

Market and Economics Report



by Dr Shane Oliver, Head of Investment Strategy & Chief Economist

Global economy

Review: Concern about the global recovery re-emerged in May. The US economy continued on the path of mild recovery, however, there are signs that the recovery will be constrained for some time. While the ISM business surveys remained strong, May private sector payroll employment was weaker than expected and consumer sentiment surveys pointed to fairly sedate confidence and only modest consumer spending prospects over 2010.

Housing market data showed some improvement with house prices rising and transaction activity strengthening. However, the high number of 'houses for sale' is troubling and shows a considerable pipeline of home owners looking to exit the market. In addition, recent housing data has been artificially boosted by a tax credit that has now expired.

The US Federal Reserve's forecast for growth over 2010 was upgraded to a range of 3.2–3.7%. Yet the American central bank conceded the potential for only a modest recovery due to "household and business uncertainty, only gradual improvement in labour market conditions and slow easing of credit conditions."

Japanese economic data was generally favourable. Japan's economy expanded by 1.2% in the March quarter. However, Japanese policy makers are cautious about declaring the economy back on track after the deep recession. Japanese exports have continued to recover, retail sales data was solid and the leading index recorded a strong rise.

Economic indicators showed that the Chinese economy is starting to cool down. While exports, retail sales, industrial production and fixed asset investment all remain strong, signs are emerging that recent Chinese tightening action has begun to take effect, with anecdotal evidence pointing to a slowdown in property sales, and business conditions surveys pointing to slower economic growth. This suggests that Chinese tightening measures may soon be eased.

News from Europe was dominated once again by sovereign debt concerns and the apparent contagion of Greece's fiscal problems. European policy makers announced significant measures in an effort to end the contagion. However, with numerous countries across Europe – including Germany – announcing tightening measures, worries about a 'double dip' back into recession in Europe have increased.

The UK also announced modest budget spending cuts, which may serve to hamper its already subdued economic recovery. The UK economy expanded by 0.3% during the first quarter of 2010, confirming that the recovery is moving at a fairly subdued pace.

Outlook: Despite obvious risks, the global recovery is continuing, but it is likely to be pretty subdued in developed countries and the risks have also increased.

Australian economy

Review: Australian economic data has been somewhat mixed. The Reserve Bank of Australia (RBA) raised the cash rate for the sixth time in seven meetings in May – taking the rate to 4.5% – but then left it on hold in June. The Australian labour market was strong again, with 33,700 new roles created in April.

In other positive news, retail sales for March and April bounced back after a weaker February and vehicle sales for April were robust. Conversely, capital expenditure for the March quarter was weaker than expected, consumer sentiment fell in April and indicators for housing finance, auction clearance rates and building approvals fell.

During the month, the Federal Government released the budget for 2010–2011, which received considerable attention due to the proposed introduction of a Resources Super Profits Tax.

Outlook: We expect reasonable growth through 2010, driven by the global recovery and stronger investment. While the RBA is on hold for now, we expect the cash rate to rise to 4.75% or 5% by year-end.

International shares

May review: The leading measure of global share market performance, the MSCI World (ex-Australia) Accumulation Index, fell 7.6% in local currencies (or +0.7% in unhedged Australian dollar terms). The US S&P 500 Accumulation Index fell 8.0% in local currency terms. In the European region, the Eurostoxx Accumulation Index fell 6.0% and the UK FTSE 100 Accumulation Index fell 6.1%, both in local currency terms. Shares in Asia also suffered with Japan's Topix Accumulation Index falling 10.8% and China's S&P/CITIC 300 Total Return Index falling 9.1% in local currency terms.

Short-term outlook [six to 12 months]: Global shares are likely to provide good returns on a 12-month plus view, given the likelihood of reasonable growth in profits and still-low interest rates. However, we expect a rougher ride than over the last 12 months.

Medium-term outlook [five to ten years]: Improved dividend yields following the share slump and profit growth around nominal GDP growth, will see medium-term returns from mainstream global shares of around 7.5% per annum on average.

Australian shares

May review: Australian shares dropped sharply during May, following the lead from global shares. The S&P/ASX 200 Accumulation Index fell 7.5%.

Risk aversion rose during the month due to renewed concerns about sovereign debt issues in Europe, the threat of increased banking regulation and moderating growth expectations in China.

The Australian market also faced an additional headwind following the Federal Government's announcement of the proposed Resource Super Profits Tax.

Short-term outlook: Australian shares are likely to provide solid returns on a 12-month view. Valuations are reasonable, interest rates are low and shares are likely to be buoyed by better economic conditions and rising profits in 2010.

Medium-term outlook: Reflecting reasonable growth prospects, medium-term returns of around 9.5% per annum are likely.

Real estate investment trusts

May review: The S&P/ASX Property 200 Accumulation Index fell 4.1% during May, but still outperformed the broader Australian equity market.

Short-term outlook: Most property stocks have recapitalised and represent good value from a long-term perspective – and the credit crunch is fading. As such, they 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

May review: International bond yields fell across the board in May. The US ten-year bond yield fell by 38 basis points (bps) to 3.28% and Japan's ten-year bond yield fell by 2 bps to close at 1.27%. In Europe, the UK ten-year bond yield fell by 27 bps to close the month at 3.58% and Germany's ten-year bond yield fell by 36 bps to 2.66%. The Eurozone sovereign crisis triggered a wider bout of risk aversion. Concerns that a tightening of fiscal policy in southern Europe would dampen European Union and world growth prospects resulted in a flight to quality in the government bond market.

Short-term outlook: Sovereign bond yields are likely to drift higher on expectations for eventually rising short-term interest rates and high public borrowing levels.

Medium-term outlook: AMP Capital expects low returns from global sovereign bonds, reflecting low bond yields.

Australian bonds and cash

May review: The RBA raised interest rates for the sixth time in seven meetings, taking the cash rate to 4.5%. Three-year Australian government bonds opened the month at a yield of 5.31% but rallied rapidly as equity markets collapsed to close the month 59 bps lower at 4.72%. Ten-year bonds did not rally as much, closing the month 34 bps lower. The three-month bank bill rate opened at 4.63% and closed 24 bps higher at 4.87%. Six-month bank bill yields also rose, opening at 4.87% and closing 8 bps higher at 4.95%.

Short-term outlook: Bond yields are likely to drift higher on the back of gradually rising global bond yields and the increasing cash rate in Australia.

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

Australian dollar

May review: The Australian dollar (A\$) fell considerably over May. The A\$ closed the month at 84.73 US cents (down 8.3% from 92.44 US cents) and JPY77.31 (down 11.1% from JPY86.92). The TWI closed the month at 67.5 (down 6.9% from 72.5). The A\$ is often susceptible to worries about global growth and increased investor risk aversion due to its commodity and high-yield status. The A\$ fall during May was also impacted by concerns about the proposed Resource Super Profits Tax on mining activity, which had a negative effect on foreign investor perceptions of Australia.

Short-term outlook: A recovery in the A\$ is likely on the back of a continuation of the global economic recovery, the positive outlook for commodities and the likelihood that Australian interest rates will remain well-above global rates.

Medium-term outlook: AMP Capital expects the A\$ to be strong over the medium term, helped by strong commodity prices.

Key financial markets

	31 May 2010	Change in one month	Change in 12 months
S&P/ASX 200 Accumulation Index	31,422	-7.5%	+20.8%
MSCI World (ex-Aust Accumulation/ unhedged in A\$)	3,476	+0.7%	+8.0%
US S&P 500 Accumulation Index	1,810	-8.0%	+21.0%
Dow Jones Eurostoxx Accumulation	395	-6.0%	+13.0%
UK FTSE 100 Accumulation Index	3,337	-6.1%	+21.9%
Japan Topix Accumulation Index	1,093	-10.8%	-0.4%
S&P/CITIC 300 Total Return Index	2,603	-9.1%	+3.2%
S&P/ASX 200 Property Accum. Index	19,044	-4.1%	+27.0%
UBS Global Real Estate Investors Index (hedged in A\$)	1,015	-5.9%	+42.5%
Aust 90-day bank bill yield	4.87%	+518 bps	+527 bps
Aust 10-year bond yield	5.37%	-595 bps	+171 bps
US 10-year bond yield	3.28%	-1038 bps	-520 bps
A\$ in US cents	84.73	-7.7%	+4.4%
Trade-weighted index	67.5	-6.9%	+6.6%

Contact us

If you would like to know more about how AMP Capital can help you, please visit ampcapital.com.au, or contact one of the following:

Financial Planners

AMP Capital's Investment Representative on 1300 139 267

Private Clients

Private Client Services on 1800 188 013

Wholesale Investors

AMP Capital's Client Service Team on 1800 658 404

Important note: While every care has been taken in the preparation of this document, AMP Capital Investors Limited [ABN 59 001 777 591] [AFSL 232497] makes no representation or warranty as to the accuracy or completeness of any statement in it including, without limitation, any forecasts. Past performance is not a reliable indicator of future performance. This document has been prepared for the purpose of providing general information, without taking account of any particular investor's objectives, financial situation or needs. An investor should, before making any investment decisions, consider the appropriateness of the information in this document, and seek professional advice, having regard to the investor's objectives, financial situation and needs. This document is solely for the use of the party to whom it is provided and may not be reproduced without express permission from AMP Capital.