

Market and Economics Report



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

Global economy

Review: Global economic conditions continued to deteriorate in December, prompting aggressive rate cuts by central banks worldwide. The National Bureau of Economic Research finally declared that a US recession commenced in December 2007. The US labour market weakened with the unemployment rate rising to 6.7% and employment registering its largest monthly fall since 1974. Manufacturing and services conditions deteriorated to their lowest level since 1982. The US housing market remained under severe pressure with housing sales and prices continuing to fall and housing starts dropping to their lowest ever recorded reading. In response to the deteriorating conditions and weaker outlook, the US Federal Reserve (Fed) took the extraordinary step of setting the federal funds target rate between 0% and 0.25%. The Fed also announced that it will employ other policy tools, including purchasing mortgage-related securities and long-term government bonds in order to 'support credit markets and economic activity'. Recessionary conditions persisted in Japan with September quarter real gross domestic product (GDP) revised lower and the leading index remaining sluggish. The Tankan survey revealed the largest decline in business and manufacturing conditions in 34 years, reflecting a struggling corporate sector. Accordingly, the Bank of Japan cut interest rates to 0.1%. Economic activity in China continued to moderate in December. Manufacturing slowed, as did the pace of retail sales growth and fixed asset investment. China's purchasing managers index registered its largest recorded monthly fall due to the continued deceleration in global demand. As a result, real GDP appeared to stall in the December quarter. Yet, China's inflation pressures are abating, creating scope for further policy response. Economic data from Europe and the UK also remained bleak. The European Central Bank (ECB) cut interest rates by 0.75% to 2.5%. Real GDP is expected to contract by 0.5% and inflation pressures are likely to dissipate. The Bank of England cut interest rates by 1% to 2%, the lowest level since 1951.

Outlook: Global growth is likely to be very weak out to mid-2009, with developed countries contracting. This should lead to falling inflation and interest rates in most major countries which, along with fiscal stimulus and lower energy prices, will aid recovery in the second half of 2009 and/or through 2010.

Australian economy

Review: Australian data releases indicated a sharp slowdown, expanding by only 0.1% in the September quarter. In annual terms, Australia's real GDP growth slowed to 1.9% year-on-year, a seven-year low. In response, the Reserve Bank of Australia (RBA) made another 'significant reduction' in the cash rate, cutting the rate by 1% to 4.25% and taking monetary policy

to an 'expansionary setting'. The labour market softened with unemployment ticking up, skilled vacancies declining and employment growth trending downwards. Business indicators were generally softer. However, the Westpac Melbourne Institute's consumer confidence measure rose as households were encouraged by interest rate cuts and lower petrol prices, and this along with the Federal Government's stimulus package appears to have helped boost Christmas retail sales.

Outlook: Domestic economic conditions are likely to be very weak over the next six months, with a mild recession now likely. Lower rates and fiscal stimulus should help prevent a deep slump and drive a recovery in 2009-2010.

International shares

Review: The leading measure of global shares performance, the MSCI World (ex-Australia) Accumulation Index, returned 1.1% in local currencies (or -3.7% in unhedged Australian dollar terms). The US S&P 500 Accumulation Index returned 1.1%. In Europe, the Eurostoxx Accumulation Index returned 0.2%, while the UK FTSE 100 Accumulation Index moved higher, returning 3.5%. Shares in Japan were also stronger, with the Topix Accumulation Index returning 3.0%, while Chinese shares were flat, with the S&P/CITIC 300 Total Return Index unchanged from the previous month's close.

Short-term outlook [six to 12 months]: Turmoil may continue over the next few months on uncertainty regarding the depth and duration of the global recession. However, global shares are likely to provide reasonable returns on a 12-month plus view, given the likelihood of better economic conditions in 2010 and attractive valuations.

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 9% per annum on average.

Australian shares

Review: Volatility remained in the Australian share market in December, though the overall monthly performance was slightly more encouraging than previous months. However, the annual return reflected the turmoil of 2008, with the S&P/ASX 200 Accumulation Index returning -38.4% for the calendar year. Weak economic data releases both locally and globally hampered the profit and economic outlook, maintaining downward pressure on shares. Numerous capital raisings, particularly in the banking sector, also weighed on investor sentiment. However, significant monetary and fiscal action to stimulate spending and restore confidence was positive for valuations. The S&P/ASX 200 Accumulation Index returned -0.3% in December.

Short-term outlook: The Australian share market is likely to remain volatile over the next few months. Further falls are possible. However, shares should improve through 2009. Valuations are attractive and interest rates are falling rapidly, and shares are likely to anticipate better economic conditions in 2010.

Medium-term outlook: Reflecting a much higher dividend yield and reasonable growth prospects, medium-term returns of around 11% per annum are now possible.

Listed property securities

Review: The S&P/ASX Property 200 Accumulation Index fell sharply in December, returning -10.5% and underperforming the broader equity market. The sector was weighed down by a flurry of capital raisings. Many companies opted not to pay distributions in December in order to conserve cash. Stocks that continued to outperform during the month were those well-capitalised with strong balance sheets, diversified funding sources and limited short-term refinancing requirements.

Short-term outlook: The next few months are likely to remain volatile due to worries about gearing levels, capital raisings and the underlying property outlook. However, listed property securities have probably seen the worst, are very good value and should benefit from lower interest rates.

Medium-term outlook: Now solid yields and moderate growth prospects mean medium-term returns of around 10% or 11% per annum are now possible.

International bonds

Review: International bond yields fell significantly in December as global equity markets remained volatile, short-term interest rates fell further and worries about deflation intensified, and safe haven flows dominated. This produced good capital gains for investors. The US ten-year bond yield fell 71 basis points (bps) to 2.21% and Japan's ten-year bond yield dropped 23 bps to 1.17%. In the European region, Germany's ten-year bond yield declined 31 bps to 2.95%, while the UK ten-year bond yield lost 75 bps to close at 3.02%.

Short-term outlook: Bond yields may fall further in the short term on the back of the global downturn and falling inflation.

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

Australian bonds and cash

Review: The Australian bond market pushed higher in December and yields fell substantially. Evidence of a further slowdown in the Australian economy prompted the RBA to aggressively reduce interest rates, which pushed bond yields lower.

The three-year bond yield opened at 3.58% and closed 47 bps lower at 3.11%. The yield on ten-year bonds ended the month 53 bps lower, falling from 4.60% to 4.07%. The spread between Australian and US ten-year bond yields widened in December as the US bonds rallied on deflation concerns and the Fed's 'commitment' to keeping rates low.

Short-term outlook: Bond yields may fall further in the short term as growth and inflation fall.

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

Australian dollar

Review: The Australian dollar (A\$) gained in December, rising against the US dollar (US\$), the Japanese yen (JPY) and the currencies of Australia's major trading partners. The A\$ closed the month at 70.29 US cents (up 7.6% from 65.33 US cents) and JPY63.76 (up 2.1% from JPY62.42). The trade-weighted index (TWI) closed the month at 55.6 (up 1.8% from 54.6).

Short-term outlook: The next six months are likely to be weak with the A\$ buffeted by local and global growth worries, falling local interest rates and commodity price weakness.

Medium-term outlook: The A\$ should rebound over the medium term, helped by a rebound in commodity prices.

Key financial markets

	31 Dec 2008	Change in one month	Change in 12 months
S&P/ASX 200 Accumulation Index	24,801	-0.3%	-38.4%
MSCI World (ex-Aust Accumulative/unhedged in A\$)	3,100	-3.7%	-24.9%
US S&P 500 Accumulation Index	1,453	1.1%	-37.0%
Dow Jones Eurostoxx Accumulation	334	0.2%	-44.6%
UK FTSE 100 Accumulation Index	2,688	3.5%	-28.3%
Japan Topix Accumulation Index	1,037	3.0%	-40.6%
S&P/CITIC 300 Total Return Index	1,531	0%	-64.7%
S&P/ASX 200 Property Accum. Index	18,007	-10.5%	-54.0%
UBS Warburg Global Real Estate Investor Index	148	7.8%	-45.0%
Aust 90-day bank bill yield	4.15%	-57 bps	-309 bps
Aust 10-year bond yield	4.07%	-53 bps	-227 bps
US 10-year bond yield	2.21%	-71 bps	-181 bps
A\$ in US cents	69.72	7.1%	-20.6%
Trade-weighted index	55.6	1.8%	-19.1%

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.