

# Market Watch

## Economic commentary

Oil prices and the Budget dominated headlines during May. Oil prices hit US\$132 per barrel while the Budget delivered a modest cash surplus, personal tax cuts and the prospect of large scale spending on infrastructure over the next few years.

Despite pressures in the economy and on inflation, budgetary or fiscal policy was not used to combat these issues. There were some cuts in spending and increases in taxation but they were outweighed by new spending and by personal tax cuts. Government spending continues to grow, albeit at a slower pace than in previous years.

Oil prices hit a new record of US\$132 during May. While growing demand from emerging markets explains some of the price increase over the past 12 months, recent sharp increases have a hint of speculation about them. Demand for oil broadly matches supply.

The AUD rose 1.3% against the US dollar (USD) during the month. It started the month at US 94.32 cents and ended it at US 95.55 cents. A year ago the AUD stood at US 82.66 cents. The AUD bought 0.4831 UK pounds at the end of May and 1.219 NZ dollars.

## Australian shares

The Australian sharemarket achieved back to back monthly gains in May. From a low point in mid-March, share prices have risen almost 12%. For the month of May the S&P/ASX 300 Accumulation index rose 1.7% but is still down 6.7% over 12 months. Providing support for the market were potential merger activity, firm energy prices and the positive outlook for bulk commodity prices.

Last year, 'debt driven' takeover bids by private equity firms hauled the sharemarket out of periods of weakness. During April and May takeovers were back in the spotlight but this time bids are being made with cash and the script or shares of the firm making the bid. Westpac offered 1.31 of its shares for every St George Bank share. The bid values St George at around \$18 billion.

During May, the QBE Insurance bid for Insurance Australia Group was rejected as was the bid by UK based BG Group for Origin Energy. Iron producer Midwest has received bids from Chinese company SinoSteel and from Murchison Metals while there was ongoing speculation of bids from China for other Australian mining companies.

Takeover speculation, combined with the expectation of firm iron ore and coal prices, saw the materials sector rise 4.1% in the month. Fortescue Metals Group rose 43.7% after it shipped its first consignment of iron ore; Mount Gibson Iron was up 11.6% while BHP Billiton rose 2.9%.

High oil prices helped the energy sector post a 19.9% gain for the month. Woodside Petroleum was up 16.3%, Santos rose 32.7% and Oil Search rose 29.3%. If the current oil price is based on speculation then volatility among the share prices of energy companies might be expected.

Comments from Macquarie Group on its future earning and the minutes of the most recent board meeting of the Reserve Bank of Australia (RBA) dampened market sentiment during May.

Relatively high interest rates led Macquarie Group to suggest that the current environment will make it difficult for the company to lift its earnings over the coming twelve months.

The RBA board indicated its bias towards a further increase in its overnight cash rate. If economic growth remains firm the RBA will act again to slow the economy. In this context, good news on economic activity might mean bad news for interest rates.

The industrials sector (-2.6%) was among the weaker sectors this month as it suffered from high oil prices and high interest rates. Increasing costs saw Toll Holdings fall 4.9%; Transurban Group was down 17.1% while Brambles fell 7.9%.

The recent rise in the sharemarket is welcome but risks remain. High interest rates are expected to hold back consumer spending and business expansion plans. If they don't, rates seem likely to move higher. This could unsettle investors. High oil prices are adding to business costs and squeezing company profits. They are also holding back consumer spending – again unwelcome news for investors.

While the worst appears to be over for the sharemarket, there are many issues that need to be overcome before solid earnings growth can resume for many listed Australian companies.

## Global shares

Major global sharemarkets saw varied outcomes during May. Concerns over the pace of US economic growth and higher oil costs held some markets back but stronger energy prices were a positive for some markets. The MSCI World index, a broad measure of global shares, rose 1.1% in USD but was down 0.2% when measured in AUD. Over 12 months, global shares were down 5.6% in USD terms and have fallen 18.4% in AUD terms.

US markets faced mixed news. Jobs data and orders for durable goods, such as computer equipment and industrial machinery, were not as weak as many expected. However, soaring oil prices dented confidence as did the 15.6% decline in earnings per share seen among S&P 500 companies as the profit reporting season came to an end.

The Dow ended the month down 1.4%. The S&P 500 rose 1.1% while the NASDAQ index rose 4.6%. Over 12 months, the Dow is down 7.3%.

European markets were similarly mixed. The UK (-0.6%), Italian (-0.8%) and Spanish (-1.4%) sharemarkets were down, however, Germany (+2.1%), France (+0.4%) and the Netherlands (+2.1%) posted gains.

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The differences reflect the varying impacts of rising energy prices and movements in currencies and interest rates. Large energy and mining companies such as Royal Dutch Shell and BHP Billiton assisted the UK market but it was dragged lower by financials such as Royal Bank of Scotland and Barclays.

Energy producer and distributor E.ON, which accounts for 10% of Germany's DAX index, rose 8% thus helping the German index move into positive territory in May. The German market is down 10.0% over 12 months while the UK's FTSE 100 index is down 8.6% over the same period.

Asian markets were also mixed. Japan's Nikkei index rose 3.5% but China's Shanghai B market fell 7.1%. Hong Kong was down 4.8% but Singapore posted a gain of 1.4%.

The two largest companies in Japan's Nikkei index, manufacturing equipment makers Fanuc and Kyocera both rose more than 4% while Canon rose more than 9%. Despite a strong month, the Japanese market is down 19.8% over 12 months.

After a stellar performance in 2007, China's sharemarkets have tumbled in 2008. The Shanghai B market is down 33.6% so far in 2008. The market in China has been exceptionally volatile and does not always reflect the health and earnings capacity of the economy. Higher interest rates in China have not helped sentiment towards that market.

The MSCI Emerging Markets price index rose 1.6% in USD and 0.3% in AUD during May. Over 12 months, emerging markets are up 3.2% in AUD thanks to strong performances from markets in Brazil, Russia and Saudi Arabia.

The global economy and global markets have many issues to resolve. How long can the Chinese authorities hold their subsidised fuel prices below world levels? Will they raise interest rates to slow their economy or will they allow their currency to rise further? A slower Chinese economy combined with a weakened US economy could unsettle investors. The global economy is still expanding but not at a pace that engenders a lot of excitement.

## Fixed interest

The Reserve Bank of Australia (RBA) left its official cash rate unchanged at 7.25% in May but the minutes from their board meeting suggest that it was a close call. If demand does not

slow the RBA will have a strong inclination to lift rates still further.

Ninety day bank bills began and ended the month close to 7.79%. Yields were lower in the middle of the month as weaker business surveys, modest wage growth and low levels of consumer sentiment suggested that demand will slow in the months ahead. The UBSA Bank Bill index returned 0.66% in May and 7.22% over 12 months.

Credit markets remain unsettled. Companies with credit ratings in the range BBB- to BBB+ saw average yields on their corporate bonds rise from 9.75% at the end of April to 10.10% at the end of May. This compares with 7.24% in June 2007.

Australian government 10 year bond yields moved higher during May leading to small capital losses. They began the month at 6.29% and ended it at 6.53%. The UBSA Composite Bond index returned 0.11% in May for a return of 3.65% over the past 12 months

## Listed property

The listed property sector fell heavily in May. Debt refinancing issues combined with the prospect of potentially higher interest rates gave the market little comfort. The S&P/ASX 200 Listed Property Accumulation index fell 9.0% to be down 32.1% over 12 months.

On a 12 month basis some relatively better performing trusts have included CFS Retail Property Trust (-8.8%), ING Industrial Fund (-10.6%) and Bunnings Warehouse Property Trust (-11.0%).

At the end of May, the estimated distribution yield on the listed property sector was 7.60%, compared with the 6.53% yield on a 10 year government bond. This difference in yield, combined with ongoing growth in the economy, did little to shield the sector during May but should provide some support for the sector over the remainder of 2008.

Global property markets also moved lower in May. The S&P/Citigroup BMI World Property index fell 3.8% in AUD terms.