound 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 subdued. Given global uncertainty and mixed Australian indicators, the RBA is likely to leave rates on hold, at least until August.

International shares

May review: The leading measure of global share market performance, the MSCI World (ex-Australia) Accumulation Index, returned -1.2% in local currencies (or +0.7% in unhedged Australian dollar terms). The US S&P 500 Accumulation Index returned -1.1% in local currency terms. In the European region, the Eurostoxx Accumulation Index returned -2.3% while the UK FTSE 100 Accumulation Index returned -1.0%, both in local currency terms. Shares in Asia were also weak, with Japan's Topix Accumulation Index returning -1.6% and China's S&P/CITIC 300 Total Return Index returning -6.0%.

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 now attractive, the global recovery should continue 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% per annum on average in local currency terms.

Australian shares

May review: Australian shares fell during May, returning -2.0% as measured by the S&P/ASX 200 Accumulation Index. Australian shares continued to underperform developed world equities, following the trend that began in early April. The headwinds of higher interest rates and an appreciating Australian dollar have caused a softening in economic data and analyst downgrades to company 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. However, the two speed economy, higher interest rates and the strong A$ suggest Australian shares may continue to lag global shares (in common currency terms).

Medium-term outlook: Reflecting reasonable growth prospects, medium-term returns of around 10% per annum are likely (or 10.5% if franking credits are allowed for).

Real estate investment trusts

May review: The Australian real estate investment trust (A-REIT) sector was flat during May, outperforming the broader Australian share market which fell by -2.0%, as measured by the S&P/ASX 200 Accumulation Index.

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

May review: International bond markets rallied during May in response to weak economic data in the US and the deteriorating outlook for Greek sovereign debt. The US 10-year bond yield fell by 23 basis points (bps) to 3.06%, and Japan's 10-year bond yield fell by 4 bps to close at 1.17%. In Europe, the UK 10-year bond yield fell by 14 bps to close the month at 3.29% while Germany's 10-year bond yield fell by 22 bps to 3.02%.

Short-term outlook: Sovereign bonds are poor value given low yields, but are a good diversifier if the world goes through another growth scare.

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

May review: Australian bond markets rallied overall during May as positive risk sentiment declined over the course of the month. Despite leaving the cash rate on hold at its May meeting, the RBA quarterly Statement of Monetary Policy reinforced its medium-term tightening bias which led to a sell-off early in the month. Three-year Australian government bonds opened the month at a yield of 5.15% and closed 25 basis points (bps) lower at 4.87%. Meanwhile, 10-year bond yields fell, opening the month at 5.44% and closing 21 bps lower at 5.23%. The three-month bank bill yield opened at 4.90% and rose 8 basis points (bps) to close at 4.98%, the six-month bank bill opened at 5.05% and closed 7 bps higher at 5.12%.

Short-term outlook: On a 12-month view, Australian bonds are likely to provide returns around current yield levels (5.2%). However, 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

May review: After surging to record highs in April, the Australian dollar (A$) fell back against the US dollar (US$), the Japanese yen (JPY) and the currencies of Australia's major trading partners (as per the Trade Weighted Index [TWI]) in May. The A$ dropped back early in the month due to weaker commodity prices and softer-than-expected employment data, which led to reduced expectations for a June interest rate rise. The A$ closed the month at 106.80 US cents (down -2.4% from 109.47 US cents) and JPY86.97 (down -2.2% from JPY88.89). The TWI closed the month at 77.8 (down -1.4% from 78.9).

Short-term outlook: The A$ is vulnerable to a correction 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.

Key financial markets

	31 May 2011	Change in one month	Change in 12 months
S&P/ASX 200 Accumulation Index	34,829	-2.0%	+10.8%
MSCI World (ex-Aust Accumulation/ unhedged in A$)	3,493	0.7%	+0.5%
US S&P 500 Accumulation Index	2,280	-1.1%	+26.0%
Dow Jones Eurostoxx Accumulation	460	-2.3%	+16.4%
UK FTSE 100 Accumulation Index	3,975	-1.0%	+19.1%
Japan Topix Accumulation Index	1,064	-1.6%	-2.7%
S&P/CITIC 300 Total Return Index	2,836	-6.0%	+8.9%
S&P/ASX 200 Property Accum. Index	20,129	-0.0%	+5.7%
UBS Global Real Estate Investors Index (hedged in A$)	1,333	+1.7%	+31.3%
Aust 90-day bank bill yield	4.98%	+8 bp	+11 bps
Aust 10-year bond yield	5.23%	-21 bps	-14 bps
US 10-year bond yield	3.06%	-23 bps	-22 bps
A$ in US cents	1.0680	+2.4%	+26.0%
Trade-weighted index	77.8	-1.4%	+15.3%

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