

Market Watch

Economic Commentary

The bad economic news continued in December. The US was officially declared in recession by the National Bureau of Economic Research. Economic data released in Australia did little to boost confidence in the local economy.

Late in December, new figures released showed that US house prices fell 18.0% over 12 months to 31 October 2008, the fastest decline on record. With consumers feeling less wealthy, spending habits are being curbed with retail sales falling 7.4% over 12 months to November.

Some good news is that US mortgage rates have started to fall. Bailout plans by the US government and US Federal Reserve have started to work. If mortgage rates fall, there will be more incentive to buy a house, this should help stem the fall in house prices and promote consumer confidence. Over December, 1 year mortgage rates fell from 5.2% to 5.0%.

President-elect Obama started to outline plans to create 3 million jobs in the US. He will boost investment in roads, bridges and public buildings to create jobs. This follows dismal employment data out of the US with the unemployment rate rising to 6.7%, its highest since 1993.

In Australia, the economic news was not much better. Economic growth for the 12 months to September 2008 was 1.9%, down from 2.9% for the 12 months to June 2008. Over the September quarter, economic growth was just 0.1% in what was the weakest quarter since September 2000.

Late in the month, the Federal Government announced another spending package. The focus of this one was infrastructure spending with \$1.2 billion to be spent on railways, \$1.6 billion on education and \$1.6 billion encouraging investment. This additional money should flow through to employment, consumption and economic growth.

The \$A rose in December. It was up 7.4% from US 65.58 cents at the start of the month to US 70.46 cents by month end. Lower interest rates in the US drove the US dollar lower.

The \$A bought 0.4834 UK pounds at the end of December and 1.2013 NZ dollars.

Australian shares

Despite a late rally, Australian share prices fell over December following a 7.8% fall in November and a 14.0% decline in October. Over 2008 the sharemarket managed to rise in only two months of the year and experienced falls in the other ten months in what has been an unprecedented 2008.

Over 2008 the Australian sharemarket fell 43.0%. This is the worst year on record since 1876 for the All Ordinaries Index. The previous worst was 1930 when the sharemarket fell 33.9%. For the record the market rose 11.3% in 1931.

The All Ordinaries Index was down 0.4% over December. The mood was mixed in the market with some strong gains and some more losses. Markets remained concerned over some weaker economic news out of Australia and globally. But some good news also buoyed confidence with further interest rate cuts and bailout plans announced.

On 8 December 2008, \$8.7 billion was pumped into the Australian economy. Pensioners and families received cash payments as part of Kevin Rudd's government spending plan. The hope was to encourage consumer spending prior to Christmas, this should boost the Australian economy.

The Reserve Bank of Australia (RBA) also gave mortgage holders an early Christmas present, cutting official interest rates by 1.0%. From a peak of 7.25% in March 2008, official interest rates now stand at 4.25%. Weaker domestic economic conditions, and the expectation that inflation will soon start to fall saw the larger than usual cut in interest rates.

Not surprising then was that the consumer discretionary sector was one of the best performers over the month, rising 8.1%. David Jones (+27.2%), Harvey Norman (+23.3%) and JB Hi-Fi (+16.9%) all rose on the anticipation of additional spending.

The Industrials sector also had a positive month, rising 6.9%. After being one of the underperformers for most of 2008, some investor interest saw the sector rise. Asciano Group rose 44.5% with takeover rumors and the divestment of its coal business. Lower oil prices and lower interest rates also helped the sector with CSR (+29.4%), Macquarie Airports (+25.1%) and Qantas Airways (+13.4%) all rising.

With some confidence returning, the more defensive cash generation sectors saw some weakness. Telecoms (-5.5%) and Utilities (-0.9%) both fell while the Financials ex Property sector (-1.3%) also had a disappointing month.

While some confidence has started to return to the market, the factors pushing the market down have not disappeared. In 2009, policy actions, lower interest rates and fiscal stimulus should help the market but it won't be clear sailing. The focus will be on company profit reporting season in February to set the tone for what will be an interesting 2009, but hopefully not as interesting as 2008 turned out to be. The S&P/ASX 200 Accumulation index (which includes re-invested dividends) fell 0.3% in December to be down 38.4% over 2008.

December 2008

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Global shares

The major equity markets were mixed in December. Some managed to make some gains while others continued the pattern of falling. This came despite weak economic news. Government spending packages and further interest rates did provide some support.

The MSCI World index, a broad measure of global shares, rose 3.1% in \$US and was down 4.1% when measured in \$A. Over 12 months, global shares were down 42.1% in \$US terms and have fallen 27.9% in \$A terms.

Talk of a large spending plan by President-elect Obama and emergency loans to US automakers managed to somewhat calm markets. Emergency loans were granted to GM and Chrysler worth \$US 13.4 billion (\$A 19 billion). The Dow Jones Industrial Index was down 0.6%, while the S&P 500 rose 0.8% and the NASDAQ was up 2.7%. Over 12 months the Dow has fallen 33.8%, its worst annual performance since 1931.

The US was officially declared to be in recession over the month. The National Bureau of Economic Research deemed the US economy entered into recession in December 2007. Time will tell when it exits. Much hope is pinned on the US housing market recovering and the potential of Obama's new spending plan.

Asian markets were predominantly higher over December. Lower interest rates are helping with Japan announcing a further interest rate cut. The Nikkei ended up 4.1% but is down 42.1% over 2008. The Japanese economy has had to contend with a rising currency, hurting its export sector, a main contributor of growth. Hong Kong was up 3.6% and Singapore rose 1.7%.

European markets were mixed over December after falls the previous two months. Cuts to official interest rates in the UK and Europe and a French government spending plan assisted markets although the headwinds of slower economic growth face markets in 2009. Interest rates now stand at 2.5% in Europe and 2.0% in the UK.

Emerging markets had a mixed month also. The MSCI Emerging Markets price index rose 7.6% in \$US and was up 0.1% in \$A boosted by some of the Asian markets. The Chinese sharemarket rose 4.5% buoyed by large cuts in official interest rates. Sri Lanka (-8.4%) and Russia (-9.6%) were negative performers. Weaker commodity prices saw the Russian market down 74.3% over 12 months.

Fixed interest

Policy makers continue to work overtime to support their financial system and encourage economic growth. Focus switched over December from bailout plans to further Federal Reserve interest rate cuts. In the US, the Federal Reserve cut interest rates from 1.00% to a target of 0.00% and 0.25%.

The Fed will now switch to unconventional policy options to provide support to the economy and financial markets. Possible examples include expanding its balance sheet, buying agency debt and buying treasury securities. The Fed has already announced its Term Asset-Backed Securities Loan Facility (TALF) which aims to get credit flowing in the consumer finance, student loan and mortgage markets.

All these actions are aimed at reducing interest rates for global inter-bank borrowing and corporate borrowing rates. The benchmark for such borrowing in \$US is known as LIBOR or the London Inter-bank Offer Rate.

At the end of December LIBOR was 118 basis points or 1.18% above the US Fed Funds rate. This compares with 120 basis points at the end of November, an average differential of 40 basis points or 0.4% over the past few years and a peak of 330 basis points or 3.3% in late September.

The turmoil in global financial markets continues to see very strong demand for government bonds. US 10 year government bond yields are at levels last seen in the early 1950s with yields at 2.21% at the end of December.

At the beginning of the month, 10 year Australian government bond yields stood at 4.60% while domestic corporate bonds with credit ratings in the range BBB- to BBB+ had an average yield of 8.64%. By the end of December, the yields were 3.99% and 8.40% respectively. Corporate bond yields remain high as illiquidity continues and the risk of defaults rises given slower economic conditions.

The UBSA Composite Bond index returned 1.25% in December for a return of 14.95% over the past 12 months. The Reserve Bank of Australia (RBA) reduced its official cash rate from 5.25% to 4.25% in December. The UBSA Bank Bill index returned 0.43% in the month and 7.60% over 12 months.

Listed property

The listed property sector continued its pattern of falling, down 10.5% in December after a slightly positive gain in November. Over 2008 the sector is down 54.0% in what has been an unprecedented 12 months.

The sector faces a number of issues as we look into 2009. Many REITs have gone through a work out period, capital has been raised, profits forecasts have been cut and distributions reduced to reflect underlying earnings. Despite this the sector still must face falling property values, rising vacancy rates and slower rental growth as we look into 2009.

Global property markets rose in December buoyed by strong gains in Europe and the US. The UBS Global Investors Index (Net TR) \$A Hedged was up 7.9% in the month to be 45.0% lower over 12 months.