

Economic Update

Sydney | 23-01-13

January/February 2013**Outlook for Investment Markets**

A combination of more sharemarket-friendly buying demand from investors and better economic prospects suggest that the broad outlook for international shares continues to remain positive. The Australian economy is going through a sluggish patch, and while commodity prices have picked up again more recently, 2013 looks likely to be a more difficult year for corporate profit growth than 2012 was. The outlook for income assets continues to be for ongoing low yields, as has now been the case for some time.

Australian Cash & Fixed Interest – Review

Australian short-term interest rates ended 2012 at 3.07 percent, down from where they were at the beginning of the year after the Reserve Bank of Australia's succession of cash rate cuts. Longer-term interest rates ended the year slightly lower – the 10-year Commonwealth bond yield started 2012 at 3.67 percent and finished at 3.27 percent. There remains a strong correlation with offshore bond yields, and hence with the state of global investor confidence. Bond yields have been rising more recently as investors have regained some confidence, up from 2.95 percent on 15 November 2012 to 3.36 percent on 16 January 2013. The \$A strengthened against the \$US over the past quarter, up 2.70 percent from \$US1.019 to \$US1.046. This mostly reflected the global weakness of the \$US, which lost 2.10 percent in overall value. The \$A gained a modest 0.50 percent in overall trade-weighted value for the quarter.

Australian Cash & Fixed Interest – Outlook

The financial futures market was at the time of writing expecting one more 0.25 percent cut from the Reserve Bank, 90-day bank bills expected to be 2.76 percent at the end of this year, down from 2.99 percent in mid-January. A further small reduction in cash rates would mean that the banks' interest rate 'specials' would continue to be competitive relative to the running yield from Australian fixed interest and other yield-bearing assets. Australian bonds are likely to continue to trade in parallel with their offshore counterparts. The outlook for the \$A is, as always, hard to call. Some factors point to appreciation, such as the recent firming of resources and energy prices, while others point to the likelihood of a weaker currency, such as the prospect of lower Australian interest rates and international investors deciding that there are better opportunities elsewhere. Overall, if anything, there are more downside than upside risks to the \$A.

Australian & International Property – Review

Australian listed property had a very strong year, up 25.20 percent in capital value and providing a total return including pre-tax income of 33.0 percent. The sector also offered relatively low volatility, the S&P/ASX200 A-REIT Accumulation Index making steady ground throughout the year.

Global listed property also had an excellent 2012. The EPRA/NAREIT Global ex-Australia Index hedged into \$A produced a 32.0 percent return. Like domestic property, the returns were steady, the market making consistent progress all year. The stars of the show were the Asian markets (+45.50 percent in \$US terms). Japanese listed property prices surged towards the end of the year, reflecting the incoming Liberal Democratic Party administration's focus on economic reflation in general and infrastructure spending in particular. The other main markets also chipped in with good gains, ranging from 18.0 percent from the US, to 25.90 percent in Europe ex-United Kingdom, and 29.90 percent from the UK itself.

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Australian & International Property – Outlook

The yield on Australian listed property remains comparatively attractive at 5.0 – 5.50 percent, even more so in an environment in which cash and bond rates are likely to remain low for an extended period. The current slowdown in overall economic growth is not great news for the sector, although industry confidence has improved in line with the recent rebound in commodity prices. A slowing economy means that any property price appreciation is likely to be modest at best.

Australian Equities – Review

Australian shares also had a good year, the S&P/ASX200 Accumulation Index gaining 16.40 percent. A good deal of this rise was concentrated in the last six weeks of the year. The financial sector returned 21.70 percent, and consumer staples – things people have to buy irrespective of the economic cycle – was up 21.0 percent. The resources sector missed out, the S&P/ASX300 Metals and Mining Index down 2.10 percent for the year, all racked up in the first half of the year when doubts about global economic activity and Chinese commodity demand were greatest. Resources stocks performed better in the second half as investor confidence became more robust, and right at the end of the year, previously falling commodity prices started to improve.

Australian Equities – Outlook

The outlook for the Australian sharemarket remains comparatively subdued. The economy is in a transition phase, overall growth slowing down as the resources sector cools, while the more domestic sectors have not picked up enough of the slack. Consensus forecasts for growth in 2013 are around the 2.80 percent mark, but likely to move lower in coming months. The economy is going through a sluggish patch, with consumer confidence steady (rather than perking up on the back of interest rate cuts), business confidence generally weak, leading indicators pulling back, and the labour market softening. Although

commodity prices have recently picked up again, 2013 looks like a more difficult year for corporate profit growth than 2012 was. This makes for a reasonably difficult backdrop for Australian shares.

International Fixed Interest – Review

The overall performance from international fixed interest was positive in 2012, the Barclays Capital Global Aggregate Index banking a 4.20 percent gain in \$US terms. But the overall result was made up of very different sub-trends. Government bonds returned only 1.50 percent, thanks to a combination of very low running yields and a small rise in yields (entailing modest capital losses) at the end of the year. Investors disillusioned with the yields on offer in the major developed economies turned to the debt of the emerging economies, and the resultant bidding up of their prices saw emerging market sovereign bonds return 18.70 percent for the year. The big payoff in international fixed interest came from corporate bonds. The Barclays Capital Global Corporate Index returned 11.10 percent for the 2012 year. The really big returns came from the riskier end of the spectrum, 'high yield' (low credit quality) corporate bonds returning 20.40 percent in the US and 26.70 percent in Europe.

International Fixed Interest – Outlook

International fixed interest continues to have value as portfolio insurance, but there are some issues of concern, particularly around government bonds. There is strong potential for capital loss when government bond yields rise again. Central banks – in particular the US Federal Reserve – are looking to keep interest rates low for even more extended periods into the future, and current investors in government bonds do not yet appear ready to sell out of their holdings. While the risk is that government bonds' next big move will be back up, this does not look like happening in the immediate future. Instructively, a number of institutional investors are managing the potential risk by keeping their portfolio maturities short, and continuing to strongly favour corporate credit over government debt.

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International Equities – Review

World sharemarkets had a good year overall in 2012, the MSCI World Index up 13.10 percent in overseas currency terms. However, most of this positive performance occurred very late in the year – the MSCI World Index rose 6.30 percent between 14 November and the end of the year. Local currency appreciation clawed back a bit of the overseas share price gains, the \$A up 1.70 percent in overall value for the year.

Germany and Japan led the field among the major developed markets, followed by France (+15.20 percent). The emerging markets also did quite well (+13.90 percent). The Chinese sharemarket was very weak for virtually all of 2012, but finally turned around in December. US shares did reasonably well, the S&P500 Index up 12.90 percent, as did European shares overall. The clear laggard was the United Kingdom, whose FTSE100 Index gained only 5.80 percent in calendar 2012.

International Equities – Outlook

The signs of improvement in global economic activity continue to be favourable for international shares. The asset class should progressively benefit from the very low income yields on cash and fixed interest, and from improving investor confidence. On the economic front, the news on balance has been getting better. US housing starts rose by 12.10 percent in December alone, the most robust level of housebuilding since July 2008, and were up a very strong 36.90 percent on a year ago. Housing will make a strong contribution to ongoing US GDP growth. In the January survey, the *Wall Street Journal's* forecasting panel expected the US economy to pick up from two percent growth in 2012 to 2.30 percent this year and 2.90 percent in 2014. While not a startlingly strong performance, this is enough to chip away gradually at the still-high unemployment rate.

The US still faces some risks: the fiscal negotiations between the Obama administration and Congress could hit potholes, and even if a political deal is reached on issues such as the debt ceiling and the level of government expenditure, it will still mean some degree of fiscal policy tightening. Overall, though, the US looks set for a gradual acceleration in business activity.

There was also good news in the rest of the world. China appears to be heading out of a short period of slower growth, and in December recorded four months of steadily increasing growth. Official Chinese growth statistics suggest year-on-year GDP growth accelerating from the 7.40 percent of the September 2012 quarter to 7.90 percent in the December quarter. The prospect of faster economic growth in Japan is also a plus, although the value of an already debt-encumbered government's plans to engage in more probably unproductive spending on infrastructure is perhaps questionable.

Business conditions in the Eurozone remain grim. Only Germany of the four large Eurozone economies looks to be recovering, slowly, from falling output in the December quarter, while the other three – France, Italy, and Spain – look to be continuing in recession. The best that can be said is that the rate of decline seems to be slowing.

The past four years have repeatedly shown that financial market squalls – or storms – can materialise with little warning. Even so, a combination of more sharemarket-friendly buying demand from investors and better economic prospects suggest that the broad outlook for international shares continues to remain positive. ■■

Performance periods refer to the month and three months to 21 January 2013.

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