

# Market & Economic Report

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## Global economy

**Review:** American economic data remains consistent with continued slow growth. The Institute for Supply Management (ISM) manufacturing survey rose in September and the non-manufacturing index fell by less than expected. Construction spending gained and durable goods were flat in August after a 4% surge in July, suggesting that US business investment is still in recovery. America's labour market picked up slightly in September with payrolls rising by 103,000 and the unemployment rate held steady at 9.1%. US retail sales disappointed coming in flat in August and consumers remained pessimistic as evidenced by September's weak Conference Board sentiment survey. President Obama challenged Congress to pass a US\$447 billion stimulus package to give "a jolt to an economy that has stalled". This package would equate to a 3% stimulus to US Real GDP. At its September meeting, the US Federal Reserve recognised that "there are significant downside risks to the economic outlook". Accordingly, the central bank launched a modern day 'Operation Twist' which involves selling short-dated Treasury bonds from its balance sheet and buying longer-dated securities with the hope that it will result in lower long-term borrowing rates.

In Europe economic data showed continued weakness, with final September purchasing managers index (PMI) manufacturing and services sector conditions indicators coming in at levels consistent with recession, and Euro-zone banks indicating that liquidity and access to finance has deteriorated to levels last seen during the global financial crisis. Germany's IFO Business Climate Index fell to a 15-month low and German factory orders fell in August showing that Europe's largest economy is seeing fading growth momentum. Euro-zone parliaments voted in favour of expanding the European Financial Stability Facility (EFSF) to €440 billion. While this is a constructive development, the immediate reality is that Europe is likely to fall into a recession over the next two quarters given budget austerity measures and damage to confidence with recent financial market turmoil. The European Central Bank kept policy interest rates on hold at 1.50% at its September meeting, although President Trichet noted that the central bank staff had "revised downwards" their economic growth forecasts.

Japanese GDP contracted by 0.5% (revised from 0.3%) in the June quarter and Japan posted a return to a trade deficit as the export sector continued to struggle. More encouraging however was the nation's small business survey which rose further in September, suggesting that Japan is now gradually emerging from a recession that was compounded by the tragic earthquake and tsunami in March.

The Chinese economy cooled to a more sustainable pace in September with manufacturing PMI improving only slightly to 50.9 from 50.7 in July. China's annual consumer price index inflation also fell to 6.1% in September, adding to confidence that July's 6.5% marked the peak. On the activity front, fixed asset investment growth, industrial production growth and retail sales growth all moderated further, but remained at relatively robust levels.

**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 official interest rates on hold at 4.75% in October but opened the door to an easing by signalling that it is becoming less concerned about inflation and raising the prospect of an interest rate cut to support demand. Australia's economic activity rebounded in the June quarter with Real GDP expanding by 1.2%. While manufacturing and construction conditions weakened again in September, building approvals and retail sales rose strongly in August, the trade surplus in August rose to its second highest level on record, and the TD Securities/Melbourne Institute's inflation gauge remained consistent with a moderation in inflation pressures. Australian consumer sentiment also improved further with the National Australia Bank business survey showing an improvement in business conditions and confidence in September, and the Westpac Melbourne Institute survey edging up 0.4% in October after a 8.1% increase in September. In addition, labour market data picked up in September with the addition of 20,000 jobs and the unemployment rate falling slightly to 5.2%. Housing finance approvals also improved, rising a seasonally adjusted 1.2% in August and building approvals increased by 11.4% in August. However, the underlying picture for the economy still remains soft, with confidence and building indicators all still at low levels and employment down 5,000 over the last six months.

**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

**September review:** The leading measure of global share market performance, the MSCI World (ex-Australia) Accumulation Index, returned -6.1% in local currencies (or 0.9% in unhedged Australian dollar [A\$] terms). The US S&P 500 Accumulation Index returned -7.0% in local currency terms. In the European region, the Eurostoxx Accumulation Index returned -6.1% while the UK FTSE 100 Accumulation Index returned -4.7%, both in local currency terms. Shares in

Asia also fell, with Japan's Topix Accumulation Index returning -0.2% and China's S&P/CITIC 300 Total Return Index returning -9.8%.

**Short-term outlook [six to 12 months]:** Given the uncertain global backdrop, shares are likely to remain volatile. However, valuations are attractive, the global recovery should continue (although Europe will likely slide into recession and the US is soft) 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

**September review:** Australian shares experienced extreme volatility during September as global share markets fluctuated on continuing sovereign debt issues in Europe. The S&P/ASX 200 Accumulation Index fell by 6.1% for the month overall.

**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 10.5% per annum are likely (or 12% if franking credits are allowed for).

## Real estate investment trusts

**September review:** The Australian real estate investment trust (A-REIT) market fell over the month, with the S&P/ASX 200 Property Accumulation Index returning -4.5% during September. The sector once again outperformed the broader Australian share market which returned -6.1% 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

**September review:** International bond markets were volatile over September, rallying strongly at the beginning of the month on safe-haven demand before falling back as risk aversion decreased. Bond yields edged higher towards month-end in response to better performance from global shares and Germany's parliamentary vote supporting an expanded EFSF. The US ten-year bond yield fell by 30 basis points (bps) to 1.92%, and Japan's ten-year bond yield was flat remaining at 1.03%. In Europe, the UK ten-year bond yield fell by 17 bps to close the month at 2.43% while Germany's ten-year bond yield fell by 33 bps to 1.89%.

**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

**September review:** Australian bond markets were volatile in September in line with the global trend. Bond yields fluctuated on the back of safe-haven demand. Three-year Australian government bonds opened the month at a yield of 3.77% and closed 15 bps lower at 3.62%. Ten-year bond yields also fell, opening the month at 4.37% and closing 15 bps lower at 4.22%. Money market yields fell further as the market continued to price in interest rate cuts by year-end. The three-month bank bill yield opened at 4.82% and fell 5 bps to close at 4.77%, while the six-month bank bill opened at 4.69% and closed 9 bps lower at 4.60%.

**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

**September review:** During September, 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 return to risk aversion weighed on the A\$ over the month. Worries about the global growth outlook combined with selling to cover losses on equity markets weighed heavily on commodity prices thereby negatively impacting the A\$. The A\$ closed the month at 96.62 US cents (down 9.8% from 107.07 US cents) and JPY74.45 (down 9.3% from JPY82.08). The TWI closed the month at 74.5 (down 2.7% from 76.5).

**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

	30 September 2011	Change in one month	Change in 12 months
S&P/ASX 200 Accumulation Index	30,239	-6.1%	-8.6%
MSCI World (ex-Aust Accumulation/unhedged in A\$)	3,147	+1.0%	-4.5%
US S&P 500 Accumulation Index	1,931	-7.0%	+1.1%
Dow Jones Eurostoxx Accumulation	351	-6.0%	-16.3%
UK FTSE 100 Accumulation Index	3,447	-4.7%	-4.4%
Japan Topix Accumulation Index	976	-0.3%	-6.1%
S&P/CITIC 300 Total Return Index	2,456	-9.8%	-11.9%
S&P/ASX 200 Property Accum. Index	18,386	-4.5%	-6.2%
UBS Global Real Estate Investors Index (hedged in A\$)	1,116	-9.8%	flat
Aust 90-day bank bill yield	4.77%	-5 bps	-24 bps
Aust 10-year bond yield	4.22%	-15 bps	-74 bps
US 10-year bond yield	1.92%	-30 bps	-59 bps
A\$ in US cents	0.9662	-9.8%	+0.1%
Trade-weighted index	72.4	-5.4%	-0.7%