

Australian economy

The Australian economy over the last 12 months proved more resilient than many first thought at the start of 2009. The resilience of the Australian economy relative to other large developed economies was attributed to several factors which have been summarised below.

- Australia did not go into the downturn with big economic imbalances. Unlike the USA and other countries, the housing market had been subdued leading into the global financial crisis.
- The Government's fiscal position, considered one of the best and most aggressive in the world, provided stimulus to support economic growth. This resulted in Australia avoiding a technical recession, which is two consecutive quarters of negative growth.
- Australian banks had only minor exposure to toxic assets, the losses on which had to be written off in the balance sheets of off-shore banks, destroying capital and the banks' ability to lend. This meant the Australian banks were not constrained in passing on rate cuts to consumers and businesses, as was the case for off-shore banks.
- China acted quickly to avert their downturn and the turnaround in China's industrial production underpinned Australian exports.
- Interest rates were quickly reduced by 4.25% over an 8 month period.

ANZ's December jobs data, released on 11 January, showed further signs of economic recovery with job advertisements at the highest level in 2.5 years. ANZ Economist, Warren Hogan, believes there will be "...a further increase in net employment of 30,000 in the month [December]..." which would "...keep pace with population and labour force growth, and help hold the unemployment rate stable at around 5.7%".

Global economy

Unlike Australia, most global economies entered a sustained period of recession. Conditions in the latter half of 2009 had however showed signs of improvement, largely attributed to the fiscal policy measure adopted by respective governments and aggressive cuts to interest rates world wide. Despite the improved economic conditions over 2009, challenges still persist for some global economies in 2010 with many still expecting a US recovery in the shape of a 'W'. A 'W' shaped recovery means there will be another period of recession before markets fully recover. One such supporter of a 'W' shaped recovery is Nobel Prize-winning economist Paul Krugman. Krugman believes there is about a 33% chance the US economy will fall into a recession during the second half of 2010 as the government ceases the various stimulus measures that have been supporting growth recently.

Equity Markets

Market volume is the amount of share transactions that takes place on the sharemarket and, as is normal for this time of year, market volume was low throughout December. Nevertheless, market returns for December were positive, which provided a nice ending to a year of market turmoil. Japan was the stand-out for December with a market return of 12.8% for the month, recovering from a disappointing November.

December market performance

| Equity Markets – Price Indices | | At Close 31/12/09 | % Change 1 Month | % Change 12 Months |
|--------------------------------|----------------|----------------------|---------------------|-----------------------|
| Australia | All Ordinaries | 4882.71 | 3.5% | 33.4% |
| Japan | Nikkei | 10546.44 | 12.8% | 19.0% |
| Hong Kong | Hang Seng | 21872.50 | 0.2% | 52.0% |
| UK | FTSE 100 | 5412.88 | 4.3% | 22.1% |
| Germany | DAX | 5957.43 | 5.9% | 23.8% |
| US | Dow Jones | 10428.05 | 0.8% | 18.8% |
| EMU* | Euro 100 | 2233.67 | 6.4% | 24.2% |
| World** | MSCI - Ex Aus | 829.96 | 3.6% | 22.5% |

| Property – Price Index | | At Close 31/12/09 | % Change 1 Month | % Change 12 Months |
|------------------------|-------------|----------------------|---------------------|-----------------------|
| Listed Trusts | ASX A-REITS | 897.30 | 2.0% | -0.2% |

| Interest Rates | | At Close 31/12/09 | % Change 1 Month | % Change 12 Months |
|--------------------------|--|----------------------|---------------------|-----------------------|
| Aust 90 day Bank Bills | | 4.28% | 0.2% | 0.1% |
| Australian 10 year Bonds | | 5.73% | 0.4% | -34.1% |
| US 90 day T Bill | | 0.06% | 0.0% | -0.1% |
| US 10 year Bonds | | 3.83% | 0.6% | 1.6% |

| Currency | | At Close 31/12/09 | % Change 1 Month | % Change 12 Months |
|----------------------|----------|----------------------|---------------------|-----------------------|
| US dollar | A\$/US\$ | 0.8973 | -2.0% | 27.7% |
| British pound | A\$/STG | 0.5555 | -0.3% | 15.7% |
| Euro | A\$/euro | 0.6262 | 2.6% | 24.5% |
| Japanese yen | A\$/yen | 83.44 | 5.6% | 31.0% |
| Trade-weighted Index | | 69.70 | -0.3% | 25.4% |

* Top 100 European stocks trading on the FTSE

** Source : www.msci.com

Source : Iress Market Technology

Past performance is not a reliable indicator of future performance.

Australian economy and markets

2010 and 2011 Outlook

Nab Capital's (NAB's) forecast always had 2010 as a recovery year, both locally and for the global economy. In mid 2009, it looked like the recovery would be tame at best and NAB's 2010 Gross Domestic Product (GDP) forecast was only 1% growth.

In light of better than expected economic data over 2009, NAB's current GDP forecast for 2010 is now 2.5%.

The drivers of the economy in 2010 are expected to be:

- Household consumption bounces back to growth rates just shy of long run averages.
- Housing construction spending is expected to rise by 7.25% in the year.
- Government spending is set to continue to boost growth with a rise of 5.5% in NAB's forecasts. Strong Government investment spending (infrastructure) is embodied in this forecast with a rise of 14.5% expected in 2010.
- Business investment is down by 1% in 2010 vs. 2009 but the quarterly profile NAB has in their forecasts means that through the year Business Investment rises by 3.6%, reflecting positive growth from the June quarter onwards.

Going into 2011, the forecast trends for 2010 generally continue:

- Consumer spending increases a little to growth close to trend, at 3.6% in 2011.
- Housing investment is forecast higher during 2011 but the pace of growth eases to 4%.
- Business investment bounces back to grow at 7%.
- Government spending eases back to grow at 2% in the year.
- NAB expects net exports to contribute -1.4% to GDP in 2011 as imports accelerate with stronger Business Investment.

Overall, NAB's forecasts see GDP growth of 3.5% in 2011.

Labour market and inflation outlook

The labour market is now in a better position and NAB expects positive employment growth from the December quarter of 2009 onwards. The concern however, is it is likely that the growth in the labour force will initially outstrip jobs growth (population growth is very fast at present compared to history).

This causes the unemployment rate to rise to a peak of 6.2% by mid 2009 and after that it starts to fall. By the end of 2011 NAB expects the unemployment rate to fall to 4.75%.

Underlying inflation is forecast to trend down to a trough of 2.1% by the end of 2010. Around the end of 2011 NAB expects underlying inflation to bottom and move back into the middle of the target of between 2% and 3%.

The Reserve Bank of Australia (RBA) needs to raise rates further to keep inflation in check, notwithstanding the recent comments from Deputy Governor Ric Battellino suggesting borrowers were facing interest rates which are back in the 'normal' range, albeit in the bottom half.

Over the next few months, NAB expects the data to show ongoing strength and despite the Battellino warnings, NAB still believes the RBA will increase rates by 0.25% in February and another 0.25% in March, before pausing for a while.

Global economies and markets

Like Australia, little economic data was released over the December period so we start 2010 with a summary of the latest data released across the major economies along with a re-cap of the International Monetary Fund's (IMF's) forecasts for global economies through 2010.

US

The US Federal Reserve (Fed) left rates on hold and again stated that economic conditions "are likely to warrant exceptionally low levels of the federal funds rate for an extended period". Inflation is expected to "remain subdued for some time", but the Federal Open Markets Committee (FOMC) was slightly more upbeat on activity. While it again said that the economy continues to pick up, it added that the deterioration in the labour market is abating, the housing sector is improving and household spending is growing 'at a moderate rate'. It also believes that financial market conditions have become more supportive of economic growth.

The November inflation data confirmed the lack of price pressures with the core rate flat in December and at 1.7% year on year. Supply is outweighing demand and this is expected to continue to dampen price pressures. As a result, the FOMC is expected to keep the federal funds rate at its current lows until late this year.

The Fed made no changes to its purchase plans for mortgage backed securities and agency debt, and specified February 1 2010 as the date that most special liquidity facilities would expire. US data released in early December was generally in line with expectations, supporting the ongoing recovery in activity.

Industrial production rose 0.8% in November (median 0.5%) after a flat outcome in October. It was the fourth rise in the past five months, and continues to trend higher. Capacity utilisation rose to 71.3% (median 71.1%) from 70.6%.

Housing starts rose 8.9% in November due to a 67% increase in multi-family homes (townhouses). Single family homes rose 2.1% and building permits rose 6%. However homebuilder confidence remains subdued. The National Association of Home Builders' housing market index fell in December.

Manufacturing fell to a 5-month low in December.

China

Indicators of business activity suggest that the Chinese economy grew in October, which followed strong growth in the September quarter. NAB expects growth of 8.25% in 2009 and 9% in 2010.

The manufacturing sector also continues to recover, but still at a slower pace than in previous years. Industrial production increased by approximately 1% in October and is 16% higher since the beginning of 2009.

The growth of government investment is estimated to have slowed in recent months. Government investment in fixed asset investments such as infrastructure fell by 3.25% in October. Despite the recent fall, investment has increased by 32% over the year. Growth has been highest in government influenced sectors which are those sectors that have high public influence. More recently, real estate investment has been strong with lower minimum deposits encouraging sales. House prices have also increased.

Inflationary pressures are re-emerging following a short period of deflation. Prices have risen by around 0.8% in the past three months and CPI is increasing.

The Chinese Government, on 10 January, released data indicating that China's exports rose 17.7% in December. The recent numbers show the first increase in just over a year and makes China the world's biggest exporter, previously Germany.

Japan

Economic activity in Japan has continued to increase and is supported by Government policy measures implemented earlier in the year. However, without these policy measures, the Bank of Japan (BoJ) considers momentum to be still quite weak. Deflationary pressures have persisted and CPI fell by 2.5% over the year ending October.

The Japanese economy grew by 1.2% in the September quarter, following growth of 0.7% in the June quarter.

The manufacturing sector is recovering quickly. Industrial production increased by 7% in the September quarter, with particular strength in machinery and electrical products. Higher external demand is also helping, with export volumes up by around 35% since early 2009.

Household conditions and consumption expanded for the second consecutive quarter. Labour markets have improved, with the unemployment rate falling by 0.6% in the past three months.

Europe

Euro area GDP grew by 0.4% during the September quarter, the first quarter of positive growth since the end of March 2008. Not all European Union member countries contributed to growth. Germany, Italy and France contributed the most to overall growth, while economies such as Spain and Greece remain in recession.

What is even more encouraging is that data available to date suggests that positive growth continued into the December quarter. Recent strength has been driven by an improvement in activity in some of the largest countries in Europe. For instance Germany's manufacturing index increased in November and was supported by a strong increase in manufacturing export orders, while the French index increased to a 37 month high as a result of strong activity in the services sector.

However, it hasn't been all good news. While there has been improvement in the economy, labour market conditions are still deteriorating, with the unemployment rate increasing to 9.7% in September. High unemployment reduces household incomes which impacts consumer spending. As a result, retail sales fell a further 0.6% in September, the tenth monthly decline in the past year. With economic growth expected to be below trend in 2010 and unemployment likely to keep rising over this period, prospects for a substantial recovery in consumer spending in the near future seem unlikely.

Global Outlook

As we enter 2010 in a much better position than the start of 2009, we would like to highlight what the latest IMF view is on where global economies are expected to head, to set the scene on what investors may expect during 2010. In the last IMF World Economic Outlook, October 2009, the IMF notes the following key points:

The recovery has already started...

- "The global economy is expanding again, and financial conditions have improved markedly. It will still take some time, however, until the outlook for employment improves significantly."
- "Emerging and developing economies are further ahead on the road to recovery, led by Asia..."
- "The triggers for this rebound are strong public policies across advanced and emerging economies, together with measures deployed by the IMF... have allayed concerns about systemic financial collapse, supported demand, and all but eliminated fears of a global depression."

Challenges persist...

- "Despite advances, the pace of recovery is expected to be slow and, for quite some time, insufficient to decrease unemployment."
- "Activity may pick up quickly in the short term. Yet the forces that are driving the current rebound are partly temporary in nature... These forces will diminish during the course of 2010."
- "A further key constraint on the pace of recovery will be limits on credit availability. Bank de-leveraging will constrain the supply of bank credit for the remainder of 2009 and into 2010 in both the United States and Europe..."
- "...consumption and investment are gaining strength only slowly... Consumption will be particularly weak in advanced economies, especially those that experienced credit booms, housing bubbles, and large current account deficits, such as the United States and the United Kingdom..."
- "...the World Economic Outlook projects activity expanding by about 3% in 2010, which is still well below rates achieved before the crisis."
- "Downside risks remain a concern. The main risk is that private demand in advanced economies remains very weak."