

ING INVESTMENT MANAGEMENT  
**HouseView**



### Global Overview

Recent data from the US suggests that the economy has finally emerged from its deep and protracted recession. Unprecedented monetary and fiscal support has been mainly responsible for the economy's upturn. The aggressive actions of the US Federal Reserve, along with the stress tests conducted on US banks earlier in the year, have stabilised the financial system. After shrinking by nearly 4%, real gross domestic product (GDP) is on track to post an annualised gain of approximately 3% this quarter. The federal government's stimulus measures in the form of the housing tax credit should generate up to 400,000 additional home sales, while nearly 700,000 vehicles have been purchased by means of the Car Allowance Rebate Scheme (CARS), commonly referred to as the 'cash for clunkers' rebate.

The fiscal measures have come at a significant cost to the public purse. The federal budget deficit will approach US\$1.6 trillion this fiscal year, up from US\$450 billion last year, however the cost to the economy, and ultimately to US taxpayers, would have been significantly greater without it. The economy would still be in a deep recession were it not for policymakers' aggressive actions.

A sustained economic recovery through next year is far from assured, as there is little evidence to suggest that private domestic demand is increasing. Furthermore, business and household credit continues to contract, reflecting both tighter lending standards and a reluctance to borrow. Outstanding credit is now 4% lower over the year, which is the steepest drop in the post-war era. We expect that this partial revival in growth will last until the end of the year, before ushering in a 5-year period of sub-par growth.

In Europe, the regional measure of GDP declined by 0.1% in the second quarter. Despite the overall negative reading, Germany and France posted positive growth results, significantly exceeding expectations. Across the region, exports fell at a slower pace, while household spending increased. In annual terms, the economy shrank by 4.7%, after contracting by 4.9% in the first quarter. The European Commission's economic sentiment indicator rose to a 10-month high, however it remains well below its long-term average of 100. Although confidence remains at low levels, households and firms appear less pessimistic about the future.

Most European regional indicators remain consistent with very weak economic activity. The manufacturing Purchasing Managers' Index (PMI) lifted in August, but has yet to signify overall expansion. Meanwhile, business and consumer sentiment also remains well below historical norms. Fiscal policy has supported growth, but government support will run out next year. Furthermore, a strong near-term pickup in domestic demand or exports appears unlikely, and commercial banks across the region are keeping a tight rein on credit expansion despite the European Central Bank's efforts to provide liquidity to the system.

In Japan, GDP was revised down to 0.6% from an initial estimate of 0.9%. Net exports and government spending boosted growth, however private demand fell sharply. The Bank of Japan (BoJ) left its key lending rate unchanged at 0.1%, but is effectively operating a zero-interest rate policy, acting as a buyer of last resort in the commercial bond market. The BoJ is also purchasing ¥1.8 trillion of government bonds each month. This quantitative easing has led to positive year-on-year growth in bank lending, while overall GDP growth has been aided by firms' inventory adjustment.

Unfortunately, these measures may not be enough to prevent the Japanese economy from slipping back into recession and a new deflationary spiral. Leading indicators point to further periods of contraction. Machinery orders have fallen sharply, and machinery producers are forecasting this trend to continue over the coming months.

The Chinese economy is experiencing a shift from mainly government-induced to more market-driven growth drivers. This has created a window of opportunity for the authorities to stop stimulating the economy without risking a relapse in growth. Capital spending increased sharply after the government announced its fiscal stimulus measures last November, leading to explosive growth in credit expansion. The resulting capital expenditure boom dramatically boosted materials imports, as well as activity in the construction sector. In addition, policies to subsidise household purchases of consumer durables, especially cars, worked exceptionally well. The consumer sector will probably continue to strengthen, as growth serves to boost income levels, improve the overall employment situation, and lift consumer confidence.

The export sector has been the weakest link in the economy, but there is increasing evidence that a recovery in overseas sales is unfolding. Purchasing managers' indices have shown a consistent improvement in export orders recently, rising above the key 50 threshold since June. A sharp slowdown in new bank lending hastened the sell-off in the Chinese stock market recently, as markets became concerned that fiscal and monetary policies were on the verge of being tightened aggressively. We believe that the recent adjustment was more a reality check as opposed to a trend change, and continue to expect robust growth over the course of the year.

The Australian economy expanded moderately in the second quarter, as growth accelerated to 0.6%, from 0.4% in the previous quarter. The unemployment rate has held steady at 5.8% for almost six months, and appears likely to confound earlier predictions of 8.5% unemployment by the end of the year. Forward-looking indicators are pointing to improved jobs growth in early 2010, but, arguably, stronger demand is likely to initially be met by increased hours-worked, rather than jobs growth. In line with the employment situation, retail sales weakened for a second straight month. Volatility in retail sales data is nevertheless high and also reflects the temporary boost from the fiscal stimulus cheques distributed late last year and again in the second quarter of this year.

Looking forward, consumer and business confidence indices have risen sharply of late, which bodes well for consumers' purchasing intentions and businesses' investing and hiring intentions. Interest rates are at very low levels and are supportive of consumer credit growth. Although we expect the Reserve Bank of Australia (RBA) to tighten monetary policy, we anticipate this process to occur gradually over the course of the next nine months, due to the strength of the Australian dollar.

## Asset Sector Overview

### Australian Cash

Australian cash returned 0.25% in August, lifting its twelve-month return to 4.62%. Having last lowered the official cash rate by 0.25% at its April Board meeting, the RBA has since maintained an unchanged monetary policy stance, most recently deciding on 1 September to retain the rate at 3.0%. Notwithstanding the stability in monetary policy, 90-day bank bills ended the month 0.29% higher at 3.49%, as recent comments by the RBA led investors to conclude that a turning point in the interest rate cycle is at hand. With regard to timing, we believe that the RBA favours moving the official cash rate up in the coming few months. However, they may struggle to justify any such move in the near term if the positive momentum in the monthly economic data does not continue. We continue to maintain an overweight exposure towards cash in our diversified funds.

### Australian Fixed Interest

The Australian fixed interest sector returned 0.72% in August, lifting its twelve-month return to 7.67%. The yield on the three-year Commonwealth Government bond rose to 4.95% from 4.82% in July, whilst the yield on the ten-year maturity fell to 5.47% from 5.71% in the previous month. In the corporate bond market, a lack of negative surprises during the month helped these bonds rally in yield, compared to government bonds. Despite the rally, corporate bonds are still seen as offering relatively good value. We presently hold an underweight exposure to Australian fixed interest within our diversified funds.

### International Fixed Interest

The international fixed interest sector, as measured by the JP Morgan World Government Bond Index (ex Australia), rose by 1.06% in Australian dollar terms in August, lifting its twelve-month return to 9.99%. Having initially weakened, bond yields rallied towards the end of the month, as caution about the strength of the economic recovery weighed on market sentiment. The outlook for a sustainable recovery remains fragile, amid conflicting concerns regarding possible over-stimulation by central banks and whether sufficient support has in fact been provided to ensure that economic momentum becomes self-sustaining. We envisage moving further underweight in the international fixed interest sector within our diversified funds, as the economic recovery gains momentum.

### Australian Shares

The Australian equity market continued its strong performance during August, finishing the month with a 6.6% gain. The sustained rebound over the past few months appears to indicate that investors had become excessively pessimistic through the downturn, with the market's price-to-earnings (p/e) ratio having contracted to levels not seen in over two decades. Accordingly, the recent rebound shows the extent to which the market has 'corrected its excessive pessimism', with the p/e ratio expanding to a more 'average' level. The August reporting season confirmed this lift in sentiment, as company profits generally exceeded expectations. In addition, the announcement of proportionally more forecast upgrades than downgrades reflected a more positive outlook for the business sector than was the case only a few months earlier.

We anticipate that businesses that have worked diligently to reduce their costs and increase their efficiency through the economic downturn will harvest the benefits of any improvement in economic conditions, as increased revenues flow directly to the bottom line. Moreover, improvements in margins and overall profitability will spur further earnings upgrades. In the light of an 'average' p/e ratio, we believe that the market is not overvalued at current levels. We presently hold an overweight exposure to the Australian shares sector within our diversified funds.

## International Shares

Global sharemarkets continued to move higher in August, continuing their strong momentum from July. The MSCI World (ex Australia) Index rose by 3.7% in local currency terms, however currency appreciation limited the gain to 2.5% in Australian dollar terms. The markets were lifted by favourable corporate earnings results and perceptions that economic conditions are improving.

On a sectoral basis, the sectors most closely correlated to global economic trends, such as Financials, Materials and Industrials, continued to do well. Conversely, the more defensive Healthcare, Consumer Staples and Telecommunications sectors were amongst the underperformers over the month.

It is evident that a considerable number of investors remain on the sidelines, awaiting confirmation that the improvement in consumer demand, employment and corporate profits, is sustainable. We presently hold a benchmark position within the international shares sector, but will look to increase our exposure if the markets fall from their current levels and provide an attractive entry point.

## Australian Property Securities Trusts

The S&P/ASX 300 A-REIT Accumulation Index rose by 16.1% in August, its best monthly return in over twenty years. The sector's gain occurred despite the prospect of continued challenging conditions in the property market, and a consequently modest outlook for A-REITs' earnings prospects. Improved conditions within the credit market and better than expected economic data further supported the A-REIT sector's performance over the month. A notable aspect of trading within the sector was the continued switch out of the large cap defensive trusts and into some of the smaller cap trusts.

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A-REIT valuations presently appear slightly cheap, as most property companies have successfully raised equity to support their balance sheets. This has attracted the interest of investors who have focused on the discounts at which capital has been raised, and the attractiveness of the sector's yields. We presently hold an underweight position in this asset class within our diversified funds.

## Global Property Securities Trusts

Global property stocks extended their gains from the previous month in August, with the benchmark index jumping by 13.0%. The renewed interest in property trusts has occurred against the backdrop of mounting evidence that global economic prospects are improving, and the realisation that REITs may be well positioned for a period of favourable performance.

At the regional level, Europe outperformed over the month, followed by North America and Asia. While European and North American investors appear to have adopted the view that the worst of the recession has passed, the strong year-to-date performance in Asia has evidently prompted an element of caution amongst the region's property investors.

At the overall level, macro-economic conditions appear to warrant an improved outlook for global property securities, with improved sentiment driving investors to seek out bargains. We nevertheless retain an underweight position within this asset class.