

MARKET OUTLOOK

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Economic Outlook

United States

The sustainability of the recovery in the US remains on everyone's minds. The US economy's growth could moderate in the near term as the effect of the Government's fiscal stimulus (including the "Cash for Clunkers" program and housing tax credits for the first home buyer) wanes. Over the longer term, the elevated number of unemployed suggests that domestic consumption will continue to be under pressure and the broader economic recovery will be modest by historical standards.

Meanwhile, debate is also shifting to the risk of maintaining low interest rates for an extended period. Many are concerned that this could lead to excessive risk taking in financial markets and rising inflationary expectations. The Federal Reserve currently sees minimal risk with these concerns as excess capacity in the economy remains large and it has assured that monetary policy will be proactive when due.

The Eurozone

For Europe, economic indicators are expected to continue to improve gradually. There are more signs of a sustainable recovery in industrial production, which benefitted from the pick up in exports on the back of inventory rebuilding. However, the high level of unemployment and continued deceleration in lending growth due to the impaired banking system will ensure that any recovery will be modest.

Asia

Similar to Europe, industrial production in Japan has turned strongly on the back of export demand. Still, the sustainability of future global demand that expected to follow on from the inventory rebuilding remains uncertain. More policy measures are needed for a broader and sustainable economic recovery. Elsewhere in Japan, deflation is expected to continue to persist for longer, adding another layer of risk to the 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

In Australia, the normalisation of monetary policy should see further rises in interest rates next year. While the effects of fiscal stimulus from earlier this year on consumer demand are clearly fading, the planned public infrastructure spending and higher activity in housing are starting to provide support. Prospects for a lift in business investment and exports in the medium term are also strengthening and, pleasingly, there are also more signs of improvement in labour market conditions.

Sharemarket Outlook

The October corrections and the latest Dubai debt scare has shown that the road to recovery will be bumpy. While there was a quick realisation that the Dubai issues were more a blip on the radar than the start of a new credit crisis, it has at least suggested that there is still a high level of caution amongst investors.

It has become increasingly obvious that this recovery will be different to previous ones, with developing economies (China, India, rest of South East Asia) leading the charge rather than the advanced economies of the US, Europe and Japan. Driven by internal demand growth and improved economic conditions on the back of massive stimulus measures, these economies have far better growth outlooks.

This focus has particular relevance to Australia given our ability to provide these developing economies with the commodities that they are so heavily reliant upon. This places this region at an advantage, an opinion that the RBA must also hold, given its historic decision to lift rates for a third consecutive month.

Australian Fixed Income Outlook

For the local fixed income market, near term performance will be driven by economic data releases and RBA commentary. Interestingly, recent data suggested a softer tone to retail sales and weak credit aggregates has seen the market moderate its RBA expectations. Against this, both consumer and business sentiment surveys are at elevated levels. The debate now is how the economy will perform with the peak boost from various fiscal stimulus measures now passed.

The market expects the RBA to continue the move towards more normal interest rate levels in a steady manner. Currently, the market has factored in a cash rate towards 4.5% by next July and 5.0% by the end of next year.

This is not necessarily bad news for fixed income investors. Given that a move towards more normal 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, may some adverse performance impact be expected. That scenario 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 is expected to remain volatile.

International Fixed Income Outlook

Key global leading economic indicators have continued to improve providing fuel to the 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 the early signs of better times. Indeed, the US Fed has flagged ongoing policy accommodation for an extended period. The ECB, in contrast, has begun discussing the timing of when to exit from extreme policy accommodation, although noting that current rate settings remain appropriate.

Sharemarket volatility and selected renewed credit concerns (Dubai World and related parties) have seen some "flight to quality" bids return to Bond markets. This was also helped by a very benign inflation outlook for the year or two ahead and growing fears that the recovery may stall next year.

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

In summary, volatility in bond yields within an overall range bound market environment can be expected to continue for some time.

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