

Market watch

April 2010

Key points

- Equity markets retreated in April on the re-emergence and spreading of Sovereign Risk concerns in Europe.
- The global economic recovery continues with stronger than anticipated growth in the US and to a lesser degree in Europe. The developing economies continue to record faster growth and are now removing policy stimulus and beginning to tighten interest rates.
- In Australia the Reserve Bank continued its efforts to move the official cash rate to average levels with rate hikes in April and now in early May, with six rate rises in the last seven meetings.

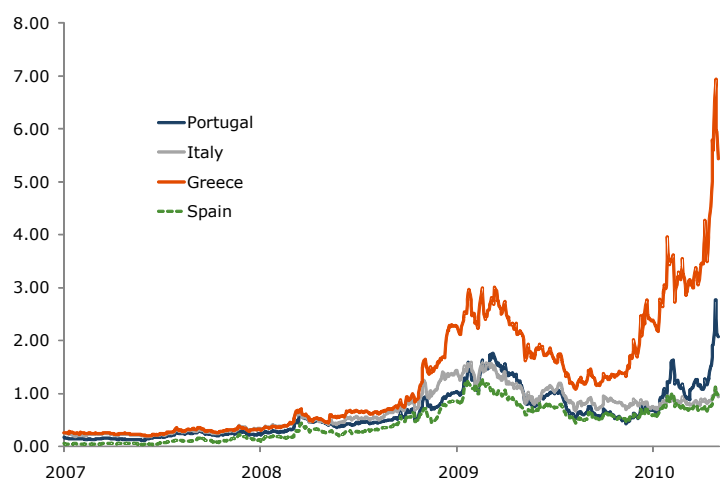
Sovereign Risk concerns re-emerged in April and led to falls in global equity markets. Risk appetite diminished despite continued evidence of a recovering global economy. The International Monetary Fund (IMF) upgraded its global growth forecast for 2010 from 3.9% to 4.2%. A two-speed global economy remains, resulting in varying policy responses. Developing economies are further ahead than developed economies in withdrawing stimulus, and are now moving towards policy tightening. The central banks of India and Brazil both lifted official interest rates in April, while China continues to tighten policies at the micro level.

Eurostat downgraded Greece's budget deficit from 12.7% to 13.6% of GDP in 2009 and highlighted that considerable uncertainty remained over these figures. This sparked renewed concerns over the country's ability to service its debt, leading to a sharp gain in Greek bond yields. As a consequence Standard and Poor's downgraded Greece's credit rating to BB+ (now junk bond status).

Standard and Poor's also downgraded the sovereign credit rating of Portugal (two notches to A-) and Spain (one notch to AA), however both remain at a much higher rating than Greece.

In April the spread of 10-year Greek government bond yields rose sharply against the equivalent German yield (see chart below), peaking at 693 basis points (bp). This compares to a spread of 343bp at the start of the month and an average of 25bp before the global financial crisis. This led to confirmation of the bailout package from the IMF and the EU totaling €110bn, with €80bn from the EU and the remainder from the IMF. The first payment will be ahead of Greece's 19 May 2010 bond redemption, however will also require further austerity measures with the aim to reduce the budget deficit to 8.1% of GDP this year and below 3% in 2014. Greece will also be subject to quarterly monitoring.

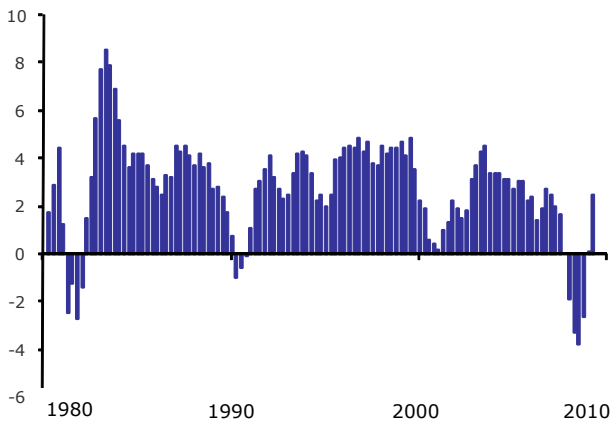
Bond yield spread above Germany



Source: Bloomberg. Data to 3 May 2010

The US economic recovery continued with payrolls data moving into positive territory, with 162,000 jobs added in March. Although slightly below expectations, it included positive revisions to January and February data. The unemployment rate remained at 9.7% with renewed confidence in jobs growth leading to an increase in workforce participation. GDP data was released for the first quarter of 2010 with an annualised pace of 3.2%, taking the annual growth rate to 2.5% – the first positive since June 2008 (see chart below). This was driven largely by inventory rebuild and private consumption. US housing market data was slightly better as weather returned to more normal conditions with improvements in new home sales (+26.9% per month), existing home sales (+6.8% per month) and housing starts (+1.6% per month), however activity remains at depressed levels. There has yet to be any clear impacts from the completion of Residential Mortgage Backed Securities (RMBS) purchases by the Federal Reserve (Fed) on 31 March 2010, with any impact likely known after any RMBS sales are made by Fannie Mae or Freddie Mac.

US annual economic growth (%)



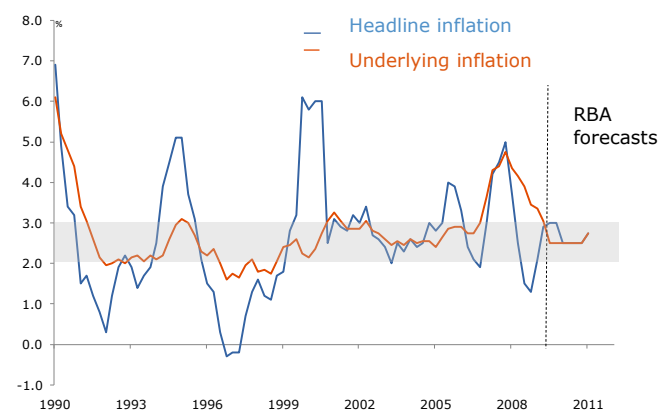
Source: Bloomberg. Data to 31 March 2010

The US Federal Reserve left the Fed Funds rate on hold in a widely anticipated move late in April. The Fed slightly upgraded its growth outlook for the economy stating that “economic activity has continued to strengthen” with inflation “likely to be subdued for some time”. Market expectations are for the Fed to begin lifting rates in Q3 2010. The Bank of England and European Central Bank also left official interest rates on hold during the month.

China’s State Council announced further actions to cool down its property market by restraining second and third home buyers and investors through higher interest rates and increasing the down payment required for a mortgage. Late in April a third reserve requirement ratio hike for 2010 was announced in an attempt to reduce liquidity in the financial system. These tightening actions are having an impact, with bank lending data released for March showing a slowdown in annual growth terms and falls in activity levels within the property market.

In Australia, first quarter 2010 CPI data was released with headline inflation recorded at 0.9% per quarter, taking the annual growth rate from 2.1% to 2.9%. The average of the trimmed mean and weighted median rose 0.8% per quarter, with the annual growth rate now at 3.05% – a slight easing from 3.35% (see chart below). Key contributors to inflation in the quarter were the cost of pharmaceuticals, automotive fuel, education, vegetables and electricity. This was partially offset by price falls in clothing, audio visual & computing equipment and fruit.

Inflation - Australia



Source: ABS, RBA. Data to 31 March 2010

Many market analysts believe that inflation is not slowing quickly enough to achieve the RBA’s forecast for the easing of underlying inflation to 2.5% pa by June 2010. The next update to the RBA’s outlook will be provided in the May Statement on Monetary Policy.

The Australian economy is operating at two speeds, with strong gains in mining investment amid signs of a slowdown in both housing finance and household consumption. In March, 19,600 jobs were added and the

unemployment rate held steady at 5.3%. The growth continues to centre on full-time jobs, with overall job gains in Queensland and Victoria. Both business and consumer confidence retreated post the fifth RBA rate hike, and housing finance recorded its fifth consecutive monthly fall.

The RBA lifted the official cash rate by 25bps to 4.25% in early April. The RBA noted that with growth likely to be around trend and inflation close to target over the coming year, interest rates needed to be closer to average and this was another step in that process. The RBA again lifted interest rates in early May to 4.50% and commented that for most borrowers interest rates were around average. The CPI data released in the month does support this and led to questions of when the RBA moves policy into restrictive levels. While interest rates are closer to average, further interest rate rises are expected this year by the market, which would take the official cash rate close to 5% by year end.

The Federal Government released its long awaited response to the Henry Tax Review and changed funding arrangements between itself and the States for Health. The response to the Henry Tax Review focused on reaping additional revenue from the resources sector through a 40% resources rent tax. In addition, other focuses included lifting savings through a higher superannuation guarantee, lowering the corporate tax rate, establishing a State infrastructure fund and providing more incentives to small business. These plans will be introduced over coming years once passed through parliament.

Australian shares

Following the strong rally in March, Australian equities lost momentum in April with the S&P/ASX 200 Accumulation Index declining 1.4%. Much of the focus was on the possible recommendations of the Henry Tax Review, which was due for publication in early May. Investors were interested to see whether a new tax regime would be imposed on mining companies and whether the tax structure on bank deposits would be amended.

The performance of individual sectors was mixed. Materials (-4.0%) stocks tended to struggle, reflecting concerns about possible changes to the tax regime in the industry

and suggestions that China might introduce measures to dampen the pace of economic growth and, in turn, bulk commodity export demand. Consumer Staples (-4.0%) also struggled as sector heavyweights Woolworths (-3.2%) and Wesfarmers (-7.9%) both lost ground. Outperforming sectors included Telecommunication Services (+5.6%) – supported by a strong return from Telstra (+6.4%) – and Utilities (-0.2%).

Merger and acquisition activity also remained a key focus for investors. Gold producer Newcrest Mining (+0.8%) made a takeover bid for rival Lihir Gold (+25.7%), while at least five interested acquirers courted MacArthur Coal (+10.1%). Neither deal had been agreed by the end of April. Elsewhere, the Australian Competition and Consumer Commission rejected National Australia Bank's (+1.7%) proposed purchase of the Australian business of AXA Asia-Pacific (-2.1%), which opens the door for a renewed bid for the assets from AMP (0.0%).

Global shares

Global share markets recorded mixed returns across regions in April, influenced by prospects for economic growth and company profits. The MSCI World Net Index fell 1.4% in AUD terms in April, taking annual returns to 8.1%.

On a sector basis both Energy (+2.2%) and Consumer Discretionary (+3.1%) recorded positive gains with rising oil prices and consumer spending. Materials (-2.0%) fell on a slide in copper, zinc and aluminium prices.

US equity markets continue to record positive gains, boosted by strength in the economic recovery and better than expected first quarter company earnings reports. The S&P 500 rose 1.5%, the Dow Jones was up 1.4% and the NASDAQ rose 2.6%. The Dow Jones is now up 70% from its low in March 2009 and is above the 11,000 mark for the first time since September 2008.

In the Eurozone equity markets were weaker, weighed down by escalation of Sovereign Risk concerns. Greece (-9.6%), Portugal (-7.1%) and Spain (-3.3%) all fell as uncertainty arose about the pace of economic growth in the years to come. France fell 4.0% while Germany retreated 0.3%.

Asian equity markets were mixed with the China Shanghai B market falling 4.4% with concerns over policy tightening, while Thailand fell 3.1% on political concerns. Japan also retreated 0.3% after sharp gains in March. Singapore rose 3.0% while Hong Kong fell 0.6%.

Global emerging markets

Emerging markets outperformed the broader global equities market despite falling 0.2% in AUD terms. Emerging markets are beginning to tighten policy with inflation pressures rising with elevated commodity prices and strong growth. The IMF upgraded economic growth forecasts for emerging and developing economies to 6.3% in 2010 and 6.5% in 2011. The strongest upgrades were to Brazil and India which are forecast to grow 5.5% and 8.8% respectively in 2010.

The Brazilian equity market fell 4.0% in April with weakness in commodity prices and higher official interest rates. Sri Lanka (+12.5%) and the Czech Republic (+6.6%) performed well.

Fixed interest

Financial markets had a choppy month once again, with tensions intensifying around Greece, European air traffic coming to a halt as a result of a volcanic eruption in Iceland, US quarterly earnings and the announcement of legal proceedings against Goldman Sachs. Equity volatility spiked higher during the month as investor risk appetite seemed to diminish with global government bonds yields rallying and credit spreads tightening.

In the US, inflation remains subdued and rate hike expectations priced in by the market are still months away. 10-year Treasury bond yields continued to trend higher in early April, touching 4% after strong payrolls and ISM data. Yields fell back to end the month at 3.66%, 7bps below the end-March level.

In Europe the focus remained on Greece, Portugal and Spain with significant increases in the spread over Bunds. German Bunds continued to rally on back of uncertainties with the 10 year Bund yield falling by 13bp to finish the month at 2.96%.

In the UK elections were called for 6 May 2010. Current polls suggest that the risk of a hung parliament remains high and the market is in

'wait and see' mode. 10-year yields fell by 8bps to finish the month at 3.85% as the impact of improved economic data and higher inflation were offset by uncertainty around the elections and Sovereign Risk concerns.

In Japan, there are continued signs of improvement in the economy. 10-year yields fell by 11bps from 1.39% to 1.28% over the month. The rally in yields was helped by the Japanese stock market falling almost 4% from its peak in early March, amidst increasing tensions around the domestic economic outlook and increasing worries about Sovereign Risk (due to excessive public debt in several larger economies).

In Australia, Commonwealth Government bond yields fell slightly in the month, roughly in line with global markets. Australian economic data was mixed, with markets anticipating the release of the 2010-11 Budget in May and a possible earlier than expected return to surplus. On the other hand, it is expected that Commonwealth Government Securities (to be issued over coming years), may be downgraded.

Australian Government bond yields traded a fairly narrow range around 5.8% for most of April, before dipping to 5.7% late in the month. Shorter term yields were unchanged and the curve flattened slightly as a result. The gap between 3 year and 10 year bonds ended April at 43 bps, the flattest curve seen so far in 2010.

The UBS All Maturities Composite Bond Index returned 0.55% in the month and 3.29% over 12 months. With the RBA lifting the official cash rate, 90 day banks bills rose from 4.49% at end of March to 4.63% at the end of April, the highest since December 2008. The UBS Bank Bill Index returned 0.35% in March and 3.63% over 12 months.

Listed property

Australian listed property securities performed well in April, with the S&P/ASX 200 Australian Real Estate Investment Trust (A-REIT) Accumulation Index adding 3.7%. The sector significantly outperformed the broader share market, which declined in value by 1.4%.

A number of factors supported investor sentiment towards property stocks. Mirvac

Group completed a AUD\$350 million equity raising, which suggests A-REITs are increasingly changing their focus from reducing debt levels to pursuing growth strategies. Such a shift would be an important development in the sector.

Transaction activity in the domestic commercial property market remained subdued, although a few deals were completed during the month. GPT Wholesale Office Fund and Stockland Group were among trusts to purchase assets in April. Further indications that asset values have stabilised would be welcome and buoy investor sentiment towards the A-REIT sector.

Global property securities also performed well in April, with the US and Canadian markets enjoying notable strength. Asian markets, including China, Japan and Singapore also gained in value, which offset weakness in European markets. As a whole, the UBS Global Investors Index added 4.1% in Hedged AUD terms.

Index performance

| Index returns – April 2010 | Level | 1 month | 12 month |
|--|--------|---------|----------|
| S&P / ASX200 Index | 4,807 | -1.4% | 27.2% |
| S&P / ASX 200 Accumulation Index | 33,973 | -1.4% | 32.4% |
| MSCI World Net Index (AUD) | - | -1.4% | 8.1% |
| MSCI World Net Index AUD Hedged | - | 0.6% | 36.0% |
| Dow Jones Index | 11,009 | 1.4% | 34.8% |
| UK FTSE 100 | 5,553 | -2.2% | 30.9% |
| German DAX Index | 6,136 | -0.3% | 28.6% |
| France CAC Index | 3,817 | -4.0% | 20.8% |
| Japan - Nikkei | 11,057 | -0.3% | 25.3% |
| Hong Kong – Hang Seng | 21,109 | -0.6% | 36.0% |
| MSCI Emerging Markets Net Index (AUD) | - | -0.2% | 24.0% |
| US 10 year bond yield | 3.65% | -17bps | 53bps |
| Australia 10 year bond yield | 5.71% | -7bps | 114bps |
| UBS All Maturities Composite Bond Index | 5,965 | 0.6% | 3.3% |
| 90 Day Bank Bill Index | 4.63% | 14bps | 155bps |
| UBS Australian Bank Bill Index | 6,865 | 0.3% | 3.6% |
| S&P / ASX 200 A-REIT Accumulation Index | 19,852 | 3.7% | 37.4% |
| UBS Global Real Estate Investors Index (Net TR) AUD Hedged | 1,078 | 4.1% | 56.8% |
| AUD/USD (end of month) | 0.9243 | 0.8% | 27.4% |

Source: Colonial First State. Data to 30 April 2010. **Past performance is no indication of future performance.** These index returns do not reflect the performance of any Colonial First State fund or investment option. For returns for any Colonial First State Fund or investment option please refer to the performance section of the Colonial First State website available at colonialfirststate.com.au.

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