

Market & Economics Report

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Global economy

Review: The global economy continues to recover with the US in particular looking increasingly robust. US Institute for Supply Management manufacturing and services sector surveys rose strongly in January. US retail sales rose by 0.6% month-on-month (mom) in December and strong gains were recorded in vehicle sales and homes sales. December quarter earnings have surprised on the upside with over 70% of results coming in better than expected. While payrolls were mildly disappointing, this was mainly due to bad weather conditions. Strong employment gains reported in the household employment survey, the fall in the unemployment rate to 9% in January and falling jobless claims all indicate that the labour market is strengthening. Reflecting this optimism, US consumer credit surged higher by US\$6.1 billion in December, and credit card debt rose for the first time since August 2008. Reflecting the improving economy, US real gross domestic product (GDP) expanded by 0.8% quarter-on-quarter (qoq) or 3.2% year-on-year (yoy).

Japan's economic recovery appears to have lost some growth momentum. Machinery orders fell by 3% in November, the third significant monthly fall in as many months, and consumer confidence has been drifting lower since mid-2010. Against this, business conditions improved in January.

In China, the People's Bank of China announced further monetary tightening to quell inflation. China's economy surprisingly accelerated in the December quarter, expanding by 9.8% yoy compared with 9.6% yoy in the September quarter. Consumer price index (CPI) inflation eased slightly to 4.6% yoy in December compared with 5.1% yoy in November, but high food prices remain a concern. Further, manufacturing conditions slipped in January, suggesting that tightening measures are starting to impact and possibly adding to confidence that additional tightening won't become aggressive.

Despite the turmoil in Europe's public debt markets, European economic indicators generally pointed to continued recovery. Industrial sentiment rose to its highest level since August 2007 in December and then rose further in January. European consumer sentiment was constant in January, but has maintained a positive trend since 2009. The German economy performed particularly strongly in the fourth quarter of 2010, with German GDP growing by 0.5% qoq and 4.1% yoy. Germany's IFO business survey also suggests that the economy still has considerable momentum.

Outlook: While sovereign debt risks in Europe remain a concern, the global economic outlook continues to improve. Global growth in 2011 should be around 4.5%.

Australian economy

Review: Australian economic data released in January and at the beginning of February was mixed. Building approvals surged 8.7% mom in December, beating expectations. The labour market added 2,300 jobs in December and, according to the ANZ Job Advertisements Series survey, overall available jobs increased by 2.4% in January. The unemployment rate dropped to 5%, although the participation rate and the number of skilled job vacancies dropped as well. Retail sales rose by only 0.2% mom in December and credit data remained soft although it appears to be stabilising. While housing finance loans rose for the fifth consecutive month in January, house prices rose modestly in the December quarter and have been largely flat for nine months now. New home sales were soft in December, as were underlying building approvals. The CPI rose by 0.4% qoq in the December quarter, keeping the annual at 2.7% yoy within the Reserve Bank of Australia's (RBA) target range of 2% to 3%. Consumer confidence and business confidence fell, although this appears mainly due to the floods. Meanwhile, the trade surplus held steady in December and points to a modest positive contribution to December quarter GDP growth. Finally, the Australian Government announced a nationwide flood levy to help fund the rebuilding of flood-affected areas.

Outlook: While the precise impact of the Queensland floods is not yet known, it is likely to knock 1% or so off March quarter GDP before rebuilding kicks in and combines with increased mining investment to boost growth from the June quarter. Given flood-related uncertainty and benign underlying inflation, the RBA is likely to leave rates on hold until mid-year.

International shares

January review: The leading measure of global share market performance, the MSCI World (ex-Australia) Accumulation Index, returned +2% in local currencies (or +5.3% in unhedged Australian dollar [A\$] terms). The US S&P 500 Accumulation Index returned +2.4% in local currency terms. In the European region, the Eurostoxx Accumulation Index returned +4.5% while the UK FTSE 100 Accumulation Index returned -0.6%, both in local currency terms. Shares in Asia were mixed, with Japan's Topix Accumulation Index returning +1.3% and China's S&P/CITIC 300 Total Return Index returning -2.1%.

Short-term outlook [six to 12 months]: Given that shares remain cheap, global shares are likely to provide good returns on a 12-month plus view as growth continues, monetary conditions remain easy, and as cashed up companies boost merger and acquisition activity, dividends and share market buy-backs. However, volatility is likely to remain high, reflecting recurring macroeconomic scares.

Medium-term outlook [five to ten years]: Constrained profit growth will see medium-term returns from mainstream global shares of around 7% per annum on average.

Australian shares

January review: Australian shares were flat during January, underperforming global shares. The S&P/ASX 200 Accumulation Index closed the month only 0.2% higher, held back by the strong A\$, renewed concerns over further Chinese policy tightening and worries about the impact of the floods.

Short-term outlook: While short-term volatility will remain high, Australian shares are likely to provide positive returns on a 12-month view. Valuations are reasonable and solid underlying economic conditions and rising profits are supportive of further gains in shares.

Medium-term outlook: Reflecting reasonable growth prospects, medium-term returns of around 9.5% per annum are likely (or 10.5% if franking credits are allowed for).

Real estate investment trusts

January review: The Australian real estate investment trust sector outperformed the broader Australian share market, returning +2.4% for the month of January while the S&P/ASX 200 Accumulation Index returned +0.2%.

Short-term outlook: Property stocks have recapitalised and are good value from a long-term perspective. With improved credit conditions and property transaction volumes having increased, 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% per annum are likely.

International bonds

January review: International bond markets generally weakened in January as global economic data showed signs of an improvement in activity. The US ten-year bond yield rose by 9 basis points (bps) to 3.38%, and Japan's ten-year bond yield also rose by 9 bps to close at 1.22%. In Europe, the UK ten-year bond yield rose by 26 bps to close the month at 3.66% while Germany's ten-year bond yield rose by 20 bps to 3.16%.

Short-term outlook: Sovereign bond yields are likely to push higher as economic conditions continue to improve.

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 rise.

Australian bonds and cash

January review: Australian bond markets rallied during January and the yield curve steepened as the market priced out the probability of further rate rises in the first half of 2011. Three-year Australian government bonds opened the month at a yield of 5.27% and closed 22 bps lower at 5.05%. Ten-year bond yields also fell, opening the month at 5.55% and closing 4 bps lower at 5.51%. The three-month bank bill yield opened at 5.04% and fell 12 bps to close at 4.92%, the six-month bank bill opened at 5.23% and closed 15 bps lower at 5.08%.

Short-term outlook: Australian bond yields are likely to provide returns around current yield levels (5.5%), or a little less as yields rise.

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

Australian dollar

January review: After ending 2010 at a 28-year high, the A\$ slipped back below parity as the US dollar (US\$) strengthened and concerns about the impact of the floods in Australia and the potential for further policy tightening in China also weighed on the A\$. The A\$ fell against the 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 99.71 US cents (down 2.6% from 102.33 US cents) and JPY81.82 (down 1.4% from JPY83.02). The TWI closed the month at 74 (down 2.4% from 75.8).

Short-term outlook: Notwithstanding short-term volatility, further gains in the A\$ are likely on the back of strong demand for commodities and relatively high Australian interest rates.

Medium-term outlook: High commodity prices and strong growth in China are likely to support higher levels for the A\$.

Key financial markets

	31 January 2011	Change in one month	Change in 12 months
S&P/ASX 200 Accumulation Index	34,582	+0.2%	+8.5%
MSCI World (ex-Aust Accumulation/unhedged in A\$)	3,572	+5.3%	+6.2%
US S&P 500 Accumulation Index	2,164	+2.4%	+22.2%
Dow Jones Eurostoxx Accumulation	457	+4.5%	+12.5%
UK FTSE 100 Accumulation Index	3,833	-0.6%	+16.8%
Japan Topix Accumulation Index	1,142	+1.3%	+3.0%
S&P/CITIC 300 Total Return Index	2,911	-2.1%	-2.1%
S&P/ASX 200 Property Accum. Index	19,821	+2.4%	+5.0%
UBS Global Real Estate Investors Index (hedged in A\$)	1,220	+2.3%	+30.3%
Aust 90-day bank bill yield	4.92%	-12 bps	+54 bps
Aust 10-year bond yield	5.51%	-1 bp	+15 bps
US 10-year bond yield	3.38%	+5 bps	-20 bps
A\$ in US cents	0.9971	-1.9%	+13.2%
Trade-weighted index	74.0	-2.4%	+6.9%

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