

## **MARKET OUTLOOK**

31-Jan-2010

### **Economic Outlook**

#### **United States**

In the US, positive trends in the December quarter GDP are expected to continue into the current quarter. Improvements in durable goods orders and consumer sentiment suggest final domestic demand will remain modestly firm with further contribution from personal consumption and business investment. Still, the economy continues to face many headwinds. Progress in the labour market looks slow and the shine in the housing sector looks to have come off. Furthermore, the tightness of credit conditions suggests the broader economic recovery will continue to be modest by historical standards. The Fed looks to remain patient on monetary policy but vigilant for any sign of inflation pressure.

#### **The Eurozone**

In Europe, evidence of softening activity at the end of last year kept the earlier expectation of only modest growth for this year. While consumption will remain sluggish, the ongoing recovery in exports will see higher industrial activity and capital expenditure which in turn should underpin overall growth. Still, the impaired banking system coupled with tight credit will continue to act as headwinds to the economy. The risk of a default of any Euro area member on its sovereign debt, including Greece, is small, but fiscal problems will remain large for some countries. In order to stabilise the situation, some countries might eventually get some financial assistance from other euro area members.

#### **Asia**

For China, the rebalancing of growth from export dependent sectors to broader domestic demand will see economic growth to continue to accelerate in the coming quarters. A favourable fiscal and monetary policy stance will remain in place throughout the year. However, concerns over credit expansion which has led to speculative asset prices and raising inflation are building momentum. The authority will continue to increase bank reserve requirements and exhortations for banks to restrict lending. In the longer term, further re-emergence of inflationary pressure will see measured rises in interest rates by the authorities, and the targeted appreciation of the Yuan will also be on the cards.

#### **Australia**

The strength in Australia economic activity is expected to continue thanks to the Government's aggressive spending packages (through its public infrastructure spending) and a continued improving global economy. The resilience of the labour market and housing sector will continue to help consumer spending and underpin the recovery process. Meanwhile, inflationary pressure has remained a touch more persistent with underlying inflation looking to trough at a higher level compared to previous cycles. Despite the decision to hold rates in February, the markets expect the normalisation of interest rates will continue this year, albeit more slowly than anticipated earlier this year.

### **Sharemarket Outlook**

For some time now we have mentioned that the recovery from the depths of the GFC would not be all smooth sailing. While taking longer to eventuate than many predicted, the correction that we have seen over the last few weeks in equity markets is testament to this hypothesis. The volatility that has been evident may just be the transition from economies relying on the

massive government stimulus packages that have been in place to economies standing on their own feet. Australia, having raised rates in every month of Q4, was seen as making this transition well, however, a pause in February did come as a surprise.

Throughout 2010 there is certainty that interest rates globally will be on the rise, but the existence of high unemployment and low underlying inflation should make the increases gradual, therefore not suppressing shares too significantly.

The outlook of a continued recovery, with further speed bumps along the way is still applicable. With the local market coming into the February reporting season, there should be more information in relation to the earnings growth that has been touted as underpinning the continued recovery in this country.

### **Australian Fixed Income Outlook**

Near term performance will be driven by economic data releases and central bank rhetoric. In terms of the latter, 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.

In any event, the market expects the RBA to continue the move towards more "normal" interest rate levels through the balance of this year. Currently, the market has factored in a cash rate around 4.25% by June and towards 4.75% by Christmas.

If the world continues its trend improvement and some upward adjustment to official interest rates begins, and inflation here troughs at higher levels than earlier thought the RBA could end up doing a bit more than is currently priced in. This will be one to watch over the next few months or so and it might impact returns over coming quarters.

However, only if or when the RBA feels the need to tighten beyond normal - to restrictive levels - may more serious adverse performance impact be expected. That scenario still seems some way off.

Given how reactive the market will be to economic data and RBA policy action along with global rate expectations, price action month-in month-out in the fixed income market is expected to remain volatile for some time yet.

### **International Fixed Income Outlook**

The global economic outlook continues to improve sparking debate amongst market participants as to the shape and the strength of the unfolding recovery and when extreme policy accommodation can begin to be reversed. Headwinds remain.

Policy makers are reluctant to risk nipping in the bud signs of better times. The US Fed has flagged that rates will continue to stay low for an extended period, although they may be prepping the market for potential policy adjustment around mid year.

Upsetting some bond investors are concerns surrounding peripheral EU economies, where sizeable budget deficits and large borrowing requirements have raised sovereign rating concerns. This saw significant underperformance from these markets with Greek 10-year bonds for instance up in yield by over 100 basis points.

In terms of market expectations, in the US some upward adjustment to official rates is expected towards the end of this year with the market pricing in around 0.50% of rate hikes from current levels near zero. If expectations there, or indeed elsewhere, shift higher, bond markets may be adversely impacted as a result. The EU and UK markets also price some modest upward rate adjustment around year end.

For the globe, the timing of "exit strategies" from prevailing levels of extreme accommodation will be interesting to say the least. In sum, volatility in bond yields within an overall range bound market environment can be expected to continue well into the year.

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