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MARKET OUTLOOK

31-Aug-2009

Economic Outlook

United States

Recent economic data released provided further evidence the global economy is improving at a better rate than widely anticipated just a few months ago. Manufacturing activity will soon be expanding again in the US while the pace of contraction in Europe has slowed markedly. The substantial inventory correction has largely worked out around the world and the rebuilding of that inventory, albeit in the face of a slower pace of demand revival, indicates that the cyclical low in production has passed.

The Eurozone

The global economy, however, remained far from healthy and many challenges remain. Despite stabilisation in general financial markets, banking sectors in many countries are expected to continue to struggle with bad loans; the latest particularly centered on commercial real estate loans. There is also a larger concern regarding the extent of the lag of most European banks (compared to their US counterparts) to write down their losses. They are also likely to continue to pare back lending to businesses to repair balance sheets and capital ratios.

Importantly, the ongoing job losses around the globe are an important stumbling block for a sustainable recovery. The latest marked decrease in job losses in the US was a welcome change but the large unemployment figures will continue to act as a drag on consumer spending, which is the largest contributor to the US economy and in turn, a major driver of global demand.

China

China has been pulling out from the global slump more decisively than any other major economy. GDP growth rebounded strongly in the June quarter, driven by faster-than-expected credit expansion and investment growth, thanks largely to government stimulus programs. Fixed asset investment in infrastructure and government-related sectors remained strong, but export-related investment is still weak. Property construction has already picked up, while retail sales remained resilient.

Importantly, there is a strong sense of déjà vu with the current recovery in China. Many feared that the large stimulus has found its way back to fuel speculation on asset prices such as property and the share market. The Shanghai Composite Index slumped 22% last month as banks reined in lending to avert asset bubbles and policy makers advised industries such as steel and cement to curb overcapacity. Notwithstanding the need to curb such activities, many actually fear that a curb in lending growth may derail a recovery. Policy should move soon from expansionary to accommodative, but not serious tightening.

Australia

Meanwhile Australia is another country that seems to have decisively rebounded from the global slump. The national accounts should confirm that stronger domestic demand in the past two quarters has lifted growth from what would otherwise be considered a technical recession. Business investment has also lifted thanks to some tax subsidies to investment in equipment.

On the outlook, there is considerable positive momentum going into this second half of the year. It is however prudent to remain cautious. The current pace of negative readings in leading indicators still suggest that the economy could remain weak in the near term. The Government's infrastructure spending will support the economy from the year end. Hopefully it extends the momentum from the expiry of the first home buyer grants. Still, the labour market also remained the key to watch for a sustainable recovery. The minutes from the latest policy meeting indicated that the Reserve Bank looks to normalise monetary policy to a more neutral level possibly even before the end of the year.

Australian Sharemarket Outlook

Since March, the Australian sharemarket has risen steeply, which may suggest to some that equities are now expensive. This isn't necessarily the case however, as the better than expected results of the latest reporting season has shown. While there is still the prospect for a short term pause or correction, especially given the traditionally rocky September/October period is upon us, the general consensus is that profit outlooks should trend higher. And with analysts suggesting that shares are still not expensive either, the general trend for shares is up.

In another sign that things are looking better domestically, a landmark trade deal was signed between Australia and China. It involved China agreeing to buy $50 billion worth of Australian liquefied natural gas over the next 20 years from the proposed Gorgon development in Western Australia.

However, the fact that Australia's major trading partners are showing signs of weakness - China's Shanghai Index slumped over 20% last month - is the dose of reality needed to stop people getting ahead of themselves; a successful recovery still has its fragility.

With the latest release of GDP figures, it is widely accepted that interest rates are likely to have bottomed and will be on the way up shortly, given that their purpose, avoiding recession domestically, has been achieved (should the positive economic data of late be taken at face value). With this in mind, the Australian sharemarket may encounter some levelling off in this period of recovery. However, the idea of a sustained recovery is only possible given that job losses until now have been well below expectations.

On the global front, markets appear to have kept pace with Australia recovery-wise, despite the global recession. Substantial gains have been made since March, however markets appear delicate and there are still uncertainties over the sustainability of the recovery. Now appears a good time for profits to be taken.

Australian Fixed Income Outlook

For the local fixed income market, near term performance will be driven by economic data releases, particularly those relating to consumption and housing. The fiscal stimulus packages have supported the economy through the first half of 2009 but the challenge now is how the economy performs without this support.

Market expectations favour an RBA rate rise prior to year end. Currently the market has factored in a cash rate towards 4.5% by the middle of 2010. Given how reactive the market will be to economic data, price action in the fixed income market is expected to remain volatile.

International Fixed Income Outlook

The key global leading economic indicators have continued to improve over the past month which has fuelled debate amongst market commentators and participants regarding the shape and strength of the recovery.

Sharemarkets have also run hard, posting strong gains over the past few months on the back of improving sentiment towards the outlook for the global economy. However, the recent price action in global bond markets, notably the US Treasury market, suggests that bond market participants are becoming more sceptical about the robustness of the economic recovery.

The nearer term outlook for the direction of global bond markets remains unclear. Further meaningful gains will be hard to come by if the economic data continues to print better outcomes, but if sharemarkets are due for a setback then bond yields may be better placed. Price action is expected to remain choppy.

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