

Market and Economics Report



by **Dr Shane Oliver, Head of Investment Strategy & Chief Economist**

Global economy

Review: The global economic recovery continued to gain momentum during January. However, worries about sovereign debt risk in Europe and concerns about Chinese tightening became a key focus. US economic data was consistent with a modest recovery, but some sectors of the economy are still struggling. On the positive side was the news that real gross domestic product (GDP) expanded 1.4% in the December quarter, the fastest quarterly growth in six years. There was another good result from the Institute for Supply Management manufacturing survey in December as it reached a five-year high, suggesting robust prospects for early 2010. The US housing market was mixed with rising house prices but soft home sales. The US housing construction sector had another difficult month, with housing starts falling 4% month-on-month (mom) in December and the National Association of Home Builders Index continuing to flatline in January. Despite historically being a leading indicator, housing construction has been absent from the current recovery, suggesting the prospects for US growth are heavily dependent on consumer spending, inventory rebuilding and business investment. The good news is that the US labour market appears to be mending - with slowing job losses and a fall in unemployment since October. A stronger labour market should help consumer spending with signs of a recovery in recent retail sales data. Economic data from Japan indicated that the country is on a very slow path to recovery. There was a significant setback in Japanese small business confidence in December, domestic demand remained subdued and consumer sentiment also struggled. However, the labour market showed signs of improvement and the manufacturing sector made some progress. Chinese economic data pointed to continued strong growth momentum. China's economy accelerated sharply during 2009 with real GDP growing 10.7% year-on-year (yoy). Retail sales growth was 17.5% yoy in December and industrial production increased 18.5% yoy. Amid fears of inflation and asset bubbles, the People's Bank of China increased the bank's reserve requirement ratio for financial institutions by 0.5% as the first step in a monetary tightening cycle. Economic recovery progressed in Europe, however the pace of growth varied considerably across countries. The European Commission's survey of consumer and economic sentiment both indicated a solid recovery is proceeding, although both measures remained below decade-average levels. The main issue in Europe though concerned sovereign debt risk in Greece and, to a lesser degree, Portugal and Spain. News from the UK was mildly encouraging, with the most severe recession in over six decades ending as the UK recorded marginal GDP growth of +0.1% quarter-on-quarter for the December quarter. The Bank of England maintained its extremely accommodative policy rate and asset purchase program to support the UK economy.

Outlook: The global recovery is continuing and still easy monetary and fiscal conditions point to solid global growth this year, particularly in the emerging world.

Australian economy

Review: Australian economic data was generally strong, suggesting that the Reserve Bank of Australia (RBA) will continue to raise interest rates in 2010. Building approvals recorded a strong surge in November and retail sales were solid for the month. Labour force data remained sound with a further 35,200 new jobs created in December. Unemployment fell to 5.5% (the lowest rate in eight months) and the ANZ job advertisement survey showed another sharp increase for December. New motor vehicle sales were also encouraging and house prices recorded their third quarter of strong rises, buoyed by the government's first-home owners grant scheme and low interest rates. In more negative news, housing finance approvals experienced the largest monthly fall since May 2008 as the government grant initiatives draw to an end. The trade price index for the December quarter was also weaker due to the strong appreciation of the Australian dollar (A\$). Total export prices fell 1.7% quarter-on-quarter (qoq) and total import prices fell 4.3% qoq. December quarter headline inflation was broadly in line with expectations, with a 0.5% rise in the quarter taking the annual rate to 2.1%. However, the RBA's preferred measures of underlying inflation remained elevated with a stronger-than-expected rise of 0.7% for the quarter to finish up 3.4% over the year.

Outlook: While September quarter GDP may be soft, we expect solid growth through 2010, driven by global recovery, a housing upturn, and stronger investment.

International shares

January review: Global shares fell on the back of China's monetary tightening, US plans to restart bank activities, and concerns about sovereign debt. The leading measure of global share market performance, the MSCI World (ex-Australia) Accumulation Index, returned -3.5% in local currencies (or -2.9% in unhedged Australian dollar terms). The US S&P 500 Accumulation Index returned -3.6% in local currency terms. In the European region, the Eurostoxx Accumulation Index returned -4.6% in local currencies and the UK FTSE 100 Accumulation Index returned -4.1% in local currency terms. Shares in Asia also dropped back with Japan's Topix Accumulation Index returning -0.7% and China's S&P/CITIC 300 Total Return Index returning -9.9% in local currencies.

Short-term outlook [six to 12 months]: Global shares are likely to provide good returns on a 12-month plus view, given the likelihood of reasonable growth in profits and still low interest rates. However, we expect a rougher ride than over the last nine months.

Medium-term outlook [five to ten years]: Improved dividend yields following the share slump and profit growth around nominal GDP growth will see medium-term returns from mainstream global shares of around 7.5% per annum on average.

Australian shares

January review: After a positive start to the year, Australian shares were then dragged lower by global weakness over the second half of January. The Australian share market as measured by the S&P/ASX 200 Accumulation Index fell 6.2% during the month. In particular, resources stocks were hit hard by concerns over monetary tightening in China and reports that tax on resources companies may be increased as part of the Henry Tax Review.

Short-term outlook: Australian shares are likely to provide solid returns on a 12-month view. Valuations are reasonable, interest rates are low, and shares are likely to be buoyed by better economic conditions and rising profits in 2010.

Medium-term outlook: Reflecting reasonable growth prospects, medium-term returns of around 9.5% per annum are likely.

Real Estate Investment Trusts

January review: The S&P/ASX Property 200 Accumulation Index was down 2.9% in January, outperforming the broader share market.

Short-term outlook: Most property stocks have recapitalised, most are good value from a long-term perspective, and the credit crunch is fading. As such they should provide solid returns over the next 12 months.

Medium-term outlook: Solid yields and moderate growth prospects mean medium-term returns of around 10.5% per annum are likely.

International bonds

January review: International bond yields generally fell in January. Japan's ten-year bond yield rose marginally by 3 basis points (bps) to close at 1.33%, but most others fell. The US ten-year bond yield fell 25 bps to 3.58% and in the European region, Germany's ten-year bond yield fell 19 bps to 3.20% and the UK ten-year bond yield fell 11 bps to close the month at 3.91%.

Short-term outlook: Sovereign bond yields are likely to drift higher on expectations for eventually rising short-term interest rates.

Medium-term outlook: AMP Capital expects low returns from global sovereign bonds, reflecting low bond yields.

Australian bonds and cash

January review: The three-year bond yield ended the month 27 bps lower at 4.45%, whereas the ten-year bond yield closed the month 34 bps lower at 5.36%, causing the curve to end the month 7 bps flatter than it opened. The three-month bank bill rate opened at 4.28% and closed 10 bps higher at 4.38%. Six-month

bank bill yields also rose, opening at 4.47% and closing 13 bps higher at 4.60%. While further interest rate rises continue to be priced into the bank bill yield curve, the timing and aggressiveness of the interest rate rises have been pared back somewhat.

Short-term outlook: Bond yields are likely to drift higher on the back of gradually rising global bond yields.

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

Australian dollar

January review: The A\$ rallied during the first weeks of January, but then fell due to concerns over monetary tightening in China and worries about the global outlook. The A\$ declined 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 88.05 US cents (down 2.0% from 89.86 US cents) and JPY79.18 (down 5.2% from JPY83.55). The TWI closed the month at 69.2 (down 0.7% from 69.7). The prospect of tightening in China typically affects commodity-linked currencies like the A\$. Additionally, China is Australia's top trading partner and one of the biggest buyers of Australian exports, making the A\$ particularly sensitive.

Short-term outlook: Further gains in the A\$ are likely on the back of the improving global growth outlook, strong demand for resources, the positive outlook for commodities and the prospect for rising local interest rates.

Medium-term outlook: AMP Capital expects the A\$ to be strong over the medium term, helped by strong commodity prices.

Key financial markets

	31 January 2010	Change in one month	Change in 12 months
S&P/ASX 200 Accumulation Index	31,886	-6.2%	+35.2%
MSCI World (ex-Aust Accumulation/unhedged in A\$)	3,362	-2.9%	-3.3%
US S&P 500 Accumulation Index	1,771	-3.6%	+33.1%
Dow Jones Eurostoxx Accumulation	406	-4.6%	+30.7%
UK FTSE 100 Accumulation Index	3,282	-4.1%	+30.4%
Japan Topix Accumulation Index	1,109	-0.7%	+15.6%
S&P/CITIC 300 Total Return Index	2,972	-10.0%	+59.5%
S&P/ASX 200 Property Accum. Index	18,875	-2.9%	+16.1%
UBS Global Real Estate Investors Index	936	-3.8%	+40.9%
Aust 90-day bank bill yield	4.38%	+10 bps	+97 bps
Aust 10-year bond yield	5.36%	-34 bps	+126 bps
US 10-year bond yield	3.58%	-25 bps	+74 bps
A\$ in US cents	88.05	-2.0%	+38.7%
Trade-weighted index	69.2	-0.7%	+30.1%

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