

May 2009

# Market Watch

## Economic commentary

The Federal government's Budget made headlines over the month. The 2009-10 Budget is expected to produce a deficit of almost \$A58bn, or 4.9% of gross domestic product (GDP). This is the largest deficit in Australia's peace-time history, both in dollars and as a share of GDP. Furthermore, the Budget is expected to remain in deficit until 2015/16, implying seven years of deficits.

The centrepiece of the budget stimulus is a \$A22bn infrastructure spending plan, focusing on roads, rail, ports, education, health, clean energy and telecommunications. In addition, there is further fiscal stimulus for the consumer through increased pensions, two further rounds of income tax cuts (which were already legislated) and an extension of the First Home Owner's Grant.

To finance these huge deficits, the government will need to issue significant levels of Commonwealth bonds taking the total on issue from around \$A80bn at end of June 2009 to just on \$A300bn by June 2013. While these debt levels are large for Australia, they compare favourably internationally. Australia's net debt to GDP ratio is expected to peak at around 14% in 2014, compared to average levels in other advanced economies of over 80%.

Surprisingly, unemployment figures improved over the month, with the unemployment rate falling to 5.4% in April, down from 5.7% in March. A total of 27,300 jobs were created over April, with the number of full-time jobs growing by 49,100 and part-time falling by 21,800. In positive news, the Australian Bureau of Statistics will increase the sample size of its Labour Force Survey from January 2010 (back to what it was in July 2007), which should improve the data series.

The \$A rose sharply and reached US 80.0 cents at the end of May, a gain of 9.7% over the month. The \$A has rallied significantly off the low it reached in October 2007 of US 61 cents with risk taking returning to markets.

At the end of May, the \$A bought 0.4950 UK pounds, 0.5665 euro and 1.2557 NZ dollars.

## Australian shares

The Australian sharemarket rose for the third consecutive month in May. This is the first three-month consecutive gain since August, September and October 2007 when the sharemarket reached its peak.

The S&P/ASX 200 Accumulation Index rose 1.4% in May, but is still down 28.9% over 12 months.

The pace of contraction in the global economy has started to ease in recent months. It appears that economic conditions were at their worst in the last quarter of 2008 and the first quarter of 2009. The global policy response has gained traction in recent months. While economic conditions remain weak there are some economic indicators that are improving. Export data out of Japan, a lift in manufacturing surveys in China and better consumer confidence surveys in the US all pointed to some improvement in economic conditions over the month.

Also assisting global sharemarkets was the announcement of the results of the stress tests of US banks. With ongoing concerns about the stability of the US banking system, stress tests were carried out by the US Federal Reserve to determine the amount of capital banks needed to raise to withstand further potential losses. A total of \$US74.6bn was needed, which was better than expected by the market, and the raisings have commenced.

In May, Rio Tinto set its benchmark contract prices for iron ore. Rio Tinto and Japan's Nippon Steel agreed to a 33% fall in iron ore prices, the first drop in seven years. While this is a substantial fall, iron ore prices remain higher than received two years ago. The Materials sector was the best performer within the Australian market in May, rising 6.6%. A lift in base metal prices also assisted the sector on the back of improved demand out of China for commodities and an improved outlook for the global economy. The Energy sector (+6.4%) also rose with the 29.7% gain in the oil price. Woodside Petroleum (+13.0%) was a top performer.

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The short selling ban on financial stocks was lifted on 25 May 2009 after 8 months. This is a positive sign and suggests that confidence has returned to Australia's banking system. The Financials Ex Property sector rose 0.3% over the month, with the major banks all ending the month in positive territory. Some financial stocks remain under pressure, with Macquarie Group (-4.3%) and QBE Insurance (-11.2%) both falling.

A number of companies raised additional equity over the month with Billabong International, Nufarm, Stockland, Adelaide Brighton, Alumina, Seek, BlueScope Steel and Macquarie Group coming to the market. Most of the top 100 companies have now repaired their balance sheets through capital raisings. Mergers and acquisition activity could be on the rise following recent capital raisings, the larger amounts of cash held by companies and some attractive valuations.

With the rise in optimism, the relatively more defensive sectors underperformed. Health Care (-7.5%), Telecommunications (-6.2%) and Consumer Staples (-5.0%) all fell. Both Wesfarmers and Woolworths fell over 5%. In the Health Care sector, CSL (-15.2%) and ResMed (-14.4%) fell heavily.

The mood in the sharemarket remains optimistic. While it is positive that the market has rallied off its low, the question is what type of economic recovery has been priced in by markets. With weaker economic news ahead, the global and Australian economies have some way to go before a permanent resumption of economic growth. Once growth starts, a slow and gradual recovery (sometimes called "U" shaped) is more likely than a fast paced recovery (called "V" shaped). The hope is that the sharemarket has factored in a dose of realism in its expectations.

## Global shares

The major global equity markets continued to rise in May on better than expected stress test results and improving economic data. The unprecedented policy response is beginning to gain traction as the banking system improves and prices less risk aversion into short term interest rates.

The MSCI World Index rose 8.6% in \$US, but was down 1.0% in \$A terms. The \$A rose 9.7% against the \$US in May. Over 12 months, global shares were down 36.4% in \$US and have fallen 24.0% in \$A.

The US bank "stress test" results were released this month. A total of \$US74.6bn of capital is required to be raised. Bank of America was required to raise \$US33.9bn, and the company has already raised two-thirds of that figure. Also impacting on US sharemarkets were the impending bankruptcy of GM, and an agreement between Chrysler and Fiat, as the US auto industry is restructured.

The Dow Jones Industrial Average was up 4.1%, the S&P 500 Index rose 5.3% and the NASDAQ was up 3.3%. Since its bottom on 9 March 2009, the Dow has rallied 29.8% to the end of May.

Asian markets were stronger in May, with some signs of better economic data released in China and to some extent in Japan. The Nikkei Index rose 7.9%, while Hong Kong was up 17.1% and Singapore rose 21.3%. The Chinese sharemarket rose 7.6%. The Indian sharemarket rose 28.3% following the incumbent government's decisive election win.

European markets posted modest gains. The European Central Bank (ECB) is moving towards introducing quantitative easing. The German government introduced its 'bad bank' plan as a way to improve confidence within the banking sector. Over the month, Germany (+3.6%), France (+3.7%) and Italy (+3.2%) all rose. In the UK, the FTSE 100 Index rose 4.1%. Gains came despite Standard and Poor's placing the UK government's credit outlook on negative. Concerns over rising government debt levels led to the downgrade.

Emerging markets were stronger in May, with the MSCI Emerging Markets Index up 16.7% in \$US and 6.3% in \$A. Russia (+28.2%) rose strongly with the strong gain in the oil price. Other commodity based countries also rose such as Brazil (+12.5%) and Argentina (+19.4%).

## Fixed interest

The Reserve Bank of Australia (RBA) left official interest rates on hold in May at 3.00%. In leaving interest rates on hold, the RBA noted that there had been considerable economic policy stimulus which should help contain the downturn and support an eventual recovery.

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Internationally, the focus moved from central bank action to government debt issues in May as a number of countries released their Budgets. The highlights are the rising issuance of government debt over the coming years and the consequent implications for longer term bond yields.

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 3.3% over the Fed Funds rate back in October 2008, LIBOR traded at 0.4% above the Fed Funds rate at the end of May. While this is an important improvement, levels still remain above the average of 0.2% before the global financial crisis.

Globally, 10 year bond yields rose over the month as the supply of government bonds increased, helping force yields higher on the back of better economic news. In the US, in one week alone, a total of \$US101bn of government bonds was sold. With an increase in budget deficits around the world, the supply of government bonds is increasing substantially. This has implications for the pace of economic recovery.

In the US, 10 year bond yields rose from 3.12% at the end of April to 3.46% at the end of May. Since the introduction of quantitative easing in mid March, bond yields in the US have risen, as bond investors sold on the back of better economic data and concerns over rising supply.

Elsewhere, 10 year bond yields stand at 3.75% in the UK, 1.49% in Japan and 3.59% in Europe. The Bank of England doubled its quantitative easing programme over the month.

At the end of May, 10 year Australian government bond yields stood at 5.28%, up from 4.57% at the end of April. The large increase in the supply of Commonwealth government bonds led yields higher. Ninety day bank bills were yielding 3.19% at the end of May, up from 3.08% at the end of April. The market is beginning to factor in fewer official interest rate cuts by the RBA.

## Listed property

The listed property sector continued to show signs of stabilisation, finishing the month up 3.8%. Out of the 16 stocks in the index, only three fell in May. The index was impeded down by Goodman Group, which fell 32.4% over the month. The sector has now recorded two consecutive monthly gains, although it remains down 50.8% over 12 months.

The pace of capital raisings slowed in May although the pace of asset sales picked up, and there could be additional raisings over coming months. While recent capital raisings are positive news with debt levels being reduced, the rise in bond yields could have a negative impact on the sector.

Global property markets also rose in May, although major markets demonstrated mixed results. Markets in Europe and Asia performed well, particularly Italy and China. The UK and US property markets were weaker. The UBS Global Investors Index (Net TR) A\$ rose 3.4% in the month to be 49.2% lower over 12 months.

The UBS Australian Composite Bond Index returned -0.75% over May as bonds sold off. Over 12 months the index has returned 11.80%.