

Monthly market view

August 2010

Key points

- Weaker global macroeconomic outlook continued to weigh on financial markets in August.
- Government bond markets to date have factored in a worse outcome than global equity markets.
- Government bond yields have fallen to levels not seen since the GFC.

Economic overview

Financial markets kept a pessimistic tone in August, driven by concerns over US economic growth and the broader global economy. Government bond yields returned to the low levels last seen during the depths of the GFC. However, this dire view of the world economy was not mirrored by global equity markets. While losses were recorded, movements were not as extreme as the bond market.

Expectations for global economic growth have been downgraded over recent months. Much of this has been driven by a slower than expected recovery in the US economy. Economic data released out of the US in August confirmed a slow and painful recovery is underway. Fears have risen over a double dip recession, driven largely by a weak labour market, deteriorating housing data and concerns strength in the manufacturing sector is retreating.

Employment data in the US indicated a slower than expected recovery in jobs. This weaker report, when combined with rising unemployment benefit claims, raised renewed doubt about a recovery in consumer confidence and spending.

One positive we can highlight for the US is the health of the corporate sector. Profit growth has been strong and productivity growth has accelerated as costs and labour have been removed in recent years. However, productivity appears to have peaked. This suggests that for businesses to continue to grow they will have to add labour or capital over coming months.

The US housing market indicated further deterioration. New (-12.4%/month) and existing (-27.2%/month) homes sales both fell in the month with the fewest new home sales recorded since data was collected. The expiration of the tax credit has dramatically impacted the US housing market. What seems clear is that the government's stimulus measure have not added to housing demand, but just brought-forward some demand. Once the stimulus packages expired the weakness continued.

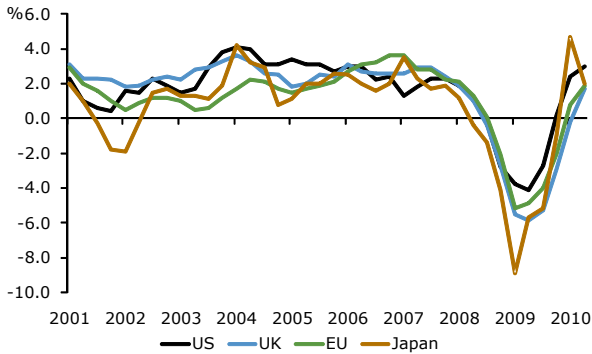
Late in August markets were keenly waiting for Federal Reserve Chairman Ben Bernanke's to speak on the US economy. Bernanke did not announce further monetary stimulus measures but did acknowledge that the Fed had the tools to undertake further stimulus if needed. Bernanke remains fairly optimistic on a slow economic recovery in 2011, but further deterioration in the economy, particularly the labour market would see another round of quantitative easing.

Data out of Europe largely surprised on the upside, particularly in the key economies. Q2 GDP data was released, showing Germany recorded growth of 2.2%/quarter, driven by exports and private consumption. France (+0.6%), Italy (+0.4%) and Spain (+0.2%) recorded modest growth. Strict fiscal consolidation measures drove the Greek economy to contract 1.5%/quarter. A weaker euro has helped Europe enormously, although with most economies just now introducing austerity measures this could be the peak of activity.

Japan has now been overtaken by China as the world's second largest economy. Japan recorded 2Q GDP growth of 0.1%/quarter compared to expectations of 0.6%/quarter, taking annual growth to 2.0% from 4.7% previously. The weaker than expected outcome was driven by slower consumer spending and a lower than expected contribution from exports. The yen reached a 15 year high against the US\$ in

August, and currency strength is expected to hamper export growth over coming quarters. See chart below of recent growth in developed economies GDP growth.

Annual GDP growth – developed economies

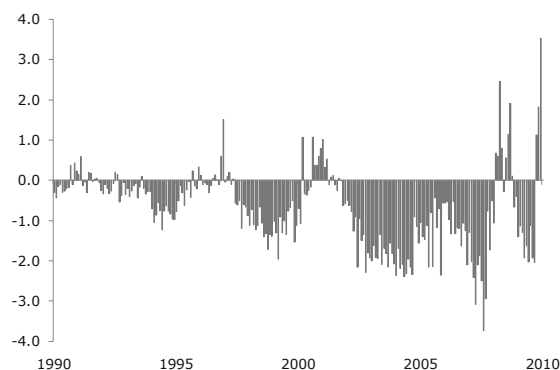


Source: Bloomberg. Data to 30 June 2010.

In Australia the key piece of news was the Federal election on August 21 resulting in a hung parliament. From an economic point of view the outcome is somewhat irrelevant. The key drivers of Australian economic growth over coming years will be the resources boom, strong mining and gas investment and the resulting strength of the domestic Australian economy.

Economic data released during August continued to show the strength of the Australian economy. A record trade surplus of \$3.5bn was driven by strong volumes and prices for iron ore and coal. (See chart opposite). Consumer confidence rose 5.4% while business confidence remains at a depressed level. Employment data continued to show strength with 23,500 jobs added in July, over 300,000 have been added over the past 12 months. The unemployment rate rose to 5.3% from 5.1% as strong labour market conditions encouraged job seekers to return to the labour force, increasing the participation rate. Capital expenditure intentions data was upgraded with \$A123bn of work is expected this financial year, with much of this work in mining and gas.

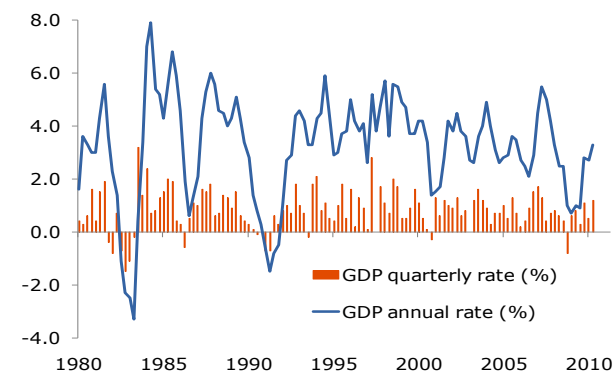
Monthly trade surplus (\$Abn)



Source: Bloomberg. Data to 30 June 2010.

In early September Q2 GDP data was released indicating that the Australian economy is gaining momentum quickly. Q2 GDP growth was 1.2%/quarter, higher than market expectations of 0.9%/quarter. This took the annual growth rate to 3.3%, the fastest since March 2008. Growth was driven by personal consumption and net exports. Importantly the transition from government stimulus to private demand is underway. The terms of trade increased 12.5%/quarter, driving nominal GDP growth to 10%. This is leading to a surge in income flowing into the Australian economy, a key driver the RBA will be watching in setting interest rates.

Australia – economic growth (%)



Source: ABS. Data to 30 June 2010.

Australian shares

The Australian share market weakened slightly in August, with the S&P/ASX 200 Accumulation Index declining 1.2%. Most listed Australian companies released their earnings for the 2009/10 fiscal year to the market and these announcements dominated investor attention during the month.

As usual the quality of earnings announcements and the tone of outlook statements were mixed. In aggregate, earnings were broadly in line with expectations, although the analyst community downgraded earnings expectations for the current year by approximately 3%. This reflected the challenging operating conditions which persist.

Consumer Staples was the standout performer in August, buoyed by strong performances from sector heavyweights Woolworths (+7.7%) and Wesfarmers (+4.1%). Laggards included Telecoms, which was dragged lower by Telstra (-11.7%), and Financials, which was affected by slightly disappointing results from some of the major banks.

There was a major piece of merger and acquisition news during the month; mining giant BHP Billiton made a \$43 billion bid for Potash

Corporation of Saskatchewan. The bid was rejected by the Potash Board, which prompted BHP Billiton to turn 'hostile' and approach Potash shareholders directly with the US\$130 per share bid. The situation remained unresolved at month end.

While the Federal Election impasse attracted a great deal of scrutiny and media interest, it did not appear to have a discernible impact on the local share market.

Global shares

Global equity markets fell in August on elevated risk aversion as concerns over a double dip US recession gathered pace. However falls did not mirror the pessimism in global bond markets. A strong mergers and acquisition cycle is underway in the global equity market, fuelled by compelling valuations, low funding costs and high cash balances.

The MSCI World Net Index fell 1.9% in AUD and 3.5% in USD terms. A weaker Australian dollar added to returns for local investors, depreciating 1.7% against the USD over August to US 89.01 cents.

US equity markets retreated after reasonable gains in July post reporting season. Macroeconomic concerns weighed on returns despite the health of US companies and M&A activity. The Dow fell 4.3%, the S&P 500 was down 4.7% and the NASDAQ retreated 6.2%.

European markets also lost value but not to the same degree as the US. France (-4.2%), Spain (-3.0%), Germany (-3.6%) and the UK FTSE 100 (-0.6%) all fell despite the better than expected GDP data out of the region.

In Asia, equity markets were mixed. Japan saw the largest movements with the Nikkei falling 7.7% to its lowest level since April 2009. The strength of the Japanese Yen contributed to the falls in the equity market. The Yen has rallied sharply in recent months against the USD, up 8.4% since May and reached its highest level in 15 years during the month. The stronger Yen hurts earnings of large Japanese exporting companies and has weakened equity prices.

Elsewhere, China rose 8.1%, contrary to the global trend and is now 37.8% higher over 12 months. There seems to be a growing level of comfort with the sustainable slowdown in the Chinese economy. Thailand (+6.7%) and Malaysia (+4.5%) also gained while Hong Kong

(-2.4%), Singapore (-1.3%) and South Korea (-0.4%) posted falls.

On a sector basis, defensive sectors outperformed with Health Care (+0.1%) and Telcos (+0.9%) recording gains. Industrials (-5.8%) and Consumer Discretionary (-5.8%) both fell on the weaker macroeconomic outlook perceived by the market.

Global emerging markets

Emerging markets outperformed the developed global equity market in August, although still posted losses. Emerging economies continue to post reasonable growth rates and given they now almost make up 50% of the global economy this growth is helping drive the global economic recovery.

The MSCI Emerging Markets Index fell 2.2% in USD and 0.6% in AUD. China was a key outperformer in July as detailed above, Sri Lanka (+9.6%) and the Philippines (+3.4%) were also key performers.

Latin America was weak with Brazil (-3.5%), Argentina (-4.0%) and Mexico (-2.0%) suffering falls. There are concerns that the weaker US economic recovery will hurt growth out of the region, especially in Mexico given the strong trade links.

In Europe, Russia (-5.8%) and Poland (-0.6%) fell while Turkey (+0.3%) and Hungary (+1.3%) rose despite concerns remaining over the state of Hungary's fiscal position.

Fixed interest

The global economic backdrop remains uncertain and concerns about deteriorating growth prospects and deflationary pressures continue to drive bond yields lower. Support for credit continued, however, given that an attractive yield pickup compared to government bonds is on offer, and amid doubts over equity market optimism about the continuing global recovery.

It is now three years since the beginning of the global financial crisis. US 2-year Treasury yields were trading at 4.5-5.0% at that time, but are now trading around a record low of 0.5%. 10-year US and German yields are also lower by 224 bps and 220 bps respectively, trading at 2.4% in the US and 2.1% in Germany at the end of August. In Japan, ten year yields breached 1% during the month as evidence of that country's on-going deflationary problem became overwhelming.

In the US, weak economic data and expectations resulted in 10-year yields falling by 46bps to 2.42%, and 2-year yields falling to near rock bottom levels and closing at 0.48% at month end.

In the UK, Gilts rallied in August and yields moved lower in all maturities. 2-year Gilt yields fell by 13bps and ended August at 0.65%, while 10-year Gilt yields fell by 49bps to 2.83%. In Europe, Bund yields fell similar to other developed markets. 2-year Bund yields fell by around 20bps to 0.59% by month end, whilst 10-year yields ended the month 58bps lower at 2.09%.

In Australia, the RBA left interest rates on hold in early August and released its Statement on Monetary Policy. The RBA slightly upgraded its economic growth and inflation forecasts. The RBA expects growth of 3.75% in 2011 before accelerating to 4% at the end of 2012. Inflation is expected to breach the target band early in 2011 before moving back to 3% in 2012. The RBA remains concerned about global economic growth and are likely to leave rates on hold till late 2010 or early 2011. This will be dependent on offshore news, Q3 CPI data released late October and signs of stronger than expected economic activity.

Commonwealth government bond yields also fell in August. Domestic political uncertainties and the continuing rally in most major government bonds markets, particularly in the US, drove the rally. 10-year yields fell by 46bps in August to end the month at 4.73%, while the 3-year fell by 33bps to 4.25%.

The UBS All Maturities Composite Bond Index returned 1.92% in the month and 9.10% over 12 months.

Listed property

Unlike the broader Australian share market, which declined modestly, listed property securities generally performed well in August with the S&P/ASX 200 Property Accumulation Index adding 3.7%. Given the ongoing economic uncertainty globally, investors appeared to favour defensive exposures and the relative earnings stability of listed property trusts appealed against this background.

A number of A-REITs announced their results from the 2009/10 fiscal year. In aggregate results were broadly in line with expectations, mainly due to the fact that several trusts had pre-released earnings guidance to the market ahead of their official announcements.

All sub-sectors of the domestic listed property market added value in August. The Retail sub-sector (+4.8%) performed particularly well; investor sentiment towards this area of the market was buoyed by an increase in annual earnings guidance from shopping centre giant Westfield Group (+3.5%), which has a December year end. The Industrial (+3.0%) and Office (+0.6%) sub-sectors performed slightly less well.

Returns from overseas listed property markets were mixed and the UBS Global Investors Index rose 0.3%. The Hong Kong market performed exceptionally well while Canada and the Netherlands were other notable outperformers. Markets including Germany France and the US struggled to keep pace with other major regions.