AMP Capital Investors Limited
ABN 59 001 777 591, AFSL 232497

Market & Economic Update

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

NOVEMBER 2012

Global economy

Review: President Obama's win in the US presidential election, with Democrats retaining the Senate and the Republicans retaining the House means more of the same in terms of divided US government. Attention has now turned to the need to scale back the fiscal cliff of tax hikes and spending cuts by year-end, the need to raise the debt ceiling by March and the need to come up with a long-term plan to get America's budget under control in order to avoid more ratings downgrades. US financial activity has been improving, but economic data has been mixed. America's labour market improved further in October with a stronger-than-expected 171,000 gain in payrolls, although the unemployment rate ticked up marginally to 7.9%. The trade deficit was much smaller than expected in September and construction and inventories data was also stronger. October's National Association of Home Builders survey also rose, suggesting a solid recovery. Meanwhile there was a slight fall in the non-manufacturing Institute for Supply Management index and falls in retail sales in September. Overall, growth in the US is continuing but is still not strong enough to satisfy the US Federal Reserve (Fed). Hurricane Sandy and fiscal cliff worries will also weigh in the short term. Expect Fed stimulus to continue.

The European Central Bank (ECB) made no change to monetary policy in November, keeping the key policy interest rate on hold at 0.75% while acknowledging the poor economic outlook. The Bank of England also made no changes to current interest rates or its quantitative easing program. Meanwhile, the Greek parliament approved more austerity and reform measures as required by the European Union, ECB and International Monetary Fund. In terms of economic data released over the month, Europe's purchasing managers' index (PMI) manufacturing survey declined in October indicating falling economic activity. In addition, the services sector PMI was down more than originally reported for October, industrial production fell sharply and Eurozone retail sales revealed soft growth. Consistent with this, Eurozone gross domestic product (GDP) contracted -0.1% in the September quarter. In contrast, Britain's economy made a strong rebound with real GDP expanding by +1.0% in the September quarter.

Chinese economic data suggests that China's growth slowdown is stabilising. Real GDP increased +2.2% quarter-on-quarter in the September quarter pointing to a firming of China's annual growth rate in line with the government's 7.5% growth target for 2012. Inflation fell more than expected in October to just 1.7%, highlighting plenty of scope for further policy stimulus if needed. China's HSBC flash PMI increased to 49.1 in October, led by a pick-up in new orders, and the official manufacturing PMI came in at 50.2 for the month, both signalling that Chinese growth is stabilising.

Outlook: Global growth may now be passing through its softest patch with the combination of additional quantitative easing (QE3) in the US, ECB efforts to alleviate the bond crisis in Europe and the expected pick-up in housing and infrastructure investment in China likely to boost global growth over the year ahead. Expect global growth of 3% this year and 3.5% in 2013. The key short-term risk is the US fiscal cliff, but this is likely to be resolved.

Australian economy

Review: The Reserve Bank of Australia (RBA) kept the cash interest rate on hold at 3.25% in November. RBA Governor Glenn Stevens' brief statement highlighted that the global economy's "growth is forecast to be a little below average for a time." Australia's headline consumer price index recorded a large quarterly increase of +1.4 % for the September quarter although this appeared mostly related to the carbon tax introduction. The TD/Melbourne Institute Inflation Gauge pointed to continued benign inflation. The labour market again performed solidly judging by the +11,000 job gain in October and unemployment remained flat at 5.4%. Against this, however, annual jobs growth is just +0.6% year-on-year, hours worked are actually down -1.2% over the last year and a continuing slide in ANZ job ads points to soft labour market conditions ahead. The National Australia Bank survey of business confidence and conditions remained weak but at least consumer confidence has improved.

Outlook: Given the slowing in the mining boom, soft non-mining conditions and the strong Australian dollar, the RBA is likely to cut rates further over the next six months. GDP growth of around 2.5% is expected over the next year.

International shares

October review: The leading measure of global share market performance, the MSCI World (ex-Australia) Accumulation Index, returned -0.6% in local currencies (or -0.5% in unhedged Australian dollar terms). The US S&P 500 Accumulation Index returned -1.9% in local currency terms. In the European region, the Eurostoxx Accumulation Index returned +1.7% while the UK FTSE 100 Accumulation Index returned +0.9%, both in local currency terms. Shares in Asia were mixed, with Japan's Topix Accumulation Index returning +0.7%, while China's S&P/CITIC 300 Total Return Index returned -1.6% in local currency terms.

Short-term outlook [six to 12 months]: Shares may still see more short-term volatility on worries about the global growth outlook, particularly with the US fiscal cliff. However, valuations are attractive, global growth is likely to improve in 2015 and

monetary conditions are getting even easier, 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% per annum on average in local currency term, or +9% off hedging back to Australian dollars.

Australian shares

October review: Australian shares were resilient in October helped by the RBA's interest rate cut and expectations that interest rates would be lowered further by year-end. The recovery in the iron ore price also led to gains in domestic shares. The S&P/ASX 200 Accumulation Index returned +3.0% in the month.

Short-term outlook: While shares might see more short-term volatility, they are likely to provide positive returns on a 12-month view.

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

October review: The Australian real estate investment trust (A-REIT) market returned 5.3% in the month of October as measured by the S&P/ASX 200 Property Accumulation Index, outperforming the broader market. The S&P/ASX 200 Accumulation Index returned +3.0% for the month. The continued impact of a subdued global growth outlook flowed through to the RBA's monetary policy stance during October, with a reduction in the cash rate by 0.25% to 3.25%.

Short-term outlook: Property stocks have recapitalised and de-geared since the global financial crisis, and are good value from a long-term perspective. With 6% yields, A-REITs should provide solid returns over the next 12 months, albeit slower than over the last 12 months.

Medium-term outlook: Solid yields and moderate growth prospects suggest medium-term returns of around +8.5% per annum are likely.

International bonds

October review: Global bonds were stable over the month in the absence of major economic developments. The announcement of the ECB's Outright Monetary Transactions program in September and better-than-expected data releases in Europe saw a lift in sentiment at the start of the month. However doubts remained as to whether Spain would formally request a bailout from fellow European governments which tempered bond markets. Sentiment was further dampened towards month-end as Hurricane Sandy struck the north east of the US. The US 10-year bond yield rose 6 basis points (bps), from 1.63% to 1.69%. In Europe, the UK 10-year bond yield rose 39 bps to close the month at 1.85% and Germany's 10-year bond yield rose 13 bps to 1.46%. Japan's 10-year bond yield fell 2 bps to 0.78%.

Short-term outlook: Sovereign bonds are poor value given low yields, but are a good diversifier in the unlikely event the global growth outlook deteriorates further.

Medium-term outlook: Global sovereign bonds are likely to see low returns, reflecting currently low bond yields and the likelihood of capital losses when yields eventually return to more normal levels.

Australian bonds and cash

October review: The RBA's October interest rate cut led to a rally in Australian bonds as expectations of further monetary easing increased. Three-year Australian bonds opened October at a yield of 2.47% and closed 10 bps higher at 2.57%. Yields on 10-year bond yields also rose, opening the month at 3.09% and closing 4 bps higher at 3.13%. Bank bills fell in over the month. The three-month bank bill yield opened the month at 3.57% and fell 45 bps to close at 3.12%. The six-month bank bill opened at 3.52% and closed 41 bps lower at 3.11%.

Short-term outlook: Australian bonds are poor value at current yields but they are a good diversifier against global concerns.

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

Australian dollar

October review: During October, the Australian dollar rose against the US dollar and the Japanese yen but fell against the currencies of Australia's major trading partners (as per the trade-weighted index). Weighing on the Australian dollar over the month were the RBA's 0.25% interest rate cut to 3.25% and Australia's disappointing trade balance and retail sales reports. Yet the Australian dollar remained resilient as higher-than-expected inflation led to reduced rate cut expectations and as commodity prices strengthened. The Australian dollar closed the month at US$1.0374 (up +0.8% from US$1.0293) and ¥82.77 (up +2.7% from ¥80.61). The TWI closed the month at 76.5 (down -0.6% from 77.0).

Short-term outlook: The Australian dollar is likely to continue to be buffeted by worries about RBA easing and China and iron ore prices on the one hand, and the increase in the supply of US dollars under QE3 on the other.

Medium-term outlook: High commodity prices and strong growth in China are likely to see the Australian dollar remain firm over the medium term, although after rising by more than 120% since record lows in 2001 the best is behind us.

Key financial markets

	31 October 2012	Change in one month	Change in 12 months
S&P/ASX 200 Accumulation Index	35,760	+3.0%	+10.3%
MSCI World (ex-Aust Accumulation/unhedged in A$)	3,557	-0.5%	+12.1%
US S&P 500 Accumulation Index	2,467	-1.9%	+15.2%
Dow Jones Eurostoxx Accumulation	420	+1.7%	+10.3%
UK FTSE 100 Accumulation Index	4,046	+0.9%	+8.5%
Japan Topix Accumulation Index	975	+0.7%	-0.5%
S&P/CITIC 300 Total Return Index (local)	2,199	-1.6%	-14.3%
S&P/ASX 200 Property Accumulation Index	24,988	+5.3%	+30.9%
UBS Global Real Estate Investors Index (hedged in A$)	1,475	+1.5%	+20.6%
Australian 90-day bank bill yield	3.12%	-17 bps	-152 bps
Australian 10-year bond yield	3.13%	+4 bps	-130 bps
US 10-year bond yield	1.69%	+6 bps	-42 bps
A$ in US cents	1.0374	+0.8%	-1.5%
Trade-weighted index	76.5	-0.6%	-0.5%