

July 2009

# Market Watch

## Economic commentary

The Australian economy continued to show signs of improvement in July. The biggest positives continued to be in the household sector with retail sales, building approvals, housing finance and consumer sentiment all improving further in the month. In addition, while labour market weakness persisted, the rate of deterioration remained relatively subdued. The ongoing risk for the Australian economy in the remainder of 2009 is the low availability of credit especially for small businesses.

An important event in the month was a speech by Glenn Stevens, the Governor of the Reserve Bank of Australia (RBA). The Governor reiterated his message that Australia had enjoyed considerably stronger economic conditions than other global economies and the risks to growth were now to the upside. This seemed to signal to the market that the easing cycle in interest rates was over and that the next move in interest rates would be up.

The Governor's speech also highlighted two concerns. First, he is keen that the current low interest rate environment is used as an opportunity to expand Australia's housing stock, rather than just serving to bid up the prices of established homes. Second, he did suggest that while Australia had benefited from its strong relationship with China it would also be at risk if strong growth in China were to end.

Internationally, there were further signs that the global economy is emerging from its slump and that over the second half of the year it is likely to expand. The most positive signs continue to come from Asia, with China and Korea seeing growth accelerate. In China annual growth reached 7.9% in Q2 2009 from a rate of 6.1% in Q1 2009, while in Korea growth in Q2 was 2.3%, its fastest pace since 2003. Many developed world economies continued to shrink in Q2 2009 though the pace of decline slowed. In the US the economy shrank at an annual rate of 1.0% in Q2 2009, well below its pace of -6.4% in Q1 2009 and in the UK the economy shrank 0.8% in the quarter compared to -2.4% in the previous quarter.

The \$A rose over the month to end at US 83.56 cents, a gain of 3.5% over the month. The \$A continued to rally as market sentiment improved and commodity prices rose.

At the end of June, the \$A bought 0.5000 UK pounds, 0.5862euro and 1.2627 NZ dollars.

## Australian shares

The S&P/ASX 200 Accumulation Index rose 7.3% in July, the best monthly performance since March 2009. Over the year to July 2009 the index is down 10.2%. However, since reaching its low on 6 March 2009, the S&P/ASX 200 Accumulation Index has risen 36.3%.

The Australian sharemarket rose for the fifth consecutive month in July. This is the first five-month consecutive gain since the period between February and May 2007.

The strong performance of the Australian share market in July reflected the emerging recovery in the global economy, improved earnings and the continued ability of firms to raise capital. The big diversified miners performed well, as data released from China showed continued improvement. Local retailers performed well with Woolworths reporting a 9.1% annual rise in sales over the June 2009 quarter. NAB continued the trend for large companies to tap equity markets to improve its balance sheet and enable it to take advantage of opportunities to expand. Importantly, larger companies also found it easier to access debt markets with Leighton, Dexus, Lend Lease and CFS Retail Property Trust re-financing through the debt market in July.

A number of companies also announced upgrades. Paperlinx announced net debt was 30% lower than expected, Leighton Holdings announced it had won two new contracts in Abu Dhabi and Aristocrat Leisure benefited from announced regulatory changes in the United States. Macquarie Airports rose after announcing an agreement with Macquarie Group to internalise management.

The strong market sentiment meant the more cyclical sectors outperformed in July. Strongest were the Industrials (15.1%), the Materials (14.1%) and the Consumer Discretionary (12.4%), as prospects for a domestic and international recovery improved further. The Financials ex Property (+12.7%) continued their strong performance in July as the outlook for loan losses improved. The defensive sectors all underperformed with negative returns in

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Health Care (-1.4%) and small positives in Telecoms (+6.0%), and Utilities (+6.8%). For the year to July 2009 the best performing sectors are IT (+13.2%), Health Care (-6.1%) and Consumer Discretionary (-8.0%). Interestingly, the S&P ASX 200 FinxREIT index is slightly positive over the year.

Among the top 50 companies, industrial companies Bluescope Steel (+33.7%) and Leighton (+31.5%) and financials AMP (+16.4%) and ANZ Bank (+15.3%) were the best performers. This reflected the improving confidence in a sustainable recovery in Australian economic activity. Lihir Gold (-5.5%) and CSL (-5.0%) fell.

Having been tested in June, the rally in Australian equity prices accelerated in July. Key drivers of this performance were the continued improvement in performance of the Australian economy, the growing global momentum and an easing in oil prices and tightening in bond spreads. The improvement in the Australian economy has been of substantial benefit to stocks linked to consumer discretionary spending and the housing cycle, as households take advantage of government cash payments and monetary policy to raise spending levels. Retail sales in Australia grew 7.1% in the year to May 2009 compared to a 7.8% fall in the same period in the United States.

## Global shares

The major global equity markets rose strongly in July. The MSCI World Index rose 11.3% in \$US and 5.2% in \$A terms. Over 12 months, global shares were down 22.9% in \$US and have fallen 13.1% in \$A.

The 'green shoots' of recovery that have emerged over the last five to six months now suggest that the global economy has at least stabilised at current levels. These green shoots, particularly in surveys that show rising household or business confidence, suggest that a second half recovery in global growth is now more likely. The primary driver of this growth will be the developed world re-stocking process. Over the last 12 months firms have aggressively drawn down their inventories due to concerns over end-demand. But as end-demand recovers, in part because of government spending, it is expected that production will need to increase substantially.

Share market performance was weak in the opening days of July as rising interest rates and oil prices threatened to dampen a recovery in the wider economy. However, the market rallied from July 11 when equity analysts in the US became more optimistic on banking stocks. These changes led to a strong rally in US and global financial stocks that became more broad-based as the month went on.

The changing outlook for banking stocks came at the start of the US company reporting season. The season has been marked by the strong out-performance of many companies relative to the expectations of financial analysts. Companies such as Caterpillar, Apple and Citigroup (amongst many banks) all reported stronger than expected earnings. More negative analysts have commented that much of the out-performance in earnings has been due to effective cost-cutting rather than better than expected revenue growth.

The Dow Jones Industrial Average was up 8.6%, the S&P 500 Index was up 7.3% flat, while the NASDAQ was up 8.5%. Since its bottom on 9 March 2009, the Dow rallied 40.0% to the end of July. Over 12 months the Dow is down 19.4%.

The US economy's slower pace of decline was evident in the GDP figures announced at the end of July. The data showed the economy shrunk by a lower than expected 1.0% annually in the June quarter. The biggest drivers of the decline were inventories, investment and household consumption. While the decline in inventories is likely to drive a positive increase in production over the coming year, there is concern about the sustainability of household consumption as deleveraging continues.

Asian markets continued to lead the global recovery in July, with growth beginning to broaden beyond just the strong Chinese economy. The Korean economy grew 2.3% in the quarter. The Chinese sharemarket rose 15.9% and is up over 130% from its low in late September 2008. However, this performance masked a 6% one day fall at the end of the month, as investors worried about a potential tightening in monetary policy. The Nikkei Index rose 4.6%, while Hong Kong was up 12.8% and Singapore rose 13.8%. The Indian sharemarket continued its impressive gains, rising 8.1% in the month and 9.2% in the year.

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European markets also posted strong results in July. While economic data in Europe continued to point towards weakness, with Europe likely to be the last zone to come out of recession, markets rallied in line with their global counterparts. France (9.1%) and Germany (10.9%) both rose, with the UK FTSE up 8.5%. The UK FTSE has risen 21% off its early March low.

Emerging markets were stronger in July, with the MSCI Emerging Markets Index up 10.9% in \$US terms, and 7.0% in \$A. Eastern European markets enjoyed some of the strongest gains as concerns over the region's banking system eased somewhat. The Czech Republic (18.7%) and Poland (15.9%) were the best performers. The performance of emerging markets highlights the increased appetite for risk amongst many global investors.

## Fixed interest

In both Australia and globally, fixed interest markets appeared more settled over the month. The increase in issuance of government bonds picked up pace, but to date these have been met generally with strong demand by the market. Credit spreads narrowed and bond yields rose, although they traded with some degree of volatility.

The Reserve Bank of Australia (RBA) left official interest rates on hold in July at 3.00%. In leaving interest rates on hold, the RBA noted improving confidence levels, evidence that the global economy was stabilising and better conditions in financial markets. However, more recent commentary has suggested that the RBA's easing cycle is over and that the next move in interest rates will likely be up.

In financial markets, LIBOR (London Interbank Offer Rate), the interest rate at which banks borrow and lend from each other, continued to fall. From a peak of 330 basis points over the Fed Funds rate back in October 2008, LIBOR traded at 22bp above the Fed Funds rate at the end of July. LIBOR has now returned to the levels observed in the period before the global financial crisis began.

In the US, 10 year bond yields rose over the month and traded in a wide range, as high as 3.75% and as low as 3.26%. Bond prices fell in the last half of the month as equity markets rallied strongly. Importantly, the rise in bond yields has been relatively sedate compared to the rise in equity prices. In previous rallies in recent months strong rises in interest rates have been perceived as a brake on a sustainable economic recovery in the US.

Elsewhere in the world, 10 year bond yields rose over the month in Japan and the UK, with signs of an economic improvement in both economies. However, Euro area bond yields fell. They stand at 3.80% in the UK, 1.44% in Japan and 3.30% in Europe. Over the month, first-quarter GDP was revised down in the UK to -2.4%. This was the biggest quarterly fall since 1958.

At the end of July, 10 year Australian government bond yields stood at 5.69%, up from 5.52% at the end of June and a low of 3.85% in mid-January 2009. Ninety day bank bills were yielding 3.18% at the end of July.

The UBS Australian Composite Bond Index returned 0.33% over July. Over 12 months the index has returned 8.91%.

## Listed property

The listed property sector rose for the third consecutive month in July, rising 2.4%. The sector has undertaken a large work-out program over the past 12 months, raising capital and setting more realistic earnings expectations. The sector is also trading on a high yield, which has started to prove attractive to investors.

The index was impacted by the continued large rise in Goodman Group (+36.0%) and strong gains in Mirvac Group (+18.1%) and Bunnings Warehouse Property (+11.7%). This helped the industrial sector to rise (+32.5%) over the month, although it remains down 77.4% for the 12 month period.

Global property markets were stronger in July, with all major markets up strongly with the exception of Germany and Italy. The strongest performance was in China, France and Singapore.