

### Outlook for Investment Markets

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Financial markets were dominated by worries in August, so government bonds were in very strong demand and equities out of favour, mostly because of data suggesting the United States at risk. But confidence improved in September as the data indicated only a modest US slowdown, and the pattern reversed, with equities (and listed property) rallying strongly and bonds selling off. The story of global economic recovery is still intact, underpinned in particular by very strong growth in the major emerging markets, supporting growth-linked assets.

### Australian Cash & Fixed Interest – Review

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There's been little change to short-term interest rates, 90-day bank bills steady at 4.80 percent in line with the Reserve Bank of Australia's 'no change' decision at its meeting on 7 September. Longer-term interest rates followed the lead from overseas. Commonwealth bond yields, corporate yields, and wholesale funding (swap) rates all fell quite sharply in August but rose in September in line with changes in investor sentiment about the economic outlook. Ten-year Commonwealth bond yields, for example, reached a low of just over 4.75 percent at the end of August but have since risen back to 5.15 percent, a net gain of 0.25 percent over the past month. The Aussie dollar weakened in August but zoomed north in September. Over the past month, the \$A gained 6.80 percent against the \$US to just under 95 US cents, and was up 5.10 percent in overall trade-weighted value.

### Australian Cash & Fixed Interest – Outlook

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The Reserve Bank's official announcement on 7 September didn't give too much away about the Bank's intentions: "The current setting of monetary policy is resulting in interest rates to borrowers around their average levels of the past decade... the Board judged this setting to be appropriate for the time being". But the release of the full minutes, which stated that "If the central scenario came to pass it was likely that higher interest rates would be required, at some point", and a subsequent speech by the Governor pointing to the likely strength of the economy in the midst of a resources boom, made it reasonably clear that the next move will be upwards, and probably in the none-too-distant future. Current market pricing is consistent with an 0.25 percent increase by the end of the year, and another in the first half of next year. For longer-term rates, the recent rise in yields could well continue, as yields previously had got to levels that looked way too low for an economy growing at or above trend rates. Improved investor confidence, the prospect of higher local interest rates, the ongoing strength of commodity prices, and strong Asian growth are all factors which support the \$A. "Parity parties" to celebrate 1:1 to the \$US have been scheduled before and cancelled, but this time the streamers and paper hats could have their day.

### International Fixed Interest – Review

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Renewed worries in August about the economic outlook, particularly in the US, led to a remarkable surge of nervous 'safe haven' money into government bonds. The benchmark 10-

year US Treasury bond was yielding less than 2.50 percent by the end of August, and there were other dramatically low yields from Eurozone 10-year bonds (2.80 percent) and UK gilts (2.90 percent). Japanese bond yields – already extremely low – went down further still, 10-year debt reaching a low of just under 0.90 percent. In September, however, a recovery in confidence about the global outlook led to a reversal of the trend, and government bond yields rose, although yields are still very low by historical standards. Corporate bond yields followed a similar pattern, US corporate yields reaching a low of under 4.50 percent by the beginning of September, but rising since to 4.70 percent.

## International Fixed Interest – Outlook

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The current low levels of bond yields make some sense from some perspectives. Cash is offering little or nothing in most markets, and short-term interest rates will be staying low in many markets for some considerable time. The US Federal Reserve's latest statement mentions "exceptionally low levels for the federal funds rate for an extended period". It's not surprising as a result that yield-seeking investors have been forced into the bond markets by default. The role of bonds as insurance against economic or financial system setbacks also has a certain logic, particularly as no-one can be sure that the global financial crisis is well and truly dead and buried. (As one example, the credit spreads that Greece, in particular, but also Portugal and Ireland have to pay on their debt have continued to rise in recent weeks.) Equally, though, yield levels appear to have been driven to unsustainably low levels on any mainstream evaluation of the economic outlook. In the US, forecasters in the Wall Street Journal's latest poll expect inflation to rise to 1.80 percent by the end of 2011, and US 10-year Treasury yields to rise with it, to 3.80 percent. A sensible assessment is that higher bond yields, and lower bond prices, are on the cards for many markets.

## Australian & International Property – Review

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The Australian real estate investment trust sector traded sideways in August, but then got some modest benefit from the global strength of equities in September. The S&P/ASX200 AREIT Accumulation Index was up 2.40 percent for the past month, but as we've commented before, a better description would be that the sector has essentially traded sideways all year in a band of 850 - 900, and is still there (the latest reading is 886.6). Global listed property delivered on all fronts over the past month, the underlying markets benefitting both from the September rally in global sharemarket sentiment and from currency hedging protecting against the effects of a substantially higher \$A. The EPRA/NAREIT Index of global property shares (ex-Australia) hedged back into \$A was up by 6.70 percent. Once again, there were quite marked variations among the regional markets. Europe (ex-United Kingdom) did best with a 9.40 percent gain, while the US was also strong (+7.90 percent), and Asia (+5.50 percent) and the UK (+5.20 percent) also contributed positively to the overall result. Japan did worst, producing only a marginal 0.20 percent gain, and in the smaller markets, the global financial crisis continued to take its toll, with for instance a further 5.60 percent fall in Greek property share prices.

## Australian & International Property – Outlook

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The main issue for Australian listed property is that the current yield – around 5.50 percent for the larger names – is uncompetitive with the yields on less risky assets (4.80 percent on cash,

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5.10 – 5.20 percent from 10-year Commonwealth bonds), let alone corporate bonds. To make it a fair bet in overall return terms, listed property would have to offer some capital gains. Further takeover activity remains likely, as the economics of rationalisation remain attractive. It's also possible that some of the larger discounts to net assets might narrow as financing conditions improve, generating price gains for some of the more out of favour trusts. But this does not currently add up to a compelling story. Global property will continue to benefit from improved investor confidence about the economic outlook. But the asset class has also been one of the beneficiaries of investors desperate for income in a world where cash in the bank and government bonds offer poor yields. This is helping the asset class now, but bond yields are likely to rise from their unusually low current levels, and when that happens global property is likely to struggle to retain its support. The sector also remains difficult to summarise. Conditions range from still-depressed markets with large distressed property overhangs (some of the peripheral Eurozone economies), through to overheated markets where local authorities are trying to rein in prices (China, Hong Kong, Singapore).

## Australian Equities – Review

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Although there are no serious concerns about the outlook for the Australian economy, local shares were not spared the global sharemarket weakness in August, but equally also shared in the global recovery in confidence in September. The end result was a decent 4.20 percent gain for the S&P/ASX200 Accumulation Index over the past month, with little to choose between the Industrials (+4.10 percent) and the Resources (+4.40 percent).

## Australian Equities – Outlook

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Recent surveys have suggested that the Australian economy may be slowing a little. The Westpac/ACCI manufacturing industry survey for the September quarter showed actual activity slowing down, and expected activity equally softening. The latest National Australia Bank business survey showed confidence up but actual activity steady and forward orders weaker. The latest reading on consumer confidence from the Westpac/Melbourne Institute also showed a decline, although read together the preceding August rise and this latest September fall cancelled each other out, suggesting that consumers are still overall in decent spirits. Whatever hesitation these surveys might be picking up, however, does not seem to be affecting the overall performance of the economy very much. Retail sales in July, for example, increased by 0.70 percent, more than forecasters had expected. Job creation also continues to be substantial – there were nearly 31,000 new jobs in August, 53,000 new full-time jobs offset by 22,000 fewer part-time ones. At worst, all that may be happening is the impact of fiscal stimulus running off and modestly tighter monetary policy kicking in, and the business outlook into 2011 continues to look strong. As the Reserve Bank put it in its latest minutes: "The aggregate financial position of the household and business sectors remained sound, the stronger economy boosting wage incomes and profits... the Australian economy had solid momentum and that firms expected to increase investment significantly over the period ahead." This remains a very healthy environment for the domestic sharemarket.

## International Equities – Review

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There was a marked change in sentiment in global sharemarkets over the past month. The MSCI World Index was weak in the second half of August on the back of renewed fears about

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the global and (especially) US economic outlook, but recovered strongly in September as confidence improved. The net result is that world shares were up 5.90 percent over the past month in overseas currency terms. The much stronger \$A, however, meant that there was only a marginal 0.40 percent gain in local currency. The improved sentiment flowed through to nearly all the major markets. The US was up 6.30 percent (S&P500), Europe up 6.10 percent (MSCI Europe), and Japan up 2.50 percent (Topix). Asia, eastern Europe, and Latin America all contributed to a 4.20 percent increase on the MSCI Emerging Markets Index. The odd market out in an otherwise strong month was China, where the Shanghai Composite Index was down -1.90 percent.

## International Equities – Outlook

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The key issue for global sharemarkets over the past month was the perceived outlook for the US economy. Two issues in particular had worried investors – consumer spending, and the labour market. Retail sales had fallen in June, prompting fears that household retrenching could imperil the economic recovery, and these fears were aggravated by what was happening to new claims on unemployment insurance. These are usually averaged over four weeks to take out volatility: on that basis, new claims had been more or less stable since March, but had then risen in July and August. This had raised concerns that the US labour market was turning softer, or even presaging a double-dip recession. In recent weeks, however, both sources of concern have eased. Retail sales picked up in July and again in August, ahead of forecasters' expectations. The level of initial jobless claims has also headed down again, and even though it is not yet back down to where it started, fears of a weakening labour market have eased considerably. The Fed's assessment in its latest policy statement was that "the pace of recovery in output and employment has slowed in recent months", but that it also expected ongoing recovery ("a gradual return to higher levels of resource utilization"). Other forecasters agree with this picture of continuing recovery, but not as rapid a recovery as thought earlier. The Wall Street Journal's September poll of forecasters expected GDP growth of 2.50 percent this year (down from 2.90 percent in the August poll), and 2.80 percent next year (down from 2.90 percent). World sharemarkets in short have been through a US-focused exercise of reassessing expectations. On the US front, while not as strong as originally hoped for, the recovery is ongoing, and elsewhere the global economy is in good shape, particularly in the larger emerging markets. In Asia, indeed, the issue for policymakers has been how to cope with what might be unsustainably fast growth. A secondary worry for investors over the past month had been the scale of any potential slowdown in Chinese growth as the government tried to cool its pace, but latest industrial production figures (+13.90 percent year-on-year in August) have allayed concerns for now. India shows the same picture, the central bank aiming to rein in extremely fast growth. Industrial production in July was up 13.80 percent on a year earlier. Although there may still be risks to some of the slower-growing OECD economies, overall the outlook for economic activity globally remains positive for international shares.

*Performance periods refer to the month and three months to 22 September 2010.*

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