

Market & Economic Report

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Global economy

Review: US economic conditions have remained consistent with continued economic growth, although growth remains fragile and constrained. The Institute for Supply Management (ISM) survey for manufacturing climbed higher to 52.7 in November while the ISM non-manufacturing conditions index fell to 52. America's labour market strengthened in November with 120,000 jobs added and the unemployment rate dropping sharply to 8.6%. October nominal retail sales rose 0.5% month-on-month (mom) and industrial production increased 0.7% mom, revealing solid economic activity. The US Federal Reserve (Fed) left interest rates at 0%-0.25% in November and maintained its commitment to "exceptionally low" interest rates until mid-2013. The Fed also downgraded its US growth forecast for 2011 in recognition of slower activity. US growth is now expected to be circa 1.6% compared to the June forecast of circa 2.8%. The Fed's November meeting minutes showed forecasts for "moderate" economic growth but also expressed concern that Europe's banking and debt crisis is a "significant downside risk". Notably, the Fed's survey of bank lending surveys showed that US banks were tightening loan standards for European banks to a "considerable" degree.

In the Eurozone the sovereign debt crisis continued to intensify. After a turbulent start to the month governments in both Greece and Italy were replaced with technocrats focusing on implementing austerity and economic reform packages. The European Commission revised downwards its growth forecasts with Europe now expected to expand by +1.5% in 2011 and then slow further to +0.5% in 2012. We expect a mild recession in 2012. Eurozone data remained weak. The region's purchasing managers' index (PMI) for manufacturing fell to 46.4 in November, continuing to highlight the immediate recession prospect for the region. Europe announced another set of measures in December focused on a fiscal union, a strengthening of bailout funds and more money for the International Monetary Fund. Unfortunately it does nothing to address the economic deterioration and liquidity problems in bond markets. More aggressive European Central Bank (ECB) support is required, but it remains reluctant for now.

In positive news, growth prospects for Japan continued to improve with real gross domestic product (GDP) for the September quarter expanding by 1.4% quarter-on-quarter (qoq), or 5.6% annualised. This came after the 0.5% qoq decline in Japan's real GDP for the June quarter and 0.9% decline for the March quarter. Japan's index of coincident economic indicators also rose a preliminary 1.3 points in October, rising for the first time in three months and vehicle sales picked up rising 24.1% year-on-year in November.

The Chinese economy continued to cool with the manufacturing PMI falling to 49.0 from 50.4 in November. While this was the lowest reading since February 2009, the index is at levels that suggest China's industrial activity is continuing to grow but at a more moderate pace. Industrial production, fixed-asset investment and real estate indicators also point to a slowdown. Fortunately inflation has fallen sharply providing room for policy easing going forward.

Outlook: The global recovery is likely to continue, albeit slowly. Europe's debt problems pose the biggest threat. Watch the ECB.

Australian economy

Review: The Reserve Bank of Australia (RBA) cut rates by 0.25% to 4.25% in December, stating that Australia's "inflation outlook afforded scope for a modest reduction in the cash rate". Meanwhile, Australia's economy grew by more than expected in the September quarter with GDP rising 1.0% qoq but was largely driven by mining investment. The labour market softened with new jobs falling by 6,300 and the unemployment rate rising to 5.3% in November. Consumer sentiment improved significantly with the Westpac Melbourne Institute survey rising by 6.2 points to 103.4 in November while retail sales rose only 0.2% in October. The National Australia Bank business survey for October showed an improvement in business confidence which increased by three points after a sharp fall in August. The housing sector remained weak with building approvals falling 10.7% in October. In its Statement of Monetary Policy for November, the RBA revised down its Australian growth and inflation forecasts for 2012 and 2013 by approximately 0.5% compared to August.

Outlook: While mining investment is booming, retailing, housing, manufacturing and tourism are likely to remain soft. Given global uncertainty and mixed Australian indicators, the RBA is likely to cut rates further next year.

International shares

November review: The leading measure of global share market performance, the MSCI World (ex-Australia) Accumulation Index, returned 0.9% in local currencies (or -1.2% in unhedged Australian dollar terms). The US S&P 500 Accumulation Index returned -0.2% in local currency terms. In the European region, the Eurostoxx Accumulation Index returned -2.4% while the UK FTSE 100 Accumulation Index returned -0.2%, both in local currency terms. Shares in Asia also fell back, with Japan's Topix Accumulation Index returning -4.7% and China's S&P/CITIC 300 Total Return Index returning -6.2%.

Short-term outlook [six to 12 months]: Given the uncertain global backdrop, 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, sub-par economic policy making and social tension.

Australian shares

November review: Australian shares fell back in November in line with the global trend as global share markets weakened on fears that the ongoing Eurozone debt crisis will damage global growth. The S&P/ASX 200 Accumulation Index returned -3.5% for the month overall.

Short-term outlook: While short-term volatility will remain high with further weakness possible in the next few months, 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 over.

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

November review: The Australian real estate investment trust market remained in positive territory over the month, with the S&P/ASX 200 Property Accumulation Index returning 2.6% during November. The sector outperformed the broader Australian share market which returned -3.5% 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, 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 9.0% per annum are likely.

International bonds

November review: International bond yields were mixed throughout November on sovereign debt worries in Europe. The US ten-year bond yield fell 4 basis points (bps) to 2.07%, while Japan's ten-year bond yield rose 2 bps to 1.07%. In Europe, the UK ten-year bond yield fell by 13 bps to close the month at 2.31% while Germany's ten-year bond yield increased 25 bps to 2.28%.

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

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 eventually return to more normal levels.

Australian bonds and cash

November review: Australian bond markets rallied in November further to the erosion of risk sentiment throughout the month. Three-year Australian government bonds opened the month at a yield of 3.80% and closed 58 bps lower at 3.22%. Ten-year bond yields also fell back, opening the month at 4.43% and

closing 42 bps lower at 4.01%. Money market yields fell significantly at the start of the month, following on from October's losses. The three-month bank bill yield opened at 4.64% and fell 11 bps to close at 4.53%. The six-month bank bill opened at 4.59% and closed 28 bps lower at 4.31%.

Short-term outlook: Australian bonds are poor value at current yields but 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

November review: During November, the Australian dollar (A\$) fell 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\$ was dragged lower by global growth concerns which saw falls in risk assets generally. The A\$ closed the month at 102.83 US cents (down 2.3% from 105.30 US cents) and JPY79.70 (down 3.3% from JPY82.43). The TWI closed the month at 74.6 (down 3.0% from 76.9).

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

Key financial markets

	30 November 2011	Change in one month	Change in 12 months
S&P/ASX 200 Accumulation Index	31,303	-3.5%	-6.0%
MSCI World (ex-Aust Accumulation/unhedged in A\$)	3,204	+0.9%	-5.2%
US S&P 500 Accumulation Index	2,137	-0.2%	+7.8%
Dow Jones Eurostoxx Accumulation	372	-2.4%	-10.3%
UK FTSE 100 Accumulation Index	3,724	-0.2%	+3.2%
Japan Topix Accumulation Index	935	-4.7%	-13.4%
S&P/CITIC 300 Total Return Index	2,406	-6.2%	-19.7%
S&P/ASX 200 Property Accum. Index	19,587	+2.6%	+2.4%
UBS Global Real Estate Investors Index (hedged in A\$)	1,184	-3.2%	+4.5%
Aust 90-day bank bill yield	4.53%	-11 bps	-51 bps
Aust 10-year bond yield	4.01%	-42 bps	-140 bps
US 10-year bond yield	2.07%	-4 bps	-73 bps
A\$ in US cents	1.0283	-2.3%	+7.3%
Trade-weighted index	74.6	-3.0%	+2.2%