AMP Capital Investors Limited
ABN 59 001 777 591, AFSL 232497

Investment Strategy & Economics

AMP CAPITAL

Weekly market & economic update

By Dr Shane Oliver, Head of Investment Strategy & Chief Economist

WEEK ENDING 20 JANUARY 2012

Data/Event	Units*	Movement		Trend
		LATEST	PREVIOUS	
China – Real gross domestic product, December	yoy	+8.9%	+9.1	⇓
Australia – New motor vehicle sales, December	mom	-2.9%	-0.7%	⇓
US – Consumer price index, December	mom	0.0%	0.0%	⇔
Australia – Unemployment rate, December	-	5.2%	5.3%	⇑
US – Existing home sales, December	actual	4.61 million	4.42 million	⇑

Financial markets

Indicator	Friday, 20 January 2012	Friday, 13 January 2012	Weekly change	20 January 2011	12-month change
S&P/ASX 200 Index	4,240	4,196	+1.0%	4,784	-11.4%
S&P/ASX 200 Property Trusts	816	831	-1.8%	855	-4.6%
US S&P 500	1,315	1,289	+2.0%	1,280	+2.7%
Dow Jones Eurostoxx	238	229	+4.0%	284	-16.1%
UK FTSE 100	5,729	5,637	+1.6%	5,868	-2.4%
Japan TOPIX	756	735	+2.8%	927	-18.5%
CITIC/S&P 300 China A	2,101	2,012	+4.4%	2,654	-20.8%
MSCI World (ex-Aust/in LC)	871	851	+2.3%	919	-5.3%
Aust 90-day bank bill yield	4.38%	4.41%	-3 bps	4.93%	-55 bps
Aust 10-year bond yield	3.82%	3.84%	-2 bps	5.65%	-183 bps
US 10-year bond yield	2.02%	1.86%	+16 bps	3.45%	-143 bps
Oil – West Texas Crude	98.46	98.70	-0.2%	88.86	+10.8%
A$ in US cents	1.0484	1.0322	+1.6%	0.9871	+6.2%
TWI	76.9	76.7	+0.3%	74.3	+3.5%

Major upcoming global economic releases and events

Date	Data/Event	*Units	Previous	Forecast
24 January	Eurozone – PMI manufacturing, January	index	46.9	47.4
25 January	US – FOMC rate decision, January	-	0.25%	0.25%
25 January	Australia – Consumer price index, December quarter	yoy	+3.5%	+3.4%
26 January	Korea – Gross domestic product, December quarter	qoq	+0.8%	+0.5%
26 January	Japan – Consumer price index, December	yoy	-0.5%	-0.2%

*Month-on-month (mom); quarter-on-quarter (qoq); year-on-year (yoy); seasonally adjusted annual rate (saar)

Headline developments of the past week

> **Despite ratings downgrades across the Eurozone, a sharp downgrade to the World Bank's 2012 global growth forecast (from 3.6% to 2.5%) and news that the International Monetary Fund (IMF) is seeking to increase its lending capacity by US$500 billion, global share markets and other related trades continued to rally over the last week**. It's not that investors and the markets have their heads in the sand but rather that the ratings downgrades and the news from the World Bank and IMF have already been factored in and tell us nothing new. In the meantime Eurozone bond auctions have gone reasonably well and global economic data releases have been reasonably favourable.

> The ratings downgrades have been well flagged since early December, the downwards revisions to the World Bank's growth forecasts just sees them catch up to private sector growth expectations and its been well known over the last few months that the IMF was looking at increasing its emergency lending capacity.

> On the World Bank's comments about the risk of a deeper downturn than that of the global financial crisis there is no doubt that the risk is there, but it was most intense three months ago. Since then moves by the European Central Bank (ECB) and other central banks to provide cheap access to funding for banks have reduced the tail risk of a meltdown in global financial markets. So while these comments provide a reminder that Europe is still a big risk, they are a bit dated.

> It's doubtful the IMF will get the full amount of its extra funding, with both the UK and the US looking unlikely contributors - they think the ECB should do more - so more pressure is likely on emerging countries to chip in.

Major global economic releases and implications

> **US data releases over the last week remained positive**. Manufacturing conditions indicators for the New York and Philadelphia regions showed further improvement in January and industrial production rose solidly in December. Evidence of a stabilisation and possible improvement in the housing sector continues to build with housing starts and permits continuing to trace out a sideways to slightly up trend and good gains in home builder conditions, home sales and mortgage applications. Initial jobless claims fell to their lowest level since June 2008 indicating that the jobs market is continuing to improve. Finally, inflation remained benign in December. The pick up in the US appears to be continuing into the New Year. Is the US undergoing a renaissance with General Motors the world's number one car seller again and Honda choosing to build a 'supercar' plant in Ohio rather than in Japan?

> **US December quarter earnings results have been off to a mixed start, but have improved**. So far 60% of results have come in better than expected which compares to 70% or more at the same point in the past ten reporting periods. However, the 60% compares to just 47% a few days ago so the trend appears to be improving with good results from tech stocks (albeit Google missed). Consensus expectations are for 10% earnings growth.

> **Similarly in Europe economic data was generally better than expected** with a solid rise in a ZEW measure of economic sentiment, a rise in construction activity and a smaller than expected rise in inflation in December.

> **Chinese economic data was also encouraging** with gross domestic product (GDP) growth for the year to the December quarter slowing to 8.9%, which is stronger than expected. Growth in industrial production and retail sales also came in stronger than expected and the HSBC flash manufacturing conditions index improved marginally in January. There is still no sign of a hard landing in China and with economic growth, inflation and the property market cooling down there is likely to be further policy easing in the months ahead.

> In Japan, consumer confidence and machine orders recorded better-than-expected gains.

Australian economic releases and implications

> **Australian economic data was mostly disappointing**. While housing finance rose in November, maintaining a slight uptrend over the last year, it is yet to show much evidence of a solid recovery from the falls of 2010. Moreover, consumer confidence failed to recover much from a sharp fall in December, motor vehicle sales fell in December and the December labour market report highlighted very soft employment conditions. In fact, through 2011 there was no jobs growth. The only reason unemployment hasn't increased more sharply is because labour force participation has declined. To be fair part of the softness in employment in 2011 is payback for the record 366,000 new jobs of 2010. But it also reflects much softer economic conditions and with further falls in job ads and more talk of job layoffs, particularly in the finance sector, a further rise in unemployment is likely in the months ahead, possibly pushing the unemployment rate up to around 6% by year-end. Finally, the terms of trade fell in the December quarter as export prices fell and a weaker Australian dollar (A$) boosted import prices. **All of this combined with the TD Securities inflation gauge suggesting that inflation remains benign, supports the case for more rate cuts from the Reserve Bank of Australia, with the next cut likely to occur at next month's meeting**.

Major market moves

- > **Global share markets continued to push higher over the last week** helped by favourable economic data, solid earnings results in the US and solid debt auctions in Europe. Australian shares followed suit but lagged somewhat due to weaker-than-expected Australian economic data.
- > **Commodity prices rose** on improving confidence regarding global growth. Improving investor confidence also pushed up the euro and the A$.
- > Bond yields rose in the US, UK and Germany on improved investor sentiment, but Italian and Spanish yields fell.

What to watch over the week ahead?

- > **In the US, the Federal Reserve is expected to make no changes to monetary policy when it meets on Wednesday but it will start to publish its view on appropriate levels for the Fed Funds rate out to 2014**. These are expected to show no change in the Fed Funds rate for the next two years which may have the effect of keeping long-term bond yields down in the US. The post meeting press conference will also be watched closely to judge how likely another round of quantitative easing is in the US. On the data front, durable goods orders for December (due Thursday) are likely to show solid growth, new home sales (also Thursday) are expected to show modest growth and December quarter GDP due Friday is expected to show solid annualised growth of 3%. Data for house prices and consumer sentiment will also be released. President Obama's State of the Union address on Tuesday is unlikely to contain anything substantive but a risk is that it may see more populist proposals for a tax on large financial institutions.
- > **In Europe, a finance minister's summit on 23 January and a leaders' summit on 29 January will be watched for progress towards the fiscal compact** that was agreed back in December. January manufacturing conditions indicators (PMIs) (Monday) are expected to improve slightly from bleak December readings.
- > In Asia, Korean December quarter GDP data (Thursday) is expected to show a 0.5% gain and Japanese inflation data (Friday) is likely to show ongoing deflation.
- > **In Australia, the main focus will be on December quarter inflation data due Wednesday**. We expect headline inflation of 0.3% in the quarter or 3.4% year-on-year (yoy), but underlying inflation of just 2.4% yoy. This should prove to be no barrier to another interest rate cut next month. The risk is on the downside for headline inflation thanks to a plunge in banana prices.

Outlook for markets

- > **After strong gains so far this year shares are getting a bit overbought and vulnerable to a correction. What's more Europe is likely to remain a source of volatility, with, for example, ongoing issues regarding Greece's debt restructuring. However, the broader picture for shares is looking more favourable**: valuations are attractive particularly against very low bond yields, the risk of a meltdown in Europe has receded, the global recovery looks like it will continue (albeit at a slower pace than seen in 2010 and 2011), monetary conditions are easing and there is lots of cash on the sidelines. We expect a good year for shares overall.
- > The last two years have seen the Australian share market lag global shares due to a combination of worries about Chinese policy tightening, relatively tight monetary conditions in Australia and the strong A$. Going forward we expect to see relief in terms of the first two which should see the relative performance of Australian shares start to improve. We continue to see the ASX 200 pushing up to 4800 by year-end.
- > **Global bond yields are very low in core countries** suggesting low returns unless Europe's debt crisis intensifies. Australian government bonds are relatively more appealing with higher yields. Australian corporate debt is an even better investment proposition if one needs income or is worried about shares.
- > **The A$ is likely to see its usual large price swings this year but generally remain solid**. Australia is one of the very few countries with a stable AAA rating and so is partly perceived as a 'safe haven'.