



Outlook for Investment Markets

While sharemarkets pulled back over the past month, increased investor confidence that the global credit crisis is drawing to a conclusion is refocusing attention on anticipated financial and economic recovery. Local and global share prices will be driven increasingly by improving profits and the anticipation of better times ahead, although the need to reduce debt and recapitalise will continue to weigh on property stock values for some time.

Australian Cash & Fixed Interest – Review

Ninety-day bank bill yields were essentially unchanged over the past three months, yielding just over 3.10 percent, reflecting the unchanged stance of monetary policy. (The last movement was the 0.25 percent cut in April.) Bond yields have been more volatile, in line with shifting investor sentiment. Ten-year Commonwealth bond yields had reached around 5.80 percent by mid-June as demand for safe haven assets fell. Over the past month, government bonds have been in greater demand as sharemarkets have weakened, so the 10-year yield has dropped back to 5.30 percent. The \$A was strong for much of the past quarter to mid-July, trading at over 80 US cents in late May and early June, but has given ground in recent weeks, and was 77 cents at the time of writing. Even after this recent drop the \$A was up 8.30 percent against the \$US for the quarter, and up 5.80 percent in overall trade-weighted value.

Australian Cash & Fixed Interest – Outlook

The Reserve Bank is unlikely to make any near-term changes to interest rates, having given itself another lever to pull, but having shown signs of wanting to keep it in reserve. Although credit market conditions have improved, there are still reasons to expect longer-term interest rates to remain relatively high. These include the banking system's structural dependence on scarce overseas funding, and the apparent reluctance of retail investors to commit to long maturities. Global and local economic recovery could also put upward pressure on longer-term interest rates. Commonwealth bond yields remain low relative to returns from good-quality corporate debt. The longer-term risks to prices are also highest for government bonds, because of the global flood of issuance to fund expansionary fiscal policies. The \$A tends to rise when global investors are less risk-averse, and sell off when they're more anxious. The \$A could strengthen over the medium term if investors consider Australia the beneficiary of ongoing growth in the Asia-Pacific region.

International Fixed Interest – Review

Shifting investor confidence in recent months is reflected in world bond market movements. Higher government bond yields in May and June were outcomes of diminished investor anxiety. The US 10-year Treasury yield rose from around 2.60 to 3.80 percent from April to

June, and the UK, Eurozone, and Japanese government bond markets showed similar patterns. More recently investors have become less confident, and government yields have fallen again as demand for them has increased. The JP Morgan index of government bonds ended the three months to mid-July down slightly in price (- 0.20 percent) and correspondingly slightly higher in yield (the average yield is 2.80 percent, held down in particular by ultra-low Japanese yields, where the 10-year yield is one percent). Increased investor confidence about an ending to the global financial crisis – even if more challenged in recent weeks – has led to lower corporate borrowing costs. In April, low credit quality borrowers in the US were paying 16.0 percent for their debt. This has dropped to 12.60 percent over the past three months.

International Fixed Interest – Outlook

The outlook for global government bonds is not encouraging, following an enormous expansion in supply and the movement in the global economy from recession to recovery. Barring some left-field accident that could lead to another investor flight, government bond prices have little opportunity to rally and considerable room to fall. Among corporate bonds, there has been a major rally in credit spreads and an improvement in companies' ability to issue new debt. The progressive movement in the global economy from a depressed environment to one with improving growth prospects is not a favourable backdrop for international fixed interest.

Australian & International Property – Review

The Australian real estate investment trust sector recorded gains in late May and early June, but gave ground more recently. The S&P/ASX200 AREIT Index was up 3.60 percent over the three months to mid- July, but down 4.30 percent over the past month. The year-on-year figures remain painful reading, prices down 42.90 percent. Increased investor optimism about an end to the credit crisis and global recession had an especially strong effect on the global listed property sector. This was because the property stocks had been especially exposed to the refinancing risks and higher costs posed by crippled financial markets. The sector therefore rose sharply from March onwards. More recent investor jitters have had a greater effect on global property than sharemarkets generally – the EPRA/NAREIT Index of World Property ex-Australia hedged into \$A was down 8.70 percent over the past month, but was still ahead by 6.60 percent for the quarter, because of the earlier strong rises.

Australian & International Property – Outlook

The domestic listed property sector continues to be characterised by capital raisings, reductions or suspensions in dividend payments, and ongoing asset writedowns (Macquarie Infrastructure Group has written down the value of its portfolio by 28.0 percent), or sales (such as Macquarie CountryWide's disposal of 75.0 percent of its 86- property US portfolio). Investors remain wary of the convoluted structures and the embedded risks from the offshore exposures. The impact of the global recession and the need to reduce debt and recapitalise will continue to weigh on global property stock values for some time. Major property stocks continue to take hits when writing down the valuations of their properties – British Land last month announced a 40.0 percent reduction in the value of its portfolio. The Asia- Pacific

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region is attractive, with low interest rates, largely unimpaired banks, growth, and favourable demographic trends.

Australian Equities – Review

The Australian sharemarket bounced back from March through to early June, when investors began to believe that the worst downside risks to the local and world economies had been overcome. Since mid-June, though, mixed economic data has prompted investors to question whether sustained economic recovery has indeed begun. The result for the domestic sharemarket was a small 3.30 percent gain for the three months to mid-July, all attributable to the earlier recovery, as the sharemarket fell back 5.70 percent over the past month. The Industrials and Resources were both up 3.30 percent over the past three months.

Australian Equities – Outlook

Recent Australian economic data has been mixed, but has generally signalled that the economy is either approaching or already in a turning point. Indicators such as the Westpac/Melbourne Institute consumer confidence survey have for the most part been healthier, and housing market indicators have also shown improvement. The labour market is still showing signs of weakness, but the current consensus forecast for the decline in Australian growth this year is now only -0.20 percent, a very good outcome by developed economy standards. In this environment, share prices will be driven increasingly by improving profits and anticipation of better times ahead.

International Equities – Review

World sharemarkets were the beneficiaries of optimism from March to June about the outlook for global growth, but a cautious rethink has been the key recent influence. The net result for the three months to mid-July was a small gain for the MSCI World Index of 3.10 percent in overseas currency terms. The stronger \$A meant world shares were marginally lower in \$A terms, down 0.40 percent. Most major sharemarkets ended the past three months with small single-digit percentage increases. The S&P500 in the US gained 2.60 percent, the MSCI Europe 3.40 percent, and Japan's Topix 3.10 percent. Asian share prices did especially well on the strength of Chinese growth. The Shanghai Composite Index was up 27.40 percent, while Hong Kong, Singapore, and Taiwan also did very well. The underperformer was Russia, where prices fell 10.10 percent for the quarter to mid-July.

International Equities – Outlook

The outlook for world growth continues to improve. Actual hard data is still mixed. Recent US jobs numbers were worse than expected, latest retail sales figures have been weak, and the recent fall in the world oil price does not suggest any great increase thus far in the pace of economic activity. However, forward-looking surveys of consumer and business confidence are for the most part turning for the better. OECD leading indicators are suggesting an upturn not too far away, and the Wall Street Journal's July poll of US forecasters showed an expectation that US growth would resume in the September quarter, and pick up further in the

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December quarter. And China continues to power on, growing at an annual rate of about 7.90 percent in the June quarter, faster than the 6.10 percent recorded in the March quarter. This anticipation of recovery or its reality will be the key influence on world sharemarkets over the coming year.

Performance periods refer to the month and three months to 10 July 2009.

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