

Market & Economic Report

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Global economy

Review: US economic data remains consistent with continued modest growth. America's economic growth rebounded in the September quarter with Real gross domestic product (GDP) expanding by 0.6 % quarter-on-quarter. The labour market recorded mild jobs growth in October of 80,000 compared to September's revised 158,000 result, and unemployment edged slightly lower to 9.0%. Consumer credit rose US\$7.4 billion in September and retail sales surged but fell short of expectations in October. The Conference Board's confidence survey for October saw a further 6.6 point decline in confidence to 39.8, the lowest result in the past 31 months. The Institute for Supply Management manufacturing and services conditions indices also disappointed in October. In terms of housing data, the Standard & Poor's Case-Shiller major 10-city index revealed that America's house prices have largely drifted sideways over the past three months to August, whereas construction spending rose slightly in September. The US Federal Reserve's (Fed) Beige Book survey for September provided a cautious assessment of the US economy, with the report describing "the pace of growth as 'modest' or 'slight' and contacts generally noted weaker or less certain outlooks for business conditions". The Fed left monetary policy unchanged in November but reaffirmed that it stands ready to use all its tools if need be. So a third round of quantitative easing is still on the table.

Europe's 27 key political leaders met in Brussels and announced on 26 October that they had agreed on a plan involving a bigger write-down of Greek debt, recapitalising European banks and boosting the firepower of the bailout fund to prevent further contagion to other countries. This led to a few days of relative calm in markets but was short lived with the Greek Prime Minister announcing a referendum on 31 October on the latest bailout package, causing a bout of panic as investors fretted it could lead to Greece going through a disorderly default and even leaving the euro, and then announcing it was off. While the Greek Prime Minister won a parliamentary confidence vote, Greece is forming a new unity government in order to pass the terms of the new debt restructuring plan, probably ahead of fresh elections early next year. This still leaves much uncertainty about the outlook for Greece. Political instability has also spread to Italy. Partly reflecting this, Italian bond yields were pushed to a euro-era high. In terms of economic data, the European Commission's business and consumer sentiment readings deteriorated further in October to levels suggestive of a contraction in economic activity over coming quarters. In addition, the October PMI manufacturing conditions index for the region was revised down even further, the unemployment rate increased to 10.2% in September and retail sales fell 0.7% month-on-month in September. In short, Europe appears to be either in or

heading into recession. Partly reflecting this, the European Central Bank cut its key interest rate to 1.25% in November.

Growth prospects for Japan appeared to improve in August with the leading index falling only marginally, however this was revised down further and preliminary readings revealed a 1.4 point fall in September. Housing starts and construction orders also disappointed.

The Chinese economy continued to cool to a more sustainable pace in the September quarter with Real GDP slowing to 9.1% year-on-year (yoy) from 9.5% yoy in the June quarter. China's export growth also slowed sharply in September to 17.1% from 24.5% yoy in August, with growth of exports to Europe in particular slowing markedly. Adding to evidence that July marked the peak in Chinese inflation was October's consumer price index inflation result which came in at 5.4% yoy. In China, manufacturing conditions indicators (PMIs) remained above the 50 level and the services PMI fell but remains solid. This all supports the view that China's economy is slowing but not coming to a hard landing as many fear. Falling inflation is paving the way for monetary easing in the months ahead.

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

Australian economy

Review: The Reserve Bank of Australia (RBA) cut rates by 0.25% to 4.50 in November, noting that "it is likely to be some time yet before concerns about the European situation can definitively be laid to rest". The RBA's Quarterly Statement on Monetary Policy backed up the move to cut rates by revising down both growth and inflation forecasts for 2012 and 2013. Australian economic data releases were mostly resilient in the face of global turmoil. Australia's labour market stabilised in October with 10,000 jobs created and the unemployment rate remaining at 5.2%. The Westpac Melbourne Institute's index of consumer sentiment surged in November on the back of the RBA's rate cut and retail sales rose solidly again in September. In October, the National Australia Bank business survey showed an increase in confidence on rate cut expectations but a slide in conditions. Australia's trade surplus narrowed in September but remained strong. The housing market disappointed with falls in house prices, new home sales and building approvals.

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

International shares

October review: The leading measure of global share market performance, the MSCI World (ex-Australia) Accumulation

Index, returned 8.6% in local currencies (or 0.9% in unhedged Australian dollar [A\$] terms). The US S&P 500 Accumulation Index returned 10.9% in local currency terms. In the European region, the Eurostoxx Accumulation Index returned 8.6% while the UK FTSE 100 Accumulation Index returned 8.2%, both in local currency terms. Shares in Asia also gained, with Japan's Topix Accumulation Index returning 0.4% and China's S&P/CITIC 300 Total Return Index returning -5.8%.

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

October review: Australian shares rebounded in October as global share markets gained with hope of a plan to address the European sovereign debt crisis. Australian shares were given an additional lift by heightened expectations for an interest rate cut. The S&P/ASX 200 Accumulation Index returned 7.3% 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

October review: The Australian real estate investment trust market gained over the month, with the S&P/ASX 200 Property Accumulation Index returning 3.8% during October. The sector underperformed the broader Australian share market which returned 7.3% 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

October review: International bond yields rose throughout October on positive US economic data releases and in anticipation of a comprehensive proposal from the European Union Summit. The US ten-year bond yield increased 19 basis points (bps) to 2.11%, and Japan's ten-year bond yield rose 2 bps to 1.05%. In Europe, the UK ten-year bond yield rose by 1 bp to close the month at 2.44% while Germany's ten-year bond yield increased 14 bps to 2.03%.

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

October review: Australian bond markets rallied in October in line with the global trend. Three-year Australian government bonds opened the month at a yield of 3.62% and closed 18 basis points (bps) higher at 3.80%. Ten-year bond yields also gained, opening the month at 4.22% and closing 21 bps higher at 4.43%. 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 4.77% and fell 13 basis points (bps) to close at 4.64%. The six-month bank bill opened at 4.60% and closed 1 bp lower at 4.59%.

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

October review: During October, the A\$ rose 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 spurred higher by stronger commodity prices which surged on the back of renewed hope that Europe's sovereign debt problems would be resolved. The A\$ closed the month at 105.30 US cents (up 9.0% from 96.62 US cents) and JPY82.43 (up 10.7% from JPY74.45). The TWI closed the month at 76.9 (up 3.2% from 74.5).

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

	31 October 2011	Change in one month	Change in 12 months
S&P/ASX 200 Accumulation Index	32,431	+7.3%	-3.7%
MSCI World (ex-Aust Accumulation/unhedged in A\$)	3,174	+0.9%	-6.1%
US S&P 500 Accumulation Index	2,142	+10.9%	+8.1%
Dow Jones Eurostoxx Accumulation	381	+8.6%	-12.6%
UK FTSE 100 Accumulation Index	3,729	+8.2%	+1.0%
Japan Topix Accumulation Index	980	+0.4%	-3.5%
S&P/CITIC 300 Total Return Index	2,565	-5.8%	-8.0%
S&P/ASX 200 Property Accum. Index	19,084	+3.8%	-2.3%
UBS Global Real Estate Investors Index (hedged in A\$)	1,223	+9.6%	+5.3%
Aust 90-day bank bill yield	4.64%	-13 bps	-23 bps
Aust 10-year bond yield	4.43%	+21 bps	-64 bps
US 10-year bond yield	2.11%	+19 bps	-49 bps
A\$ in US cents	1.0530	+9.0%	+6.9%
Trade-weighted index	76.9	+3.2%	+5.8%