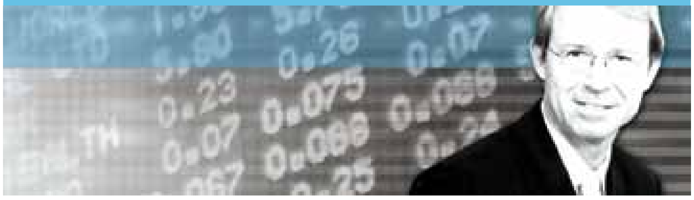
January 2010

Market and Economics Report



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

Global economy

Review: The global economic recovery gained momentum during December. US economic data indicated a continuing recovery. The US labour market is seeing diminishing job losses with falling unemployment claims pointing to a return to job growth soon. The unemployment rate also dropped slightly to 10%, although this is still close to a 26-year high. Among more encouraging news was a strong result from the Institute for Supply Management manufacturing survey. Retail sales also recorded a solid rise for the second consecutive month in November. Consumer sentiment also made gains, although it has advanced in a see-saw pattern. In contrast, the US housing construction sector is yet to show signs of sustained recovery. November's housing starts improved, but only back up to the average level of the last six months. Although optimistic about the recovery, the US Federal Reserve maintained its commitment to "keep exceptionally low levels of the Federal Funds rate for an extended period". Japan's economy showed further evidence of a mild recovery. Industrial production continued to revive in October, with output having increased by 23% from the low point in February 2009. The Bank of Japan's quarterly business conditions survey showed a modest gain in the December quarter indicating that Japan's corporate sector is slowly recovering. Third quarter gross domestic product (GDP) was revised downward to 0.3% expansion quarter-on-quarter compared with the original estimate of 1.2% growth. Chinese economic data remained robust. The Purchasing Managers Index (PMI) rose to 55.9 in December, well above the threshold which signals a solid expansionary phase. Industrial production continued to rise, recording a better than expected 19.2% year-on-year (yoy) growth for November. China's annual consumer price index (CPI) recorded its first positive result in November after nine months of deflation. European economic data released during December was mixed. Retail sales figures for November were weak, with real spending in annual terms remaining well below last year's level. Unemployment rose to a decade-high of 10%. In positive news, surveys of conditions in manufacturing and services companies rose. News from the UK was more positive with house prices recording their seventh consecutive monthly rise in November. Overall, house prices rose 2.7% in the year to November, although they are still well below their 2007 peak. Britain's GDP for the September quarter was revised upward but still contracted 0.2%, leaving the UK as the last major global economy still in recession.

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: The Australian economy continued its gradual recovery in December. The Reserve Bank of Australia (RBA) stated that the "risk of serious economic contraction" had "passed" in Australia and raised official interest rates for the third consecutive month. According to the RBA board meeting minutes, "members agreed that the level of the cash rate ... would be too low for an economy that had resumed expanding." Among the positive economic news, labour market conditions continued to surprise on the upside with a further 31,200 new jobs created in November. The unemployment rate fell slightly to 5.7% and the ANZ job advertisement survey showed a sharp increase in advertised vacancies. According to the National Australia Bank survey, business confidence improved to its highest level since May 2002. Meanwhile, business conditions fell during November but retained most of the previous month's sharp gains. Australia's Real GDP result of +0.2% for the September quarter confirmed Australia's position as one of the strongest economies compared with many developed nations. In less positive news, the current account deficit for the September quarter widened.

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

December review: The leading measure of global share market performance, the MSCI World (ex-Australia) Accumulation Index, returned +3.7% in local currencies (or +3.6% in unhedged Australian dollar terms). The US S&P 500 Accumulation Index returned +1.9%. In the European region, the Eurostoxx Accumulation Index returned +5.6%; while the UK FTSE 100 Accumulation Index returned +4.4%. Shares in Asia also gained ground with Japan's Topix Accumulation Index returning +8.0% after three months of negative returns and China's S&P/CITIC 300 Total Return Index returning +1.8%.

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

December review: The Australian share market, as measured by the S&P/ASX 200 Accumulation Index, rose a further 3.7% in

December to end the year up by 37%. This made Australia one of the strongest performing developed markets in 2009, and was the best year for Australian shares since 1993. Gains were evenly spread across sectors, but stocks with exposure to China outperformed the wider market as data continued to highlight the strength of Chinese domestic demand.

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

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

Real Estate Investment Trusts

December review: The S&P/ASX Property 200 Accumulation Index returned +3.4% during December, slightly underperforming the broader equity 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

December review: International bond yields rose across the board in December. The US ten-year bond yield rose 64 basis points (bps) to 3.83% and Japan's ten-year bond yield rose 3 bps to close at 1.30%. In the European region, Germany's ten-year bond yield rose 23 bps to 3.39% and the UK ten-year bond yield rose 50 bps to close the month at 4.02%.

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

December review: The three-year bond yield ended the month 11 bps higher at 4.72%, whereas the ten-year bond yield closed the month 46 bps higher at 5.70%. The shorter-dated bonds reacted to generally strong economic data, whereas the longer-dated bonds performed in line with the US and sold off strongly in the last week of December. Bank bill yields continued to rise during the month as a year-end premium was priced into the yield curve. The three-month bank bill rate opened at 4.03% and closed 25 bps higher at 4.28%. Six-month bank bill yields also rose, opening at 4.42% and closing 5 bps higher at 4.47%.

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

December review: During December, the Australian dollar (A$) fell against the US dollar (US$) for the first month since January 2009. However the A$ rose strongly against the Japanese yen (JPY) due to JPY weakness. The A$ rose only slightly against the currencies of Australia's major trading partners (as per the Trade Weighted Index [TWI]). The A$ closed the month at 89.86 US cents (down 1.9% from 91.58 US cents) and JPY83.55 (up 4.4% from JPY79.16). The TWI closed the month at 69.7 (up 0.6% from 69.1). The US$ rose due to expectations that the US Federal Reserve is moving closer to raising interest rates. This, combined with dovish comments from the Reserve Bank of Australia and subdued Australian GDP data, saw the A$ fall.

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 December 2009	Change in one month	Change in 12 months
S&P/ASX 200 Accumulation Index	33,986	+3.7%	+37.0%
MSCI World (ex-Aust Accumulation/ unhedged in A$)	3,462	+3.6%	-0.3%
US S&P 500 Accumulation Index	1,838	+1.9%	+26.5%
Dow Jones Eurostoxx Accumulation	426	+5.6%	+27.6%
UK FTSE 100 Accumulation Index	3,422	+4.4%	+27.3%
Japan Topix Accumulation Index	1,117	+8.0%	+7.6%
S&P/CITIC 300 Total Return Index	3,300	+1.8%	+97.0%
S&P/ASX 200 Property Accum. Index	19,433	+3.4%	+7.9%
UBS Global Real Estate Investors Index	973	+5.7%	+27.4%
Aust 90-day bank bill yield	4.28%	+25 bps	+13 bps
Aust 10-year bond yield	5.70%	+46 bps	+163 bps
US 10-year bond yield	3.83%	+64 bps	+162 bps
A$ in US cents	89.86	-1.9%	+27.8%
Trade-weighted index	69.7	+0.6%	+25.4%

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