

Market watch

February 2010

Key points

- Two- speed economic recovery is clear, but performance also now differs between developed economies with the US leading the recovery amongst developed nations.
- The Australian economy remains on track with the Reserve Bank of Australia (RBA) upgrading both economic growth and inflation forecasts.
- Some evidence of risk aversion was evident in investment markets in February. While equities rallied, emerging markets and credit underperformed.

Economic overview

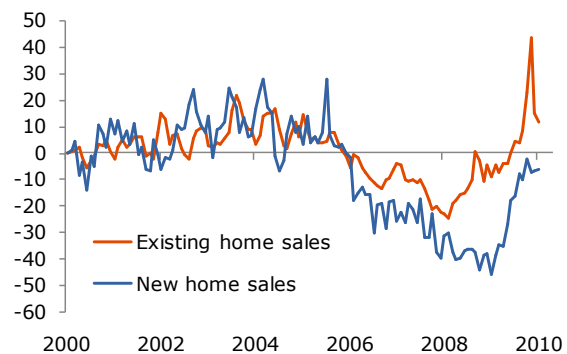
Equity markets gained ground over February 2010, but there was a general tendency towards risk aversion with credit spreads widening and emerging market equities underperforming the broader equity market. Three main sources of risk are evident; Sovereign risk concerns in Greece and other parts of Europe particularly Spain, Portugal, Italy and Ireland, tightening of monetary policy in China and potential policy tightening and re-regulation in the US. What is clear is that not only is there a two speed global economy between developed and developing economies, but the pace of recovery between developed economies is becoming more varied. The US economy is recording strong sequential growth, with Quarter 4 2009 GDP growth revised up to 5.9% (from 5.7%) in the month, while Europe, Japan and the UK are lagging the economic recovery.

The next several months are likely to prove difficult for analysing economic data from the US and China. The US has been plagued by severe snow storms since December and this is already having an impact on a wide range of data including retail sales, housing sales and employment. In China, the impact of recent policy tightening will be confused by Chinese New Year celebrations, making it difficult for both the financial markets and Chinese officials to determine the effectiveness of its recent attempts to slow the economy. This has the potential to create volatility within global financial markets.

US housing market data has been weak and remains a focus for market participants, especially after a

recovery in second-half 2009. New home sales (-11.2%) and existing homes sales (-7.2%) fell in January, albeit hampered by severe weather (see chart below for annual growth in US housing sales). US house prices were mixed with the S&P Case Shiller index rising 0.3% in seasonally adjusted terms in December, taking the annual growth rate to -3.1% while the Federal Housing Finance Agency (FHFA) US House Price Index fell 1.6%. Employment data released for January saw a further 20,000 jobs lost (versus expectation of +15,000) and large downward revisions to December figures. In positive news manufacturing jobs rose for the first time in three years. The US unemployment rate now sits at 9.7%, down from 10.0%.

Annual growth in US house sales (%)



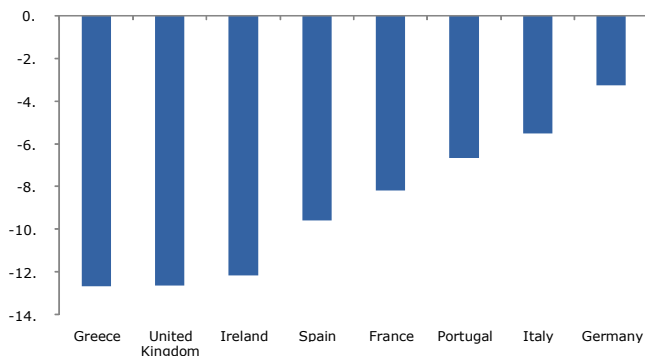
Source: Bloomberg. Data to 31 January 2010.

The US Federal Reserve (Fed) lifted the Discount Rate in February from 0.5% to 0.75%. The key point here is that the Discount Rate is not the Fed Funds target rate (the official cash rate) and the decision should not be seen as a tightening in monetary policy and will not raise the cost of credit for the economy. This move, in addition to the closure of other extraordinary credit programs is intended as a further normalisation of the Fed's activities. The Discount Rate is the interest rate the Fed charges banks for direct loans and was traditionally seen as an emergency loan facility only for banks. The motivation behind the move was an improvement in financial conditions, which can be seen as a positive step for the US. In terms of monetary policy, the Fed reiterated its stance that economic conditions warrant that

interest rates remain exceptionally low for an extended period.

In Europe, focus remained on Sovereign risk concerns centering on Greece. To date, the lack of a concrete plan from Greece to reduce its annual budget deficit (currently 12.7% of GDP) has concerned markets, with the country plagued by strikes as citizens oppose tough fiscal measures proposed by the government to improve the budget position. The European Union (EU) has agreed to stand behind Greece to safeguard the financial stability of the region however a detailed rescue plan was not announced. The EU said it will strictly monitor Greece's budget reduction progress, as such the Greek government will submit a report in mid-March, followed by regular updates. EU intervention may be imminent, however it will be careful to draft a plan that will aim to reduce moral hazard issues within the region and provide incentive for other economies, particular Spain and Portugal to undertake meaningful deficit reduction strategies. The chart below shows forecast government budget deficit positions as a percentage of GDP in Europe in 2009.

European Government budget deficit positions (% of GDP in 2009)



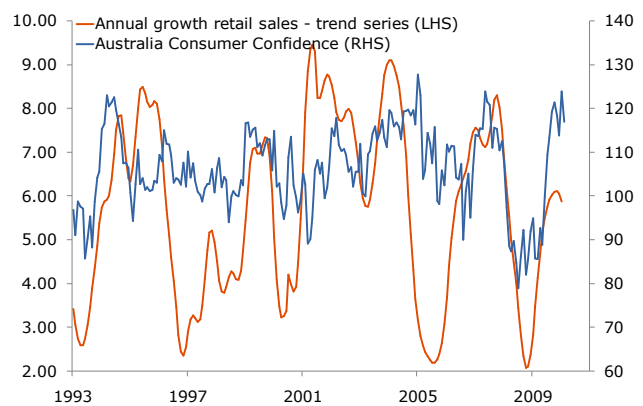
Source: OECD

In Australia, employment data for January was released, with the unemployment rate falling to 5.3%, down from 5.5% at December 2009. 52,700 jobs were added in the month, with the breakdown still skewed towards part-time (+36,900) versus full-time (+15,900). This was the fifth consecutive month of jobs growth and takes total jobs added to around 190,000 over this period. As the economy continues to recover, it would be expected that further full-time jobs were added and for productivity and hours worked to rise.

Other data out in February saw housing finance fall 5.5% in December, due to some weakness in the first-home owner segment, rising official interest rates, worsening housing affordability and the expiration of the larger first home owner grant. Both business and consumer confidence remain at near record highs, although this is not being

reflected in activity levels (chart above right), with retail sales falling 0.7% in December. Other positive news centered on capital expenditure and intentions data. In the 2010 Financial Year approximately A\$100bn of investment work is planned, with around half of this to be dedicated to mining investment.

Retail sales growth and consumer confidence



Source: ABS and Bloomberg. Data as at 28 February 2010

The RBA left the official cash rate on hold in February at 3.75%. In the minutes associated with the meeting, the RBA described the decision as 'finely balanced' between an optimistic domestic outlook and concerns over Sovereign risk in Europe. The RBA meaningfully upgraded GDP and inflation forecasts, with growth now forecast at 3.25%-3.5% through 2011-2012, while underlying inflation is now forecast to range 2.5%-2.75% across the forecast horizon, up from 2.25%-2.5% previously. Market expectations remain for the official cash rate to stand between 4.5% and 4.75% by year end. In early March, the RBA lifted the official cash rate to 4.00%.

Australian shares

The Australian share market recorded a positive return in February, with the S&P/ASX 200 Accumulation Index adding 2.2%. The key focus for investors during the month was the steady stream of earnings announcements which were released by listed companies for the December 2009 half year and accompanying trading updates.

The reporting season confirmed that the much-anticipated cyclical earnings upgrade cycle is yet to materialise. Indeed, close examination of companies' earnings releases highlighted that sales growth remains modest in most sectors. In many areas of the market, sluggish sales growth is being offset by lower operating and interest expenses, with companies continuing to drive earnings growth through reductions in costs.

Dividend payments were generally higher than consensus expectations, reflecting the strength of corporate balance sheets. Healthy distributions are

expected to form a key component of the total return from equities in the coming months, while share buybacks and special dividends could provide a further boost for investors in companies with excess capital.

Following the weakness in January, it was encouraging to see the Australian share market record a positive return in February given negative offshore news. The reporting season did highlight that the earnings recovery is yet to gather pace and affirms our view that stock selection will form a key part of total returns from the local share market in 2010.

On a sector basis, performance was mixed with Consumer Staples (+6.2%) the top performers while Telecoms (-10.2%) underperformed with a disappointing update from Telstra (-6.9%). HealthCare (+3.8%) and Utilities (+3.2%) also performed well. Amongst the top 50 companies Wesfarmers (+15.2%), OneSteel (+10.9%) and CSL (+10.3%) performed well while Toll Holdings (-20.9%) fell on a weak profit result.

Global shares

Global share markets were positive in February although performance was mixed across regions with the US and Asia ex Japan stronger while Europe and Japan weakened. The MSCI World Index rose 1.2% in US\$ terms and 0.6% in A\$ terms.

Stronger commodities prices saw Materials (+2.5%) perform well while Energy (-0.1%) weakened despite stronger oil prices. Both the US and UK Natural gas price fell in February.

The US share market performed well despite some mixed economic data. Concerns over the lift to the Discount Rate were dismissed with the market buoyed by expectations that the Fed Funds rate will remain at the current low level for an extended time. The Dow Jones index rose 2.6% with the S&P 500 up 2.9% and the Nasdaq rising 4.2%.

In the Eurozone equity markets were weaker with concerns over Sovereign risk and the negative impact fiscal consolidation will have on potential economic growth rates. Greece (-6.6%) and Spain (-5.6%) fell sharply while Germany (-0.2%) and France (-0.8%) posted more modest falls.

In Asia, Japan's Nikkei fell (-0.7%) with the slow pace of economic recovery while Hong Kong (+2.4%) and Singapore (+0.2%) posted gains. Export volumes across Asia have been improving and are a positive sign for economic growth within the region.

Global emerging markets

Emerging markets rose slightly in US\$ terms but underperformed the broader equity market as investor risk appetite fell in February. To date emerging markets have been boosted by stronger economic growth as most countries avoided wide scale bank losses, especially Asian and South American economies.

The MSCI Emerging Markets index rose 0.3% in US\$ and fell 0.3% in A\$. The Chinese Shanghai B Index rose 4.7% while other top performers included Mexico (+4.1%) and Sri Lanka (+4.7%). Leading emerging markets lower were Eastern European countries, likely caught up with Sovereign risk issues in Greece, Russia (-4.2%), Czech Republic (-3.2%), Poland (-3.4%) and Hungary (-2.6%) all fell.

Fixed interest

Bond markets concentrated on Sovereign risk in February as yields were pushed wider by Greece. Market participants are concerned that Greece's large fiscal deficit and high funding needs are not confined to its own borders, with Portugal, Italy, Ireland and Spain experiencing similar, albeit smaller, stresses. The political incentives to reduce budget deficits are seen as low in many European countries, particularly before elections such as in the UK and Eastern Europe. If the market remains unconvinced about the future of these large deficits, Sovereign risk premiums may rise, pushing bond yields higher.

In the US, the Fed announced several initiatives during the month to extend its implementation of "exit strategies". This included ending the Mortgage Backed Securities purchasing program and raising the Discount Rate by 25bps to 0.75%. While US Treasuries rallied during the second half of February, they remained relatively unchanged over the month. The 10 year yields rose by 3bps to finish February at 3.62% at end of February.

In Europe, yields fell over the month as a result of investors moving into German bonds, out of other European countries. 10 year yields fell by 9 basis points to 3.10% at end of February.

Weaker UK budget deficit numbers for January unsettled the market. The delicate fiscal position may be pushed to centre stage in the lead up to the coming elections. 10-year yields rose on Sovereign risk concerns, while the 2-year yields fell on expectations inflation will fall sharply over coming months. The 10 year government bond yield rose by 12 basis points to 4.03%.

In a sign of confidence in the Australian banking system, the Commonwealth government announced it is withdrawing its guarantee of Australian banks wholesale funding and large deposits on 31 March 2010. This move comes as the use of the guarantee has fallen significantly in recent months as bank funding costs have moderated. Australian regional banks however are expected to be most impacted by the withdrawal of the Government guarantee as their funding costs remain at elevated levels.

The Commonwealth has also announced the withdrawal of its guarantee scheme for State-government bonds, as at 31 December 2010. Lower total government bond issuance is expected due to expected large improvements in Budget deficit forecasts over the next three years. Less government bond supply together with more demand for government bonds may place downward pressure on bond yields in Australia.

Commonwealth government bond yields rose during the month. The 10-year yield was 5.44% at end of February, up 5 basis points.

As a result the UBS All Maturities Composite Bond index returned 0.50% in February and 3.43% over 12 months. With the RBA leaving the official cash rate on hold, 90 day banks bills fell to 4.13% at end of February from 4.38%. The UBS Bank Bill Index returned 0.35% in February and 3.47% over 12 months.

Listed property

The announcement of Australian listed property companies' earnings from the December 2009 half year dominated investor attention in February. The S&P/ASX 200 Property Accumulation Index rose 1.4% during the month, reflecting increased confidence that property companies will be able to deliver sustainable earnings and that the recovery in the domestic economy will be maintained. Few companies reported earnings which materially exceeded consensus expectations but, importantly, negative earnings surprises were also few and far between.

Improvements in the Australian labour market are expected to buoy investor sentiment towards property stocks this year. The drop in the unemployment rate should support retail sales, office demand and industrial activity, all of which are important factors in property market investment.

Overseas listed property stocks also appreciated in February, with the UBS Global Investors Index adding 3.3% in Hedged Australian dollar terms. Several US and European property companies reported their earnings to the market in February. While most companies were reasonably cautious in their outlook statements, investors are anticipating

a gradual improvement in global economic conditions and a recovery in asset values, both of which should support earnings growth in the remainder of this year and beyond.

Index returns – February 2010	Level	1 month	12 month
S&P ASX 200 Index	4,638	1.5%	38.7%
S&P ASX 200 Accumulation Index	32,576	2.2%	44.7%
MSCI World Net Index in A\$	-	0.7%	10.1%
MSCI World Net Index AUD Hedged	-	2.2%	48.2%
Dow Jones Index	10,325	2.6%	46.2%
UK FTSE 100	5,355	3.2%	39.8%
German DAX Index	5,598	-0.2%	45.7%
France CAC Index	3,709	-0.8%	37.2%
Japan - Nikkei	10,126	-0.7%	33.8%
Hong Kong – Hang Seng	20,608	2.4%	60.9%
MSCI Global Emerging Markets Index in A\$	-	-0.4%	36.7%
US 10 year bond yield	3.61%	3bps	60bps
Australia 10 year bond yield	5.44%	6bps	103bps
UBS All Maturities Composite Bond Index	5,967	0.50%	3.4%
90 Day Bank Bill Index	4.13%	-26bps	96bps
UBS Bank Bill Index	6819	0.3%	3.5%
S&P ASX 200 A-REIT Accumulation Index	19,150	1.5%	40.6%
UBS Global Real Estate Investors Index	967	3.3%	72.7%
A\$ in US cents	0.8954	1.3%	40.1%
Oil price	\$US79.7/barrel	9.3%	78.0%
Gold price	\$US1117.6/ounce	3.4%	18.6%

Source: Bloomberg. Data to end of February 2010.

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