

Market watch

January 2010

Key points

- Global economic recovery continues slowly, driven by China and Australia.
- International Monetary Fund (IMF) upgrades 2010 growth forecast to 3.9% from 3.1%
- Investment markets saw a return of risk aversion in January with equity markets falling over January and rising demand for government bonds.

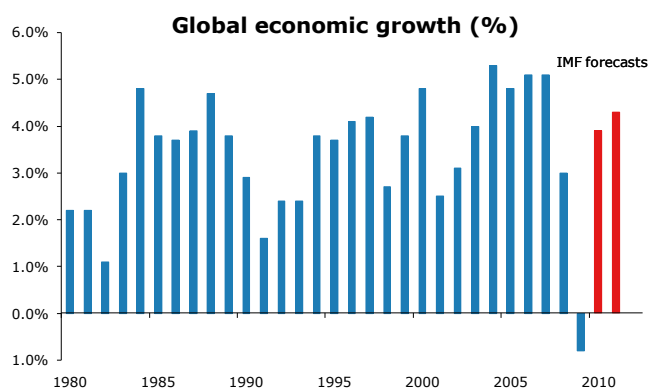
Economic overview

The year began with a return of risk to investment markets with equity markets falling and bonds rallying. Sovereign risk concerns in Greece and other parts of Europe, tightening of monetary policy in China and regulatory risk overshadowed the continued economic recovery. The pace of recovery differs between countries, with those whose banking systems were relatively unscathed achieving a faster pace of recovery, as monetary policy has more impact. This includes China, Australia and some parts of South America. Countries such as the US, Japan, UK and Europe are recording a slower pace of recovery, still weighed down by slow money creation. As a result the pace at which various policy stimulus measures are unwound will differ.

The International Monetary Fund (IMF) upgraded its global economic growth forecasts. The IMF estimated the global economy contracted by 0.8% in 2009, the first contraction since World War II. As the chart opposite shows, the IMF upgraded its 2010 forecast from 3.1% to 3.9%, driven by a stronger pace of recovery post the crisis but to date has been driven by policy stimulus and faster growth in Asia. The forecast for 2011 is 4.3% but is dependent on continued near term support from fiscal stimulus, reform of the financial system and successful communication and removal of government stimulus.

The US recorded a 5.7% seasonally-adjusted annualised GDP growth rate in the December quarter, compared to 2.2% in the September quarter. Of this 5.7%, 3.4 percentage points of growth was due to a lower amount of inventory destocking. Stronger than expected consumer and business demand for equipment also assisted while the government detracted from growth with reduced

spending. Over 2009 the US economy shrank 2.4% in 2009, the biggest fall since 1946.



Source: IMF. Data as at January 2010.

US housing market data weakened. New home sales (-7.6%) and existing homes sales (-16.7%) fell in December, albeit negatively impacted by cold weather and uncertainty over the expiry of a tax credit. The US labour market shed more jobs, with 85,000 lost over December, a weaker result than markets had expected and following on from the +11,000 gain in November. The unemployment rate held steady at 10.0%, assisted by a sharp fall in the participation rate. The underemployment rate is now 17.3% with the labour market remaining one of the main headwinds for a US economic recovery and a key indicator for the Federal Reserve. The Federal Reserve left the Fed Funds rate on hold in January, albeit with one dissenter to maintaining the statement that the outlook "warrants exceptionally low levels of the federal funds rate for an extended period".

The European economy continues to recover slowly, hurt by lingering concerns over sovereign risk and large government deficits and debt burdens. Consumer confidence rose in January but the unemployment rate has reached 10.0%. Money supply growth is negligible and this makes a return to economic growth challenging. Japan's sovereign credit rating outlook was lowered by Standard and Poor's given a lack of plan on how to reduce the nation's large debt burden.

In China, economic growth over the December quarter recorded a 10.7% annual growth rate, up

from 9.1% the prior quarter and recovering from a low of 6.1% in March (see chart over page). Inflation also rose to 1.9% over the 12 months to December, although around half was due to higher food prices. Given the strength in the data and recovery in trade, it is no surprise the Chinese government has begun to remove some of the accommodative monetary policy in place. So far this has taken the form of lifts to the reserve ratio requirement (RRR) for banks, higher short term interest rates and attempts to reduce the amount of lending within the economy.



Source: Bloomberg. Data as at 31 December 2009.

In Australia, 4Q 2009 CPI was released with headline inflation rising 0.5% over the quarter taking the annual rate of inflation to 2.1% from 1.3%. Underlying inflation (which removes short-term volatile price movements) rose by 0.65% over the quarter and 3.4% over the year and remains outside the Reserve Bank of Australia's (RBA) 2%-3% target band.

The Australian labour market continued its recent improvement with 35,200 jobs created in December and the unemployment rate falling to 5.5% from a revised 5.6% in November (see chart below). Consumer confidence also rose with the recent strength in the labour market and buoyant residential property prices.



Source: Australian Bureau of Statistics. Data as at 31 December 2009.

As a result of recent strength in the Australian economy and inflation data released over January, market pricing puts the official cash rate between 4.75% and 5.00% by year end (from 3.75% in early February) as the RBA looks to move policy back towards a more normal level given the outlook for the Australian economy. In the meantime, the Australian economy is expected to continue to grow, driven by record mining investment, large infrastructure projects and business spending as profit growth returns and improved household spending from improved balance sheets and greater confidence. Headwinds could be offshore policy tightening and rising costs.

Australian shares

After a bright start in the first few trading sessions of 2010, the Australian share market struggled in January. The S&P/ASX 200 Accumulation Index declined 6.2% during the month, with all industry sectors losing ground. Energy stocks (-9.8%) were among the worst performers, partly due to weakness in the oil price, while Materials stocks (-9.1%) also underperformed as investors became concerned that the Commonwealth Government might change the way it taxes mining companies as part of the Henry Tax Review which has yet to be released.

Merger and acquisition activity remained a feature of the market in January, with a number of companies announcing possible takeovers. Following a raft of equity raisings in 2009, most companies appear to be well capitalised and this could prompt an increase in the number of takeovers in Australia and overseas this year.

Investors also focused on the upcoming fiscal first half reporting season. Most Australian listed companies will announce their semi-annual results to the market in February. As ever, investors will be looking for updated earnings guidance for the full year and the tone of outlook statements will have an important influence on sentiment.

Global shares

Global share markets were weaker in the first month of 2010 with falls in all major markets. The MSCI World Index fell 4.1% in US\$ terms and 3.0% in A\$ terms.

Globally the Materials (-8.7%) and Energy sectors (-5.5%) led returns lower on policy tightening in China. The oil price fell 8.2% over the month and most commodity prices were lower on concerns of a policy induced slowdown in China.

The US share market also fell on concerns of changes to banking regulations proposed by President Obama. In positive news, Federal Reserve Chairman, Ben Bernanke was re-elected for a second term. The Dow Jones index fell 3.5% with the S&P 500 down 3.7% and the Nasdaq falling 5.4%.

In Europe equity markets were weaker with Spain (-8.3%) retreating on sovereign risk concerns. Germany (-5.9%) and France (-5.0%) also fell with the UK FTSE 100 down 4.1%. Japan's Nikkei was down 3.3% despite the credit rating outlook downgrade while Hong Kong fell 8.0% on China's policy action.

Emerging markets

Emerging markets fell and underperformed the broader global equity market on risk aversion. The IMF forecast a 6% growth rate for emerging market and developing economies in 2010. One concern is surging capital flows and policies will be needed to manage this.

The MSCI Emerging Markets index fell 5.7% in US\$ and 4.7% in A\$. Brazil (-5.4%) and Mexico (-4.7%) led emerging markets lower on links to China and commodity prices. China fell 3.9%. Sri Lanka (+7.4%) and Czech Republic (+5.3%) outperformed other regions.

Global fixed interest

Government bonds in the major markets performed well with investor interest returning to the sector. Globally government yields fell, with US bond yields taking the lead, primarily on the back of 'flight to quality' due to sovereign risk concerns, the new regulatory proposals, and further weakness in developed economies.

The Greece sovereign risk story continued to worry the market, and sent Greek yields wider still, with Portugal and Spain following. German bond yields stayed low due to deteriorating sentiment about worsening debt problems in the Eurozone.

In the US, government bond yields with the 10 year yield fell from 3.84% at the end of December 2009 to 3.58% at end of January. This rise reflected the worse than expected employment data, some risk being taken off the table on the back of some disappointing earnings news, and 'flight to quality' on Sovereign risk concerns.

In Europe, German bond yields stayed low due to deteriorating sentiment about worsening debt problems in the Eurozone. The European Central Bank left policy rates unchanged at 1.0% with no further announcements on policy withdrawal. The Greece Sovereign risk story continued to take centre stage with Moody's expressing concerns that the Greek economy may face a 'slow death' from the dire budget outlook.

Over January, Australian government bond yields took the lead from the US and the 10 year government bond yield fell to 5.38% from 5.64%. The Australian labour market data did surprise the market with its improvement compared to past months and put some upward pressure on yields

during the month before succumbing to offshore pressures.

As a result the UBS All Maturities Composite Bond index returned 1.35% over January and 1.67% over 12 months. With the RBA expected to continue to lift official cash rates over 2010, 90 day bank bills rose from 4.28% at end of December to 4.38% at end of January. The UBS Bank Bill Index returned 0.35% in January and 3.42% over 12 months.

Listed property

The weakness in the Australian share market weighed on listed property stocks, with the S&P/ASX 200 Property Accumulation Index falling 2.9%. The Industrial sub-sector (-7.5%) was the worst performing area of the market, as investors have taken profits after recent strong gains in the sector. Stocks in the Commercial sub-sector (+5.3%) also underperformed, in spite of favourable Australian employment data which should support demand for office space in the medium term. The Retail sub-sector (+0.3%) was the best performing area of the market in January.

Sales data suggests there is increasing demand for commercial property. A number of transactions in properties worth less than \$50 million have been completed, partly due to strong demand from wealthy individual investors. Sales of properties worth more than \$100 million, which are typically owned by institutional investors, have been fewer, although a pickup in transactions at the larger end of the market is possible this year.

Overseas listed property stocks also struggled in January, with the UBS Global Investors Index losing 3.8% of its value during the month in Hedged \$A terms. The sector has added more than 40% in the past 12 months as investors have anticipated an improvement in operating conditions. Evidence of acceleration in the pace of global economic growth could provide further momentum for the sector in 2010.

Index	Level	1 month %	12 month %
S&P ASX 200 Accumulation Index	31,886.25	-6.2%	35.2%
MSCI World Net Index AUD Hedged		-3.3%	32.5%
MSCI World Net Index in A\$	-	-3.0%	-2.3%
Dow Jones Index	10,067	-3.5%	25.8%
German DAX Index	5,608	-5.9%	29.3%
France CAC Index	3,739	-5.0%	25.7%
Japan - Nikkei	10,198	-3.3%	27.6%
Hong Kong – Hang Seng	20,122	-8.0%	51.5%
MSCI Global Emerging Markets Index in A\$	-	-4.5%	28.9%
US 10 year bond yield	3.58%	-6.6%	26.2%
Australia 10 year bond yield	5.38%	-4.7%	31.2%
UBS All Maturities Composite Bond Index	5937.38	1.35%	1.67%
90 Day Bank Bill Index	4.38%	2.4%	28.5%
UBS Bank Bill Index	6795.81	0.35%	3.42%
S&P ASX 200 A-REIT Accumulation Index	18,875	-2.9%	16.1%
UBS Global Real Estate Investors Index	936	-3.8%	40.9%
A\$ in US cents	0.8889	-1.2%	39.8%
Oil price	US\$72.9/barrel	-8.2%	74.9%
Gold price	US\$1081.9/ounce	-1.5%	16.9%

Source: Bloomberg. Data to 31 January 2010.

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