

# Market watch

May 2010

## Key points

- Risk aversion returned sharply in May. This was driven by sovereign risk concerns in Europe and its impact on European economic growth, the re-emergence of financial regulation and signs of an economic slowdown in China.
- A three-speed global economy has emerged led by Asia and emerging economies (including Australia), followed by the US and Japan with UK and Europe lagging.
- In Australia the Federal Government released its 2010/11 Budget showing a return to surplus in 2012/13 and very low government debt levels – a welcome differentiator with the current concern over sovereign debt levels.

## Economic overview

The month of May saw a marked shift away from risky assets. This was driven by sovereign risk concerns in Europe and the consequences it holds for European economic growth, concerns over financial regulation in the US and Germany and signs of an economic slowdown in China. As a result global equity markets fell sharply, government bonds predominantly rallied, credit spreads widened and currency markets saw volatile movements.

Sparking the flight to safety was a deterioration of sovereign risk concerns in Europe, with a focus on Greece, Portugal and Spain. Downgrades by the major credit ratings agencies and the drying up of liquidity saw the situation escalate sharply. These developments had taken place despite the agreement on a financial rescue package for Greece by the European Union (EU) authorities and the IMF (worth €110bn over 3 years). Clearly, the risk of a significant

liquidity crisis in EU markets (that could have potentially flowed over to other major markets) was enough to see the EU authorities announce a very significant package of reforms and policy initiatives.

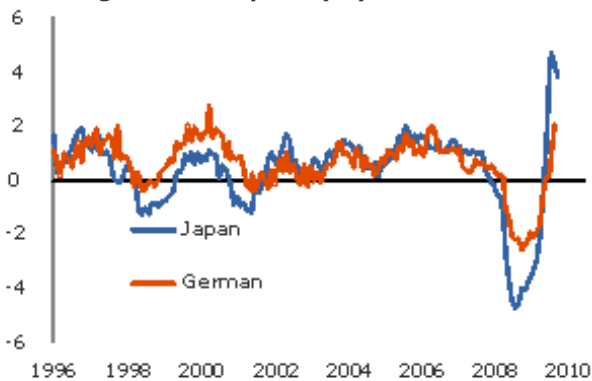
The EU rescue package is worth €750bn. This is a massive amount and is worth 10.6% of total EU sovereign debt, 8.4% of 2009 GDP and just over 70% of the outstanding debt of Portugal, Greece, Ireland and Spain. The package contains a €60bn stabilisation fund which Greece has already accessed. It also contains a €440bn special purpose vehicle (SPV) established by the EU members, proportionally to their size, and guaranteed by the same. The IMF has agreed to provide a further €250bn that can be made available to countries that require financial assistance and the European Central Bank has agreed (and since enacted) to purchase government bonds from EU members in the secondary market. This is providing significant and ongoing liquidity to the debt of EU members.

These policy initiatives are highly significant and should be sufficient to ensure that the EU sovereign debt crisis does not turn into a global liquidity crisis. However fiscal policy tightening will still be needed across the EU for an extended period, implying that economic growth out of this region will likely remain subdued for a number of years to come. This caused market volatility post the announcement of the rescue package as the realisation widened of anemic growth out of these countries for some time.

Some European economies, particularly Germany and France are benefiting through a weaker euro. The euro has depreciated 19% against the USD over the past six months, helping German exports to rise sharply, up 21% over 12 months (see chart of Japan and Germany exports). To date consumer

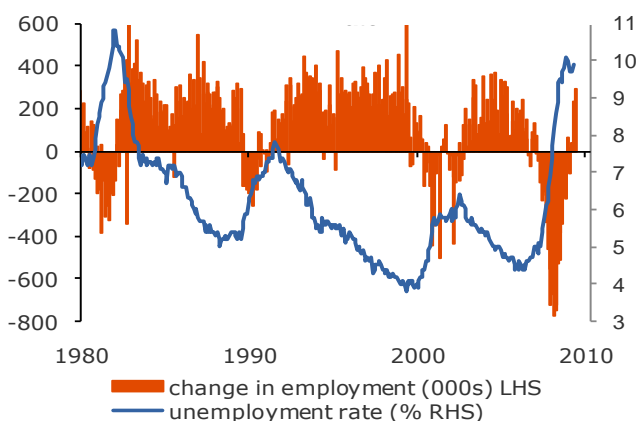
confidence has held up relatively well, although the main concern over coming months will be social unrest (as governments look to reduce public sector wages and cut back on services) and as unemployment remains high. For financial markets the difficulty will be in balancing the need for reduction in debt levels and the negative impact on economic growth and the result this will have on European returns over coming years.

**Annual growth in exports (%)**



Surprisingly, US economic growth has remained on the upside in recent months, assisted by improvements in manufacturing production, demand for durable goods and improving consumer spending. The US labour market added 290,000 jobs in April, with 190,000 in the private sector (the government will be a large hirer over coming months for the upcoming Census). The unemployment rate sits at 9.9%, up from 9.7% (see chart below). Consumer confidence is rising and new (+14.8%) and existing (+7.6%) homes sales rose - the expiration of a tax credit at the end of April is likely to have pulled sales forward.

**Non-farm payrolls and unemployment rate**



There are signs of an economic slowdown in China. This has largely been driven by recent measures to curb speculation in the property sector through demanding higher down payments and through winding back bank lending. Property prices and sales have fallen in Shanghai and Beijing with some additional weakness in other areas of domestic demand. This has led to expectations that the pace of policy tightening will slow, especially when combined with expectations of weak growth in Europe and possible negative implications for Chinese exports to the region.

In Australia, the 2010/11 Budget announcement was largely overshadowed by the proposed introduction of the Resources Super Profits Tax (RSPT). Economic data released in May showed areas of softness and strength for the Australian economy. Although remaining above average, consumer confidence weakened 7% in May. Housing finance fell for its sixth straight month after recent interest rate rises while house prices rose 20% for the 12 months to March 2010. The labour market continues to add jobs with 110,000 added in 2010 to end of April with the unemployment rate sitting at 5.4%. GDP data will be released in early June and while a positive number is expected it is likely to be lower than the previous. This is driven largely by government capital spending as the private sector has yet to fully return to growth mode.

The RBA lifted the official cash rate by 25bps to 4.50% in early May and left rates on hold on 1 June 2010. The RBA has now moved the official cash rate back to around average levels and expects to leave rates on hold in the 'near-term'. Also in early May the RBA revised its growth and inflation forecasts. GDP growth is forecast at 3.25% year-end 2010, 3.75% at year-end 2011 and now at 4.0% for year-end 2012. Headline inflation is now forecast at 3.25% year-end 2010, 2.75% at year-end 2011 and 3.0% year-end 2012. Underlying inflation is now expected to be 2.75%-3.0% over the forecast horizon, rather than 2.5%-2.75%. It is worth noting that if the RBA's forecasts to end 2012 are correct, with GDP at 4.0% and inflation at 3.0%, then the current 4.5% cash rate is likely to be well below "neutral" with further rate hikes expected over time.

## **A comment on the proposed introduction of the Resources Super Profits Tax**

The proposed introduction of the Resources Super Profits Tax (RSPT) provoked strong debate between mining companies, economists and the Federal Government. There seems general agreement that the move from a State-based rebates system to a Commonwealth-based royalties system is a move towards a better and more efficient taxation system, and that it is generally fair to demand greater revenue from the mining sector (given the resources being exploited are non-renewable).

The debate revolves around the tax applying to existing projects, the size of the tax at 40% of profits and the structure of the tax. The last point involves the government's proposal to provide offset for any losses incurred in failed projects and the uplift factor above which the profits-tax is charged, being the long-term government bond yield, or around 6% on average. Effectively the government is providing protection against 40% of the downside if the project fails, in return for 40% of the upside through effectively providing a guaranteed tax credit. The aim is to reduce a company's weighted average cost of capital, or lower the risk of the investment in the mining company. According to the government, this guaranteed tax credit should be valued by the market, but to date has not. The issue arises from mining companies not wishing to be protected from any downside risk and preferring to have access to the upside above a reasonable rate of return. Uncertainty over the proposed RSPT and the very public nature of the debate has seemingly impacted international investors' perception of Australia's country risk premium and has led to share price volatility.

This confusion and uncertainty has seen share prices of mining companies fall, at the same time as a move towards risk aversion, largely created out of Europe, and signs of a slowdown in the Chinese economy. It has been argued this has seen an exit of some large global investors given the uncertainty of the investment environment in Australia. However, other countries are also making changes to royalty schemes and other taxation changes including Brazil, Chile and India. The government is now undertaking

consultation with the industry and has left open room for changes. The general consensus is that a move towards a tax more like the existing Petroleum Resources Rent Tax (PRRT) would be seen as a positive development.

Some resource companies have also argued that the proposed RSPT will lead to lower investment in Australia and fewer mine expansions. This must be placed in the context of expected demand and prices for Australia's natural resources over coming years, which are expected to remain robust given the outlook for Chinese economic growth and demand over the coming decade. While we should expect further uncertainty as the government's tax plan is debated and eventually decided upon, the general expectation is that mining investment will continue to be a source of growth in Australia, and Australia will continue to be seen as a safe place to invest.

### **Australian shares**

There was a lot of news for investors in the Australian equity market to digest in May. The proposed introduction of the Resources Super Profits Tax (RSPT) early in the month resulted in substantial share price volatility in the materials sector as analysts and other observers debated the potential earnings impact of the proposal. Mining companies are, unsurprisingly, opposed to the change in tax structure, although the introduction of the RSPT would accompany a reduction in the company tax rate from 30% down to 28%. This would be a welcome development for all companies outside the materials and energy sectors.

Concerns over a slowdown in the pace of Chinese economic growth also affected the outlook for Australian equities, while a further destabilisation in European sovereign debt markets also did nothing to support investor sentiment towards the Australian share market. Reflecting these issues, the S&P/ASX 300 Accumulation Index declined 7.5% during the month.

Merger and acquisition activity remained an interesting theme in the market in May. Lihir Gold (+4.5%) agreed to be acquired by Newcrest Mining (-2.9%), Healthscope (+25.6%) was the subject of a number of competing takeover approaches and

Transurban Group (-15.6%) received a sweetened takeover offer from two Canadian pension funds. Transurban Group rejected the bid, which resulted in the potential acquirers selling their significant stakes in the company. Elsewhere, iconic brewer Foster's Group (+2.6%) announced it intends to demerge its wine and beer businesses in early 2011.

Given the ongoing uncertainties in global financial markets, volatility in the Australian share market could persist for some time. While European sovereign concerns do not affect Australian listed companies directly – the major banks have confirmed they have minimal exposure to Greece, for example – problems in the Eurozone do have a significant influence on investor sentiment towards risk assets globally.

Arguably more pertinent for investors in the Australian share market is the possibility of a deceleration in the pace of economic growth in China. A slowdown in Chinese growth, even to the long-term average of around 8% per year, would have a meaningful impact on export demand and could exert downward pressure on commodity prices. Both of these factors could affect earnings growth prospects in the materials and energy sectors, in particular.

Most companies are now in the final month of their 2009/10 fiscal year and investor attention will, increasingly, be on the full year reporting season which will commence in August. The tone of companies' outlook statements for the 2010/11 year will have an important influence on investor sentiment in the next few months.

### **Global shares**

Global share markets fell sharply in May on loss of risk appetite and flight to safety in the form of US government bonds. The MSCI World Net Index fell 9.6% in USD and rose 0.4% in AUD terms. The AUD depreciated 9.9% against the USD in May, driven predominantly by the aversion to risk. In addition this was due to expectations the RBA will delay its tightening cycle, expectations commodity prices may soften as China's economic growth slows and uncertainty over the proposed introduction of the RSPT.

A three-speed global economy has emerged, led by Asia, some Latin American countries and Australia. The US and Japan are next, with UK and Europe showing anaemic growth – weighted down by hefty fiscal consolidation requirements. In May, the varying paces of economic growth were largely ignored with widespread losses across all regions.

On a sector basis both heaviest falls were recorded in financials (-12.0%), energy (-12.6%) and materials (-11.0%). The re-regulation of the financial system, particularly in the US contributed to falls in May. The US Congress is aiming to increase consumer protection from poor lending practices, strengthen the oversight of derivative markets and ban proprietary trading at banks. While the final shape of any re-regulation of the US banking system remains unknown, what does seem clear is that banks are likely to have more controls over their activities going forward than has been the case in the recent past. While this may be seen as a positive, it also likely means less leverage in the banking system and slightly lower profitability and economic growth over the medium term.

US equity markets fell with the S&P 500 down 8.2%, the Dow Jones fell 7.9% and the NASDAQ also fell 8.3%. European markets also fell with Spain down 10.8%, Greece fell 16.9% and Portugal was down 2.7%. France and Germany were down 8.1% and 2.8% respectively.

Asian equity markets were weaker with the Nikkei falling 11.7% despite some improvements in economic conditions. Hong Kong and Singapore were down 6.4% and 7.5% respectively.

### **Global emerging markets**

Emerging markets fell broadly in line with developed markets, down 9.2% in USD and 0.2% in AUD terms. The Chinese Shanghai B index experienced sharp falls on signs of a moderate slowdown in the economy, falling 16.1%. Other key markets to fall were Russia (-11.0%), Hungary (-10.8%) and Argentina (-9.3%). Both the Philippines (+1.0%) and Sri Lanka (+1.2%) managed to record slight gains.

Despite recent falls, emerging economies continue to record economic growth on the strong side. This has been reflected by recent moves by central banks in Brazil, India and Malaysia to lift interest rates to curb rising inflation pressures, largely due to food and commodity prices.

**Fixed interest**

May saw a flight to safety with government bond yields falling in most regions. The VIX volatility index, which shows the price investors pay to insure themselves against US equity market movements, rose to the highest levels since March 2009. An additional source of risk came from regulation reforms in several developed nations in the second half of the month. Rising capital and liquidity requirements are putting increased pressure on banks, potentially further tightening credit conditions and banks' willingness to lend.

US Treasuries rallied and yields fell across the curve in May. The reaction to the Greek crisis and further deterioration in Europe caused investors to fear a full-blown liquidity crisis spreading to other European sovereigns and beyond. As a result, the Treasury market quickly moved from focusing on inflationary concerns to deflationary fears. The rise in global risk aversion on the back of intensifying worries in Europe resulted in a rally in all maturities. The yield on the benchmark 10-year note dropped by 36bps following the highs in early April, and finished the month at 3.30%.

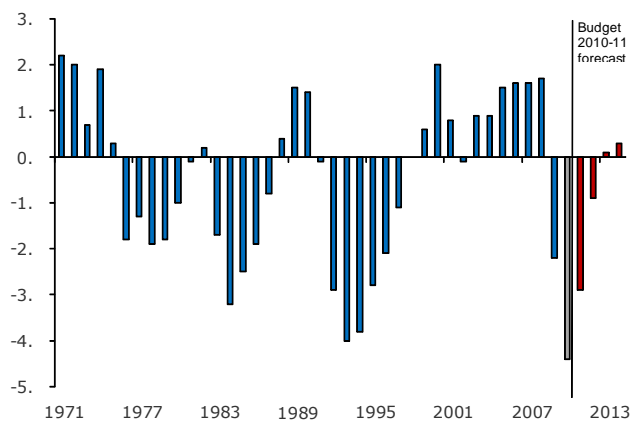
The intensifying sovereign risk crisis and concerns about European banks lead to flight to quality, and German Bunds yields fell sharply across the curve. The 10-year benchmark bond yield touched a record low level of 2.575% intra month, and ended the month at 2.66%, or 36bps lower than the previous month.

Risk aversion due to the European crisis and uncertainty surrounding the elections saw a flight to quality and Gilt yields fell in all maturities in May. The curve steepened as a result as shorter term yields falling by more than longer term ones. The 10-year benchmark Gilt yield fell by 33bps and ended the month at 3.52%.

In its monthly meeting, the Bank of Japan kept rates accommodative and unchanged at 0.10%. Inflation has remained in negative territory, and even though the quantitative easing in 2010 helped financial stability, it did very little to help stir the economy from its deflationary course. Japanese Government Bonds rallied across the curve in May, with 10-year yields falling by 3bps to 1.25%.

In Australia the Federal Government announced the Commonwealth Budget would return to surplus three years earlier than previously forecast, in 2012/13. The Budget is expected to improve from a deficit position of \$A57.1bn this year, \$A40.8bn in 2010/11 and \$A13.0bn in 2011/12 before moving into surplus. The Budget can be seen as an exercise in fiscal consolidation with improvements in the deficit due to improvements in the underlying economy. In a global context these outcomes are welcomed and places Australia's economic performance in a favorable light. See chart below.

**Budget balance % GDP**



For the better part of the month, risk appetite was reduced as the debt crisis in Europe intensified, and riskier asset classes sold off on concerns that the global recovery may stall. Commonwealth government bonds rallied in May and yields fell in all maturities. The 10-year fell by 33bps over the month to 5.37%.

The UBS All Maturities Composite Bond Index returned 1.65% in the month and 5.78% over 12 months.

**Global credit**

Credit spreads widened in global markets across the quality spectrum given the loss of risk appetite. Global credit markets sold off during the month as European sovereign risk contagion fears intensified. US investment grade credit spreads widened by 29bps in May, while global high yield spreads widened by 133bps.

**Listed property**

Australian listed property securities lost value in May, although the sector fared better than the broader share market. The S&P/ASX 200 Australian Real Estate Investment Trust (A-REIT) Accumulation Index declined 4.1% during the month. Since employment and activity levels have such an important influence on rents and commercial property values, property securities tend to be affected by economic data and future growth prospects. Concerns over a possible slowdown in the pace of growth in China, which in turn could have repercussions for Australian growth, therefore dampened investor sentiment towards property stocks.

All areas of the listed property sector weakened in May, although there was a significant variance of returns from sub-sectors of the market. The industrial sector, which has performed exceptionally well in the past 12 months (+147%), declined by 11.8% in May, dragged lower by falls in stocks including Goodman Group (-11.9%) and ING Industrial Fund (-11.5%). By contrast, the best performing sub-sector was retail (-1.3%) as data confirmed that retail sales in Australia continue to rise. Sector heavyweight Westfield Group (-1.4%) reported the greatest increase in sales at its US shopping centres in nearly three years, suggesting consumer confidence remains buoyant despite the ongoing economic uncertainty.

Global property securities also came under downward pressure, consistent with the declines in major global equity indices. The UBS Global Investors Index fell 5.9% in May with all markets suffering falls. Italy and China were among the markets to suffer the greatest weakness. Hong Kong and Canada were among markets which outperformed the global benchmark.

## Index performance

Index returns – May 2010	Level	1 month	12 month
S&P/ASX200 Index	4,430	-7.9%	16.0%
S&P/ASX 200 Accumulation Index	31,422	-7.5%	20.8%
MSCI World Net Index (AUD)	-	0.3%	8.4%
MSCI World Net Index AUD Hedged	-	-7.9%	18.7%
Dow Jones Index	10,137	-7.9%	19.2%
UK FTSE 100	5,188	-6.6%	17.4%
German DAX Index	5,964	-2.8%	20.7%
France CAC Index	3,508	-8.1%	7.0%
Japan - Nikkei	9,769	-11.7%	2.6%
Hong Kong – Hang Seng	19,765	-6.4%	8.8%
MSCI Emerging Markets Net Index (AUD)	-	1.2%	16.8%
US 10 year bond yield	3.28%	-37bps	-17bps
Australia 10 year bond yield	5.37%	-34bps	9bps
UBS All Maturities Composite Bond Index	6,063	1.6%	5.7%
90 Day Bank Bill Index	4.87%	24bps	168bps
UBS Australian Bank Bill Index	6,891	0.4%	3.8%
S&P/ASX 200 - A-REIT Accumulation Index	19,044	-4.1%	27.0%
UBS Global Real Estate Investors Index (Net TR) AUD Hedged	1,015	-5.9%	42.5%
AUD/USD (end of month)	0.8459	-8.5%	5.6%

Source: Colonial First State. Data to 30 May 2010. **Past performance is no indication of future performance.** These index returns do not reflect the performance of any Colonial First State fund or investment option. For returns for any Colonial First State Fund or investment option please refer to the performance section of the Colonial First State website available at [colonialfirststate.com.au](http://colonialfirststate.com.au).

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