Market Update & Outlook

January 2011

- US outlook remains unchanged as interest rates stay low
- Authorities target rising food prices in China
- Aussie dollar reaches new closing high against USD

What's inside?

The pulse

→ **Australian Cash rate** steady at 4.75%

↑ **AUD/USD** 6.4 US cents to 1.02 US dollar

→ **US Federal Funds rate** maintained at between 0% and 0.25%

Top 10 considerations for 2011

Robert Henderson – Chief Economist, Markets

Given the fairly positive outlook for global growth in 2011, we feel now is an opportune time to think about some of the key issues facing Australian and global economies this year. Robert Henderson, Chief Economist, Markets with NAB, shares his thoughts.

NAB's outlook for 2011 sees the economy growing by around 4% over the year to the December quarter 2011.

Underpinning this strong growth outlook is a forecasted increase of 18% in business investment during 2011. This considerably offsets the 1% fall in Government spending and by far outperforms soft growth in private consumption of 3%.

Higher interest rates will still be needed from the Reserve Bank of Australia (RBA) and we are expecting another 0.5% rise in the cash rate to 5.25% by September 2011. That said, the timing of the first hike of the year is now looking uncertain in light of the Queensland flooding.

For the Australian dollar, we see limited upside from the above parity highs we saw late in 2010. We expect the peak to be at 1.0500 against the US dollar with some tailing off this peak back into the high 90 US cents range in late 2011 and into 2012.

Now, as we move into 2011 with this outlook in mind, we briefly outline the Top 10 considerations which are likely to have a bearing on the economy and markets over the year ahead.

1. High household savings ratio

The high rate of household savings over the past few quarters contributed to the pronounced slowdown of retail and housing demand in 2010. If the household savings ratio starts to decline during 2011, the RBA will need to raise rates further to keep inflation in check.

2. Productivity growth

This issue has evaded the media spotlight but is an important issue for Australia. The latest national accounts showed productivity grew at an annual trend rate of 1.1% over the year to the September 2010 quarter. This is down on the average rate since 1990 of around 2.25%, and off a peak of nearly 3.5% at the end of the 1990s.

Why is this important?

If we don't achieve better productivity per hour over the years ahead, Australia will effectively be wasting some of the potential benefits from the resources boom.

3. Infrastructure

The infrastructure enhancement work that began during the global financial crisis seems to have gone missing. In particular, it seems not enough emphasis is placed on ranking projects in terms of how they positively enhance productivity growth.

Some might argue that, with the economy now quite strong, the time for infrastructure spending has passed. Nevertheless, productivity enhancing infrastructure programs need to be undertaken before waiting until the next downturn.

4. Fiscal policy

Fiscal policy needs to be tightened more rapidly than what is currently occurring.

If the Government is worried about the multi-speed economy, tightening fiscal policy could help. This is because it would take some of the pressure off the Reserve Bank to lift interest rates and would also help to keep the exchange rate from appreciating further. Both of these factors are contributing to the woes of the 'low speed' sectors of the economy.

5. The high value of the Australian dollar

In our view the Australian dollar is not overvalued. Its rise over the past year has been a reflection of rises in the underlying fundamentals which determine the value of the currency.

When looking at the three fundamental drivers of the currency: commodity prices; investors' appetite for risk and interest rate differentials, the rise in the currency has been completely consistent with the rise in the fundamentals.

6. The multi-speed economy

The resources boom, with the associated high terms of trade and the strong performance of the mining sector, has given rise to what the media calls a 'two speed economy'. The more appropriate term however is a multi-speed economy.

There are many reasons for the different performance of various sectors. However there is no doubt the higher currency, higher interest rates, the rise in the household savings ratio and the end of the fiscal stimulus have all played a part.

7. House prices

The International Monetary Fund (IMF) recently released a paper that says house prices in Australia are 5 – 10% overvalued. This is less than their earlier view of around 17.5%.

The IMF does not conclude that Australian house prices will fall by that much. Rather, it says if there is a correction it is likely to be "orderly". It also says sustainable levels of house prices can be achieved if incomes and rents rise faster than house prices.

At NAB, we are forecasting modest growth in house prices ahead in the range of 5-8%, over the coming year. This is partly because of the underlying growth in demand for housing, due to rapid population growth, although this has slowed down of late.

8. Sovereign debt issues

2010 was plagued by sovereign debt concerns in Europe. Fears about the sustainability of the fiscal positions of several smaller countries in the Eurozone saw the cost of borrowing rapidly rise for affected Governments. The most spectacular was Greece but Ireland followed and Spain and Portugal have been mentioned in this context many times.

These Governments have been more or less forced by the markets to undertake severe Budget restraint, which will slow their economies for years ahead.

As an issue, sovereign debt is likely to resurface over 2011 and perhaps for more than a decade ahead. However the €750bn rescue plan should ensure the issue does not boil over into a full blown crisis.

For Australia, the main way the sovereign debt issue could come home to roost is through the cost of bank funds. Only about 4% of Australia's exports go to continental Europe so weak growth there matters little for Australia.

9. China tightens too far and/or is a bubble waiting to burst

Every time China tightened monetary policy in 2010 there was a cry from the media that China's economy was about to go bust.

The truth is China's economy recovered strongly, mainly due to the largest fiscal stimulus anywhere in the world. As the economy hit a +10% growth rate, the authorities moved to slow it down, to prevent 'overheating'. India also had a similar experience.

Our view is that the slowing in China's growth, to a more sustainable pace, is good news for Australia and there is no evidence that the authorities are prone to make policy mistakes.

And lastly;

10. Is a US recovery on the cards?

Many commentators say the Fed's latest round of quantitative easing (QE2); printing money to buy US$600bn of US Treasury bonds won't work. But it already has - the rise in the sharemarket, which anticipated the decision to implement QE2, is now showing up in stronger retail sales.

The fall in the US dollar also helped the trade accounts. After the latest US trade release, which was much better than the market expected, economists were scrambling to add 0.25% – 0.5% to their US GDP forecasts.

Market Update & Outlook

January 2011

Global economies

Following its meeting in early December, the US Federal Reserve Bank (Fed) kept its funds rate steady at between 0% – 0.25% and maintained it would keep it steady for the foreseeable future.

The overall outlook for the US economy has remained unchanged, with the muted recovery having little impact on the elevated unemployment rate.

That said, the initial jobless claims for the week ended 17 December 2010 came in a touch lower.

A reflection of this can be seen in the National Federation of Independent Businesses' (NFIB) Small Business Optimism Index which rose in November and is at its highest level since December 2007. The small business sector is seen as a cornerstone of employment, so this is an encouraging result.

Retail sales over November were also above expectations and October sales estimates were revised up. This means we should see some increase in expected consumer spending growth for the December quarter of 2010, when figures become available.

Across the Atlantic, Europe continued to struggle through December, with the debt crisis taking centre stage. Despite this, the recent credit ratings downgrades didn't have an overly negative effect on markets, though there was some decline in smaller European equity markets and major stocks both in Europe and the US.

Closer to home, in the Asia pacific region, China's National Development Reform Commission disclosed its growth, inflation and lending targets for 2011.

The growth target was left unchanged from this year's 8%, while the Consumer Price Index (a measure of inflation) is targeted at 4% for 2011, which is up from 2010. Bank lending has been retained at the same level as 2010's 7.5 trillion Yuan.

The authorities expect inflation to continue to rise into the first half of 2011, peaking around mid-year. Their recent inflation report showed a rise to 5.1%, which was above forecasts of 4.7%, and mainly driven by food prices.

Meanwhile China's November growth data continued to look good, as authorities exercised further tightening by increasing the Banks' Reserve Requirement by 0.5% to 18.5%. This was seen as a positive move and a more targeted measure to control the surge in food inflation instead of just lifting rates.

Big movers this month

Going up – Materials +6.8%

Going down – Telcos -0.7%

December market performance

Equity Markets – Price Indices	Index	At Close 31/12/10	% Change 1 Month	% Change 12 Months
Australia	All Ordinaries	4846.88	3.64	-0.73
Japan	Nikkei	10228.92	2.94	-3.01
Hong Kong	Hang Seng	23035.45	0.12	5.32
UK	FTSE 100	5899.94	6.72	9.00
Germany	DAX	6914.19	3.37	16.06
US	Dow Jones	11577.51	5.19	11.02
EMU*	Euro 100	2325.99	4.82	4.13
World**	MSCI - Ex Aus (Gross)	899.06	5.64	8.33
Property – Price Index	**Index**	**At Close 31/12/10**	**% Change 1 Month**	**% Change 12 Months**
Listed Trusts	ASX A-REITS	828.68	-0.26	-6.66
Interest Rates		**% At Close 31/12/10**	**% At Close 30/11/10**	**% At Close 31/12/09**
Aust 90 day Bank Bills		5.03	5.04	4.28
Australian 10 year Bonds		5.51	5.41	5.73
US 90 day T Bill		0.12	0.16	0.06
US 10 year Bonds		3.29	2.80	3.83
Currency		**At Close 31/12/10**	**% Change 1 Month**	**% Change 12 Months**
US dollar	A$/US$	1.02	6.67	14.03
British pound	A$/STG	0.66	6.34	17.98
Euro	A$/euro	0.76	3.49	22.07
Japanese yen	A$/yen	83.04	3.50	-0.48
Trade-weighted Index		75.80	3.84	8.75

* Top 100 European stocks trading on the FTSE ** Price Index – Source: www.msci.com
Source: Iress Market Technology
Past performance is not a reliable indicator of future performance.

Market Update & Outlook
January 2011

Equity markets

Typical of December, the final two weeks of trade across global stock markets were marked by small volume and little direction so the focus is primarily on the first two weeks of trade before the festive season.

Over this period, sharemarkets remained mildly positive. The VIX index, measuring the volatility in US equities, fell to its lowest level since before the Lehman Brothers collapse. This is a clear sign investors' appetite for risk is back to levels seen before the global financial crisis.

The big market mover was the rise in US longer dated bond yields. The key driver of the rise in long dated bond yields was a string of better than expected US data. That, coupled with Obama's tax cuts pledge and the Fed re-affirming it was proceeding with its US$600bn of additional quantitative easing (printing money to buy US Government bonds), fuelled optimism that the economic recovery could gather pace in early 2011.

For Australia, an acceleration of growth in the United States in 2011 is good news, as this will help generate a positive growth outlook for the global economy.

Australian equities

	Index/Benchmark (% pa)	1 Yr	3 Yrs	5 Yrs	7 Yrs
Australian	S&P/ASX 300 Acc.	1.90	-5.04	4.38	9.94
	S&P/ASX 50 Acc.	0.44	-4.22	4.62	9.89
	S&P/ASX Small Ordinaries Acc.	13.05	-5.89	5.54	10.27

In Australia, the S&P/ASX 300 Accumulation Index finished strong over December, up 3.77%, following disappointing returns at the tail end of November.

Once again, small cap stocks outperformed their large-cap counterparts with the S&P/ASX Small Ordinaries Accumulation Index delivering a 7.07% increase in December.

Sector	1 Mth %	3 Mths %	1 Yr %
Energy	4.6	8.0	2.3
Materials	6.8	13.9	13.9
Industrial	2.3	2.2	-2.7
Consumer Discretionary	0.5	-2.0	-5.4
Consumer Staples	0.8	-4.7	2.9
Health Care	3.3	8.8	5.1
Financials	3.5	1.0	-4.5
Info Tech	5.4	6.5	-4.7
Telcos	-0.7	6.3	-10.5
Utilities	2.0	0.0	6.9
Property	1.2	-1.2	-0.7

Global equities

	Index/Benchmark (% pa)	1 Yr	3 Yrs	5 Yrs	7 Yrs
Global	MSCI World Ex Aus Acc. ($A)	-2.04	-9.82	-4.45	0.32
	MSCI World Index Hedged ($A)	10.38	-6.58	-0.34	3.84
	MSCI World Small Cap ($A)	10.66	-3.27	-2.24	4.04
Emerging	MSCI Emerging Mkts Free	4.30	-5.34	5.48	12.33
	MSCI AC Far East Free (ex Japan)	4.80	-5.12	5.12	9.39

Benefiting from a strong Australian dollar, hedged international shares outperformed their unhedged counterparts over December.

The MSCI World (ex-Australia) Index was up a mere 0.32% compared to the MSCI World Index Hedged which gained 5.68%.

Elsewhere around the world markets were mixed. Emerging Asia shares fell in December with the MSCI Far-East Asia (ex-Japan) Index falling -1.51%. Despite falls in emerging Asia, emerging Europe and South America performed well over December, offsetting falls in Asia. The MSCI Emerging Markets Index finished modestly higher by 0.24%.

Similar to Australia, global small-caps were again a stand out performer, with the return of the MSCI World Small Cap Index at 2.34%.

Property

	Index/Benchmark (% pa)	1Yr	3 Yrs	5 Yrs	7 Yrs
Australian	S&P/ASX 300 A-REIT Acc	-0.68	-21.36	-9.79	-1.65
Global	UBS Global Investors Index	7.26	-9.17	-5.37	N/A

Listed property was mixed throughout the month with Australian property delivering a much needed gain of 1.2%. Global property was not able to match the positive returns of Australia with the UBS Global Investors Trust Index finishing relatively flat, down 0.02%.

Fixed interest

	Index/Benchmark (% pa)	1 Yr	3 Yrs	5 Yrs	7 Yrs
Australian	UBS Composite 0 + Years	6.04	7.43	5.76	5.94
	Australian 90 Day Bank Bill	4.68	5.02	5.54	5.55
Global	BarCap Global Agregate Index	-7.40	0.43	-1.08	1.62
	BarCap Global Ag,. Index Hedged	9.28	8.84	7.70	7.31

Fixed interest returns were mixed over December. The Barcalys Capital (BarCap) Global Aggregate Trust Index was impacted by a strong Australian dollar and finished down a hefty 5.22%. In hedged terms the index was relatively flat with a fall of only 0.02%.

Australian dollar (AUD)

The AUD/USD rallied in December, from 95.92 US cents up to an intra-day high of 1.0231 USD and a new closing high of 1.0253 USD on 31 December.

Supporting this was China's growth and interest rate differentials which are tipped to continue throughout 2011. However, the Queensland flooding and reduced prospect of a mid-year interest rate rise has led to a slight sell-off of the AUD through January.