Market Watch

August 2005

Economic Commentary

The highlight of the month was the Reserve Bank of Australia's (RBA) quarterly Statement on Monetary Policy. The statement outlined the underlying strength of the economy and the benign outlook for inflation.

Of note were above average global economic growth, a resurgence of activity in Japan and China's more flexible exchange rates. Domestically the statement noted solid employment growth, the tax cuts, rising exports and an improved outlook for the farm sector.

Among statistics released in August, the unemployment rate remained at 5%, average weekly earnings rose to $1008.30 while new car sales were up almost 5% on a year earlier. Retail spending was up 3% on a year ago but lending for investment housing was down 6% from levels seen earlier in the year.

The Australian Dollar fell against the US dollar (USD) during August. It started the month at US 75.86 cents and ended it at US 75.33 cents. The AUD bought 0.4177 UK pounds at the end of August and 1.086 NZ dollars.

Australian shares

The Australian sharemarket hit new highs during August, driven by profit reporting, commodity prices and stable interest rates. The S&P/ASX 300 Accumulation index rose 2% to be up 30.1% over 12 months. The All Ordinaries price index reached 4462.7 late in the month.

The profit reporting season is in full swing. At the time of writing some 65% of the top 300 companies had reported, and their earnings had risen 36% over the same period last year.

Despite a rash of profit warnings earlier in the year, there have been some outstanding profit results. AMP, Brambles, Rio Tinto, Sonic Healthcare and Woodside Petroleum stood out. It was also impossible to ignore the record $8.5 billion full year earnings of BHP Billiton, a rise of 89% as copper, coal, iron ore and oil prices rose.

AMP lifted earnings 22% on cost cutting, improved sales and as rising sharemarkets lifted assets under management. Brambles saw its CHEP pallet business improve and lifted its second half earnings 74%, while Rio Tinto lifted its profits 34% as output and prices for iron ore rose. Sonic lifted earnings 34% and Woodside Petroleum saw earnings rise 20% on the back of higher oil prices and increased output.

These solid profit performances helped lift returns from shares. AMP was up 8.7% for the month, BHP Billiton rose 5.7% and Brambles was up 6.8%. Sonic (+20.9%), and Woodside (+10.1%) also performed well.

In terms of the traditional industrials and resources company classifications, industrials lifted earnings

19% over the same period last year while resource companies have lifted earnings 82%. Even excluding the impact of BHP Billiton and Rio Tinto, the resources sector has seen earnings grow 59%.

Energy companies were among the top performers during August. With oil prices pushing above USD70 per barrel, Woodside, Santos (+9.9%), Oil Search (+8.0%) and Roc Oil (+4.2%) all had an outstanding month.

The broader market got off to a good start early in the month when the RBA left official interest rates unchanged and noted that the medium term risk of higher inflation had abated. Soon after, bond yields fell towards 5.1% making the equity market, with its strong dividends, look even more attractive.

Takeovers, mergers and asset sales tend to excite the market. This month saw Toll Holdings bid for Patrick Corporation, Sigma purchased Arrow Pharmaceuticals, while Alinta repackaged some of its pipeline and power assets before selling them off as an infrastructure fund. Alinta rose 18.1%, Sigma was up 17.9% and Toll rose 4.1%.

Despite reaching record levels, the market does not appear overly expensive compared to other assets and by historical standards. Dividend yields compare well with bond yields while price to earnings ratios are not excessive. The key however, is earnings. Solid global and domestic economic growth is necessary to generate the earnings currently expected by the market. If growth slows, it's buyer beware.

Aiding Australian economic growth are strong commodity prices, low interest rates, business investment and infrastructure spending. Threats to domestic growth include slower growth in China, oil prices slowing global demand and excessive interest rate rises in the US.

Global shares

Global sharemarkets had a modest month in August. While the Japanese market performed well, US and European markets held back returns. The MSCI index rose 0.8% in USD but was up 1.9% when measured in AUD.

Why the disparity between markets? Broadly speaking, oil and growth fears held back the US and Europe while several Asian markets benefited from renewed optimism in Japan and growth in China.

In the US, the Dow fell 1.5% during August. The S&P 500 was down 1.1% and the NASDAQ fell 1.5%. The falls come despite a successful reporting season during which US companies saw June quarter earnings rise 11.5% over the same period last year. But that's history.

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Market Watch Continued

Investors are concerned that rising interest rates and rising oil prices will suck growth out of the US economy.

At USD70 per barrel, following the devastation of Hurricane Katrina, oil threatens to slow US growth. Rising costs could lead to inflation or, if absorbed by companies, lower profit margins. Neither option is appealing to equity markets.

Also keeping US investors nervous was Wal-Mart, the world's largest retailer, which saw second-quarter profits rise 5.8%, its smallest quarterly gain in four years. The company added to investor distress by downgrading its profit outlook. Also cutting profit forecasts were Deere, the world's largest farm equipment supplier and PC maker Gateway.

Mainland Europe followed the lead of the US. Germany was down 1.2% while France also fell 1.2%. Europe is even more oil dependent than the US – though it must be noted that both economies are now more efficient in their use of oil than they were 10 to 15 years ago. Nonetheless high oil prices can still hold back already fragile consumer spending.

The UK's FTSE 100 index rose 0.3% reaching its highest level in three years but it eased back later in the month. A slowing economy prompted the Bank of England to cut official interest rates by 0.25% to 4.5% and this may have cheered on the market.

In Asia, the Japanese market rose 4.3%, but Singapore (-3.3%) and South Korea (-2.5%) fell. Economic news coming out of Japan is picking up and if the upcoming elections give a mandate for reform, then further economic and market growth seems possible.

The strongest global sectors during August were energy (+6.1%) and utilities (+1.6%). The rise in energy was based on oil and gas prices while utilities are attractive for their yield and 'defensive' qualities. Not surprisingly, given concerns about oil and the economy, the weakest global sector was consumer discretionary (-1.2%).

In the months ahead, markets will be watching to see how oil impacts upon the economy. How much will growth slow or are higher oil prices the outcome of stronger global demand? If China and the US maintain their current growth and Japan kicks in with a better performance then we may not have seen the end of higher energy prices.

Fixed interest

The RBA left the official cast rate unchanged at 5.5% following its August board meeting. However, its US equivalent, the US Federal Reserve lifted its Fed Funds rate by 0.25% to 3.5%.

In Australia, the RBA noted that risks to higher inflation had declined since May. Although the RBA expects inflation to edge upwards towards a peak of 3%, it noted that a slowdown in the economy should help contain inflation pressures in the medium term.

With these views of inflation in mind, 90-day bills crept lower, beginning the month at 5.65% and ending it at 5.62%. The UBS Australia Bank Bill index rose 0.48% in August to be up 5.67% over the past 12 months.

Domestic bond yields followed the lead of the US where 10 year yields fell 0.26% to 4.01%. In Australia, 10 year bond yields fell 0.08% to 5.04%.

Yields fell for four reasons. Firstly there was very strong demand for bonds at a recent US Treasury bond auction, with demand from both domestic and foreign sources. At the same time, economic data showed softness in the US economy while the US Fed provided benign comments on the outlook for medium term inflation. Finally, high oil prices are acting like a tax on the global economy and will potentially curtail growth.

The UBS Australia Composite Bond index rose 0.82% during August as a rise in capital values, due to lower bond yields, added to regular interest income. The index was up 7.19% over the past 12 months.

Listed property

The S&P/ASX 200 Listed Property Accumulation index rose 1.7% in August to be up 17.6% over 12 months. Helping achieve these returns were lower bond yields and some reasonable profit results within the sector.

While profits reported by trusts were in line with expectations, comparisons with the previous year were complicated by the extent of merger & acquisition activity over the year. However, a feature of the reporting season to date has been the 6.1% increase in net tangible assets (NTA).

For the month of August, industrial trusts were up 4.3%, retail trusts posted a 0.6% return while commercial trusts rose 1.0%. Over 12 months, the strongest listed property sector was industrial with a return of 33.9%.

With the top four trusts accounting for almost 60% of the S&P/ASX 200 Listed Property index, returns are significantly influenced by a handful of companies. The premium to NTA remains high at 43% but yields remain firm at 7.2%.

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