

MARKET REVIEW

31-Dec-2009

International Economic Review

United States

Economic data released in December was relatively mixed but overall more on the positive side. The highlight was the better than expected labour market report. Non-Farm Payrolls fell less than expected in November, while the previous month's decline was also revised. The unemployment rate edged lower to 10.0% from 10.2% in November.

Reflecting a more optimistic outlook for business and labour market conditions, the Conference Board Consumer Confidence Index rose to 52.9 in December from 50.6 in November. Retail sales rose 1.3% in November following a 1.1% rise in October. Sales excluding auto climbed 1.2%.

The news from the country's housing market continued to be mixed. Housing starts rose to 574,000 units in November from 527,000 units in October. Similarly, existing home sales rose to 6.54 million units from 6.09 million units annualised over the same period, while new home sales fell to 355,000 units from 400,000 units for the same period. Housing recovery is relatively muted compared to previous recessions.

Meanwhile, headline CPI rose 0.4% in November to be 1.8% higher on annual terms. Excluding food and energy, core CPI was flat for the month, leaving the annual rate at 1.7%, only slightly higher than the 1.5% low back in August.

On the outlook, the closely watched ISM Manufacturing Index decreased to 53.6 in December from 55.7 in October. The Non-Manufacturing Index fell back to 48.7 in December, having spent only two months above the threshold of 50, suggesting recovery in the service sector remains fragile.

Europe

In Europe, industrial production fell 0.3% in October, reversing the previous month's rise. Production remained weak at 11.2% lower than a year ago. Pleasingly, the CPI was 0.5% higher than a year ago in November, after spending five months in negative territory. On the outlook, the closely watched proxy for European economic growth, the German IFO Index, rose 94.7 in December from 93.9 in November. In contrast, the ZEW Economic Sentiment Index fell 0.7 points to 50.4 in December. The conflicting signs on the outlook suggest recovery remains fragile for the continent.

Asia

Japan industrial production rose 2.6% in November, but remained 5.2% lower than a year ago. In the labour market, the economy lost another 110,000 jobs in November, a disappointing outcome after 250,000 were lost in October and September. Interestingly, the unemployment rate rose slightly to 5.2% in November. On prices, national CPI rose six tenths of a percentage point to -1.9% in November leaving the economy in a deflationary grip.

China industrial production rose 1.7% in November, bringing the annual rate to 19.2%. Deflationary concerns in China look to have eased with the annual rate of CPI in November registering 0.6%, the first positive figure since January last year. On the outlook, the Manufacturing PMIs, measured separately by China's National Bureau of Statistics and the private company Markit, remained above the 50 threshold at 55.2 and 55.7 respectively in December.

Australia

Australia's economy expanded less than expected in the September quarter with real GDP rising only 0.2% compared to 0.6% recorded in the June quarter. Domestic demand grew at a healthy pace of 1.3% but was offset by weaker net export numbers. The economy grew only 0.5% in annual terms.

Meanwhile, the more recent data was generally mixed. Another round of strong employment data was the highlight of the month, lending weight for further normalisation of interest rates in the New Year. Employment grew by 31,200 in November, and the unemployment rate fell 0.1% to 5.7%.

Reflecting recent interest rate hikes, however, the Westpac-MI Consumer Confidence Index fell 3.8% to 113.8 in December. Despite the latest fall, the index remained elevated compared to earlier this year. Elsewhere, private sector credit rose a meagre 0.1% in November, following a 0.1% decline in October. Housing finance approvals fell 1.4% in October, reversing some of the 3.3% rise in September. The NAB Business Confidence Survey surprisingly rose another 3 points to 19 against an expectation for a fall.

On the outlook, the Westpac-MI Leading Indicator, which indicates the likely pace of economic activity three to nine months into the future, was 6.7% in October, well above its long term rate of 3.1% and compared to -6.9% recorded in May last year. It spiked 8 points to 18 in August, marking the third consecutive positive month in a row.

International Sharemarket Review

Global sharemarkets continued to rise higher, led by strong performances in European and Asian bourses. Japan's Nikkei was up double digits for the month as it played catch up with the rest of the world. The US markets lagged behind but managed to close the month in the black. News of Citigroup's plans to issue new stock to repay the government bail out money weighed on the Financial sector and broader market. The stronger dollar also helped the underperformance of the Consumer Staples sector.

Australian Dollar Outlook

Major bourses performed for the month as follows:

Japan Nikkei 225	12.8%
UK FTSE 100	4.3%
US Dow Jones	0.8%
US S&P 500	1.8%
German DAX	5.9%

Australian Sharemarket Review

The local sharemarket improved on the 1.8% return of November, posting a gain of 3.6% (S&P/ASX 200 Accumulation Index) to close out the year. Initially the market traded sideways before an end of month rally coinciding with the Christmas period.

Every sector finished the month in positive territory, led by Industrials (up 7.0%) and IT (up 7.3%), while the Telecommunications sector lagged (up 1.0%). The banks were under pressure from liquidity requirements and concerns over funding costs, highlighted by Westpac's move to up its mortgage rates by 45 basis points following the RBA's 25 basis point increase of the cash rate. Discretionary retailers disappointed as investors took profits on hearsay of weaker pre-Christmas sales.

Merger and Acquisition activity continued to intensify, with AMP upping its bid for AXA Asia Pacific Holdings, only to be trumped by National Australia Bank which had been recommended by the Board of AXA. Nufarm ended its takeover discussions with Sinochem, and instead opted for a strategic investment from Sumitomo. Woodside Petroleum ended the year's capital raisings as it sought to raise \$2.5bn, largely seen as from left-field.

Large Caps

The best performing Australian large-cap stocks during the month were Incitec Pivot (24.6%), Centennial Coal (21.6%) and Alumina (19.5%).

- Incitec Pivot's share price improved based on the outlook for soft commodities and continued improvement in fertiliser demand.
- Alumina announced that it would benefit from the expansion of the Alumar refinery in Brazil, which opened up during the month with double its previous capacity.
- The worst performing Australian large-cap stocks during the month were Lihir Gold (-8.9%), David Jones (-6.3%) and Nufarm (-6.1%).
- Anecdotal soft retail trading over the Christmas period affected discretionary retail stocks, including David Jones.
- Nufarm rejected Sinochem's revised acquisition proposal at the end of the month, and signed a Memorandum of Understanding with Sumitomo relating to a proposed strategic investment from the agrochemical company.

Small Caps

- The best performing Australian small-cap stocks during the month were Murchison Metals (47.1%), Rivercity Motorway (47.1%) and Karoon Gas Australia (38.0%).
- Murchison Metals, among a host of junior miners, had a strong finish to the end of the year as spot iron prices soared and there was an upgrade on resource estimates.
- Positive drill results on its Poseidon well assisted Karoon Gas Australia during the month.
- The worst performing Australian small companies stocks during the month were Bannerman Resources (-38.6%), Conquest Mining (-21.4%) and Biota Holdings (-21.0%).
- Biota Holdings responded to an ASX price query during the month. The response indicated that there was no announcement to be made which could provide an explanation as to the share price drop and volume change.

- Elders struggled after announcing its recapitalisation plan, where a debt refinancing deal was completed and the launch of a deeply discounted capital raising. An annual loss of \$A415.4m for FY09 was also announced during the month.

Major Indices

The major indices performed as follows during September:

S&P/ASX 200 Accumulation Index	3.7%
S&P/ASX 200 Industrials Accumulation Index	3.8%
S&P/ASX 200 Resources Accumulation Index	3.6%
S&P/ASX Small Ordinaries Accumulation Index	4.3%

Listed Property

The Listed Property sector climbed 3.4% (S&P/ASX 200 A-REIT Accumulation Index) in December, slightly underperforming the broader market return of 3.7% by 0.3%. The sector as a whole performed much better than in November, as only two stocks failed to post a positive return.

Positive sentiment returned to the sector, especially regarding commercial property. Increased risk appetite saw Commercial and Industrial REITs perform best.

The capital raising theme continued into December, with Abacus Property Group completing a \$91.4m placement to institutional investors. The company said the proceeds would go to reducing debt and providing capacity for future acquisitions and working capital requirements.

Merger and Acquisition activity also continued strongly despite the Investa IPO not proceeding, with Lend Lease, Mirvac Group, and Challenger Kenedix Japan Trust all involved in deals.

Australian Fixed Income Review

Central bankers everywhere have become more confident of better times ahead but understandably remain cautious. Policy remains stimulative and large Government budget deficits remain the order of the day. The debate as to when and how extreme policy accommodation is wound back has begun.

Locally, both business and consumer confidence measures have consolidated at high levels and a favoured leading indicator - the Westpac/MI Leading Index - has surged. The local labour market continues to remain relatively resilient and the unemployment rate edged down to 5.7% last month. Unemployment has ranged between 5.5% and 5.8% since March. Perhaps the cyclical high for unemployment is in, which would be a marvellous result.

The ongoing improvement in the economic outlook has prompted the RBA to begin adjusting official interest rates. The need for "emergency levels" has passed and a return towards more normal levels has begun. There have been three rate hikes, each by 0.25%, lifting cash to a still low 3.75%. However, the RBA has reminded us all that both borrowing and lending rates in the economy have risen by more than the 0.75% of official rate moves. The RBA says that these moves are worth approximately an extra 1.0%, such that current interest rates in the economy are analogous to an official rate of nearer to 4.75%.

The RBA will make allowance for this when setting policy. In other words "normal" official interest rates which we have previously described as nearer to 5.50% may now be lower to account for economy wide interest rates. As such, the "new normal" may be nearer to 4.50%. In any event the market is now pricing in a cash rate of around 4.75% by Christmas 2010.

In terms of market moves, the benchmark 3-year bond closed higher by 0.36% at 5.06%, while the benchmark 10-year bond closed higher by 0.52 % at 5.76%. The UBS Composite Bond Index delivered a return of -0.38% as capital losses from rising yields impacted returns.

International Fixed Income Review

The global economy has stabilised and the outlook continues to improve. While clearly welcome, labour markets remain weak although job losses thankfully appear to be moderating. In the US, the unemployment rate sits at 10.0% and EU-wide unemployment sits at 9.8%.

Key central banks remain cautious not wanting to risk stifling signs of better times ahead. The US Fed continues to suggest that rates are likely to be kept low for an extended period. However, in the EU the ECB has begun a discussion as to the timing of when to exit from extreme policy accommodation, although noting that current rates still remain appropriate and the crisis isn't over.

US Treasury yields and UK Gilts sold off somewhat as a major ratings agency flagged concerns about deficits and borrowings, and raised the possibility of sovereign credit downgrades in a couple of years if things don't improve. Also impacting markets was a partial unwinding of the late November rally fuelled by Dubai World and flow on credit concerns.

In terms of price action, the US Treasury 2-year note closed higher by 0.47% at 1.14% and the 10-year note, the global benchmark, closed at 3.83% higher by 0.63%. The global fixed income market return, as measured by the Barclays Capital Global Aggregate Index (hedged into A\$) delivered a return of -0.62%.

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