



Outlook for Investment Markets

Economic and financial news has generally been on the better side of expectations, with shares and listed property the key beneficiaries. Reduced investor anxiety has also led to a major rally in corporate bond prices. As a result, 'safe haven' assets such as government bonds have been less in demand. The major investment question now is whether markets have overshot the outlook for better times ahead.

Australian Cash & Fixed Interest – Review

Interest rates rose over the past quarter. Ninety-day bank bills moved up slightly by 0.15 percent to 3.30 percent. Bond yields moved appreciably higher, the 10-year Commonwealth bond rising in yield from 4.90 to 5.50 percent. Wholesale borrowing rates also rose markedly, the three-year swap rate rising by just over one percent to 5.20 percent. The \$A was strong: at 82.1 US cents, it was up 8.50 percent against the \$US for the quarter and up six percent in overall trade-weighted value.

Australian Cash & Fixed Interest – Outlook

The minutes of the Reserve Bank of Australia's August meeting said that the Bank "had [previously] left open the possibility of further reductions in the cash rate should further downside risks to the economy emerge. It now appeared unlikely this would be necessary". While the Bank noted that it was still not clear how much of the recent better than- expected performance of the economy was permanent or temporary (people spending the government fiscal stimulus), either way the Bank no longer feels that it may have to cut rates again. The futures market is now pricing in an 0.50 percent increase in the 90-day bank bill rate by the end of the year, though it's equally possible that the Bank will want to wait and see how the economy is evolving rather than start raising rates again straight away. The prospect of better economic conditions ahead, and correspondingly lower investor anxieties, are likely to lead to further rises in government bond yields and wholesale credit rates, though credit spreads (what corporates pay over and above the base wholesale rate) should continue to decline. The \$A has been in demand as global investors have been prepared to take on more foreign risk and as the previous safe haven allure of the \$US has lost some attraction. The \$A could remain strong as long as investors feel more comfortable with the state of the global economy.

International Fixed Interest – Review

There were cross-currents in international fixed interest markets over the past quarter. As investors became less worried about global economic or financial meltdown, government bonds initially lost some of their 'safe haven' attractiveness, particularly in May and June: prices fell and yields rose. These improved yields appear to have generated greater buying

interest in July and August, prices rising again. For the quarter as a whole, investors in the government bonds included in the JP Morgan Index ended up all square. Increased investor confidence translated into a rather different outcome for corporate bonds, however, where there was a strong rally with prices rising sharply. The Barclays index of investment-grade US corporate bonds, for example, showed an 8.70 percent gain for the quarter, and the bonds that investors had been most worried about (subinvestment grade or 'junk') were even stronger again, the Barclays index of US low-grade debt rising 16.80 percent and the European equivalent by 13.30 percent.

International Fixed Interest – Outlook

"More of the same" is the most likely outlook for international fixed interest. Short-term interest rates should remain very low, as none of the developed countries' central banks is anywhere near the position of tightening the current supportive stance in monetary policy. Government bond yields should continue to rise: the current average yield of 2.80 percent looks too low when investor demand for safe haven assets is no longer so intense, and when new supply of bonds is likely to rise sharply because of expansionary fiscal policies. Gradually recovering investor confidence should lead to further tightening in corporate credit spreads – assuming that the global financial crisis doesn't spring any surprises.

Australian & International Property – Review

The sharemarket as a whole had a buoyant quarter, but even so the listed property sector managed to outperform it by a handsome margin, the S&P/ASX200 A-REIT Index up 25.10 percent for the period. This still leaves investors with a substantial 39.0 percent loss over the past year, but is nonetheless a major turnaround for the previously depressed sector. There was a similar outcome in the overseas listed property markets, with a 24.20 percent increase for the quarter in the EPRA/NAREIT Global ex-Australia Index hedged back into \$A. Among the underlying markets, the United Kingdom (up 33.70 percent in sterling terms) and Japan (up 31.20 percent in yen) led the way, with smaller but still worthwhile gains in North America (+18.0 percent in \$US) and Europe (+18.0 percent in euro terms).

Australian & International Property – Outlook

Headline results from the property trusts continue to look alarming – Dexus Property Group, for example, has just posted an A\$1.46 billion loss for the 2008/09 year, due to an A\$1.60 billion hit to property valuations. Even though the economic outlook is brightening, there will be a lag before it starts to improve the operating results of the property companies. And rising longer-term interest rates will feed adversely into the formulae for valuing properties, leading to further writedowns. All that said, the tide has turned for the sector, asset sales and equity raisings having improved balance sheets to the point where some of the trusts which survived the credit crunch are now in a position to consider buying more assets. With the recession closer to its end, investor sentiment less panicked, and the running yield attractive even after distribution cuts, the outlook for the sector is appreciably better than it was. The ongoing easing in the global credit crisis and cautiously improving economic outlook have also improved the prospects for the global property sector. There's still a long way to go – US REITs alone have US\$152.0 billion of debt maturing between now and 2013 that will require

refinancing in still problematic debt markets, and lower-quality more indebted names will struggle to survive – but overall the fundamentals for global property are gradually on the mend.

Australian Equities – Review

The local sharemarket had an excellent quarter to 19 August, the S&P/ASX200 Accumulation Index up 14.60 percent. The Industrials were especially strong, with a gain of 17.10 percent, while the Resources were up 8.90 percent. Increased confidence that the worst of the global financial crisis is over, and that Australia's banks had weathered the storm better than most, was reflected in further strong rises in bank shares (up 22.30 percent for the quarter) and in financials generally (+19.30 percent).

Australian Equities – Outlook

The Australian sharemarket has benefitted from a happy confluence of improved domestic economic activity, better-than-expected growth in export markets in Asia, and a relatively robust financial sector compared to other developed economies. Any number of statistics and surveys have pointed to a better economic outcome than had been feared. Perhaps the clearest was the National Australia Bank business opinion survey for July, which showed a positive reading on business conditions for the first time in 18 months. The bottoming out of the Westpac/Melbourne Institute leading indicators survey was also strongly suggestive of a turning point for the better. Forecasters are now revising their estimates of how bad the slowdown was (not as deep or as long as anticipated, with GDP in calendar 2009 now expected to be down by a marginal -0.10 percent), and raising their outlook for next year (the consensus forecast is +1.50 percent). As with overseas markets, the local sharemarket may have got carried away too far too quickly on this taste of better times ahead, and there are residual questionmarks about domestic consumer spending and the global economy, but the fundamental backdrop for local shares remains supportive.

International Equities – Review

It was a good quarter for world sharemarkets, which continued to build on the earlier recovery that had set in from the low point in March. July was an especially strong month, though more recently shares have come back a little. Overall, the MSCI World Index was up 10.0 percent in overseas currency terms over the past quarter. These gains will not show up in local investors' portfolios to the same extent, however, because the strength of the \$A largely clawed back the rise in overseas share prices. Local investors therefore recorded only a small 2.10 percent gain in \$A terms for the quarter.

International Equities – Outlook

The rally in world shares has reflected a steadily improving economic outlook. In the key US economy, a majority of forecasters now believe that the recession either ended in the June quarter or will end this September quarter. The Wall Street Journal consensus forecast is for steady growth in the two to three percent range out to mid-2010. In Japan, the world's second-

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largest economy grew (by 0.90 percent) in the June quarter, the first increase in 15 months, and there were also small GDP increases in both France and Germany. Growth in Asia has been well above expectations, and China could grow by close to 10.0 percent this year, a highly-impressive outcome given the generally weak state of its developed economy export markets. The big question for global sharemarkets is whether the recent rally has been overoptimistic, rising too far and too quickly even after justifiably factoring in the recent change for the better in the global economic and financial outlook. Risks remain around the state of consumer spending in the developed economies, and the potential (although much reduced from last year's panic) for further twists in the global financial crisis. It would not therefore be surprising if world sharemarkets go into 'wait and see' mode after the recent rally to await further confirmation of the improved outlook.

Performance periods refer to the month and three months to 19 August 2009.

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