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## Outlook for Investment Markets

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Deteriorating economic conditions and the unwinding of debt continue to cast a long shadow over the outlook for local and international shares and property. On the income side, there's the prospect of lower yields from cash as a result of further cuts to interest rates, while holding government bonds is likely to remain a useful insurance policy while uncertainties over the financial and economic outlooks remain high.

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## Australian Cash & Fixed Interest – Review

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Short-term interest rates fell over the past quarter, 90-day bank bill yields dropping 0.70 percent to 3.10 percent. This was mainly the result of further easing in monetary policy by the Reserve Bank, which cut the cash rate by 1.25 percent over the period. Longer-term interest rates rose, however. Ten-year Commonwealth bond yields were up 0.50 percent to 4.50 percent, and corporate yields rose 1.10 percent to 7.50 percent, and swap rates – the base rates for many corporate financings – also rose. The \$A was up 8.40 percent in overall value over the past quarter. This was virtually all due to a surge over the past month, when the \$A rose six cents against the \$US to just under 72 US cents, and by 7.20 percent in overall trade-weighted value. During periods of peak concern about the global credit crisis, demand for the \$US has surged, leading to corresponding selloffs in the \$A. As the past month showed, when investors feel less worried, demand for currencies like the \$A improves.

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## Australian Cash & Fixed Interest – Outlook

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The Reserve Bank noted in its latest monetary policy statement that the world economy was slowing more than previously allowed for, financial markets were showing some improvement, that Australia was faring better than many countries, and that extensive policy stimulus had been applied both overseas and at home. While the Bank said nothing explicitly about future moves, it's likely that the cash rate will be cut again. Futures market prices suggest that bank bills will bottom out around 2.75 percent in September, consistent with one or two more 25 basis point cuts. This would reduce further the yield from cash relative to other assets. Despite their relatively low yields, Commonwealth bonds remain an attractive insurance policy should improving trends in the global credit crisis prove premature. The history of the credit crisis shows that it can continue to spring unpleasant surprises. While the Australian dollar is arguably close to where it 'ought' to be on a purchasing parity basis, the outlook for the \$A remains hostage to fickle changes in global sentiment about the credit crisis and the economic slowdown.

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## International Fixed Interest – Review

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International fixed interest markets have waxed and waned on fears about the global financial crisis. Demand for 'safe haven' assets such as US Treasury bills and Treasury bonds was most intense last December. As more policy initiatives were taken, investors have not had quite the same levels of fear about the future. Yields on government bonds consequently rose over the quarter, and prices were down 1.20 percent. Investors have become more concerned about the impact of the recession on the corporate world, which has led yields on corporate debt to rise.

## International Fixed Interest – Outlook

The international fixed interest asset class has evolved into a number of sub-sectors. Government bond yields remain low. There is also the risk of greatly increased supply (and lower prices), as governments face the prospect of substantial deficits, and the need to issue debt to finance them. Even so, holding government bonds remains a useful insurance policy while uncertainties over the financial and economic outlooks remain high. Investment-grade corporate bonds are also attractive, but the third sub-sector, low-quality or 'junk' corporate debt, is not.

## Australian & International Property – Review

The Australian listed property sector hit a cyclical low point in the first half of March, and has since rebounded. The S&P/ASX200 Index of Australian Real Estate Investment Trusts (AREITs) was up 36.50 percent from its 9 March low at the time of writing. The pronounced weakness in the period up to 9 March means that the sector still lost ground over the past quarter (down 10.50 percent). International property shares followed the same pattern as international shares more generally, selling off sharply in November, recovering in December and into January, but then weakening again. The EPRA/NAREIT index of global property shares (ex-Australia, and hedged into \$A) was down four percent over the past three months. The United Kingdom was especially badly affected.

## Australian & International Property – Outlook

The outlook for domestic property remains clouded. Financing issues are still problematic, distributions have already been cut (in some cases severely), and any gradual recovery in prices is overshadowed by the emerging signs of a serious economic slowdown. The outlook for global property shares is similarly gloomy. General Growth Properties' collapse into the arms of its creditors is a further warning sign that the process of deleveraging – unwinding the massive amount of debt previously acquired – still has a long way to run, and that there will be casualties along the way.

## Australian Equities – Review

Australian shares moved into positive territory for the quarter, the S&P/ASX200 Accumulation Index up 6.40 percent. This was due entirely to a strong rally over the past six weeks from the low point on 6 March. The financial sector made a particularly strong contribution, the banks' share prices increasing by a remarkable 33.90 percent over the same period. Resource

shares also contributed to a positive outcome, the S&P/ASX200 Resources Index up 13.60 percent for the quarter.

## Australian Equities – Outlook

Australian economic indicators and corporate profit results will be disappointing in coming months. The unemployment rate rose in March to 5.70 percent. Other indicators, including the latest Westpac-Melbourne Institute leading economic index and the National Australia Bank business opinion poll show the poor state of business conditions and confidence, and give little reason for optimism about the short-term economic outlook. At some point, however, the fact that the indicators will be looking 'less bad' could well be enough to spur increased buying interest. Local shares now also have improved valuations, and comparatively attractive levels of dividend income.

## International Equities – Review

World sharemarkets hit a low point in the second week of March, having slumped in late 2008 as the financial crisis intensified, and then lurched further south earlier this year as the scale of the global recession became more evident. Greater optimism about a resolution to the financial crisis has sparked a resurgence in the prices of banking stocks, which helped fuel a broader rally. The MSCI World Index was up 11.90 percent over the past month, and in positive territory (+2.90 percent) for the past quarter. Both the Dow Jones and the S&P500 indices in the US were stronger over the past month, and European markets also advanced, although previous weakness meant that they were all ahead only slightly for the quarter as a whole. The emerging markets had an especially strong quarter, the MSCI Emerging Markets index up 17.40 percent. Two of the most heavily beaten-up emerging markets, China and Russia, were major contributors.

## International Equities – Outlook

There's still a high degree of uncertainty about the international financial and economic outlook. A key issue is the scale of the knock-on effects of the credit crisis and deleveraging, which have been much greater than expected. The credit crisis does however appear to have stabilised, and the pace of cyclical worsening may be slowing down. This does not mean that recovery is actually underway, or likely to be soon, but that the economic indicators appear to be deteriorating at a slower rate. An example is the likely evolution of the US economy, which if current forecasts are right will have contracted by five percent at an annual rate in the March quarter, but only 1.80 percent in the June quarter. "The worst is past" theme could well start to support international sharemarkets as a result, and at some point – it could still be some way down the track – international shares will begin to anticipate the eventual economic upturn. And while sharemarkets have until now more or less moved together, markets could from here be more discriminating, and countries and regions with better prospects (Asia especially) could outperform.

*Performance periods refer to the month and three months to 17 April 2009.*

Source Courtesy of Morningstar Australia

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