

Market & Economics Report

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Global economy

Review: The past month has been characterised by a marked increase in pessimism and risk aversion globally due to renewed sovereign debt issues in Europe, the US debt ceiling debacle and the subsequent loss of its AAA credit rating from Standard & Poor's, and weak economic data. Economic indicators showed a slowing in the US economic recovery with June quarter gross domestic product (GDP) revised down to just 0.2% quarter-on-quarter (qoq), compared to original estimates of 0.3% qoq. US retail sales for July rose, although surveys showed consumer sentiment was at its lowest reading since 1980. On the positive side, the key Institute for Supply Management (ISM) manufacturing conditions survey fell by less than feared in August and is well above the level of 42 that is normally associated with recession. Payroll employment, however, stalled in August increasing the likelihood that the US Federal Reserve will implement further stimulus following its meeting later this month. This is initially likely to take the form of extending the duration of its balance sheet, but a third round of quantitative easing, i.e. QE3, is highly likely to follow in October or November.

In early August, in response to increasing turmoil in various bond markets, the European Central Bank (ECB) announced it would buy bonds in secondary markets in a bid to stabilise the bond yields of vulnerable European countries. This saw Italian and Spanish bond yields fall. European data releases were generally poor during August. Europe's real GDP expanded by only 0.2% qoq in the June quarter, which brings the annual growth rate to 1.7% year-on-year. The manufacturing purchasing managers' index fell to 49.0 and industrial production fell in July. In Germany, the IFO business climate index fell to 108.7, which is a 14-month low and suggests the German economy is slowing from 3% growth in the first half of 2011 to below 2%. ECB President Trichet appears to have signalled that he is becoming less worried about inflation. The next move in European interest rates is likely to be down, reversing the misplaced rate hikes of earlier this year.

Japanese GDP contracted by 0.5% qoq in the June quarter, which was expected after the earthquake and tsunami in March 2011. Japan's exports fell in August as did business confidence and new housing construction. Retail sales in August and industrial production in July were softer than expected while government spending and public investment both rose in August.

Amid inflation worries in China, monetary policy remained tight with money supply and lending slowing. China's economy remained strong, with August data releases showing increases in industrial production, fixed-asset investments and retail sales and exports, albeit at a slower pace. China's inflation rate

slowed to 6.2% in August from 6.5% in July and appears to have peaked.

Outlook: The global recovery is likely to continue, but the risk of renewed recession in the US and Europe is high.

Australian economy

Review: The Reserve Bank of Australia (RBA) left interest rates on hold at 4.75% at its September meeting, with Governor Glenn Stevens stating that "uncertainty and financial volatility is reducing confidence and may result in more cautious behaviour by firms and households". Domestic economic data released over the month was generally soft. Consumer sentiment fell to 89.6 in August and Australia's leading index slowed. During August, employment fell and the unemployment rate rose to 5.3%. August data for new home sales, building approvals, house prices and private credit was weak. Although GDP climbed by a robust 1.2% in the June quarter, compared with a revised 0.9% fall in the March quarter, growth looks unlikely to be sustained at this pace.

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

International shares

August review: The leading measure of global share market performance, the MSCI World (ex-Australia) Accumulation Index, returned -7.0% in local currencies (or -4.8% in unhedged Australian dollar [A\$] terms). The US S&P 500 Accumulation Index returned -5.4% in local currency terms. In the European region, the Eurostoxx Accumulation Index returned -12.8% while the UK FTSE 100 Accumulation Index returned -6.6%, both in local currency terms. Shares in Asia also fell, with Japan's Topix Accumulation Index returning -8.4% and China's S&P/CITIC 300 Total Return Index returning -4.2%.

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 attractive, the global recovery should continue (although the risks in Europe and the US have increased) 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 7.5% per annum on average in local currency terms. Shares are likely to remain volatile.

Australian shares

August review: Australian shares experienced extreme volatility during August as global share markets fluctuated in response to the risk of a US recession and continuing sovereign debt issues in Europe. Australian shares proved more resilient than global shares as they benefited from expectations of interest rate cuts before year-end. The S&P/ASX 200 Accumulation Index fell by 1.9% for the month overall, although this masks some dramatic intra-month movements.

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. 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

August review: The Australian real estate investment trust market rose over the month, with the S&P/ASX 200 Property Accumulation Index returning +3.1% during August. The sector outperformed the broader Australian share market which returned -1.9% 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 9.5% per annum are likely.

International bonds

August review: International bond markets rallied strongly as bond yields fell in response to the possibility of a US recession and continuing sovereign debt issues in Europe. The US ten-year bond yield fell by 58 basis points (bps) to 2.22%, and Japan's ten-year bond yield fell by 5 bps to close at 1.03%. In Europe, the UK ten-year bond yield fell by 26 bps to close the month at 2.60% while Germany's ten-year bond yield fell by 32 bps to 2.22%.

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

August review: Australian bond markets rallied strongly in line with global bond markets as bond yields fell in response to the possibility of a US recession and continuing sovereign debt issues in Europe. Three-year Australian government bonds opened the month at a yield of 4.36% and closed 59 bps lower at 3.77%. Ten-year bond yields also fell, opening the month at 4.80% and closing 43 bps lower at 4.37%. Three-year

Australian government bonds opened the month at a yield of 4.36% and closed 59 bps lower at 3.77%. Ten-year bond yields also fell, opening the month at 4.80% and closing 43 bps lower at 4.37%.

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

August review: During August, the 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 volatile over the month in line with global share markets and swinging investor sentiment. Falling commodity prices and increasing expectations that the next move in Australian interest rates will be down also weighed on the currency. The A\$ closed the month at 107.07 US cents (down 2.6% from 109.93 US cents) and JPY82.08 (down 2.7% from JPY84.40). The TWI closed the month at 76.5 (down 2.4% from 78.4).

Short-term outlook: The A\$ is vulnerable to further volatility and weakness 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

	31 August 2011	Change in one month	Change in 12 months
S&P/ASX 200 Accumulation Index	32,215	-1.9%	+1.9%
MSCI World (ex-Aust Accumulation/unhedged in A\$)	3,118	-4.8%	-5.1%
US S&P 500 Accumulation Index	2,077	-5.4%	+18.5%
Dow Jones Eurostoxx Accumulation	374	-12.9%	-6.3%
UK FTSE 100 Accumulation Index	3,618	-6.6%	+6.7%
Japan Topix Accumulation Index	979	-8.4%	-2.1%
S&P/CITIC 300 Total Return Index	2,723	-4.2%	-1.1%
S&P/ASX 200 Property Accum. Index	19,252	+3.1%	-2.7%
UBS Global Real Estate Investors Index (hedged in A\$)	1,238	-4.9%	+16.2%
Aust 90-day bank bill yield	4.82%	-19 bps	+7 bps
Aust 10-year bond yield	4.37%	-43 bps	-39 bps
US 10-year bond yield	2.22%	-58 bps	-25 bps
A\$ in US cents	1.0707	-2.6%	+20.0%
Trade-weighted index	76.5	-2.4%	+10.9%

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