

## **MARKET OUTLOOK**

30-May-2009

### **Economic Outlook**

The global economy will continue to face challenges in the coming months. The path to economic recovery looks to be stretched and continues to be clouded by many hurdles. However, leading indicators of economic activity have started to improve and there is more evidence to suggest the pace of contraction has further eased. Nevertheless, the market should remain cautious of the many potential pitfalls ahead.

The prospect of a more prolonged recession hinges on further deterioration in employment, business investment and household spending. While these late cycle risks are well understood, the recent rise in oil prices and yields in long term bonds could also potentially dampen the recovery efforts. It is unusual to see the oil price and long term yields rise at this point in the cycle where the liquidation of inventories has not yet turned and recovery remains tentative. A further sharp rise in oil price would eventually hit consumer pockets as they have to pay more at the pump. The rise in long term yields similarly would see mortgage and lending rates move higher, reversing some of the easing in interest rates and further curbing household spending.

The market should not be too optimistic of the bottoming of economic numbers - recovery looks to be protracted rather than a sharp "v", notwithstanding the rebuilding of inventories which could itself produce an interim recovery in some activity. It is prudent for a guarded optimism for the economy at this stage.

### **Australian Sharemarket Outlook**

Despite the strong gains in the domestic market into May, there is still a sense of consolidation going on, with the prospect of shares falling back again a distinct possibility. Volatility is likely to remain in the short to medium term, with capital raisings, further bank losses, and rising unemployment - despite last month's surprisingly positive figures - set to keep everyone on their toes.

Shares are still attractive relative to cash and bonds at the moment, and most investors are still underweight equities. Further improvements in economic data will likely see this weighting change, as the economy looks to go into recovery mode later in the year. Given sharemarkets normally lead economic recoveries, even with the prospect of a further correction, it is possible that this is beginning to happen and investors' risk appetites are again increasing.

### **International Sharemarket Outlook**

Economic indicators are trending in the right direction for a recovery in 2010, possibly sooner in some developing countries. Equity markets are likely to show the way given that they historically bottom some six months before the economic cycle. Despite news of Australia technically avoiding recession with a slight growth in the economy in the March quarter, things are still not what can be deemed rosy, either here or abroad. Credit worldwide is still tight,

confidence remains fragile and balance sheets are under pressure stemming from the economic weakness - the restoration of which is essential for a recovery.

Until economic recovery arrives or forecast earnings enter an upgrade cycle, equity markets are likely to remain volatile, with periodic corrections par for the course. However, the unprecedented amount of fiscal stimulus worldwide and the generational lows in interest rates are likely to have some traction.

### **Australian Fixed Income Outlook**

As discussed in the International Fixed Income Review, bond yields globally have suffered quite a setback in the last month. Australian fixed income has not been spared. This setback in yields is an "echo" of the enormous rally to lower yields around the end of last year. That rally was a massive flight to quality as fears of GD2 swept the globe. The arrival of "green shoots" discussed above has allowed the extreme positioning of that rally to unwind, returning yields towards more reasonable levels.

Longer term bond yields may be choppy and subject to bouts of setback as the market copes with this ongoing supply. Nonetheless, the still poor economic backdrop, with muted inflation pressures, should allow yields overall to remain at relatively low levels for quite some time. From here yields should stabilise, and more range bound as opposed to directional trading to occur.

Closer to home, the numbers remain mixed and unfortunately the labour market looks set to deteriorate further throughout 2009. Indeed the Government forecasts as much in the latest budget. This will keep alive hopes of further rate cuts here which should provide support for the Australian market, especially shorter term securities where the cash rate and its perceived direction is more important. Expectations are for ongoing gradual improvement in credit markets.

### **International Fixed Income Outlook**

As mentioned above, bond yields globally have been impeded over the last four to six weeks, "echoing" the enormous rally to lower yields around the end of last year. The arrival of "green shoots" has allowed the extreme positioning of that rally to unwind, returning yields towards more reasonable levels.

The performance and direction of the overall fixed income market will be driven by how perceptions of these economic "green shoots" evolve. Governments everywhere have announced fiscal stimulus responses to the downturn requiring sizeable issuance of Bonds. Given the unprecedented nature of this supply, periods of "indigestion" are inevitable.

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