PCG
PROFESSIONAL CONSULTANTS GROUP
WEALTH MANAGEMENT

Monthly Economic Summary
July 2010

Outlook for Investment Markets

It's been a month of two halves, the first dominated by fears of sovereign debt defaults, and the second by some recovery in investor confidence. Asset classes evolved as expected in these circumstances, 'safe haven' assets such as government bonds and gold doing well in the first period, and riskier shares, property, and lower-quality credit doing better in the second half. The outlook from here is still uncertain, but provided the financial sector springs no more major adverse surprises – an important 'if' – the ongoing recovery in the global economy should prove supportive for growth assets.

Australian Cash & Fixed Interest – Review

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Australian Cash & Fixed Interest – Outlook

The Reserve Bank's latest statement said that it had done quite a lot of tightening already, and now that interest rates are back "around their average levels of the past decade", the Bank is not minded to do much more any time soon: "this setting of monetary policy as appropriate for the near term". The markets mostly tend to agree, though they still expect some small rise in interest rates down the track – 90-day bank bill futures have priced in one more 0.25 percent increase by the middle of next year. Longerterm interest rates could drift modestly upwards, as there is a degree of inflation risk, the Bank itself noting that "[i]nflation appears likely to be in the upper half of the target zone over the next year". The outlook for the $A is as always a difficult call to make, but if foreign exchange markets continue to recover from their sovereign debt scare the $A could continue to benefit from yield-chasing investors, given the interest rate rises to date (and perhaps a bit more to come), whereas rates in the US, the Eurozone, and Japan are likely to remain very low for some time yet.

International Fixed Interest – Review

The sovereign debt issues of the past few months have stimulated strong demand for 'safe haven' assets, which in turn has led to further rises in government bond prices. Higher prices have meant lower yields, the yield on US 10-year Treasuries having reached a low of 3.15 percent on 7 June. In recent weeks, however, investors have felt more relaxed about the outlook for borrowers, so bond prices have dropped back. The US 10-year yield has risen back up to 3.25 percent. The net result is that government bond prices were down modestly over the past month (-0.40 percent on the JP Morgan Global Government Bond Index) but up

for the past quarter overall (+1.40 percent). Corporate bond markets have shown a similar pattern of increased concern followed by some greater degree of comfort: lower-quality European corporate bonds, for example, were down 1.80 percent over the past quarter, but up 1.20 percent over the past month.

International Fixed Interest – Outlook

Sovereign debt problems have not vanished completely. The markets are still pricing Greek debt – currently yielding 9.40 percent compared to Germany's 2.75 percent – as if default is probable. However, investors' default worries have clearly abated to some degree. One measure of banks' unwillingness to lend to each other – the 'TED' spread, or extra cost the bank has to pay to fund itself compared to what the US Treasury pays – peaked in early June and has started to fall as worries about banks' potential losses on sovereign bonds have diminished. If worries continue to ease, then government bonds are likely to underperform, especially as the average yield on a global government bond portfolio remains abnormally low at only 2.50 percent and the likely supply of government debt is very large. Corporate bonds may be the better option, especially as an improving global economic environment has led to lower bond defaults than expected. Credit ratings agency Fitch reported recently that corporate bond defaults in the US market in the year to date have been only one percent, a much more solid outcome than anticipated. Ongoing financial system fragility does however mean that central banks will be keeping short-term interest rates low well into next year: the futures market expects the US Federal funds rate, for example, to still be under one percent at the end of next year.

Australian & International Property – Review

The Australian real estate investment trust sector has behaved much like the wider sharemarket recently, only more so, with a stronger recovery rally in recent weeks than the market overall. The S&P/ASX200 AREIT Accumulation Index gained 10.70 percent over the past month and 3.60 percent for the past quarter. Before getting too excited, however, it's worth remembering that this rally was very much in the context of earlier weakness, and a better description would be that the sector has essentially traded sideways since the start of the year. The EPRA/NAREIT Index of global property shares was up six percent for the past month as the sector, like global shares generally, recovered from earlier weakness in May. Although not too much should be read into month-by-month outcomes in what has been a highly-volatile sector, Europe (ex-UK) and Asia (ex- Japan) were the best-performing regions, with more modest returns from the US and the UK, while Japan was weak (down 2.70 percent for the month, in yen).

Australian & International Property – Outlook

It's hard to see any catalyst to trigger renewed investor interest in the domestic listed property sector. Yields are not attractive, given that investors are being offered only a small pickup in yield (less than one percent) over Commonwealth bonds, in exchange for holding a significantly more volatile asset. Nor is the sector an obvious bargain from a valuation point of view, most trusts trading at or modestly above net tangible assets. The asset class is therefore likely to stay below investors' radar until there is a change in its relative attractiveness compared with other options. There are probably more negatives than positives

for global listed property. The global economic recovery is clearly a valuable plus, but other factors may count for more in coming months. There is still an overhang of troubled property loans on banks' books. While most attention has focused on the commercial property assets US banks might have to put on the market, more recently the problems of banks in the more troubled Eurozone economies have come to the fore. In Spain, for example, the central bank has estimated that over a third of Spanish banks' property and construction loans are "troubled" to some degree. The yield from global property is also low (3.70 percent), and the asset class remains especially vulnerable because of its leverage to Global Financial Crisis-style setbacks. There's also the potential for overvalued Chinese property to unwind: China's sharemarket has been conspicuously weak in recent months on fears that either an asset bubble will burst, or that policy moves will deliberately prick it. All this means that it's hard to get excited about global property at this juncture.

Australian Equities – Review

The Australian sharemarket has taken its direction from global events, plunging in the second half of April and into May before rallying in more recent weeks. The end result has been the same as in overseas markets – a decent gain for the past month (+5.90 percent for the S&P/ASX200 Accumulation Index), but not enough to claw back the earlier losses, the Index down 5.60 percent for the past quarter. As might be expected, the re-emergence of financial sector worries did the banks no good, and although they too have rallied more recently they were still down 7.40 percent for the quarter. Despite the prospect of a new tax on their profits, Resources stocks did better than the Industrials, with a 9.60 percent gain for the month compared to the Industrials' 4.40 percent. The sharemarket has also just received a boost from news of a commercial agreement between Telstra TLS and the Federal Government over the role of Telstra's assets in the new national broadband network, and Telstra shares were at the time of writing trading at A$3.27 compared with A$2.95 at the end of May.

Australian Equities – Outlook

Not much has changed in terms of the outlook for business activity. While some indicators of business (the May National Australia Bank poll) and consumer confidence (the June Westpac/Melbourne Institute survey) have weakened, the declines have been relatively modest and may have been overinfluenced by media coverage of overseas debt worries and falling share prices. And while 'confidence' tends to bob around depending on the latest news, indicators more linked to actual business activity have held up rather better. These include the readings for actual trading conditions and employment in the NAB survey, and most importantly, latest employment data which showed a substantial rise in new jobs in May (nearly 27,000) and a falling unemployment rate. Consensus forecasts continue to point to solid economic growth of 3.0 - 3.50 percent both this year and next, supported by strong growth in the important Asian export markets, and this continues to look like a supportive environment for shares.

International Equities – Review

The past month has witnessed a severe outbreak of investor anxiety, principally over risks to sovereign debt, followed by a recovery in confidence after rescue packages for Eurozone borrowers and evidence that efforts are being made by the more indebted borrowers to

restore the state of their fiscal books. The MSCI World Index graphically reflects this change in mood, having reached a low point in early June before rallying strongly since. The Index is as a result up 3.80 percent in overseas currency terms for the month, though still down 4.20 percent for the quarter as a result of the earlier jitters. The past month's outcome is less positive in local currency terms, world shares down 1.90 percent.

International Equities – Outlook

The worst fears of world sharemarkets – that GFC 2: The Sequel was about to premiere – have not been realised. Markets may still expect some specific sovereign debt defaults, as the pricing of Greece's outstanding debt suggests, but they do not now expect a generalised shockwave of contagion from individual countries' problems. This is thanks to official support packages and to real efforts from the more indebted borrowers to restructure their finances and improve the workings of their economies. Absent any further unexpected financial sector shocks, sharemarkets are therefore likely to shift their attention from debt problems to the economic outlook. On that score, the latest jobs news out of the US led many analysts to question the strength of US recovery. After some months of decent private sector job gains (158,000 in March, 218,000 in April), May's outcome was an unexpectedly small gain of only 41,000. There are also some questions about the impact of fiscal policy tightening. While it is obvious that some countries (such as the UK with its tough emergency budget on 22 June) need to take early action, it is not obvious that some others (notably Germany) need to. There is a risk that fiscal retrenchment could upset the nascent economic recovery in some of the major economies. That said, the strong consensus among economic forecasters is that this year and next will see continued growth in world trade and business activity. Very few countries are expected to suffer declining GDP (except some of the smaller European states, and the maverick Venezuela) in either year. Although growth expectations for the major economies are not high, this is made up for by the strong growth expected in the largest emerging economies, where the likes of China, India, and Brazil are growing very rapidly. China's growth is expected to be around 10.0 percent this year and nine percent next, and India is not far behind. Overall, this ongoing global recovery should provide a favourable backdrop for world shares.

Performance periods refer to the month and three months to 23 June 2010.

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