

# Market watch

March 2010

## Key points

- Equity markets performed well in March, with growing confidence over a near term solution to Sovereign risk concerns in Greece and continued improvements in economic data globally.
- The Australian economy outperformed most other developed economies in 2009.
- Bond yields rose sharply in both the US and Australia, while the market continues to expect the Reserve Bank of Australia to lift the official cash rate back to 5% this year, and even further in 2011.

## Economic overview

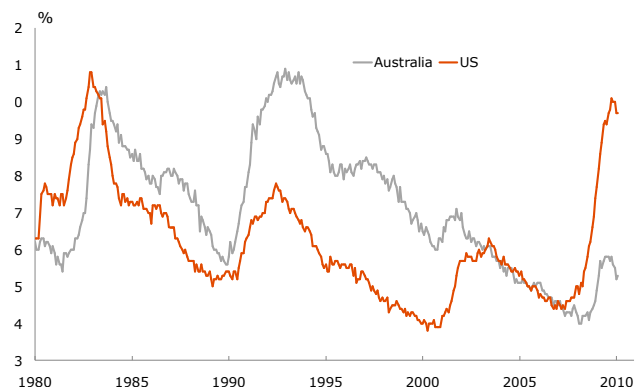
Equity markets performed well in March, with growing confidence over a near term solution to Sovereign risk concerns in Greece and continued improvements in economic data globally. While developing economies continue to record a faster pace of recovery, there are also clear signs of improvement in the US and to some extent Japan and Europe, with the latter assisted by a weaker euro.

In coming months the key issues that could cause volatility in investment markets include; the Federal Reserve (Fed) ceasing purchases of Residential Mortgage Backed Securities (RMBS) and the possible negative implications for the US housing market, renewed concerns over Sovereign risk in Greece and policy tightening in China.

To date the Fed has purchased up to 100% of new issuance of RMBS and concerns are held over the possible rise in US mortgage rates come 31 March 2010. Over March, Greece issued just over €10 bn in bonds, with varying degrees of success and needs to issue a further €10 bn before the end of April. Discussions over a possible rescue package continued over March and there is now a plan, involving both the European Union and IMF if need be. The other main area of uncertainty is timing of policy tightening in China and the US. China is expected to begin lifting official interest rates in coming months while debate continues over a possible revaluation of the Yuan.

US economic data released in March highlighted the negative impact of bad weather in January and February. The US labour market shed 36,000 jobs in February and the unemployment rate held steady at 9.7% (see chart below with US versus Australian unemployment rates). Bad weather continued to hamper a recovery in employment, but market expectations are for a sharp increase in jobs in March (partly on the back of increased employment for the coming census). Consumer spending continues to recover (retail sales rose 0.8% in February), while the housing sector remains at depressed levels with further falls in new (-2.2%/mth) and existing home sales (-0.6%/mth), lower housing starts (-5.9%/mth) and concerns over rising foreclosure and inventory levels. The US recovery continues to be driven by the manufacturing sector, with durable goods orders continuing to rise. US corporate profitability also continues to improve sharply, largely on the back of reduced costs.

## Australia and US unemployment rate (%)



Source: Bloomberg. Data to 28 February 2010 for Australia and 31 March 2010 in the US.

The US Federal Reserve left the Federal Funds rate on hold in a widely expected move in March. The markets focus remained on the accompanying statement, where the Fed maintained its commitment to keep rates at an exceptionally low level for an "extended period". While the Fed is not expected to move the Federal Funds rate until late 2010, it is expected this commitment could be removed around mid-year, if not earlier.

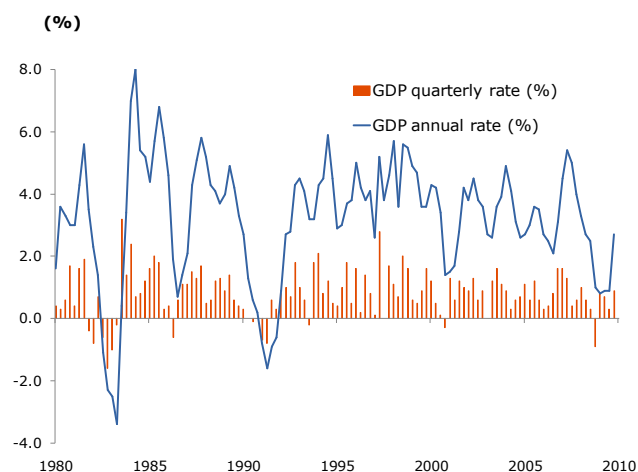
Some improvements have also occurred in the Japanese economy. The Bank of Japan has undertaken further quantitative easing, while government stimulus is also expected to help household consumption over 2010. Retail sales have improved while the labour market has seen the unemployment rate fall from a peak of 5.6% in July 2009 to 4.9% at the end of February.

Sovereign debt issues in Europe and the outlook for a weaker recovery have seen the euro weaken in recent months, falling 7% against the USD since the start of the year. This is helping the prospects of an export led recovery in Europe, which is particularly beneficial for France and Germany.

Economic data released in China continued to show signs of strength, albeit with some sequential slowdown in growth rates. Data was released for both January and February given Chinese New Year celebrations. Inflationary pressures continue to be the main worry, rising 2.7% for the 12 months to February, up from 1.5%. Whilst most of the pressure is from food prices, there are reports of wage demands of up to 20% in parts of the manufacturing sector, particularly coastal regions. Industrial production rose 12.8% over 12 months while fixed asset investment rose by 26.6%. Discussions have centered on the next policy tightening, in particular any moves to revalue the Yuan.

In Australia, Q4 2009 GDP data was released. The Australian economy recorded growth of 0.9% in the quarter, taking the annual growth rate to 2.7% (chart below). This confirmed Australia's position as one of the best performing developed economies in 2009 and was due to a very effective government stimulus packages, strong banking system, population growth and trade links to Asia. The growth in Q4 was primarily driven by government stimulus efforts through small business investment, driven by tax incentive schemes and through direct government investment work.

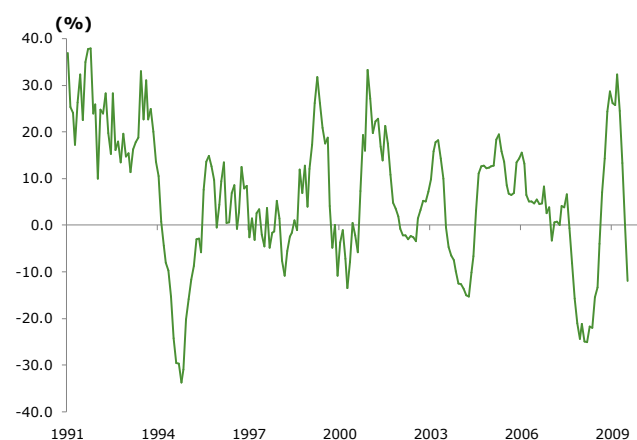
**Australia Gross Domestic Product (GDP) (%)**



Source: ABS. Data to 31 December 2009.

Other data out in March was on the weaker side. After six months of strong employment gains, only 400 jobs were added in February, with the unemployment rate rising from 5.2% to 5.3%. The underlying data was better, with an increase in full time jobs and a lift in hours worked. Retail sales fell 1.4% in February, a further symptom of the household sector deleveraging. Housing Finance has also weakened, falling 7.9% in the month of January, the fourth consecutive month of falls (see chart below). Rapidly rising house prices, supply shortages and rising official cash rates are likely to be hampering the market. The RBA has raised its concern over the lack of supply of housing and the recent strong gains in house prices.

**Annual growth in housing finance (%)**



Source: ABS. Data to 31 January 2010.

The RBA lifted the official cash rate by 25 basis points (bps) to 4.00% in early March. The RBA noted that this was "a further step in the process" of returning interest rates "closer to average". This fits with the RBA's belief that with "growth likely to be close trend and inflation close to the target over the coming year, it is appropriate for interest rates to be closer to average". Further interest rate rises are expected by the market over 2010, with the market pricing in a 5% cash rate by year end. During other RBA speeches during the month, the RBA reiterated that interest rates are likely to continue to gradually move towards more normal levels. The RBA has also highlighted some broader risks to the global economy; fiscal consolidation in the developed world, capital flows in the developing world and the need to increase domestic demand in Asia.

**Australian shares**

The Australian share market performed very well in March, with the S&P/ASX 200 Accumulation Index adding 5.7%. These gains more than offset the weakness in January and ensured that the market ended the first quarter of 2010 in positive territory (+1.3%).

There were further signals that the economic recovery remains on track, which supported investor sentiment towards equities. Data showed that the economy grew by 2.7% in the year to December 2009, while favourable employment data was also released.

Against this background, stocks with some leverage to the economic cycle tended to outperform. Energy (+8.9%) was the best performing sector, while more defensive areas of the market, such as Utilities (+1.7%) and Consumer Staples (+2.0%), were among the laggards.

The Materials sector (+7.8%) also performed well. Bulk commodity export demand is expected to be supported by quickening global economic growth, while the pricing environment also appears favourable for producers. Iron ore producers are currently in negotiations with Asian steel makers and some analysts have suggested they will be able to secure a 90% (or more) increase in contract prices for the coming year as well as moving toward shorter term contracts rather than annual ones.

While official interest rates are rising, the equity market took the increase in interest rates in its stride, as a certain degree of monetary tightening has already been fully anticipated by investors. The test will be for companies to deal with rising cost pressures and higher interest rates at the same time as the market is expecting a return of profit growth due to operating margin expansion.

### **Global shares**

Global share markets recorded broad based gains across all regions. The MSCI World Net Index rose 5.9% in US\$ terms and 3.6% in A\$ terms.

On a sector basis both Materials (+9.0%) and Industrials (+8.0%) recorded strong gains. This performance is reflective of the type of economic recovery being experienced, through strong demand for commodities in emerging economies and through a manufacturing led recovery in the developed economies, especially the US.

The US equity market reached a new high since the low 12 months ago in March, although still has not reached the high seen in October 2007. Company profits have recovered sharply, rising 31% in the 12 months to December 2009. This has largely been driven by aggressive cost cutting, improved productivity growth and expected rebound in operating leverage. This should help promote employment growth. The Dow Jones index rose 5.2% with the S&P 500 up 5.9% and the Nasdaq rising 7.1%.

In the Eurozone equity markets were also stronger. Some certainty over a possible rescue plan for Greece and the benefits of a weaker euro are providing improved confidence. Germany (+9.9%),

France (+7.2%) and Spain (+5.2%) finished higher. Greece finished up at 8.1%.

In Asia, Japan's Nikkei rose 9.5% on rising confidence in prospects of improvements in the economy. The Nikkei is now at its highest level since October 2008. Hong Kong (+3.1%) and Singapore (+5.0%) recorded more muted gains.

### **Global emerging markets**

Emerging markets outperformed broader developed markets in March. Eastern Europe saw the strongest gains, assisted by growing confidence of a concrete plan in Greece. Emerging economies continue to lead the recovery in the global economy, with particular focus placed in China, India and Brazil. Each country has unique drivers of economic growth despite all being developing economies.

China remains focused on infrastructure development, manufacturing and the export sector, requiring intense commodity usage. India remains predominantly focused on the services sector and raising living standards while also undertaking infrastructure and investment work which should lead to continued demand for raw materials. Brazil is still recovering, recording economic growth of 4.3% in the 12 months to December 2009. Key drivers for the economy are a growing middle class, residential construction, mining, energy and agricultural investment. While China and India are heavy users of commodities, Brazil is both a supplier and demander of commodities.

The MSCI Emerging Markets index rose 8.0% in US\$ and 5.4% in A\$. Turkey (+13.2%), Poland (+9.7%) and Hungary (+14.0%) all rose sharply. China recorded muted gains, rising 1.8% as expectations of further policy tightening gained pace while India (+6.7%) and Brazil (+5.8%) both rose.

### **Fixed interest**

Global bond yields rose in March in most developed markets. Yields spiked in both the US and Australia, with 10-year yields reaching their highest point since mid 2009. The main drivers in the US were Sovereign risk concerns, two poor US bond auctions and tensions between the US and China intensifying.

The US Treasury market sold off (yields rose) sharply towards the end of the month and auctions for 5 and 7 year bonds were weak due to lack of demand. A combination of Sovereign risk concerns in Europe, continued warnings from rating agencies about unsustainable fiscal deficits, and intensifying tension between the US and China put upward pressure on yields. Possibly assisting the sell-off was an increase in bond supply by the Japanese Treasury. Over the month, 10-year yields rose by 21bps.

Greece announced additional budget cuts worth €4.8bn (2% of GDP) before the EU summit, in line with demands from the European Commission. Portugal has also announced further plans to trim its budget during the month. Despite its efforts, Fitch downgraded Portugal by one notch to (AA-) with a 'negative' outlook during the month.

Over the month, UK government yields fell with 10- year bond yields falling from 4.03% to 3.94%. The key driver of the move in the 10-year was the substantial cuts announced in the medium to long term supply in the Budget, as well as the reaction to credit rating agencies pressing for fiscal consolidation.

Japan's economy showed signs of improvement during the month, with better retail sales and other improving pieces of economic data. Japanese Government Bond (JGB) yields rose in March with 10-year yields 9bps higher on the month to 1.40%. In Australia, Commonwealth Government bond yields rose in March, in line with the global trend and as a result of better economic fundamentals.

The RBA Financial Stability Review reiterated that Australia's financial system is resilient. The RBA Governor was quite vocal about the improvement in housing and iron and ore prices in an interview at the end of March. Hence, by the end of the month, the market was pricing in a greater than 50% chance of an additional 25bps rate hike at the following RBA meeting in April.

Much improved economic conditions and therefore rising official cash rates, together with a less than expected refinancing requirement from the Commonwealth Government, pushed yields higher during the month.

Commonwealth Government yields rose in March as a result of better economic fundamentals and the global trend of rising yields. Shorter term bond yields rose a little more than longer term yields due to reassessment of the RBA outlook. 10-year yields rose by 34bps to 5.78%.

The UBS All Maturities Composite Bond Index returned -0.6% in the month and 2.7% over 12 months. With the RBA lifting the official cash rate on hold, 90 day banks bills rose from 4.13% at end of February to 4.49% at the end of March, the highest since December 2008. The UBS Bank Bill Index returned 0.35% in February and 3.54% over 12 months.

#### **Listed property**

There was limited activity in the Australian listed property sector in March. The S&P/ASX 200 Property Accumulation Index recorded a return of -0.1%. Stocks in the sector failed to keep pace with the broader share market, which added more than 5% during the month.

Goodman Group, which owns a portfolio of industrial property assets, performed particularly well during the month. The company hosted an investor trip to Hong Kong, where the positive outlook for its Asian business was reinforced. In other stock-specific news, the share price of Westfield Group, which dominates the Australian Real Estate Investment Trust (REIT) sector, was volatile during the month as investors questioned whether the company would complete a major capital raising in order to pursue acquisition targets in the US.

Australian property stocks also underperformed their international counterparts over the month. The US market performed particularly well with the UBS Global Real Estate Investors Index (Net TR) AUD Hedged rising 7.1% in the month, and returning 79.7% over 12 months.

**Index performance**

<b>Index returns – March 2010</b>	<b>Level</b>	<b>1 month</b>	<b>12 month</b>
S&P/ ASX200 Index	4,876	5.1%	36.1%
S&P / ASX 200 Accumulation Index	34,449	5.7%	41.7%
MSCI World Net Index (AUD)		3.6%	15.3%
MSCI World Net Index AUD Hedged		n/a	n/a
Dow Jones Index	10,857	5.1%	42.7%
UK FTSE 100	5,680	6.1%	44.7%
German DAX Index	6,154	9.9%	50.6%
France CAC Index	3,974	7.2%	41.6%
Japan - Nikkei	11,090	9.5%	36.8%
Hong Kong – Hang Seng	21,239	3.1%	56.4%
MSCI Emerging Markets Net Index (AUD)		5.4%	37.1%
US 10 year bond yield	3.83%	21bps	116bps
Australia 10 year bond yield	5.78%	35bps	136bps
UBS All Maturities Composite Bond Index	5,932	-0.6%	2.7%
90 Day Bank Bill Index	4.49%	37bps	136bps
UBS Australian Bank Bill Index	6,842	0.3%	3.5%
S&P / ASX 200 - A-REIT Accumulation Index	19,141	-0.1%	40.6%
UBS Global Real Estate Investors Index (Net TR) AUD Hedged	1,036	7.1%	79.7%
AUD/USD (end of month)	0.9172	2.4%	32.7%
Oil price	US\$83.76 /barrel	5.1%	68.7%
Gold price	US\$1113.25 /ounce	-0.4%	21.1%

Source: Colonial First State. Data to 31 March 2010. **Past performance is no indication of future performance.**

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