

MARKET OUTLOOK

31-Oct-2009

Economic Outlook

The global economy is expected to continue to recover, albeit at a gradual pace. Some major developed economies including the US and Japan have started to record positive growth, however, other economies, especially the UK, are lagging behind.

United States

For the US, the fear of a "double dip" recession will continue to remain until there is further evidence of a sustainable recovery. The economy continues to face many challenges. Economic growth could be moderate as the effect of the Government's fiscal stimulus (including the "Cash-for-klunkers" program and housing tax credit for first home buyers) wane. Nevertheless the Government may yet deliver another round of fiscal stimulus. More importantly, while the pace of job losses has eased markedly since earlier this year, the unemployment rate is expected to continue to rise above 10% and to remain elevated for much of next year. This underpins the view that the recovery in consumer spending and to the broader economy will be modest compared to previous recessions.

The Eurozone

Economic indicators in the Euro area continue to improve gradually with modest growth expected in the September quarter. The improvement in industrial production has been most encouraging and could lead to the first positive quarter since early 2008. Similarly with the US, higher excess capacity, particularly in the labour market, will ensure that any recovery will be modest. Meanwhile, the details of September GDP for the UK were quite terrible with broad based weakness in the economy remaining. While there is some positive news, recent data still highlights that the economy would continue to face challenges for the remainder of the year.

Asia

Economic conditions in Japan have continued to improve. Industrial production has turned strongly as exports recovered mainly due to increased demand from other Asian economies. Still, the outlook for exports remains uncertain partly because the current upswing is fuelled by inventory rebuilding, while global demand is expected only to recover gradually. Some policy measures have helped the economy but more is needed. On prices, deflation will continue to persist for longer, putting another layer of risk to the recovery.

For China, the fiscal stimulus package has and will continue to underpin the recovery in the economy. Investment growth is expected to remain strong due to the fiscal and monetary policy stimulus in place. Concerns remain over excessive lending particularly in housing mortgages. While this had supported the recovery in the construction sector, the unintended consequences of speculative house prices needs authorities to place restrictions on lending.

Australia

In Australia, the normalisation of monetary policy should see further interest rate rises next year. The RBA has upgraded its forecast for the economy to grow at trend growth next year, and underlying inflation, while expected to moderate in the near term, is expected to remain close to the higher side of the 2-3% target next year. Pleasingly, leading indicators of employment suggest labour demand is improving. While the trend still suggests a further

deterioration in the unemployment rate, it is not expected to peak at higher single digits as forecasts earlier this year suggested.

Sharemarket Outlook

The last few weeks have shown that the global recovery is not quite out of the woods yet, as markets finally made corrections to the rally that began in March. Domestic and global markets have run hard since those March lows, and have therefore been susceptible to a correction based on poorer economic data. It is still too early to determine whether this correction is to be sustained into a relapse of the bear market, or just an inevitable blip on the road to recovery. However, the latter scenario is likely, as despite the cautious economic data of late out of the US, not too much has changed elsewhere. In Australia, the economy is still improving, evidenced by the RBA's move to increase the cash rate by a further 0.25% at the recent November Board Meeting.

As mentioned last month, IPO activity has intensified domestically, with Myer the first of the bigger floats, to be followed shortly by Kathmandu. This is a good indicator of the feeling towards the market and economy.

It is worthy to note that we are coming into the traditionally strong period for equities from a seasonal perspective, which will be interesting to see given the last few weeks of volatility.

Australian Fixed Income Outlook

For the local fixed income market, the near term performance will be driven by economic data releases, particularly those relating to consumption and housing. Interestingly, retail sales have taken a step back as peak contribution from the fiscal stimulus packages has now passed through the economy. The challenge now is how the economy performs without this support.

The market expects the RBA to begin the move towards more normal interest rate levels towards year end and to continue in 2010 in a steady, measured manner. Currently, the market has factored in a cash rate towards 4.5% by the middle of 2010, and 5.0% by the end of 2010.

This is not necessarily bad news for fixed income investors. Given that a move towards more normal interest rate levels is already factored in, price damage or capital losses next year may be moderate. Delivering on what is already expected is nothing to be feared. Only if or when the RBA feels the need to tighten beyond normal - to restrictive levels - can some adverse performance impact be expected. That scenario still seems some way off.

However, given how reactive the market will be to economic data as well as RBA and global rate expectations, 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 through and beyond the mid-year period 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.

Sharemarkets have also run hard posting strong gains since March, in line with the improvement in sentiment towards the outlook for the global economy. Interestingly, bond markets could have been expected to react adversely to this debate but haven't. Perhaps a very benign inflation outlook for the year or two ahead partly explains this. The growing realisation that the recovery will end up sub-par next year is also a factor. Irrespectively, volatility in bond yields can be expected to continue for some time.

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 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. Price action is expected to remain choppy.

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