

December 2009

# Market Watch

## **Economic overview by the Investment Markets Research team**

December highlighted the gradual recovery in the global economy but also the fragility of the financial system. Sovereign risk concerns took centre stage and focused on Greece, Spain, Ireland, Mexico and Dubai, rattling investor nerves. Looking into 2010, sovereign risk and the ability of governments to reduce debt positions will be one of the key issues for investment markets in 2010.

The US economic recovery has to date been driven by the consumer, with businesses still weak and held back by tight financing conditions. Consumer confidence and retail sales both improved over the month. The US labour market showed signs that the long period of deterioration was ending. Payrolls fell by 11,000 in November, compared to expectations of 125,000 and 111,000 the prior month. The unemployment rate fell from 10.2% to 10.0% but is expected to rise again throughout 2010. Businesses are likely to put off hiring new staff until a concrete economic recovery is underway, productivity gains have been maximized and hours worked have risen for existing employees.

The US housing market data continues to be mixed. Existing home sales (+7.4%) and new home sales (-11.3%) demonstrate the disparity in the US housing market. Existing homes sales inventory fell to its lowest level since the housing crisis started in 2006 at 6.5 months supply (peak was 11.3) but remains above the long term average of around 4.5. Housing starts rose 8.9% in November although remain volatile and constrained by tight credit supply to developers and a preference by buyers to purchase existing homes given a lower purchase price. Looking into 2010, inventory restocking and business investment should be key drivers of a US economic recovery, while housing construction is likely to remain volatile while above average excess supply remains.

In other US data for the third quarter of 2009, annualised GDP was revised down for the second time to 2.2% (originally 3.5%) and expectations by financial markets of a US Federal Reserve tightening was brought forward from September 2010 to June 2010. Chairman Ben Bernanke reported that economic activity continued to pick up but reiterated that current conditions will warrant exceptionally low levels of interest rates for an extended period. This follows a number of large US financial institutions

looking to repay TARP money in December with Bank of America repaying its funds while Wells Fargo and Citigroup plan to in the near term. Banking regulation is set for reform in 2010 with The Basel Committee on Banking Supervision issuing proposals to lift capital requirements and tightening the definition of acceptable capital.

The US dollar recovered in December, appreciating against all major currencies as prospects of an economic recovery gain pace and as sovereign risk and banking issues remain in Europe. The US dollar rallied 7.6% against the yen, 4.5% against the euro and 1.5% against the British pound. These gains come after the US dollar falling to its lowest level in 14 years against the yen in November.

In Australia, third quarter 2009 GDP was released with the economy recording just 0.2% growth, taking the annual growth rate to 0.5%. While this data is quite dated it does show the Australian economy continues to outperform other developed economies. The growth was driven by government spending, household consumption and dwelling investment. Detractors from growth were business investment and net exports, although both of these are expected to contribute to growth in 2010.

The Australian labour market continued its recent improvement with 31,200 jobs created in November and the unemployment rate falling to 5.7% from 5.8%. Consumer confidence softened with recent official interest rate rises while business confidence is at seven year highs.

As a result of this strength the Reserve Bank of Australia (RBA) lifted the official cash rate by 0.25% in December, its third consecutive monthly gain, taking the official interest rate to 3.75%. Financial markets expect the process of normalization to continue in 2010, however a Deputy Governor in December highlighted that with banks lifting interest rates more than the RBA, monetary policy could be now back in the 'normal' range. This saw financial markets remove some chance of a tightening when the RBA meets next in February.

## **Australian shares**

Trading volumes in the Australian share market were relatively low in December, but the S&P/ASX 200 Accumulation Index was nevertheless able to rise 3.7%. 2009 was one of the most volatile years on record for the Australian equity market, but

December 2009

# Market Watch

favourable performance in December extended gains in 2009 as a whole to more than 37%.

The performance of individual sectors in December suggested that investors are anticipating improved economic conditions in 2010. The Industrials (+7.0%) and Materials (+4.3%) sectors outperformed while more defensive areas of the market, such as Telecoms (+1.0%) and Consumer Staples (+2.0%), were among the laggards. Stocks which derive a meaningful proportion of their income offshore also tended to perform well, as the Australian dollar reversed its recent strength against the US dollar. These included News Corporation (+18.5%) and QBE Insurance (+15.1%).

Merger and acquisition activity remained a key focus for investors during the month. National Australia Bank (-4.3%) tabled a bid for AXA Asia Pacific (+13.1%), which is also the subject of a competing takeover offer from AMP (+9.6%), while several other companies announced bolt-on acquisitions. Nufarm (-6.1%), on the other hand, walked away from negotiations with Sinochem after the potential acquirer reduced its offer price. Capital raisings also remained a feature of the market, with Woodside Petroleum (-2.4%) raising \$2.5 billion in order to fund the development of its Browse liquefied natural gas project.

2009 was good year for Australian equity investors with returns exceeding 37%, while 2010 is shaping up to be slightly more challenging. Interest rates are rising and there are high expectations for profit growth. Companies will need to match and exceed these expectations for gains to continue. A recovering economy, improved balance sheets and recent cost control will help but rising official interest rates could prove a hurdle.

## Global shares

Global share markets were stronger in December with Japan and other Asian countries leading the returns. The MSCI World Index rose 1.7% in US\$ terms and 3.3% in A\$ terms. Over 2009 returns from global equity markets added 9.0% in A\$ terms.

Globally investors moved into the Consumer Discretionary sector (+3.8%) while Financials (-1.2%) fell with concerns over the European banking sector and as possible changes to regulation are discussed globally.

The US share market underperformed other regions despite further evidence of a recovering economy. The Dow Jones index rose 0.8% with the S&P 500 gaining 1.8%, taking 2009 returns to 18.8% and 23.5% respectively.

In Europe, equity markets were stronger despite sovereign risk issues; Germany (+5.9%), France (+7.0%) and Spain (+2.5%) all rising. Japanese equity markets performed well after a weak November. The Japanese government introduced another stimulus package, focussed on assisting job growth and helping small business credit. The Nikkei rose 12.9% taking 2009 returns to 19.0% while Hong Kong (+0.2%) and Singapore (+6.1%) rose for the month.

## Global emerging markets

Emerging markets added value in December and slightly outperformed broader global equity markets. The MSCI Emerging Markets index rose 3.8% in US\$ and 5.5% in A\$.

Leading emerging markets higher were Sri Lanka (+16.2%) and Turkey (+15.9%), up on rising optimism and confidence. Top performers for 2009 included China (+127.6%), Sri Lanka (+125.3%), Russia (+106.9%) and Argentina (+101.2%).

Saudi Arabia fell 3.2% in December and was one of the worst performing emerging markets in 2009, rising 28.0%.

## Fixed interest

Global yields moved generally higher in December, despite some negative global news, such as the downgrade of Greece and Moody's comments on the fiscal challenges facing the US and the UK. The rating agencies are increasingly questioning several developed economies' longer term 'resilience' to maintain their AAA ratings.

In the US bond yields moved lower initially, only to rise generally by month end. The 10 year rose by 0.64% to 3.84% on the back of generally improving global economic data and the unwinding of long positioning after the dust settled on the Dubai event.

The European Central Bank left official interest rates on hold, although did begin the process of exiting some of its liquidity measures as conditions improve. Sovereign debt concerns continued to weigh on the

December 2009

# Market Watch

bond market. Greece was downgraded one notch to BBB+, and put on watch negative by both Fitch and S&P over concerns about how the government would reduce the budget deficit from 12.7% to 3% of GDP. The outlook on Spain and Portugal were also revised to negative. Government bond yields rose into year end, probably on the back of the improved global economic conditions. 10 year yields rose to 3.39% from 3.16%.

In the UK the Bank of England kept interest rates on hold. A pre-budget report imposes a 50% levy on bank bonuses and signals a further increase in income taxes in 2011. This led to rising yields initially, but this trend reversed as inflation came in higher than expectations and glimpses of improvement were noted in the data. 10 year government yields rose by from 3.52% to end the month at 4.02%.

In Australia domestic factors added factors added to domestic yields moving higher in December as well as the move in US government bond yields. The 10 year government bond yield rose from 5.24% at the end of November to 5.64% at the end of December. As a result the UBS All Maturities Composite Bond index returned -0.38% over December and 1.73% over 2009.

The lift in cash rates by the Reserve Bank of Australia saw 90 day bank bills rise from 4.03% at the end of November to 4.28% at the end of December. The market is still expecting further interest rate rises in 2010, although have taken out the chance of some hikes early in the year. The UBS Bank Bill Index returned 0.32% in December and 3.47% over 2009

## Listed property

Investor sentiment towards listed property stocks in Australia and overseas continued to improve in December in anticipation of a further improvement in operating conditions. The Australian S&P/ASX 200 Australian Real Estate Investment Trust (A-REIT) Accumulation Index added 3.4% in December, extending gains in the financial year to date to more than 23%. The sector returned 7.9% for 2009, better than the 54% loss in 2008. The Industrial sector was once again the best performing area of the market, rising 9.3%; companies in this sector tend to be most leveraged to an improvement in economic conditions.

The UBS Global Investors Index, which tracks the performance of international property stocks, climbed 5.7% during the month, extending gains in the financial year to more than 37.2%. Asian markets including China, Singapore and Japan typically performed well, while stocks in Europe generally fared less well. The US and Canadian property sectors also generated strong returns during the month.

Economic growth forecasts suggest the pace of growth in developed regions will accelerate this year, which should result in lower vacancy rates and exert upward pressure on rents and property values. As a result, investor sentiment towards property stocks is likely to remain buoyant if economic data continues to improve as anticipated in the early months of 2010.