

Review of 2008 and outlook for 2009



Key points

- 2008 has seen a major loss of wealth as the US sub-prime mortgage crisis turned into the worst global financial and economic crisis since the Great Depression.
- The global economic outlook for 2009 comes with much greater than normal uncertainty. Pressure to reduce debt levels means that there is a risk the economic slump could drag into 2010, but an unprecedented global policy response suggests that it's more likely to see a gradual recovery become evident by the end of 2009.
- Further downside in equities and credit is possible in the first half of 2009 but both should end the year stronger than now. Having outperformed listed assets over the last year, unlisted assets may be relative underperformers over the year ahead.

2008 – a year of turmoil

2008 is a year most investors would prefer to forget. I must confess up front that I didn't see anywhere near the severity or the duration of the panic that occurred and initially had thought that markets would improve through the second half. So what went wrong?

As in 2007, the past year has been dominated by the US sub-prime mortgage crisis. But the difference has been that it morphed through a combination of mounting losses, growing panic amongst banks and investors and a few mistakes by policy makers, into the worst financial/economic crisis since the Great Depression. During the first half of the year there was a perception that the fallout from the sub-prime mortgage crisis was manageable. In fact, during the first half of the year talk that the emerging world would remain strong saw commodity prices pushed to record highs as investors deserted shares for commodities. Associated inflation concerns saw several central banks raise interest rates, including the RBA. These moves proved to be big mistakes. However, things changed radically for the worst during the second half after US authorities let investment bank Lehman Brothers fail. This led to the failure or rescue of numerous other financial institutions in the US and Europe. While the US authorities quickly rushed in with a "bank rescue plan", in convincing Congress of the need to pass it they inadvertently convinced the world of the severity of the problem. The result was a massive slump in share markets through September, October and November, a renewed blow-out in borrowing spreads in money and credit markets, a plunge in commodity prices and huge gyrations in currencies including a 30% slide in the A\$ after nearly reaching

parity mid year. When the dust settled it was clear that all the turmoil had also caused immense damage to the global economy as confidence plunged. The past year is a reminder as to how important sentiment is in keeping the global financial system and economy motoring along. Once broken it is hard to repair. The slump in world trade and commodity prices also dragged emerging countries into the downturn. Thanks to synchronised recessions in Europe, Japan and the US, advanced countries are now on track for their worst post war recession. And the Australian economy has virtually stalled in response to the global downturn, falling commodity demand, reduced confidence and a loss of wealth, all made worse by rate hikes earlier in the year.

Big falls in growth assets

The end result has been a terrible ride for investors, as indicated by the returns shown in the following table.

Investment returns for major asset classes

Total return	2007	2008
Global shares (in Australian dollars)	-2.6	-24.9
Global shares (in local currency)	4.4	-38.8
Asian shares (in local currency)	35.5	-46.6
Australian shares	16.1	-38.4
Global bonds (hedged into A\$)	7.0	9.4
Australian bonds	3.5	15.0
Global listed property securities	-15.6	-45.0
Listed property trusts	-8.4	-54.0
Unlisted non-residential property	21.2	3.0*
Australian residential property	12.8	-3.0*
Cash	6.7	7.6
Average balanced growth super fund	6.0	-22.0*

* Estimate. Source: Datastream, Intech, REIA, AMP Capital Investors

- From their highs last year Australian shares have had their worst bear market since the 1973 to 1974 slump, led by consumer discretionary, industrial and financial shares. Global shares also slumped. But unhedged international equity investors were helped to some degree by a fall in the A\$.
- Listed property fell sharply both globally and locally in response to worries about debt, cuts to distributions and expected falls in property values. Unlisted property returns remained positive thanks to solid rental growth, which initially offset upwards pressure on yields. Australian housing had negative returns on average as house prices fell, offsetting modest rental income.
- Government bonds were star performers as yields were pushed lower in response to flight-to-safety demand and slumping

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growth. Corporate debt suffered further losses though as investors anticipated rising defaults. Cash also provided relatively strong returns.

As shares are the dominant investment in most super funds this translated into losses for most investors.

Outlook for 2009

Right now the economic outlook is bleak. The downturn is accelerating and leading indicators show no signs of bottoming. And the uncertainty is greater than usual given the unprecedented blow to the global financial system and the resultant pressure to reduce debt levels. However, the policy response of governments has also been unprecedented, with monetary easing, fiscal stimulus and capital injections. The new administration should also help renew US confidence next year.

Key macro themes for 2009 are likely to be:

1. **Global recession during the next six to nine months** made worse as households in rich countries reduce debt levels. **However, some sort of recovery should start to become visible during the second half or at least in 2010.** Some of the conditions for global recovery are falling into place (e.g. falling oil prices, falling inflation, falling bond yields and fiscal and monetary stimulus). But others are yet to fall into place (such as a slowing rate of decline in US house prices, better credit markets and a fall in private sector borrowing rates in the US). We lean towards a second half improvement thanks to government policy action but uncertainty is high.
2. **A deflation scare is likely to develop** in response to the slump in commodity prices and rising global excess capacity pushing inflation rates negative.
3. **Global interest rates are likely to fall further and stay low for an extended period.** US and Japanese interest rates look likely to fall to zero, while European rates are heading down to 1%.
4. **Commodity prices are likely to be weak** until later in 2009 or 2010 when global growth improves.
5. **Profits are likely to fall sharply in response to the slump in growth, possibly by around 20 to 30%.**
6. Australia is better placed than many countries. Our financial system is less impaired, there is more scope for policy easing and the fall in the A\$ will help domestic production. But even in Australia the risks are high given high levels of debt and house prices and our high reliance on foreign capital. This, along with **the gathering global recession, the plunge in confidence and negative wealth effects, indicates Australia will at least have a mild recession** probably during the first half. Inflation will fall sharply as lower commodity prices and the slump in growth feed through. Unemployment is likely to rise to 7% to 9%. Later in the year though early signs of recovery should hopefully start to be evident helped by further interest rate cuts taking the cash rate below 3% and further fiscal stimulus taking the budget into deficit.

Looking at the major asset classes for year ahead:

- Given the immense uncertainty regarding the economic and profit outlook, and with economic recovery still at least six to nine months away it's still too early to say that we have seen the end of the bear market in shares. Further falls are possible into the early part of the New Year. However, **having fallen 50% or more from their highs in 2007, shares are excellent value from a long term perspective.** If we are right and an improvement in global growth starts to occur before the end of 2009 then shares will anticipate this and start to move higher, probably during the June quarter. So on balance we expect Australian and global shares to end 2009 higher, albeit the outlook comes with greater than normal uncertainty.

- **Asian shares are likely to be outperformers**, reflecting better growth prospects.
- **Commodity prices and the A\$ are likely to remain weak** until global growth improves.
- **Cash is becoming far less attractive as interest rates fall.** Cash returns are likely to be 4% or less.
- **Bond yields may still push lower** as it becomes clear that **inflation and cash rates will stay low for a long time.** However, with yields so low returns are likely to be constrained at around 5% to 6%.
- **Corporate debt is far more attractive with yields of 9% or more.** It is already factoring in a deep and protracted recession so is probably even better value than equities on a risk adjusted basis.
- **Listed property** may stay constrained in the first half of 2009 by the need for capital raisings and worries about valuations, but thanks to much better yields 2009 should be a better year.
- **Unlisted non-residential property is likely to see some downwards pressure on returns** as rental growth slows due to the economic downturn and as upwards pressure on cap rates or yields continues in response to forced selling and higher yields available on other assets. However, the lack of overbuilding is an offsetting positive as is the fact that unlisted property never ran as hard as listed property in the good times.
- **Average house prices are also likely to remain under pressure.** Lower interest rates and higher home owner grants will help. But affordability is still poor and rising unemployment will keep potential home buyers sidelined at the same time that defaults rise. Expect falls of 10% or so in average house prices.

Our return expectations imply most super funds should see a return to positive returns through 2009, although the first few months may see more weakness.

Debt deflation is the big risk

If we are wrong it is likely to be because pressure on the part of consumers to reduce debt levels leads to a more protracted and deeper recession delaying any share market recovery into 2010. Key signposts to watch in this regard include private sector borrowing rates in the US, consumer confidence and credit markets. China is also worth watching.

Conclusion

There is no guarantee shares have bottomed. And uncertainty is much higher than normal. But history tells us that there are great opportunities for long term investors when fear is running rampant and confidence is blown, when shares are trading on dividend yields well above bond and cash yields, and when governments are doing everything possible to bring about an economic recovery.

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