

Market & Economic Report

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Global economy

Review: The European debt crisis continues to dominate financial markets and undermine confidence. However, US economic data has been resilient in the face of global turmoil. The US ISM manufacturing survey improved in December rising by 1.2 points to 53.9, suggesting that the US economy ended 2011 with activity expanding at a +2 % GDP pace. The American labour market picked up with a gain of 200,000 jobs in December and the unemployment rate falling further to 8.5%. US house prices drifted lower with the Standard & Poor's Case Shiller Major 10 cities Index recording a 1.1% decline in October. More encouraging was the Conference Board's confidence survey which rose almost 10 points to 64.5 in December, as well as the Bloomberg Consumer Comfort Index which climbed to -44.8 in the period ended 31 December, the best reading since mid-July 2011. US nominal retail sales proved mildly disappointing in November recording a marginal monthly rise of 0.2%. The US Federal Reserve (Fed) maintained the federal funds rate target range between 0% to 0.25% at its December meeting, reaffirming previous guidance that interest rates should remain "exceptionally low" until mid-2013. In the meeting minutes for December, the Fed noted that there were a number of factors restraining US economic growth such as "fiscal and banking issues in the euro area" as well as "fiscal tightening in the US, high levels of uncertainty among households and businesses, the weak housing market and household deleveraging". After much debate, the US Congress agreed to extend a payroll tax cut and increased unemployment benefits beyond their December expiry which should help mitigate a sharp fiscal contraction in 2012.

European leaders met on 9 December to address the sovereign debt crisis and generally agreed on a number of key proposals: A 'fiscal compact' limiting Government budget deficits to -0.5% of nominal GDP, the European Financial Stability Facility will be "rapidly deployed" and the European Stability Mechanism brought forward to start in July 2012. There was also a proposal to provide the International Monetary Fund with €200 billion of loans to "deal with the crisis". Later in the month, the ECB announced that 523 European banks will take a total of €489 billion in three-year loans under its long-term refinancing operations. Yet European business surveys continue to indicate recession in the region. The purchasing manager's index (PMI) manufacturing survey for December rose marginally by 0.5 to 46.9, but suggests that European industrial production is still contracting. The ECB decided to lower its key policy interest rate at its December meeting by a further 0.25% to 1.0%.

In Japan, September quarter GDP rose 1.4% quarter-on-quarter (qoq), revised slightly down from the previous estimate. Monthly economic data releases were more mixed. Vehicle

sales improved rising 23.5% year-on-year (yoy) in December, bank lending picked up at +0.2% yoy in November and the tertiary activity index beat market expectations increasing 0.6% month-on-month (mom) in October. Yet Japan's exports fell again in November, providing another reminder of the global slowdown.

In China, the official PMI rose to 50.3 in December after dipping below 50 in November. Overall, this report is consistent with China's economy slowing to around 8% growth in the first half of 2012. Elsewhere, Chinese economic data was positive. Retail sales improved 17.3% yoy in November, industrial production was up 12.4% in the month and fixed asset inventories rose 24.5% yoy year-to-date.

Outlook: Europe's debt problems pose the biggest threat to the global recovery. Given a likely European recession, a slow global growth phase for 2012 appears the main scenario.

Australian economy

Review: The Reserve Bank of Australia (RBA) cut interest rates by 0.25% to 4.25% in December affirming that Australia's "inflation outlook afforded scope for a modest reduction in the cash rate". The central bank also stated that Europe's banking and sovereign debt problems are "likely to weigh on economic activity there over the period ahead". Australian economic activity was solid in the September quarter. Real GDP expanded by 1.0 % qoq in the July to September period with annual growth now running at +2.5% yoy. The labour market softened in November with a loss of 6,300 jobs and the unemployment rate edging 0.1% higher to 5.3%. Australia's business confidence and conditions were generally stable in November according to the National Australia Bank survey. Consumer sentiment slipped back in December with the Westpac Melbourne Institute survey falling by 8.9 points to 94.7 in December. Retail trade in November was flat, similarly to October's marginal 0.2% mom rise. Australia's trade surplus narrowed in November to A\$1.38 billion from October's A\$1.42 billion. While only a marginal contraction, the trade result does indicate tougher global trading conditions for exporters over recent months.

Outlook: While mining investment is booming, retailing, housing, manufacturing and tourism are likely to remain soft. Given global concerns and mixed Australian indicators, the RBA is likely to cut rates again in 2012.

International shares

December review: The leading measure of global share market performance, the MSCI World (ex-Australia) Accumulation Index, returned +0.7% in local currencies (or +0.2% in unhedged Australian dollar [A\$] terms). The US S&P 500

Accumulation Index returned +1.0% in local currency terms. In the European region, the Eurostoxx Accumulation Index returned -0.3% while the UK FTSE 100 Accumulation Index returned +1.3%, both in local currency terms. Shares in Asia remained weak, with Japan's Topix Accumulation Index returning +0.1% and China's S&P/CITIC 300 Total Return Index returning -6.9%.

Short-term outlook [six to 12 months]: Given slower global growth, shares are likely to remain volatile with further weakness possible over the next three months. However, valuations are attractive, the global recovery should continue (although Europe will likely slide into recession) 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 +7.0% per annum on average in local currency terms. Shares are likely to remain volatile though reflecting constrained growth in advanced countries.

Australian shares

December review: Australian shares experienced continuing volatility during December as global share markets fluctuated on sovereign debt issues in Europe. The S&P/ASX 200 Accumulation Index fell by 1.4% for the month overall.

Short-term outlook: While short-term volatility will remain high, 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 coming to an end.

Medium-term outlook: Reflecting reasonable growth prospects, medium-term returns of around +10% per annum are likely (or +11.5% if franking credits are allowed for).

Real estate investment trusts

December review: The Australian real estate investment trust (A-REIT) market fell back over the month, with the S&P/ASX 200 Property Accumulation Index returning -2.7% during December. The sector underperformed the broader Australian share market which returned -1.4% for the month, 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 yields, A-REITs should provide solid returns over the next 12 months.

Medium-term outlook: Solid yields and moderate growth prospects suggest medium-term returns of around +9.0% per annum are likely.

International bonds

December review: International bond markets were volatile in December with concerns about Europe's ability to implement tighter fiscal discipline. The US ten-year bond yield fell by 19 basis points (bps) to 1.88%, and Japan's ten-year bond yield fell by 8 bps to 0.99%. In Europe, the UK ten-year bond yield fell by 33 bps to close the month at 1.98% while Germany's ten-year bond yield fell by 45 bps to 1.83%.

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

Medium-term outlook: Global sovereign bonds are likely to see low returns, reflecting currently low bond yields and the

likelihood of capital losses when yields eventually return to more normal levels.

Australian bonds and cash

December review: Australian bond markets were volatile in December in line with global movements. Three-year Australian government bonds opened the month at a yield of 3.22% and closed 9 bps lower at 3.13%. Ten-year bond yields also fell, opening the month at 4.01% and closing 34 bps lower at 3.67%. Money market yields were mixed as the market continued to price in interest rate cuts in the first quarter of 2012. The three-month bank bill yield opened at 4.53% and fell 6 bps to close at 4.47%, while the six-month bank bill opened at 4.31% and closed 12 bps higher at 4.43%.

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

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

Australian dollar

December review: During December, the A\$ fell against the US dollar (US\$) and the Japanese yen (JPY) but rose against the currencies of Australia's major trading partners (as per the trade-weighted index [TWI]). Commodity prices tumbled on the back of global growth concerns and a rise in the US\$ with safe-haven buying. This in turn affected the A\$ which fell below parity during the month for the fourth time since August 2011. The A\$ closed the month at US\$1.0209 (down 0.7% from US\$1.0283) and JPY78.43 (down 1.6% from JPY79.70). The TWI closed the month at 75.5 (up 1.2% from 74.6).

Short-term outlook: The A\$ is vulnerable to further volatility and weakness on global growth concerns but should remain solid given 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 firm over the medium term.

Key financial markets

	31 December 2011	Change in one month	Change in 12 months
S&P/ASX 200 Accumulation Index	30,879	-1.4%	-10.5%
MSCI World (ex-Aust Accumulation/unhedged in A\$)	3,210	+0.2%	-5.3%
US S&P 500 Accumulation Index	2,159	+1.0%	+2.1%
Dow Jones Eurostoxx Accumulation	371	-0.3%	-15.2%
UK FTSE 100 Accumulation Index	3,770	+1.3%	-2.2%
Japan Topix Accumulation Index	936	+0.1%	-17.0%
S&P/CITIC 300 Total Return Index	2,240	-6.9%	-24.6%
S&P/ASX 200 Property Accum. Index	19,068	-2.7%	-1.5%
UBS Global Real Estate Investors Index (hedged in A\$)	1,209	+2.2%	+1.4%
Aust 90-day bank bill yield	4.47%	-6 bps	-57 bps
Aust 10-year bond yield	3.67%	-34 bps	-188 bps
US 10-year bond yield	1.88%	-19 bps	-141 bps
A\$ in US cents	1.0209	-0.7%	-0.2%
Trade-weighted index	75.5	+1.2%	-0.4%