AUGUST 2011 INVESTMENT OUTLOOK

5th AUGUST, 2011

Chief Investment Office

KEY INVESTMENT VIEWS AND CHANGES

- July and early August have seen a dramatic lift in market volatility and investor risk aversion, with equity markets having fallen by more than 10%. Sovereign debt concerns in the European periphery and the US have been behind the deterioration in investor sentiment.
- In both regions, policy actions may have helped avert a full-blown debt crisis, but have also focussed investors' minds on the problems. Exacerbating the market response has been a period of weak economic activity.
- Interest rates of all maturities have fallen sharply, both domestically and in the US. As such, local yields now appear at odds with economic conditions and the messages conveyed by the RBA. The implication is that the market sees the outlook as substantially more worrisome than does the RBA.
- The slower pace of domestic growth evident throughout H1 2011 persists. However, while the economy has slowed, it is not recessionary. Looking forward, we expect continued growth, though at a 'below trend' pace, as household budgets remain under pressure.
- Considering the high correlation between markets at present, this month we cover our individual asset class views in the context of our 'base case' or central scenario. We then follow with an assessment of the risks around the base case.
- In Europe and the US, recent events have indicated that there are deep-seated issues that are difficult to resolve. However, in both cases, policymakers have displayed a commitment to prevent a global crisis from developing. We expect this to remain the case and a crisis to be averted. By excluding a full-blown debt crisis from our base case, we assume that market behaviour over the period ahead will be determined primarily by the underlying economic trends.
- In this regard, we expect continued domestic growth at a 'below trend' pace and recession fears in the US to prove unfounded. Accordingly, the degree of risk aversion should abate in the weeks ahead. This drives our positive view of equities (and credit) for the month ahead. Meanwhile, with bonds seen as clearly overvalued, we expect yields to move higher through August and September.
- Beyond our base case, European sovereign risks remain (with the possibility of global contagion) and a further significant deterioration of business activity in the US is plausible. While these scenarios are not part of our base case they could develop, leading to further equity losses and still lower bond yields. The precise nature of events under these scenarios are, of course, unknown as are the policy responses and their effectiveness.

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MONTHLY MARKET REVIEW

The table below summarises our investment views from last month and assesses them against actual performance over the subsequent period.

	Prior Assessment	Performance*	Outcome
Bonds			
International	US yields to rise**	-41bp	x
Domestic Government	Domestic yields to rise**	-103bp	x
Corporate Bonds	iTraxx Australia index to fall	+33bp	x
Inflation Linked Bonds	ILBs to outperform nominal bonds	+2.1%	✓
Equities			
International (local currency)	MSCI World index to rise	-10.6%	x
Domestic	ASX200 index to rise	10.7%	x
Domestic	Equities to outperform bonds	-13.0%	x
Currencies			
AUD (vs USD)	AUD/USD to decline	-2.8%	✓

* Returns from July 4, 2011 to August 4, 2011

** 3 year bonds. Neutral range for monthly move in domestic yields is +/-26bp

*** Neutral range for monthly ASX200 equity performance is +/-2.6%

Hints of panic as sovereign debt concerns weigh

July and early August, far from seeing a reduction in uncertainty, have seen a dramatic lift in market volatility and investor risk aversion. On August 4, this culminated in signs of panic in markets, with the US S&P500 falling 4.8% in a single session (taking the fall over 7 sessions to 10%).

Through this period, sovereign debt concerns, relating to the European periphery and the US (as legislators debated the debt ceiling), have been at the forefront. In both regions, policy actions during the month may have helped avert a full-blown debt crisis but have also drawn attention to the problems. Add to this a period of weak economic news and the result has been a serious deterioration in investor confidence.

Interest rates of all maturities have fallen sharply (both domestically and in the US) amid economic concerns and risk aversion. The domestic 3yr bond yield at one point traded at 3.71% or more than 100bp below the cash rate. Such yield levels appear at odds with the domestic economic environment and the messages conveyed by the RBA - the implication being that the market sees the economic outlook as substantially more worrisome than does the RBA.

Finally, credit markets have weakened along with equities, such that the Australian iTraxx credit spread index is 33bp wider over the month.

Background to the US debt ceiling issue

On May 16, the US hit its self-imposed $14.3 trillion debt ceiling due to the ongoing budget deficit (which is projected to be $1.6 trillion this year). Since then, spending and accounting adjustments have acted as a 'stop-gap' but a lasting solution was required by August 2 to avoid a debt default or a dramatic curtailment of government spending.

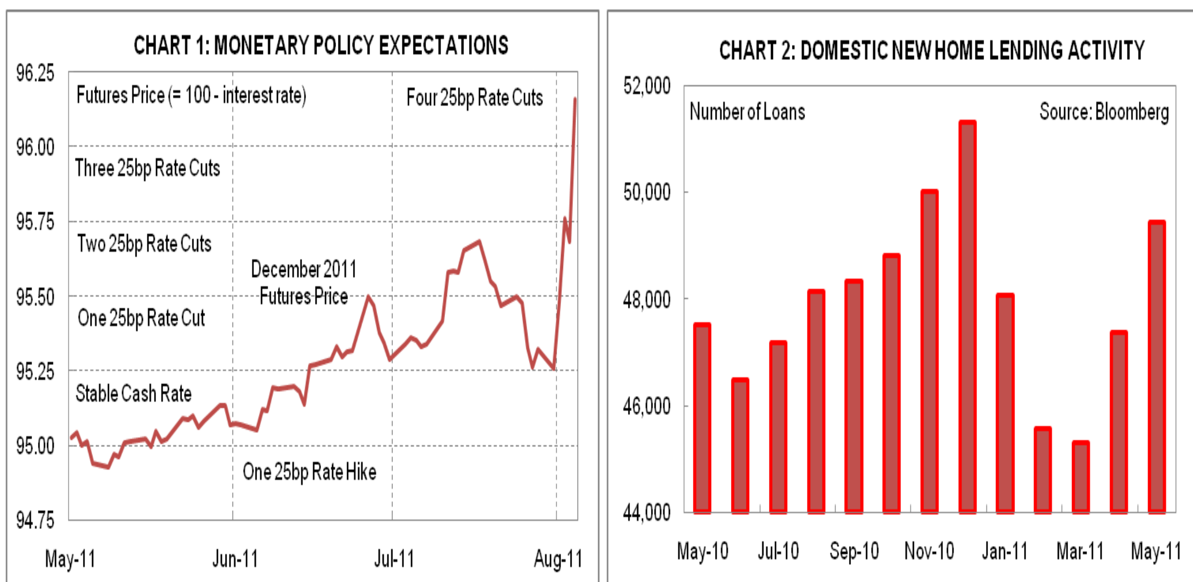
Negotiations repeatedly stalled in the lead up to August 2, amid partisan bickering. As a result, Moody's ratings agency put its Aaa US bond rating on watch for a possible downgrade while Standard & Poor's put the US on 'creditwatch', implying a 50% probability of a rating cut within 90 days. Meanwhile Fed Chairman Bernanke stated that a US default would trigger a "major crisis" in the global economy and financial system.

11th hour agreement
On August 2, the Congressional impasse was resolved, allowing the passage of legislation to raise the debt ceiling and reduce the budget deficit. The Democrats appear to have given more ground than Republicans in the final deal as the deficit cutting plan focuses on spending cuts (some already identified and some to be determined by a panel in the months ahead) rather than tax increases.

Subsequent to the agreement, Moody's have reaffirmed the nation's Aaa credit rating but have retained a negative ratings outlook. This, plus the heightened concern regarding the condition of the US of the economy, helps to explain the lack of a 'relief rally' in markets after the debt deal was reached.

Which way for domestic monetary policy?
Volatility in domestic interest rate markets rose further in July. Only two months ago, we noted that the market was "excessively hawkish" regarding the prospects for higher official interest rates. Similarly, we saw the shift in sentiment in favour of rate cuts during June as unwarranted.

Chart 1 shows that the futures market has since become more convinced that official interest rates are set to fall, and sharply, with current pricing anticipating at least 3 rate cuts by the end of the year. This is despite the Q2 CPI report showing an increase in the annual headline inflation rate, from 3.3% to 3.6%, and the RBA having considered tightening policy at its August meeting.



ECONOMIC DEVELOPMENTS

The European debt crisis response
On July 21, European policymakers took additional steps to shore up the finances of the peripheral nations and prevent the debt worries there from spreading. Among the elements of the package announced are the following.

- The EU and IMF will provide additional funding for Greece. Interest rates will be reduced and maturities extended also, thereby reducing funding pressures.
- Through a number of voluntary options, the private sector will also contribute additional funds. The program involves exchanging existing Greek bonds into alternative securities, some of which will be AAA rated. Private sector losses will be incurred in the exchange, however.
- Borrowing costs for Portugal and Ireland will be lowered, in a measure designed to reduce the risks of contagion.

While the announcement was positively received, the issues are far from permanently resolved and nervousness persists, with yields on Italian and Spanish bonds seen as key barometers of risk in Europe.

Domestic economy remains sluggish
The slower pace of domestic activity evident throughout H1 2011 persists, despite the strength in mining. However, as stated previously, while the economy has slowed, it is not recessionary.

Recent sentiment surveys (both business and consumer) along with certain activity indicators, have been weak. Notwithstanding this, July saw the release of positive data on new home lending (a key leading indicator), which now stands 9% above the March 2011 low (as per Chart 2 on page 3).

Looking forward, we expect continued domestic economic growth, though at a ‘below trend’ pace, as household budgets remain under pressure due to cost of living increases and higher taxes (including the July 1 commencement of the Flood Reconstruction Levy).

New Zealand outlook brightening
This month we provide a brief update on the New Zealand economy, noting that business sentiment and activity indicators have risen strongly in the aftermath of the February earthquake. Further underpinning activity has been the strength of agricultural commodity prices and exports. On this basis, in its July statement, the RBNZ began laying the groundwork for a reversal of the 50bp rate cut implemented in the aftermath of the quake.

OUTLOOK – BASE CASE SCENARIO

Considering the high correlation between markets at present (bond yields versus equities, domestic versus offshore), this month we cover our individual asset class views in the context of our ‘base case’ or central scenario. We then follow with an assessment of the risks around the base case.

‘Crisis pricing’
Despite the US debt agreement and Greek funding package, markets remain on edge. Indeed, looking at bond markets, it can be argued that they are priced for a crisis (or at least recession). Examples are provided below.

- On August 5, the futures market was pricing in more than 3 RBA rate cuts by year end (despite the RBA considering a rate increase in August).
- US 3yr bond yields have retreated by more than 100bp (from 1.46% to 0.43%) since February.

Aside from global events, local markets are weighing up the risks of a ‘home grown’ recession. Such a development is possible, as is a US recession or a dramatic escalation of the European debt crisis. On balance, however, these do not fall within our “base case”.

Weak growth, no crisis
In Europe and the US, recent events have indicated that there are deep-seated issues that are difficult to resolve. However, in both cases, policymakers have displayed a commitment to prevent a global crisis from developing. We expect this to remain the case and a crisis to be averted.

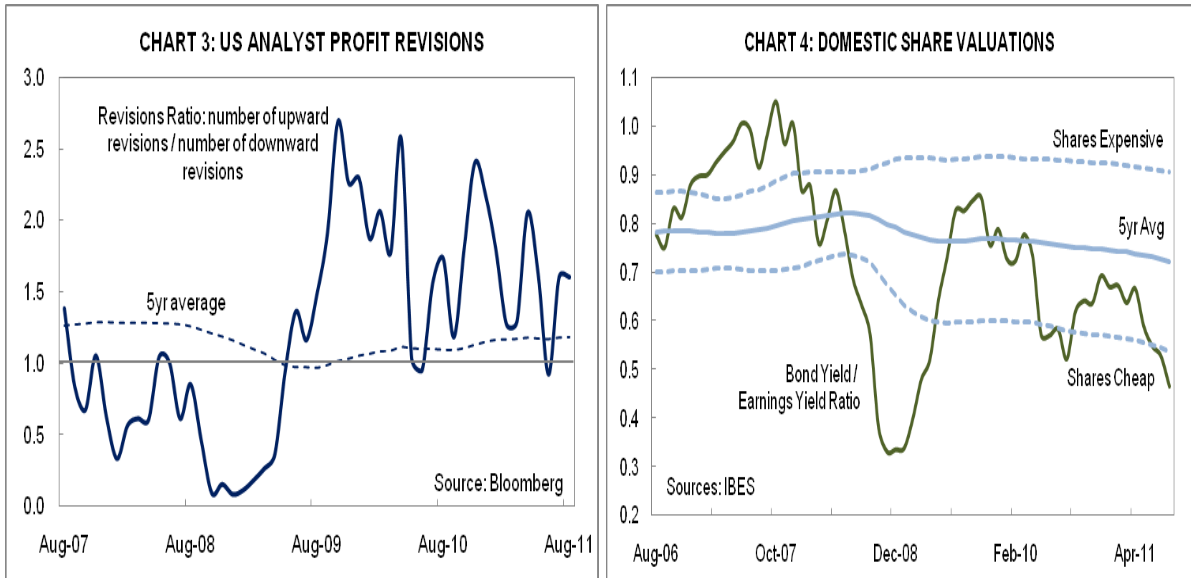
By excluding a full-blown debt crisis from our base case, we assume that market behaviour over the period ahead will be determined primarily by the underlying economic trends.

In this regard, we expect the data to improve in coming months as the influence of a number of temporary factors recedes. These include the impact of the Japan earthquake plus the earlier run up in petrol prices (which peaked in May). Also, from an Australian perspective, there has been the lingering impact of the weather events over the summer and last year’s interest rate increases.

Overall, we expect continued growth at a ‘below trend’ pace locally. In the US, recession fears should prove unfounded (as they were last year), with the economy remaining on its “two steps forward, one step back” trajectory.

Market implications – equities and credit spreads

Consistent with our assessment that a crisis is not pending and that the economic trends will improve, we expect the current heightened degree of risk aversion to abate in the weeks / months ahead. This, in turn, drives our more favourable view of equity prospects.



Additional support for this stance comes from earnings and valuations. Chart 3, for example, shows that US corporate profits forecasts are still being revised higher (revisions up exceed those down). Chart 4, meanwhile, shows that shares are attractively valued, versus bonds (as well as versus history).

Given the close correlations, the conditions seen as conducive for improved equity performance are also expected to be reflected in a narrowing of credit spreads over the period ahead.

Investment Conclusions: MSCI world equity index and ASX200 index to advance over the month ahead.
iTraxx Australia credit spread index to fall over the month ahead.

Market implications – bonds and interest rates

On our assessment, recent bond moves have pushed yields further into overvalued territory, as made evident by the following.

- From a US perspective, the real bond yield (here we use the yield on the 5yr inflation linked bond) is trading at negative 81bp – well below the GFC lows.
- Domestically, the 3yr government bond yield traded below 3.75% during the month. This compares to an overnight cash rate of 4.75% and represents the greatest negative spread between cash and bonds since the GFC.

Accordingly, as the current degree of market nervousness diminishes, we expect yields to move higher.

Investment Conclusion: Australian and international bond yields to rise over the month ahead.

RISK ASSESSMENT

European contagion or US downturn

European sovereign risks remain, with the possibility of global contagion. Equally, a further significant deterioration of business activity in the US is plausible. While these scenarios are not part of our base case they could develop, leading to further equity losses and still lower bond yields.

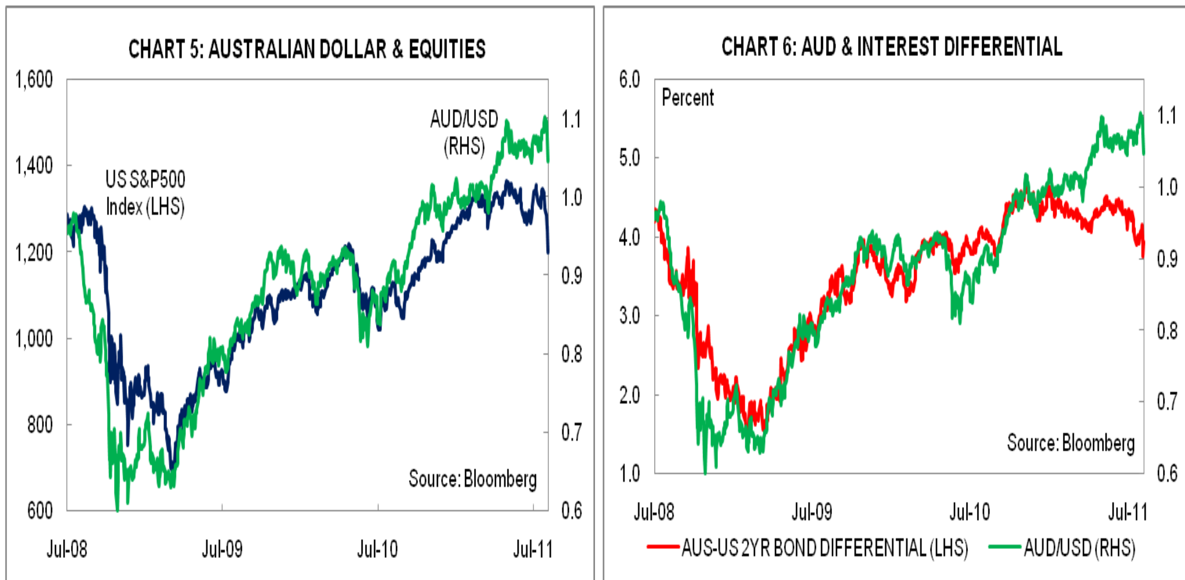
An alternative scenario which could play out is one of weaker equity (and credit markets) accompanied by sharply higher bond yields – brought about by a crisis of confidence in the quality of sovereign debt. This is seen as more damaging economically than the GFC type experience of lower bond yields.

The precise nature of events under these scenarios are, of course, unknown as are the policy responses and their effectiveness.

AUSTRALIAN DOLLAR OUTLOOK

AUD transitioning to a 'safe haven' reserve currency?

Typically, the AUD weakens in times of rising risk aversion and weaker equity markets. However, cracks have become evident in this relationship recently, noting that the fall in the AUD since the July *Outlook* is small relative to that in equities (see Chart 5). Similarly, Chart 6 shows the recent divergence between the AUD and interest differentials. There are a number of explanations for the recent change in these relationships.



1. With the current episode of market nervousness related to US sovereign debt concerns, the market is keeping downward pressure on the USD (in contrast to the usual market support for the USD in times of crisis).
2. The AUD has historically held a close relationship to the gold price. With gold trading near record highs, this has been supportive for the currency.
3. Finally, an alternative explanation is that the AUD is acquiring "reserve currency" or "safe haven" status. Certainly, the economic arguments are persuasive, given Australia's strong fiscal position and sound economic performance. Furthermore, IMF data show that there has been an increase in global central bank holdings of "other" currencies (which includes the AUD).

At this stage, we remain a little sceptical of the "reserve currency" argument and note, for example, that the AUD has, in fact, depreciated during the month against the established safe havens of the Swiss Franc and Japanese Yen. We, therefore, expect the AUD to remain (at least in part) inversely related to the degree of risk aversion. On this basis, we anticipate a firmer AUD over the period ahead.

Investment Conclusion: AUD to rise versus USD.

Important note

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For further information on this report please contact:

Craig Lamb, Head of Investments
Ph: 02 8121 0916 Email: craig.lamb@suncorp.com.au

Steven Milch, Investment Strategist
Ph: 02 8121 0921 Email: steven.milch@suncorp.com.au