

- Financial markets were a little more stable in December, buoyed by the latest outcomes from the European Union (EU) Leaders Summit and new measures by the European Central Bank to assist term funding requirements of EU banks.
- Other major news focused on the outlook for sovereign credit ratings in Europe and global banks, while US economic data continued to surprise on the upside.

Stephen Halmarick  
Head of Investment  
Markets Research



Belinda Allen  
Senior Analyst  
Investment Markets



James White  
Senior Analyst  
Investment Markets

## Economic overview

The EU leaders announced two major initiatives to help stabilise EU sovereign debt markets; a new 'fiscal compact' and measures to enhance

the European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM). The 'fiscal compact' aims to strengthen the fiscal and governance regime surrounding the euro area and imposes a new fiscal rule on Member States. As a result it is expected that general government budgets shall be balanced or in surplus – this is when the annual structural deficit does not exceed 0.5% of nominal GDP – otherwise automatic sanctions will be imposed. No specific details are available as yet.

The permanent bailout fund, the ESM will be brought forward to July 2012 and, together with the EFSF, will have a combined limit of €500bn. Additional funding of €150bn by the EU has provisionally been committed for the IMF. The aim is that a further €50bn will be contributed by non-EU member states. While these measures are a further step in the right direction there is not, as yet, a comprehensive solution to the debt and economic problems in Europe.

The ECB continued to support the European banking system while universally ruling out direct support for sovereigns. The ECB lent €483bn in 3-year funding to EU banks. This was the first 3-year auction with previous assistance restricted to funding for 12 and 13 months. Another 3-year auction is due to take place in February. It appears a significant amount of these funds were placed back on deposit with the ECB. The ECB's balance sheet expanded to €2.73tr in December, up from €2.42tr a month earlier. EU officials hope that banks will use these funds to resume buying EU sovereign bonds.

Further austerity measures were announced in Spain and Italy. The Italian Prime Minister, Mario Monti, received final approval for his emergency

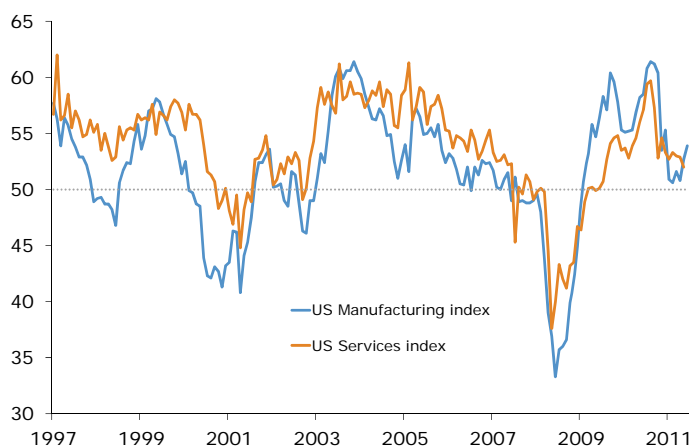
budget. In Spain, the new government announced a blowout in its budget deficit from 6% to 8% of GDP. Further austerity measures were subsequently announced.

In the US, political negotiations also took centre stage, with the focus on the extension of payroll tax holiday and long-term unemployment benefits. Only a two-month extension was agreed to, with negotiations due to resume early in 2012 for a full-year extension.

Otherwise, US economic data continued to surprise on the upside, particularly labour market and Purchase Managers index data. Initial unemployment claims reached the lowest level since July 2008 and the unemployment rate fell to 8.6%. Employment creation remains weak, however, and will be a focus for financial markets in 2012 to signal that a stronger economic recovery is underway.

In early December the ISM Manufacturing Index reached a six-month high of 53.9, although it remained below the peak of 61.4 recorded in February 2011. See the chart below for details. The University of Michigan Consumer Confidence Index continues to rebound. The index is up 25% since August 2011, but remains below the average of the past five years.

### US ISM Manufacturing and Services



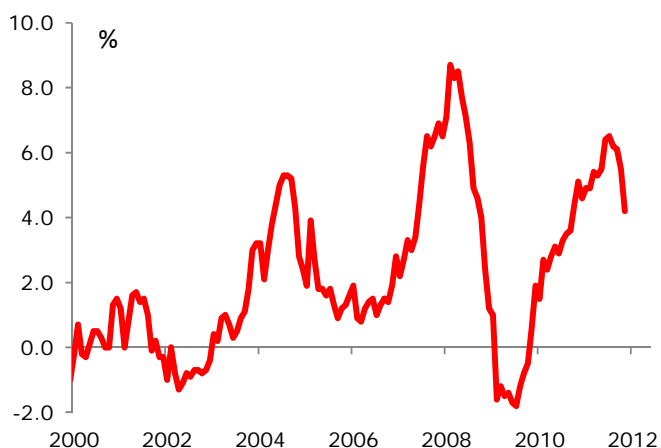
Source: Bloomberg.

Inflation in the US appears to have peaked, with headline CPI slowing to 3.4%/yr in November, down from a peak of 3.9%/yr in September. This is helping to increase purchasing power among consumers, and is correlated with recent

USD strength. The USD Spot Index finished 2011 on a high, up 1.4% over the year and 10% higher from the April low.

In China, monetary policy was eased through a lowering of the reserve requirement ratio for banks from 21.5% to 20.0%. This was the first easing since October 2008. It is expected any easing in policy in 2012 from China will be gradual with the policy focus based on the Central Economic Work Conference to be "proactive fiscal and prudent monetary policies", indicating "growth stabilisation" policies rather than control over inflation. Inflation in China has continued to ease, with the annual rate falling to 4.2%/yr in November, down from 5.5%/yr the previous month and a peak of 6.4%/yr in June. This should enable a gradual easing of policy during 2012. See the chart below for details.

### China Annual Inflation (%)

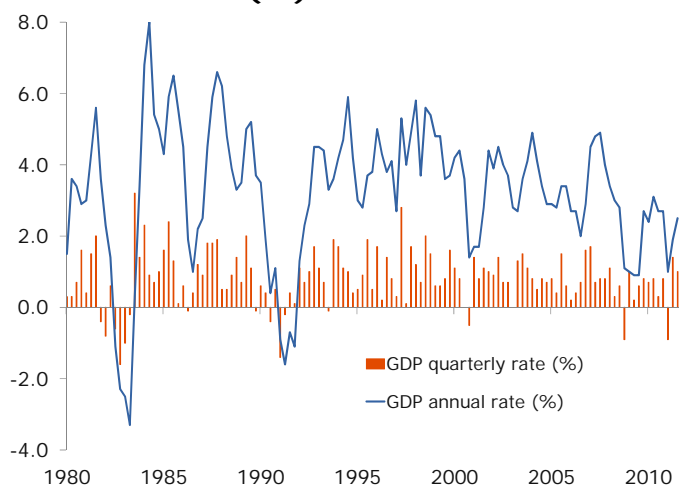


Source: Bloomberg.

In Australia, Q3 GDP data was released with growth of 1.0%/qtr and 2.5%/yr. See the chart on the following page for details. The dominant source of growth in Q3 was capital expenditure and household consumption. The mining and construction industries recorded growth of 5.0%/qtr and 3.7%/qtr respectively.

Employment data continued to show signs of weakness with 6,300 jobs lost in November and the unemployment rate rose to 5.3% from 5.2%. Consumer confidence fell by 8.3% in the month on offshore news, while business confidence remained flat over the month.

## Australia GDP (%)



Source: Bloomberg

## Australian shares

December was a relatively quiet month in the Australian share market. Trading volumes were relatively low, particularly leading into the Christmas and new year holiday period. The interest rate cut provided a boost to the market early in the month, but these gains proved to be short lived. In the month as a whole the S&P/ASX 200 Accumulation Index closed 1.35% lower, extending its decline in 2011 to more than 10%.

Foster's Group, one of Australia's most iconic companies was delisted from the Australian share market during the month after it was successfully acquired by UK-based brewer SAB Miller. Its last day of trading as a publicly-owned company was Friday 2 December 2011.

In other corporate activity, Whitehaven Coal and Aston Resources agreed to merge. The merged entity will be the largest independently-owned listed Australian coal company with a market capitalisation of around \$5 billion. The merger process is expected to take several months to complete.

The other notable feature of the market in December was a stream of earnings downgrades from retailers following disappointing sales in the crucial pre-Christmas period. Billabong, JB Hi-Fi and Kathmandu Holdings all revised down their earnings expectations.

In spite of two recent interest rate reductions by the Reserve Bank of Australia (RBA), conditions remain challenging for discretionary retailers. This is due to relatively low consumer confidence levels – the savings rate has recently increased and is now above 10% – and the increasing number of people shopping online, often from overseas websites where goods are typically cheaper than those available in Australian stores.

## Global shares

Global equity markets stabilised in December. Volatility and trading volumes were low compared to the remainder of 2011 due to the holiday period. The MSCI World Index was flat in both USD and AUD terms, although this masked considerable divergence between markets and industry sectors. In calendar year 2011 the sector returned -7.6%.

The Dow Jones Industrial Average rose 1.4%, the S&P 500 was up 0.9% and the NASDAQ fell 0.6%. In 2011 as a whole the US equity market outperformed other regions, assisted by corporate earnings which consistently beat expectations. US companies have been able to maintain elevated profit margins despite a weak economy due to productivity and cost improvements.

In contrast European markets were amongst the worst performers in December, reflecting ongoing concerns over sovereign debt and the banking system. The German DAX was the worst performer, down 3.1%, while Italy fell 1.2%. In contrast France (+0.2%), Spain (+1.4%) and the UK FTSE (+1.2%) rose. In 2011 as a whole France was among the worst performers in Europe, down 17%.

In Asia, markets recorded mixed returns in December. China was among the worst performers, down 6.1%. Singapore (-2.1%) and Korea (-1.2%) also fell. Malaysia (+4.0%), Thailand (+3.0%), Taiwan (+2.4%) and Hong Kong (+2.5%) all rose. In Japan the Nikkei rose 0.3%, but declined in value by 15.7% during 2011.

In terms of sector performance, the Materials sector significantly underperformed, down 4.6% for the month and was also the worst performer

in 2011, down 21.2%. The December falls were driven by weaker global growth expectations and lower commodity prices. Copper (-3.6%), lead (-3.6%), aluminium (-4.3%), Zinc (-10.9%) and platinum (-10.2%) all fell while nickel rose 6.9%. The gold price also fell, down 10.5% to USD1563.7 an ounce and the oil price fell 1.5% to USD98.8 a barrel.

Health care was the top performing sector, rising 3.2%

### **Global emerging markets**

Emerging markets underperformed the broader global equity market, falling 1.3% in USD and AUD terms. In 2011 as a whole the sector returned -18.4% in USD.

There was a significant divergence of returns within the sector. With falls in commodity prices, Russia fell 6.5% and Brazil retreated 0.2%. Other markets that experienced declines included Sri Lanka (-0.2%), Poland (-4.8%), Argentina (-2.5%) and Turkey (-5.7%). The Philippines (+3.2%) and Czech Republic (+3.7%) recorded positive gains.

The focus for emerging markets in 2012 will be to monitor activity indicators for signs of slowing growth due to the sovereign debt crisis in Europe and weaker financing activity. Policy can be eased further in most emerging economies and this is expected to be a key feature in early 2012.

### **Fixed interest**

Most major global bond markets saw yields fall (prices rise) in December. Market sentiment continued to be dominated by the ongoing European sovereign debt crisis.

International credit rating agencies reacted to the malaise in Europe, rattling global market confidence after S&P placed six AAA Member States on credit negative watch (including Germany). Fitch lowered its outlook on France's AAA rating to negative and placed six other countries on downgrade watch.

At its December meeting, the ECB cut its official cash rate by a further 0.25% to 1.0%. However, the reduction in the policy rate was not a

unanimous decision with some ECB members disagreeing over the timing of the rate cut. German 10-year bond yields decreased by 45bps, closing December at 1.78%.

The UK Monetary Policy Committee (MPC) again voted unanimously to leave the official cash rate unchanged at 0.5% and retained its £275bn asset purchase program. MPC minutes from the December meeting revealed that some members believe more quantitative easing in 2012 may be required due to the deteriorating economic outlook. The UK 10-year government bond yield decreased by 33bps to 1.98% at month-end.

As widely expected, the US Federal Open Market Committee (FOMC) left the fed funds rate unchanged at its December policy meeting. The FOMC meeting minutes revealed that participants still see the US economy to growing at a moderate pace in 2012. A new communication strategy will be implemented for the January 25 meeting, with FOMC members to publish a forecast for the Fed Funds rate. Overall, US 10-year Treasury yields declined by 21bps to 1.84% at year-end, down from 2.05% at the end of November.

The Australian bond market also saw yields fall and prices rise in December. 10-year CGS yields reached 3.67% at year-end, having ended the previous month at 3.93%.

The 26bps decline in yields over the month contributed to the eleventh monthly positive return from the asset class in 2011. The last time this occurred was in 1991.

In recent months, the Eurozone debt crisis has underpinned strong demand for Australian sovereign bonds. Overseas central banks and offshore institutional investors, in particular, continue to be attracted to the developed world's highest government bond yields, supported by strong liquidity and the relative safety of the Australian government bond market.

In Australia, the RBA reduced its official cash rate for a second consecutive month by 25bps to 4.25%, citing the risk to the global economic outlook due to a likely contraction in Europe brought about by the re-intensification of the sovereign debt crisis.

## **Listed property**

The UBS Global Property Investors' index (local currency) increased 2.0% in December. Market performance was mixed, however, with only Hong Kong and China generating gains during the month. In 2011 as a whole, US REITs outperformed, with Australia the second best performing market.

REITs performed poorly in December with the S&P/ASX A-REIT Accumulation index returning - 2.7%. For calendar year 2011 however, A-REITs outperformed the broader share market for the first time since 2006. In stock specific news, the takeover proposal for Charter Hall Office was recommended by the board. Retail REITS came under pressure as retailers downgraded earnings expectations due to weak pre-Christmas sales.