

MARKET REVIEW

31-Jul-2009

International Economic Review

United States

Early estimates for June quarter GDP showed that the pace of contraction in the US economy moderated to -1.0% annualised, compared to a revised -6.4% in the previous quarter. The latest figure, however, marked the fourth consecutive contraction in the economy, the first such fall on record.

On more recent data, the closely watched ISM Manufacturing Index edged higher again in June, rising 2 points to 44.8, suggesting that the contraction in the manufacturing sectors has slowed further. The non-manufacturing index also fared better, rising 3 points to 47, the highest level since September 2008.

Despite continued improvement in the outlook, current economic conditions remain weak and the economy continued to shed jobs at an elevated pace. The non-farm payroll lost another 467,000 jobs in June, higher than the loss of 345,000 jobs recorded in May. The unemployment rate rose 0.1% to 9.5%.

In the consumer sector, retail sales rose 0.6% in June, driven primarily by autos and fuels. Excluding autos and fuels, retail sales dipped 0.2%, marking the fourth consecutive period decline. The Conference Board's Consumer Confidence Index retreated for the second straight month in July to 46.6 after surging to 54.8 in May. Housing starts rose for the third consecutive month by 3.6% to 582,000 units in July. Similarly, new and existing home sales showed marked improvements in July but, like housing starts, they remained close to multi year lows.

On the inflation front, headline CPI surprised on the upside, rising 0.7% in June. The annualised figure, however, slid deeper into negative territory at -1.4%.

Europe

The closely watched proxy for European economic outlook, the German IFO Index, rose to 87.3 in July from 85.9. In contrast, the ZEW Index of economic sentiment unexpectedly retreated to 39.5 in July after surging in the previous month. Early estimates for inflation showed CPI fell to -0.6% annualised in July, a large fall from the -0.1% recorded in June. European unemployment rose 0.1% to 9.4% in July.

Asia

China's economy expanded 7.9% from a year ago, which was a better than expected result. Meanwhile, the latest two business climate surveys continued their recent gains to remain above the expansionary threshold of 50. The Markit-CLSA PMI rose 1 point to 52.8, while the NBS PMI edged up by 0.1 to 53.3 in July. The near term outlook for manufacturing has improved considerably since the start of the year.

In Japan, industrial production rose 2.4% in June but was still 23.4% lower than a year earlier. Disappointingly, employment fell by 280,000 in June, pushing the unemployment rate to 5.4%, the highest level since June 2003. Real household spending fell 0.3% in June, bringing the annual rate of spending growth to just 0.2%. Housing starts remained 32.4% lower than a year ago in June. National headline CPI fell by 1.8% annualised in June, while core CPI is also in deflationary territory at 0.7% annualised.

Australia

The latest labour market report showed the economy lost 21,400 jobs in June following a fall of 8,500 in May. The losses were predominantly in full time positions, while part time employment was up slightly. Unemployment rose marginally by 0.1% to 5.8%, the highest level in almost six years.

Other economic data releases last month fared better than expected. The annualised growth rate of the Westpac-MI Leading Index for May stood at -3.9%, an improvement from what appeared to have been the low point in the growth cycle of -6.1% in February. Meanwhile, the Coincident Index also improved to an annualised growth rate of -0.1% from -0.5% previously.

In the corporate sector, the NAB Business Confidence Survey returned to positive territory for the first time since December 2007, rising four points in June after a two point decline in May.

In the consumer sector, the Westpac-MI consumer sentiment survey showed further improvement, rising 9.3 points in July to 109.4 after surging in June. Housing finance approvals rose 2.2% in May, marking the eighth straight monthly rise. Private sector credit grew 0.1% to be 3.4% higher than a year earlier. However, business and personal credit both fell.

Headline CPI rose 0.5% for the June quarter but dragged the annual rate down to 1.5% from 2.5% in the March quarter. The trimmed mean and weighted median measures were 3.6% and 4.2% respectively in June. While inflation continued to fall, the RBA's preferred statistical measure of core inflation remained outside their target band of 2-3%.

International Sharemarket Review

The rebound in international sharemarkets continued in July with strong gains in all major indices around the globe. News of further signs of economic recovery emerged, and the positive tone from earnings reports helped to propel the market on higher confidence. Cyclical sectors outperformed while defensive sectors, including telecoms and healthcare, lagged behind.

Australian Dollar Outlook

Major bourses performed for the month as follows:

Japan Nikkei 225	4.0
UK FTSE 100	8.5
US Dow Jones	8.6
US S&P 500	7.4
German DAX	10.9

Australian Sharemarket Review

The Australian sharemarket produced its largest monthly return since March 2000. This continues an extraordinary run which has seen the S&P/ASX 200 Accumulation Index grow by 26.9% in the past five months (up 7.3% in July).

July's strong performance was curious in that there was little news flow and most companies were in a blackout period prior to the reporting season. Gains in Australia were broadly in line with those of most global equity markets.

Financial stocks again performed strongly. The improving economic outlook saw the Big Four banks all post strong gains during the month despite the National Australia Bank's \$2.75 billion capital raising. Asset managers also had a strong month given the bullish market sentiment.

Resource stocks outperformed the index on the back of strong commodities prices.

Defensive stocks again lagged the index. Healthcare, Utilities and Telcos have been amongst the worst performing sectors over the past quarter as increasing investor risk appetite has meant higher beta stocks are being preferred.

Large Caps

The best performing Australian large-cap stocks during the month were West Australian Newspapers (38%) and the Goodman Group (38%).

- A strong rally in media stocks globally assisted in pushing newspaper publisher West Australian Newspapers higher in July. The improving domestic outlook also benefited the newspaper that relies on classified ads as a major revenue source.
- The Goodman Group was a beneficiary of investors increasing risk appetite and preference for REITs more highly leveraged to the global economy.
- The worst performing Australian large-cap stocks during the month were Paladin Energy (-7.5%) and Lihir Gold (-6.1%).
- Paladin Energy announced during the month that it had lowered its production target for uranium. This led some investors to take profits in a company that has run hard over the past six months.
- Despite announcing solid production results, Lihir Gold lost ground during the month after agreeing to sell its Ballarat gold operations when it failed to meet the company's original production forecasts.

Small Caps

The best performing Australian small-cap stocks during the month were HFA Holdings (97%) and MEO Australia (96%).

- HFA Holdings benefitted from the rebound in global equity markets, improving the profit outlook for the group.
- The response to MEO Australia's quarterly activities report was very strong during the month. During the quarter MEO commenced the farm-out process for its WA-360-P site and is expected to commence oil and gas production in the near term.
- The worst performing Australian small-cap stocks during the month were the Macquarie DDR Trust (-23%) and IMF Australia (-22%).
- The Macquarie DDR Trust was hurt by a combination of asset revaluations announced during the month and investors switching to higher beta REITs.

- It was a similar story for IMF Australia with investors shifting to higher beta stocks. IMF did announce a final fully franked dividend of 10 cents during the month.

Major Indices

The major indices performed as follows during July:

S&P/ASX 200 Accumulation Index	7.3
S&P/ASX 200 Industrials Accumulation Index	7.0
S&P/ASX 200 Resources Accumulation Index	8.0
S&P/ASX Small Ordinaries Accumulation Index	9.0

Listed Property

The Australian property sector finished the month 2.4% higher (S&P/ASX 200 A-REIT Accumulation Index), underperforming the broader equity market by 4.9%. The gap between the best and worst performing stocks was 40.5% as stock specific issues rather than sector based concerns dominated the month.

July was a quiet month for capital raisings with only Australand coming to the market for \$475 million. The dominant theme for REITs has been cap rate softening with most REITs 40-60bps lower than in October.

As we have seen with the broader equity market, risk appetite has returned to the REIT sector. The improving capital market sentiment saw capital-constrained REITs outperform the more conservatively capitalised end of the sector.

Australian Fixed Income Review

On the local economic front, both business and consumer confidence jumped higher and housing related activity continued to improve, supported by new home owners taking advantage of the new homeowners grant as well as the low mortgage rates that remain in place.

The performance of the housing market in the coming months requires close watching as rhetoric in a recent speech by the Reserve Bank of Australia (RBA) Governor Stevens suggested the RBA would be concerned if low interest rates were only resulting in higher housing prices rather than the construction of more dwellings. The financial markets interpreted this as the RBA moving to a neutral bias for now with the next move in the official cash rate favoured to be an upwards move. Current market expectations are for the RBA to have raised the official cash rate by a total of 0.50% by the end of the first quarter in 2010.

In terms of market yields, the benchmark 90-day bank bill rate rose marginally by 0.01% at 3.20%, the Australian 3-year benchmark Commonwealth government bond increased 0.18% to 4.93%, while the 10-year benchmark Commonwealth government bond closed 0.07% higher at 4.57%. The UBS Composite Bond Index delivered a return of 0.31%.

International Fixed Income Review

Sentiment towards the global economic outlook continued to improve as economic data was generally better, central bank comments were more constructive and the US company reporting season also showed some signs of improvement. Key leading economic indicators in all major economic regions are now trending higher although the absolute levels still remain low.

On the employment front, whilst being a lagging indicator, job losses are still coming through and unemployment rates are continuing to rise, notably in the US and Europe. Although rhetoric from central bankers has been more constructive, they have indicated that cash rates in the respective regions are likely to remain low well into 2010.

Credit markets have continued to perform well. Narrowing spreads have seen credit markets outperform their government counterparts over the month as investors have continued to become less risk averse.

In terms of price action, in the US Treasury market the 2-year note closed unchanged at 1.12%. The US 10 year note, the global benchmark, closed 0.06% lower at 3.48%. In other key global bond markets the UK 10-year gilt closed higher by 0.11% at 3.80%, the German 10-year bund closed lower by 0.09% at 3.30%, while the Japanese 10-year maturity closed at 1.42%, up by 0.06%. The global fixed income market return, as measured by the Barclays Capital Global Aggregate Index (hedged into A\$) delivered a strong positive return of 1.55% led by gains in the credit component.

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