

June/July 2005

Outlook for investment markets

Sharemarkets have had a good month, as earlier alarm about a slowdown in the Australian and world economies was replaced by more realistic expectations for ongoing economic growth, and share prices may move modestly higher again in coming months. Bond yields have fallen to implausibly low levels, and bond prices are now even more vulnerable to a setback. Cash rates have held steady, and are likely to stay at current levels for the rest of the year.

Australian Cash & Fixed Interest – Review

Short-term interest rates have not budged over the past month or quarter, with 90-day bank bill yields remaining at 5.65 percent. Bond yields, on the other hand, have continued to fall. Ten-year Commonwealth bond yields have reached a new low at 5.07 percent, down 0.20 percent for the month and 0.50 percent for the quarter. The headline data suggests that the \$A weakened against the \$US over the past month, falling by nearly two percent to just over 76 US cents. A better description would be that the \$A has been trading sideways within a 76 – 78 cents range for over six months. In overall trade-weighted value, the \$A has gained over the past month, due to the \$A's resilience against non-\$US currencies.

Australian Cash & Fixed Interest – Outlook

The stability in short-term interest rates reflects that monetary policy settings have not changed (the Reserve Bank left rates alone at its June policy meeting), and are not expected to: the futures

market anticipates unchanged monetary policy out to the end of 2006. The Reserve Bank said when it last raised rates in March that further increases could be in store, but recent data suggesting a slowdown in housing finance, and in the economy generally, has led Bank-watchers to conclude that no further tightening will be needed.

Much of the fall in local bond yields can be attributed to the influence of overseas yields, which have fallen to levels hard to understand in terms of economic fundamentals. Although bond yields look 'too low' for Australian and world economies still growing at reasonable rates, in these odd market conditions there is no guarantee that yields will rise as one might otherwise expect.

The recent pattern for the \$A of modest decline against the \$US but overall steadiness in value may well continue. The \$US appears to be recovering on a global basis, and a lower \$A/\$US cross-rate reflects this improvement, but the \$A's overall value looks well-supported by Australia's relatively high interest rates, which should continue to attract overseas inflows.

Australian Property – Review

Listed property trust prices have been pretty volatile for a supposedly defensive sector. After sagging by some 10.0 percent between January and early May, the sector staged a vigorous recovery over the past month, the S&P/ASX property trusts index rising 7.50 percent from its cyclical low point, and up five percent over the past month alone. One long-running item of corporate activity in the sector was finally resolved during the month, with GPT severing its links with Lend Lease. After a period of substantial consolidation and mergers, the sector is also seeing some new listings – the A\$270.0 million debut of Charter Hall on 10 June, and the forthcoming A\$113.0 million float of Trafalgar.

Australian Property – Outlook

The recent recovery in listed property trust prices comes down to the lure of bargain-hunting after the sell-off earlier this year; increased overseas interest in the sector; and the fall in bond yields, which has made property yields more attractive. These issues could take prices higher again in coming months. There is some evidence, though, that investors are becoming more discriminating about the sector, favouring retail and industrial trusts over the more accident-prone generalist vehicles and those most exposed to the slowing domestic housing market. This heightened awareness of the risks from 'stapling' and overseas expansion (where relative inexperience with local conditions may cause issues) means investors may be taking a more cautious view about listed property than previously.

Australian Equities – Review

The Australian sharemarket has continued to recover from the sell-off in March and April, when weaker overseas sharemarkets and evidence of slowing local economic momentum had combined to push prices lower. Over the past month, the Australian market has risen by a strong 5.75 percent, and therefore posted a small gain for the quarter (0.20 percent). Industrial stocks (up 6.30 percent) outpaced Resources (3.40 percent).

Australian Equities – Outlook

The outlook for domestic corporate profits remains mixed. The economy has slowed: March quarter GDP growth was 0.70 percent, with the year-on-year rate only 1.90 percent, and some recent indicators have been weak (notably retail sales in April). Other data, however, has been stronger (particularly employment, with 14,000 new jobs in May), and most forecasters consequently expect only a modest cyclical slowdown. The latest *Consensus Economics* forecast is for 2.60 percent growth in calendar 2005, improving to 3.10 percent in 2006. This would translate into growth in pre-tax

profits of 7.70 percent this year, and 5.90 percent next. Equity analysts have similar views as the economic forecasters for this year, but are markedly more optimistic about 2006. These expectations for Industrials look overoptimistic, and prices may be vulnerable to earnings disappointments. Recent further rises in commodity export prices are however encouraging for Resources shares' profit prospects.

International Fixed Interest – Review

World bond yields have fallen even further over the past month. Yields on world government bonds fell below three percent by mid-May, and then continued to move lower. The decline has again been widespread. The key 10-year US Treasury yield dropped 0.18 percent to 4.04 percent (and was below 3.90 percent at one point), with Eurozone yields down 0.30 percent to 3.10 percent, and the yield on UK gilts down to 4.23 percent. Japanese 10-year government bonds shared in the trend, down 0.10 percent over the past month to just under 1.20 percent.

International Fixed Interest – Outlook

The recent behaviour of bond yields has puzzled analysts – including such eminent authorities as the chairman of the US Federal Reserve. At an IMF conference this month, Dr. Greenspan canvassed a number of potential reasons, including expectations of slower economic growth; Asian central banks' buying of US Treasury bonds; money flowing from low interest rate areas (the Eurozone, Japan), and so driving down other countries' higher yields; and a global glut of savings looking for a home. None of these reasons seemed especially convincing. While inflation in many countries remains low, justifying modest bond yields, most forecasters have concluded that yields have fallen to levels below those justified by a benign inflationary outlook, and that if current forecasts of global economic activity prove correct, yields are likely to rise.

International Equities – Review

World sharemarkets have had a good month, with the MSCI World Index up 3.10 percent. Translated in \$A terms, the increase was slightly lower at 2.70 percent, because of the \$A's modest appreciation over the past month. The pattern of recovery from the sharemarket sell-offs of March and April has varied quite widely. All the major US indices are showing gains for the month (led by the NASDAQ's 5.10 percent rise). European shares were up overall, though German companies were weaker. Japan was also up slightly, while other Asian markets were mixed (Hong Kong and Taiwan down, Singapore and Korea up).

International Equities – Outlook

Some good news has supported recent advances, notably Dr. Greenspan's remarks about US economic growth, and more optimistic assessments of the outlook for Japan. Equally, though, there are cross-currents: increased acceptance that oil prices will remain high; a strong likelihood that US interest rates will continue to rise; and deterioration in the near-term outlook for some European economies (notably France, where already-high unemployment was an important issue in the recent European referendum). Overall, while the latest month's advance in prices is good news, there are also sound reasons to expect only modest progress in coming months.

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