

July 2008

Market Watch

Economic commentary

A slowing economy with higher inflation emerged in July. Inflation for the year to June came in at 4.5% compared with 2.1% a year earlier. Contributing to annual inflation were financial and insurance services (+9.9%), transportation (+6.9%) and health costs (+4.8%).

Retail spending growth has also softened as the economy slows under the weight of interest rates and high oil prices. Retail spending growth for the year to June 2008 was only 3.2% compared with growth of 7.0% for the year to June 2007.

Credit growth slowed to 11.7% for the 12 months to June compared with 15.4% a year earlier while building approvals are down 7.8% on June last year.

The AUD pushed as high as US 98 cents in July, its highest level against the US dollar in 25 years but was only modestly weaker over the month. It started July at US 95.69 cents and ended it at US 94.15 cents. A year ago the AUD stood at US 85.87 cents. The AUD bought 0.4752 UK pounds at the end of July and 1.283 NZ dollars.

Australian shares

The new financial year began on a downbeat. The S&P/ASX 200 Accumulation index fell 4.6% in July to be down 15.6% over 12 months. While banks stole the headlines with increased provisions for bad and doubtful debts, it was the energy and materials sectors that led the market down. Oil prices fell and investors worried about the impact of slower global economic growth on commodity producers.

Oil prices fell from a peak of US\$145 per barrel to end the month at US\$124, a decline of 14.5%. At the same time Woodside Petroleum fell 20.3% in the month, Oil Search was down 15.7% and BHP Billiton, which earns around 15% of its revenue from oil, fell 9.1%.

The decline in the price in oil came as the International Monetary Fund (IMF) released its latest forecasts for global economic growth. The IMF suggests that global growth is expected to decelerate significantly in the second half of 2008, before recovering gradually in 2009.

Softer global growth could imply weaker commodity prices in 2008-09, however the IMF noted that growth in China is expected to be close to 10% in 2008-09 while emerging economies in total should see growth of around 7%. This suggests strong demand for commodities will continue.

Within the materials sector Rio Tinto fell 7.5%, Fortescue Metals Group was down 26.9% while Lihir Gold was down 17.3%.

National Australia Bank and ANZ Banking Group announced increases in their provisions for bad and doubtful debts in July. ANZ said conditions in global credit markets, a weak New Zealand economy and a softening Australian economy led them to increase provisions. National Australia Bank lifted its provisions due to exposure to sub-prime related debt.

Over the month, Commonwealth Bank was down 1.1%, ANZ fell 13.2%, NAB was down 6.8% but Westpac rose 7.8%. Banks lifted mortgage rates during July due to their higher cost of borrowing.

In times of uncertainty, companies with strong cash flows often outperform the market. In July, Woolworths (+3.1%), Telstra (+6.1%) and Lion Nathan (+3.3%) all performed relatively well. Woolworths lifted sales almost 9% over 12 months and the market expects spending on communications and beer to hold up.

The acid test for the market will come as the Australian profit reporting season unfolds during August and September. While a number of firms have announced profit downgrades, the bulk of companies have said little.

Key issues from the reporting season, apart from current earnings, will be dividend policy, capital management and outlook statements. Will companies maintain or cut dividends? Will companies seek fresh capital? Will the large resource companies actually lift dividends?

The S&P/ASX All Ordinaries index has fallen 26.3% since its high in early November 2007. The decline in share prices has pushed dividend yields up to levels rarely seen in the past 15 years. It has also reduced the price to earnings ratio of the sharemarket down to a level not seen since 1984.

If Australia slips into deep recession and company earnings fall substantially then, maybe, the current level of pessimism and market prices are warranted. If however, Australia's economic growth slows rather than stops, then recovery from current levels should emerge.

Global shares

Global sharemarkets were mostly weak during July. The slowing global economy and on-going fallout from the sub-prime crisis dominated sentiment. The MSCI World index, a broad measure of global shares, fell 2.5% in USD and was down 0.9% when measured in AUD. Over 12 months, global shares were down 12.7% in USD terms and have fallen 20.9% in AUD terms.

Sentiment towards US investment banks and institutions involved with mortgages remains fragile. Weakness in US house prices saw more losses by US banks; several banks were shut down by regulators and the US government had to step in with assistance for the large US mortgage providers Fannie Mae and Freddie Mac.

Despite the headlines, Citigroup rose 13.4% and Wachovia was up 11.2%. However Lehman Brothers were down 12.5% while Merrill Lynch fell 16.0%.

During July, the Dow rose 0.3%, the S&P 500 fell 1.0% and the NASDAQ rose 1.4%. The Dow is down 13.9% over 12 months.

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Apart from Germany, European markets moved lower in July. Concerns over the adequacy of bank capital, high oil prices and an increase in official interest rates have taken their toll on investor sentiment. Economic growth has slowed in Europe and Europe's stronger currency makes life tough for their exporters.

The German market rose 1.0% but Italy was down 4.4%, France fell 1.0% while the market in the Netherlands was down 6.1%. Across the English Channel, the UK's FTSE 100 index fell 3.8% to be down 14.9% over 12 months.

Asian markets were mixed. Japan's Nikkei index fell 0.8% but the Hang Seng index in Hong Kong rose 2.9%. China's Shanghai B index was up 0.3% but is down 42.6% so far in 2008.

Healthcare (+4.3%) and consumer staples (+0.6%) were among the stronger global sectors in July. Healthcare companies GlaxoSmithKline (+7.0%) and Johnson & Johnson (+6.4%) performed well in July as did Campbell Soups (+9.4%) and Heinz (+5.3%).

The weakest global sector for the month was energy (-13.7%) as oil prices fell. Exxon Mobil fell 8.7% while BP was down 10.6%.

The MSCI Emerging Markets price index fell 4.2% in USD and 2.6% in AUD during July. Illustrating the volatility of these markets, Turkey was up 19.3% in the month while Russia was down 17.2%.

Financial conditions and high oil prices are slowing the global economy. Some regions are stronger than others but slower economic activity makes the task of lifting earnings more challenging. The task will be made easier when sub-prime losses are sorted out and if oil prices ease back. Until then, markets seem likely to display the trend-less volatility of recent months.

Fixed interest

The Reserve Bank of Australia (RBA) left its official cash rate unchanged at 7.25% in July. In discussing its outlook, the RBA board noted in July that the tightening in financial conditions, in conjunction with other factors including rising fuel costs, is working to restrain demand.

If demand remains restrained, pressures on inflation will eventually abate allowing interest rates to decline. While that point is yet to be reached, further news on economic weakness will hasten the day.

The UBSA Bank Bill index returned 0.67% in July and 7.49% over 12 months. Ninety day bank bills traded in a tight range with a high of 7.83% and a low of 7.71% during the month before ending July at 7.76%.

Credit markets remain strained but some yields have edged lower. Companies with credit ratings in the range BBB- to BBB+ saw average yields on their corporate bonds fall from 10.10% at the end of May to 9.62% at the end of July. This is still well up on the 7.24% seen in June 2007 but an improvement nonetheless.

Australian government 10 year bond yields have moved lower since mid-June as a slower economy suggests lower inflation over time. Ten year yields peaked at 6.79% in mid-June and have since moved down to 6.22%, providing bond holders with further capital gains. The UBSA Composite Bond index returned 1.79% in July for a return of 5.58% over the past 12 months.

Listed property

The listed property sector fell still further in July. In the context of weak equity markets, the sector fell 5.0% to be down 36.5% over 12 months. Investors remain nervous about debt levels within the sector in the face of high interest rates and a slower economy.

Westfield Group performed relatively well falling only 0.6% while Centro Properties Group found some support, rising 10.2%. Pulling the listed property index down were GPT (-31.5%), Goodman Group (-17.5%) and Stockland (-14.1%)

At the end of July, the estimated distribution yield on the listed property sector was 9.4%, compared with the 6.22% yield on a 10 year Commonwealth government bond. As yet, this difference in yield has not convinced the bulk of investors to support the sector.

Global property markets edged higher in July. The S&P/Citigroup BMI World Property index rose 1.7% in AUD but is down 27.2% over 12 months.