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Market & Economic Update

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Global economy

Review: American economic data shows that growth continues, but remains sub-par. As a result, the US Federal Reserve (Fed) has announced an open-ended round of quantitative easing (QE3) that will continue until the outlook for the labour market improves substantially. Payrolls for August disappointed with the addition of only 96,000 new jobs, and athough the unemployment rate fell to 8.1%, this mainly reflected a fall in the participation rate. The Institute for Supply Management (ISM) index disappointed in August coming in a reading of below 50 for the third month, and construction spending also fell in July. On the positive side though, US retail sales rebounded strongly in July, the ISM non-manufacturing conditions index rose in August and productivity growth was revised up for the June quarter. US housing data has also been resilient with rises in building permits, the National Association of Home Builders confidence survey and house prices.

In Europe recessionary conditions continue to prevail. Economic activity in the Eurozone contracted again in the June quarter with real gross domestic product (GDP) falling -0.2%. Unemployment within the region remained elevated at 11.3% in July and business surveys for August were also consistent with a mild recession. After committing to do whatever it takes to defend the euro at the end of July, the European Central Bank (ECB) delivered broad details about how this will work via its Outright Monetary Transactions plan, the main goal of which is to bring bond yields in troubled countries back to sustainable levels. The tail risk of a euro break-up triggering a re-run of a deep global financial crisis-style recession in Europe and potentially a global recession is receding.

China's economy has slowed. Both China's official purchasing managers' index (PMI) and the HSBC flash PMI declined in August and industrial production also slowed in July, mainly on the back of weaker export demand from Europe. Fortunately, forward indicators for investment such as housing starts and a pick-up in infrastructure approvals point to an improvement in growth over the next six months. A speed-up in the pace of approval of five-year plan infrastructure projects suggests the Chinese authorities are trying to get infrastructure spending back on track after a soft patch.

Economic data releases in Japan have been soft. Japan's economy grew by a less-than-expected +0.3% in the June quarter and Japan's leading indicators and confidence have also deteriorated.

Outlook: Global growth may now be passing through its softest patch with the combination of 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.

Australian economy

Review: The Australian economic environment has been mixed. On the positive side GDP growth over the year to the June quarter was 3.7% which is well above that in most other comparable countries. Australian private business investment also recorded a solid result in the June quarter. Countering this though, labour market conditions deteriorated in August, retail sales fell sharply in July and the trade deficit widened. Consumer sentiment also remains sub-par as evidenced by the Westpac-Melbourne Institute survey and the National Australia Bank business survey shows that business conditions and confidence remain soft. In terms of housing data, residential building approvals fell sharply in July. The non-mining sectors of the economy are still struggling and the mining boom seems to be losing momentum led by sharp falls in iron ore prices. The Reserve Bank of Australia (RBA) kept the key policy cash interest rate on hold at 3.50% in September, recognising that "risks to the outlook" for the global economy are "still on the downside".

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

August review: The leading measure of global share market performance, the MSCI World (ex-Australia) accumulation index, returned +2.0% in local currencies (or +4.5% in unhedged Australian dollar terms). The US S&P 500 accumulation index returned +2.3% in local currency terms. In the European region, the Eurostoxx accumulation index returned +4.1% while the UK FTSE 100 accumulation index returned +2.1%, both in local currency terms. Shares in Asia fell, with Japan's Topix accumulation index returning -0.6%, while China's S&P/CITIC 300 total return index returned -4.9%.

Short-term outlook [six to 12 months]: Shares may still see more short-term volatility on periodic worries about the global growth outlook. However, valuations are attractive, the global recovery should continue 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 terms.

Australian shares

August review: Australian shares performed in line with their global counterparts in August. Early in the month better-than-feared profit results and expectations of increased global policy intervention saw Australian shares rise to their highest level since May. However, from mid-August, Australian shares retraced gains as global growth concerns resurfaced and the iron ore price collapsed.

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

August review: The Australian real estate investment trust (A-REIT) market underperformed the broader Australian share market in August, returning -0.1% as measured by the S&P/ASX 200 Property accumulation index. The S&P/ASX 200 accumulation index returned +2.1% for the month. Sentiment improved at the start of the month on renewed hopes that the European Central Bank would address the region's sovereign debt crisis and on expectations of QE3 by the Fed. This flowed through to Australian markets which saw cyclical sectors outperform defensives. While A-REITs underperformed shares over the month, the sector's one-year rolling outperformance of +16.2% shows its comparative defensive nature. A-REITs have now outperformed domestic shares over one-, two- and three-year time horizons.

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.

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

International bonds

August review: Bond yields in major countries edged sideways in August, awaiting detail from ECB president Draghi on his bond-buying plans. Talk of QE3, hopes of forthcoming invention by the ECB in the region's debt crisis and better-than-expected economic data also impacted bond markets. US bond yields were flat to mildly higher. The US ten-year bond yield rose +6 basis points (bps) to 1.57% and Japan's ten-year bond yield rose +1 bp to 0.80%. In Europe, the UK ten-year bond yield fell -1 bp to close the month at 1.46% while Germany's ten-year bond yield rose +4 bps to 1.33%.

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

August review: The RBA left interest rates on hold in August, expressing confidence regarding Australia's outlook. Given solid retail and housing data and improved sentiment regarding the resolution to Europe's debt crisis, Australian bond yields rose initially. From mid-month, however, Australian bonds rallied on news that BHP had shelved approximately A$50 billion of projects that were previously being planned and on renewed concerns about China's growth outlook. Three-year Australian government bonds opened August at a yield of 2.52% and closed -5 bps lower at 2.47%. Meanwhile ten-year bond yields rose, opening the month at 3.05% and closing +4 bps higher at 3.09%. The three-month bank bill yield opened the month at 3.55% and rose by +2 bps to close at 3.57%. Meanwhile, the six-month bank bill opened at 3.53% and closed -1 bp lower at 3.52%.

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

August review: During August, the Australian dollar fell against the US dollar, the Japanese yen and the currencies of Australia's major trading partners (as per the trade-weighted index). In the first part of the month the Australian dollar was supported by positive domestic data and the RBA's upwards revision of economic forecasts. However concerns about China's economic outlook, the sharp fall in iron ore prices and deteriorating global prospects saw the Australian dollar fall. The Australian dollar closed the month at US$1.0293 (down -1.9% from US$1.0493) and ¥80.61 (down -1.6% from ¥81.96). The trade-weighted index closed the month at 77.0 (down -2.4% from 78.9).

Short-term outlook: The Australian dollar is likely to continue to be buffeted by worries about China and iron ore prices on the one hand, and the boost to growth-oriented assets being provided by QE3 and ECB actions 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 August 2012	Change in one month	Change in 12 months
S&P/ASX 200 Accumulation Index	33,982	+2.1%	+5.5%
MSCI World (ex-Aust Accumulation/ unhedged in A$)	3,501	+4.5%	+12.3%
US S&P 500 Accumulation Index	2,451	+2.3%	+18.0%
Dow Jones Eurostoxx Accumulation	408	+4.1%	+9.3%
UK FTSE 100 Accumulation Index	3,981	+2.1%	+10.0%
Japan Topix Accumulation Index	952	-0.6%	-2.8%
S&P/CITIC 300 Total Return Index (local)	2,149	-4.9%	-21.1%
S&P/ASX 200 Property Accum. Index	23,424	-0.1%	+21.7%
UBS Global Real Estate Investors Index (hedged in A$)	1,454	+0.5%	+17.5%
Australian 90-day bank bill yield	3.57%	+2 bps	-125 bps
Australian 10-year bond yield	3.09%	+4 bps	-128 bps
US 10-year bond yield	1.57%	+6 bps	-65 bps
A$ in US cents	1.0293	-1.9%	-3.9%
Trade-weighted index	77.0	-2.4%	+0.7%