Colonial First State

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September 2009

Market Watch

Economic commentary

The Australian economy continued to show its resilience in September, with second-quarter GDP showing a better than expected gain of 0.6%/qtr, above expectations. Growth on the quarter was driven by domestic demand through private consumption and private investment, spurred on by government cash handouts and business investment incentives. This took the annual pace of growth to 0.6%/yr, from 0.4%/yr in the first-quarter 2009, but well down from 3.0%/yr for the 12 months to June 2008.

Other data over the month was mixed. Retail sales rose in August (+0.9%), following a 0.9% fall in July. This took the annual rate to 5.8%, from 5.3%. The unemployment rate remained at 5.8% in August, although a further 27,100 jobs were lost. The fall in the participation rate to 65.1% from 65.3% saw the unemployment rate remain steady.

The Federal Government released its final Budget outcome for 2008/09. The Budget deficit was A$27.1bn, or 2.3% of GDP, versus forecast of A$32.1bn or 2.7% of GDP. The better result was due to higher than expected tax revenues from company profits. Revisions were also made to the Government's net debt forecasts, upgrading the net asset position as at 30 June 2009 from A$4.7bn (-0.4% of GDP) to A$16.1bn (-1.3% of GDP) due to higher asset values.

The Reserve Bank of Australia (RBA) released its semi-annual Financial Stability Review in September. The RBA stated that conditions in the global financial system have improved significantly since last March, although remain under a degree of stress. Confidence has started to appear, assisted by improved prospects in the global economy. On Australia, the RBA noted that the Australian financial system remained resilient throughout the crisis and loan losses and impairments have been lower than other countries.

The A$ rose in September, closing the month at US0.8838 cents, a gain of 11.9% over the month on expectation that interest rates in Australia will be lifted before the end of the year.

At the end of September, the A$ bought 0.5518 UK pounds, 0.6035 euro and 1.2205 NZ dollars.

Australian shares

The S&P/ASX 200 Accumulation Index rose 6.2% in September, the seventh consecutive monthly gain. Over the 12 months to September 2009 the index has risen 8.3%. Since reaching its low on 6 March 2009, the S&P/ASX 200 Accumulation Index has risen 54.3%.

The continued strong performance of the Australian sharemarket in September was driven by better than expected economic data in Australia, further signs of recovery in the global economy and supportive initiatives out of the G20 meeting in the US. As a result, company profit expectations have risen.

Signs that global economic growth is recovering continued in September, with further improvement in manufacturing surveys and confidence indicators. This has been supported by commentary from the Federal Reserve over September. The Federal Reserve stated that "economic activity has picked up following its severe downturn". It also noted that economic conditions would warrant exceptionally low levels of the federal funds for an extended period of time. This eased concerns over a premature tightening of the Fed Funds rate.

Also assisting confidence within the global economic recovery was rhetoric from the G20 meeting. Outcomes of the meeting centred around ensuring fiscal and monetary stimulus was not withdrawn until growth takes hold. Discussions were also held about changes to financial regulation, with a plan to force banks to link bonuses to long term performance and to lift the amount of capital banks must hold.

Over the past 12 months, Australian listed companies have raised around A$100bn in new equity. Over September, Primary Health Care, Paladin Energy and AWB were just some of the companies to raise additional equity, with a number of small companies also accessing the market. With investor appetite for equities returning, the initial public offering market has re-emerged. Myer announced its upcoming offering, and retailer Kathmandu is also considering an IPO. Merger and acquisitions activity is growing in Australia with ANZ Banking Group and Macquarie Group announcing acquisitions, while Nufarm was the subject of a takeover bid.

The growing risk appetite and inflows in the Australian sharemarket saw the following sectors perform well; Financials ex A-REIT (+9.8%), A-REIT (+9.5%) and Consumer Discretionary (+9.5%). The release of the RBA's Financial Stability Review assisted the gains in the major banks with ANZ Banking Group (+14.6%) and Commonwealth Bank of Australia (+12.5%) top performers. Within the Consumer Discretionary sector, both media companies and retailers performed well. Ten Network (+16.5%) rose with the sale of a stake by a major shareholder while Austar United (+18.7%) and Macquarie Media Group (+36.4%) also gaining.

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The weaker sectors in the Australian market included Energy (+1.5%) and Materials (+2.5%). Oil prices rose slightly, up 0.9% over the month while other commodity prices were softer on concerns demand may weaken from the Chinese. The Telecoms sector (+0.3) underperformed with Singapore Telecom falling, while Telstra rose (+0.3%) despite the Federal Government announcing its strong desire for Telstra to separate its fixed line assets from its retail business.

Among the top 50 companies, ANZ Banking Group (+14.6%), Macquarie Group (+15.7%) and GPT Group (+12.9%) performed well. Fortescue Metals Group (-13.8%), Incitec Pivot (-6.0%) and OneSteel (-5.5%) all fell.

The Australian sharemarket has rallied sharply over past six months. This was driven by realisation that the worst case scenario for the global and Australian economies did not eventuate, and that prospects of recovery for the global economy are improving. While this is positive, share price gains are now starting to factor in substantial earnings growth over the next few years. For this to happen private demand must return within the economy, allowing companies to grow revenues and expand operating margins to provide earnings growth. The big test will be when governments around the world begin to withdraw the large amounts of monetary and fiscal stimulus.

Global shares

The major global equity markets rose in September with signs of recovery in the global economy and rhetoric from world leaders and central bankers over stimulus packages. The MSCI World Index rose 3.8% in US$ and fell 1.0% in A$ terms. The stronger Australian dollar held back returns for local investors. Over 12 months, global shares were down 4.7% in US$ and 14.8% in A$.

While the recovery in the global economy looks to be taking hold, it is likely to be fragile and slow. This was well recognised by a number of notable central bankers over the month. Chairman of the Federal Reserve, Ben Bernanke noted "Even though from a technical perspective the recession is very likely over at this point, it's still going to feel like a very weak economy for some time". Data out of the US over the month confirmed this with weaker than expected existing and new home sales and durable goods orders.

In the US, the labour market continued to deteriorate, although at a slower pace. In August, 216,000 jobs were lost, fewer than consensus and July. However the unemployment rate rose to a 26 year high of 9.7% with the underemployment rate, measuring those who work part-time, but would prefer to work full-time rose to 16.8%. Unemployment rates reached 7.9% in the UK, 5.7% in Japan, 18.5% in Spain and 7.7% in Germany.

In the US, the Dow Jones Industrial Average was up 2.3%, the S&P 500 Index was up 3.6%, while the NASDAQ was up 5.6%. Since its bottom on 9 March 2009, the Dow rallied 48.3% to the end of September. Over 12 months the Dow is down 10.5%.

Asian markets were mixed over the month with Japan the main area of weakness after recent gains. The Chinese sharemarket rose 3.8%, following a 15.4% fall in August. An official from the Chinese National Bureau of Statistics suggested the Chinese economy will have no issues recording an 8% growth rate by end of 2009. Japan fell (-3.4%), while Hong Kong (+6.2%) and Singapore (+3.1%) rose.

European markets also posted solid gains in September as economic data continued to show signs of improvement. In Germany, Chancellor Angela Merkel was re-elected, suggesting she would press ahead with tax cuts and labour market deregulation. Germany (+3.9%), France (+3.9%) and Spain (+3.4%) all rose. The UK FTSE 100 index also posted positive gains, rising 4.6 %.

Emerging markets were stronger in September with the MSCI Emerging Markets Index up 8.9% in US$ terms, and 3.8% in A$. Argentina (+15.7%), Russia (+12.9%) and Sri Lanka (+12.7%) all rose strongly over the month. The Philippines (-2.4%) and Czech Republic (-1.0%) both fell. The performance of some emerging markets highlights the increased appetite for risk amongst many global investors with large amounts of liquidity within the global financial system searching for an attractive investment.

Fixed interest

In both Australia and globally, fixed interest markets continued to trade in a less volatile manner over the month. Credit spreads narrowed slightly and bond yields generally fell. Government bond issuance continued around the world, but continues to be met by reasonable levels of demand with excess liquidity looking for a home.

The Reserve Bank of Australia (RBA) left official interest rates on hold in September at 3.0%, as widely expected by financial markets. In leaving interest rates on hold, the RBA signaled some improved optimism for the Australian economy, stating "Economic conditions in Australia have been stronger than expected, with consumer spending, exports and business investment notable for their resilience". The RBA did note a change in risks to inflation, highlighting that the "likelihood of inflation being persistently below the target now looks low".

Financial markets have begun to price in tightening of the official cash rate in Australia. This was reinforced by stronger than expected retail sales and commentary by Governor Glenn Stevens suggesting interest rates will have to move higher off their current unusually low levels. Governor Stevens also warned for the need for both monetary and fiscal policy discipline.

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At the end of September, 10 year Australian government bond yields stood at 5.36%, down from 5.42% at the end of August and a low of 3.85% in mid-January 2009. 90 day bank bills were yielding 3.38% at the end of September, preempting a rate hike in coming months by the RBA. The Australian Office of Financial Management issued a new Inflation Linked Bond in September, with a total of A$4bn raised. This was met by strong demand from the market. With revisions to the 2008/09 Budget Deficit, it is likely that total bond issuance will be lower over the years ahead than originally forecast.

The UBS Australian Composite Bond Index returned 0.72% over September. Over 12 months the index has returned 7.07%. The UBS Australian Bank Bill index returned 0.28% in September and 4.31% over 12 months.

In financial markets, LIBOR (London Interbank Offer Rate), the interest rate at which banks borrow and lend from each other, continued to fall. From a peak of 330 basis points over the Fed Funds rate back in October 2008, LIBOR traded at four basis points above the Fed Funds rate at the end of September. LIBOR has now returned to levels observed in the period before the global financial crisis began.

In the US, 10 year bond yields continued to trade in a wide range, starting at 3.40% and reaching as high as 3.48% before finishing at 3.31%. The rise in bond prices coincided with rising share prices and expectations that the Federal Reserve will stay on hold through most of 2010. The Federal Reserve also announced changes to asset purchase programs for agency mortgage backed securities, gradually slowing the purchases to promote a smooth transition in markets and prevent sharp rises in mortgage rates.

Elsewhere, 10 year bond yields fell over the month in the Euro area and Japan while rising slightly in the UK. They stand at 3.59% in the UK, 1.30% in Japan and 3.22% in Europe. The Chinese government announced plans to make the first issue of bonds in Yuan in Hong Kong, worth around US$ 879 million. The aim is to increase the use of Yuan in the international market.

Listed property

The listed property sector also continued to rise, gaining 9.8%, following a sharp 16% rise in August. The sector has now risen 56.8% off its lows in May. Confidence has returned to the sector, following large capital raisings and debt reductions.

The index was impacted by large gains in ING Industrial Fund (+24.87%), Abacus Property Group (+22.2%) and Charter Hall Group (+18.9). The diversified was the best performing sub-sector over the month, rising 11.4%. Concerns still remain about the outlook for commercial property, with credit still tight in the sector.

Global property markets also moved higher in September. With the exception of Italy, China and Japan, all major markets recorded positive returns. The strongest performance was in Germany. The UBS Global Investors Index (Net TR) A$ rose 5.8% in the month to be 25.3% lower over 12 months.