



Monthly Economic Summary May/June 2009

Outlook for Investment Markets

The key development across all asset classes has been the impact of increased investor confidence about the outlooks for the credit crisis and the global economy. Providing this is not derailed by further twists in the credit crisis saga, it should lead to increased demand for growth-related assets and less demand for 'safe haven' assets such as government bonds and the \$US. Both local and global property are likely to lag, however.

Australian Cash & Fixed Interest - Review

Short-term interest rates have been rock-steady, 90-day bank bill yields trading a shade over 3.10 percent. Although there was a further small cut of 0.25 percent to the official cash rate during the quarter, the markets had already moved beforehand in anticipation. Longer-term interest rates, however, have continued to rise. Ten-year Commonwealth bond yields are back up to five percent (+0.77 percent for the quarter), and other longer-term rates are also higher. The five-year swap rate, for example, is 0.80 percent higher for the quarter at 4.90 percent. The \$A has had a very strong month (+7.60 percent) and quarter (+19.80 percent) against the \$US, and has also been strong on an overall trade-weighted basis (+3.90 percent for the month, +14.60 percent for the quarter).

Australian Cash & Fixed Interest - Outlook

The Reserve Bank is highly likely to leave short-term interest rates where they are, or even cut a little bit more if any further downside risks materialise. The Australian economy is still weak, and there are no visible inflationary pressures. The futures market is picking a 50:50 chance of another 0.25 percent cut. The key influence on bonds is likely to be the prospect of an easing, or even an end, in sight to the credit crisis. If investor confidence continues to improve, then government bond yields will continue to rise as demand for a bolthole falls. Corporate bond yields will fall as refinancing and default risks ease (although as the likes of Great Southern's collapse shows, the last dominoes will still be falling for some time yet). Similarly, if investors continue to feel more comfortable, emboldened investors will continue to move back out of the \$US and into currencies like the \$A.

International Fixed Interest - Review

Most central banks had already cut interest rates to very low levels, leaving little scope for further reductions. The only significant move was therefore the European Central Bank's 0.25 percent reduction. Global government bond yields rose modestly, but still remained at low levels, the yield on the JP Morgan index of world government bonds now just over 2.75 percent. Corporate yields fell as confidence in the global financial crisis easing increased. This was the case for both investment grade and 'junk' bonds, but was especially marked at the low credit quality end. US companies classified as 'high yield' were paying close to 19.0 percent to raise financing three months ago: the cost is still high, but is now down to around 14.50 percent.

International Fixed Interest - Outlook

Short-term interest rates will remain low for some considerable time as central banks everywhere run supportive monetary policies. In the US, for example, futures market prices show that the Fed is not expected to reverse its current almost-zero interest rate policy before the middle of next year. Government bond yields have started to rise, a logical response to increased confidence about the improved outlook for the credit crisis. As fears recede, government bond yields should continue to rise. Similarly, the sharply-higher financing costs that all borrowers – good and bad – had to pay in the wake of the credit crisis are likely to continue to come back to more reasonable levels.

Australian & International Property - Review

Unlike the wider domestic sharemarket, which shared in a global mood of increased investor confidence, local property shares languished. Although up from their absolute rock-bottom levels reached on 9 March, the REITs have not kicked on the way the rest of the market has. The S&P/ASX 200 AREIT index was down -12.20 percent for the month, and down -1.10 percent for the quarter. As the International Equities section below discusses, world sharemarkets have rallied strongly on expectations of an easing of the credit crisis and the prospect of the global economic cycle turning for the better. Both developments were especially welcome for global property, previously among the sectors worst-affected by the credit crisis. The EPRA/NAREIT Global ex-Australia Index hedged into \$A consequently did better than world shares as a whole, up 29.0 percent over the past quarter. Even after this rally, though, the sector was still down some 48.0 percent on a year ago.

Australian & International Property – Outlook

The Australian listed property sector's relative weakness reflects ongoing structural problems. The sector has essentially been reduced to Westfield; a small number of survivors which have managed to recapitalise with new equity (including both GPT and Stockland in recent weeks), but at discounts to pre-existing share prices; and a long tail of zombie companies with little

realistic prospect of refinancing or recapitalisation. Until the outstanding problems are dealt with, investors are likely to remain wary of the sector. Many of the same issues also apply to overseas property trusts. The economic outlook, financing costs, and equity availability are improving as the credit crisis eases. But the same challenges of dilution of existing equity and still-high finance costs remain. There's also the likelihood that banks will move to clear up lending to the terminal property companies, which will increase supply onto a weak market. The worst may be past, but the global property sector is still a long way from re-emerging as a healthy asset class.

Australian Equities - Review

Local shares have once again followed the lead given by overseas markets, which have been rising on expectations of an endgame to the credit crisis and the global recession bottoming out. The S&P/ASX200 Accumulation Index was up 10.70 percent for the quarter, although has been quieter in recent weeks (up only 1.10 percent for the past month). Increased confidence about the financial sector can be seen in the performance of the local banks, up 19.20 percent for the quarter, and the wider financial sector was up 14.10 percent. Resources shares have also done well, the S&P/ASX200 Resources Index up 13.0 percent for the quarter.

Australian Equities - Outlook

Australia is going through the sort of slowdown occurring in other developed economies, although not to the same extent as the United Kingdom, the Eurozone, or (especially) Japan. Treasury forecasts from the recent Budget are now picking growth to fall 0.50 percent for the year to June 2010, followed by a modest 2.25 percent recovery the following year (though unemployment will continue to rise to 8.50 percent in the June 2010 year). This would not be a bad outcome by international standards, and reflects both vigorously expansionary fiscal and monetary policies and comparatively modest exposure to the worst of the credit crisis. Australia's banks, for example, came through in better shape than their counterparts in the UK or the US. This creates a reasonable macroeconomic backdrop for local shares to perform, although prices have already run up quite fast in anticipation of better times, and could easily plateau, waiting for confirmation that the cycle has indeed turned.

International Equities - Review

World shares continued their recovery from their low on 9 March: the MSCI World Index was up 16.50 percent for the past quarter in overseas currency terms (and up 32.0 percent from its low point). This result was curtailed for local investors (up only 1.50 percent) because of the strength in the \$A. The rises were widespread: the S&P500 Index of US shares was up 16.60 percent over the past three months, Europe up 14.30 percent, the FTSE100 in the UK up 15.30 percent, and Japan's Nikkei Index up 22.90 percent. The emerging markets were the strongest of all, the MSCI Emerging Markets Index producing a 31.10 percent advance over the past quarter. There was an especially large rise in Russia, where shares rose by as much as 71.30 percent (on the FTSE Russia Index), although this was off a previously devastated

base. Higher confidence that the global financial crisis was nearer an end inspired large rises in financial sector shares, the Datastream index of world bank shares up 49.30 percent.

International Equities - Outlook

Just as fixed interest and currency markets have been affected by a growing confidence (or at least hope) that the global financial crisis is coming nearer its end, world sharemarkets have also taken heart from the improved financial sector outlook. As an example, one of the measures frequently used to indicate the degree of sharemarket investor worry, the VIX index of US market volatility, dropped significantly in April and May. It's still on the high side by historical standards, however, suggesting that while investors are less worried than they were, there are still uncertainties in the final twists and turns of the saga. It's also encouraging that the extra margins banks have had to pay for funding compared to what the US government pays have been falling sharply, reflecting significantly less worry about the banks' standing. Investors have also been cheered by signs that the US recession in particular appears to be bottoming out. After many months of revising down their forecasts, economists are now more convinced that the current June quarter marks the low point for the US economy, and that growth will resume in the September quarter and continue to pick up from there. Similarly, there are stronger expectations that the Eurozone saw the worst in the March quarter (when GDP fell by 2.50 percent), business confidence indicators having subsequently improved. World sharemarkets have run pretty hard in anticipation of the economic turning point, and it would not be surprising if they trod water for a while until the expected recovery becomes clearer, but the worst looks past for world sharemarkets.

Performance periods refer to the month and three months to 20 May 2009.

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