

MARKET OUTLOOK

31-Dec-2009

Economic Outlook

United States

Recovery in the US remains fragile despite the economy looking to have turned around as evidenced by the expansion of GDP in the September quarter. The large excess capacity in the economy with excessive unemployment means that wages growth will be extremely modest for some time.

This coupled with tight credit conditions suggest domestic consumption looks to remain stagnated and the broader economic recovery will be modest by historical standards. However, against this backdrop, the Fed looks to remain patient on monetary policy but is also vigilant for any sign of inflation pressure.

The Eurozone

Europe will continue to face challenges in 2010 despite modest growth forecasts. The economy expanded in the September quarter, following five quarters of decline. However, the growth breakdown was not impressive. The impaired banking system (less than half of their loans are believed to be non-performing loans) coupled with tight credit will continue to act as headwinds to the economy. A focus on tightening fiscal policy this year, following the revelation of massive blowouts of budget deficits in many member countries (including Greece, Spain and Ireland), will put another layer of risk to the recovery effort.

Asia

Japan is in the midst of yet another deflationary grip. Stagnant domestic demand and a heavy reliance on exports will become more pronounced in 2010. The economy looks very much dependent on the sustainability of global demand in the future. Stimulatory fiscal policy is needed but the already large government budget deficit and low interest rates has many concerned that Japan is running out of options. Importantly, the resurgence of strength in the yen this year would add another layer of risk in this fragile recovery.

For China, the fiscal stimulus will continue to underpin the recovery in the economy. However, the continued concern over excessive lending will see Chinese authorities tighten policies for some sectors in the economy that are clearly overheated. Importantly, the authorities also need to manage inflationary expectations in light of strong inflation numbers in recent months.

Australia

Australia's economy is expected to continue to recover in 2010 with growth expectations of around 3%. Growth in consumer spending will likely be erratic, but the sharp rise in building approvals suggests that both residential and non-residential construction will be stronger. The continued improvement in trading partner economic growth should support exports, notwithstanding the stronger A\$. The economy is also expected to enjoy support from higher business investment. Thus, the normalisation of interest rates will continue in the New Year with rates expected to rise to 4.5% by mid year.

Sharemarket Outlook

The outlook as we enter 2010 is certainly a lot brighter than at this time last year. While there will still be lingering repercussions from the GFC like high unemployment, tightened credit availability, and sporadic debt blowouts (e.g. Dubai in November), the New Year comes with a heightened sense of economic soundness, which should translate into continued recovery in equity markets.

During the December quarter, signs emerged that things have bottomed in the US, prompting more positivity to capitalise on the underlying economic story. A recovery based on global economies being able to sustain themselves - i.e. not through monetary or fiscal policy - is looking likely.

While indicators suggest a return to happier times, there are still many aspects to be wary of. The expectation of higher interest rates domestically over the coming months will take money out of people's pockets, meaning consumer spending may be soft on top of a widely-expected weaker than usual Christmas period. Oil is also tipped to be on the rise, and the issue of repaying the high levels of government debt will enter the equation at some stage in the future.

The combination of these factors and others is likely to translate into sharemarkets rising further as economic conditions improve, profits grow, and inflation and interest rates remain relatively low.

Australian Fixed Income Outlook

For the local fixed income market, near-term performance will be driven by economic data releases and central bank dialogue. In terms of the latter, a very interesting speech from the RBA confirmed that adjustments to official interest rates would allow for higher borrowing and lending rates in the broader economy. The RBA quantified this as worth about 1% at the moment. Therefore, the current official cash rate of 3.75% is arguably nearer to 4.75% if one makes this allowance. We have previously argued that "normal" was circa 5.50%. Applying the RBA argument implies that the "new normal" may be nearer to 4.50%.

The market expects the RBA to continue the move towards these more "normal" interest rate levels in a steady manner through next year. Currently, the market has factored in a cash rate towards 4.75% by Christmas 2010, well down on earlier expectations which were nearer to 5.50%.

Given that a move towards these interest rate levels is already largely factored in, price damage or capital losses next year may be moderate, if seen at all. Delivering on what is already expected is not necessarily to be feared. Only if or when the RBA feels the need to tighten beyond normal - to restrictive levels - may some adverse performance impact be expected, a scenario that still seems some way off.

However, given how reactive the market will be to economic data and RBA policy action, along with global rate expectations, price action in the fixed income market is expected to remain volatile.

International Fixed Income Outlook

The global economy has continued to improve sparking debate amongst market participants as to the shape and the strength of the recovery and when extreme policy accommodation can begin to be reversed.

Nonetheless, policy makers are reluctant to risk stifling signs of better times. The US Fed has flagged that rates will stay low for an extended period although the ECB has begun discussing the timing of when to exit from extreme policy accommodation, although noting that current rate settings remain appropriate.

Upsetting some bond investors was a report from one of the major ratings agencies raising concerns over the AAA status of both the US and UK. Some smaller economies like Spain and Greece suffered actual downgrades. Unless budget outcomes improved appreciably in the next couple of years, sovereign credit downgrades may occur. The timing of "exit strategies" from extreme policy accommodation will be interesting to say the least.

Nonetheless, major global bond markets look likely to remain relatively range bound in the period ahead. Further meaningful gains will be hard to come by if economic data prints better than expected, but if sharemarkets suffer some setback, and they have become a bit flighty of late, some risk aversion may return fuelling steady to lower bond yields.

In terms of market expectations, in the US some upward adjustment to official rates is expected towards the end of next year with the market pricing in around 0.75% from current levels near zero. If expectations there, or indeed elsewhere, shift higher, bond markets may be adversely impacted as a result. In the EU, the ECB's Trichet has indicated that non-standard policy measures were likely to be discontinued soon, although he noted current rates remain appropriate and the crisis isn't over.

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