

October 2009

Market Watch

Australian economic commentary

Australian inflation data was released in October. The Consumer Price Index (CPI) increased by 1.0% in the September quarter 2009, up from the 0.5% rise in the June quarter. This took the annual rate of inflation down to 1.3%, from 1.5% in the year to the June quarter 2009. This inflation rate is obviously well below the RBA's 2%-3% target band and is the lowest annual inflation rate since June 1999.

The news for underlying inflation, which excludes volatile price movements, was not as positive with the annual growth rate remaining at elevated levels. The underlying measure of inflation rose 0.8% over the September quarter with the annual inflation rate declining to 3.5% from 3.9%. This remains above the RBA's 2%-3% target range and the RBA will watch this measure closely.

The most significant price increases in the September quarter 2009 were in water and sewerage (+14.1%) and electricity (+11.4%), explaining the strong contribution from housing costs to the headline measure. Other strong price gains were seen in property rates and charges (+5.7%), pets, pet foods and supplies (+5.4%) and automotive fuel (+4.0%). Offsetting these increases were falls in vegetables (-5.6%), fruit (-5.4%) and pharmaceuticals (-4.4%) reflecting the strong currency and impact on the price of imports.

Unemployment data was released for September:

- Employment surprised on the upside with 40,600 jobs created in September 2009, versus market forecasts of 10,000 job losses.
- This lowered the unemployment rate to 5.7%, from 5.8%. Annual employment growth turned positive, recording +0.10%. Prior to September's employment data, employment growth was -0.33% which was the weakest level since February 1993.

The A\$ rose in October, closing the month at US0.8996 cents, representing a gain of 1.8% over the month. The A\$ reached as high as 0.9292 and as low as 0.8653, rising as the Reserve Bank of Australia (RBA) lifted official cash rates.

At the end of October, the A\$ bought 0.5469 UK pounds, 0.6110 euro and 1.2533 NZ dollars.

Australian shares

The S&P/ASX 200 Accumulation Index fell 2.1% in October the first monthly fall since February 2009. The falls came in the last week of the month. Prior to this the Australian sharemarket was up almost 5%. Over the 12 months to October 2009 the S&P/ASX 200 Accumulation Index has risen 21.4%.

Sharemarkets around the world continued to rally in the first half of the month before falling in the later stages of October. While the global economic recovery continued, concerns were held that sharemarkets had risen too quickly. The global economy is growing, but the recovery is fragile and still supported by government stimulus measures. The test will be once stimulus is withdrawn and whether demand from the private sector can take over as the driver of global growth.

Concerns remain over the global banking system and the cost and availability of credit. Credit conditions remain tight, especially for small businesses, and this has the potential to hold back the pace of economic recovery. Further recapitalisations are also needed for US and European banks. There is also uncertainty over regulation changes and this rattled investor nerves despite a number of large US banks reporting gains to profits over the September quarter.

In October, some Australian companies released updated profit forecasts and results. National Australia Bank and ANZ Banking Group released profit results, which did highlight some weakness within the sector with a cautious outlook maintained. Bad and doubtful debts remained at high levels but the accompanying commentary did highlight stabilisation within losses. At various Annual General Meetings over the month, commentary was relatively upbeat, but still cautious. The stronger A\$ is also leading to some profit downgrades while the first official cash rate rise also led to weakness in some sectors.

In other news, the initial public offering by Myer was undertaken, although pricing occurred at the lower end of the indicative range. Myer was listed on the Australian Stock Exchange on 2 November. Kathmandu also firmed up its IPO with others expected to follow. Other companies continued to raise capital on the equity market, as debt financing remains challenging.

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Leading the sharemarket lower were recent strong performers; the Property Trust (-9.0%), Energy (-5.3%) and Healthcare (-4.1%) sectors all fell. Higher official interest rates, further capital raisings and concern over commercial property prices led the Property Trust sector lower. A stronger Australian dollar held back the Healthcare sector while the Energy sector fell despite higher oil prices. Within the Healthcare sector, both CSL (-5.1%) and Cochlear (-4.0%) made mention of the impacts of a stronger Australian dollar in each company's AGM commentary.

The defensive sectors were the better performers; Consumer Staples (+1.4%), Utilities (+0.6%) and Telecoms (+0.4%) all rose over the month. The Material sector (+0.2%) also gained, with commodity prices continuing to rise over the month with strong economic data out of China and continued demand for Australia's natural resources. Rio Tinto (+7.7%) and Lihir Gold (+8.9%) performed well.

Among the top 50 companies, Transurban Group (+11.2%), Lihir Gold (+8.9%) and Coca-Cola Amatil (+8.5%) were the better performers. Transurban Group rose with the release of a positive announcement on the M2 expansion in Sydney, while Coca-Cola Amatil rose on positive third-quarter operating performance. Among the poorer performers were Macquarie Group (-15.0%), GPT Group (-14.6%) and Brambles Group (-11.9%).

The weakness in the Australian sharemarket during October highlighted the fragility of risk appetite and belief in a sustainable global economic recovery post stimulus. It also demonstrated the high expectations being placed on Australian company operating performance over the next several years. For these profit expectations to be met, private final demand will need to return to lift revenues. Companies will also need to manage cost pressures from rising inflation to maintain and improve operating margins. While this is possible, the next rally in the sharemarket is likely to be more discerning on individual company fundamentals rather than broad-based gains.

Global shares

Global equity markets were weaker in October with mixed economic data and after strong gains since March. The MSCI World Index fell 1.9% in US\$ and 3.4% in A\$ terms. The stronger Australian dollar further held back returns for local investors. Over 12 months, global shares were up 15.6% in US\$ but down 14.6% in A\$ due to the A\$ appreciating 35.4% over the 12 month period.

The US economy returned to growth in the third-quarter of 2009, recording a 3.5% annualised growth rate. This was a large improvement on the 0.7% contraction recorded in the second-quarter and follows four quarters of negative growth. Driving economic growth was household consumption, in particular auto sales, residential investment and government spending. The positive GDP result is likely to boost consumer confidence over coming months and could further stimulate consumption and growth going forward.

While the GDP data was positive, other US economic data was mixed. In early October, job losses were worse than expected with a further 263,000 jobs lost (more than expected) and the unemployment rate rose to 9.8%. Expectations are for the rate to move through 10% over the next few months. The housing sector also provided mixed news with house prices and existing home sales both positive, while housing starts and new home sales disappointed expectations.

In the US, the Dow Jones Industrial Average was flat while the S&P 500 Index was down 2.0% and the NASDAQ fell 3.6% over October. Over 12 months the Dow is up 4.2%.

Asian markets were mixed over the month with China (+7.5%) and Hong Kong (+3.8%) both recording strong gains. China released positive third-quarter GDP figures, with economic growth of 8.9% for the 12 months to September, compared to 6.9% for the 12 months to June. South Korea also recorded positive economic growth figures, up 2.9% in the quarter and 0.6% over the year to September, although this did not prevent a 5.5% fall on its sharemarket. In Japan, the Nikkei fell 1.0% to be up 17.0% over 12 months.

European markets were weaker with Germany (-4.6%), France (-5.0%) and Spain (-2.9%) all falling. The UK FTSE 100 index fell 1.7% with the release of disappointing third-quarter GDP figures showing a sixth negative quarter of economic growth. The UK economy contracted by 0.4% over the September quarter, much weaker than the 0.2% the market was expecting.

Despite weakness in most sharemarkets, emerging markets were slightly stronger in October with the MSCI Emerging Markets Index flat in US\$ terms, and down 1.7% in A\$. Russia (+6.4%), Poland (+2.3%) and the Philippines (+2.3%) all recorded positive growth as emerging markets continue to attract investor inflow based on recent and expected economic performance.

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Fixed interest

Around the globe, fixed interest markets continued to move with changes to investor risk appetite and economic data. Credit spreads narrowed, but bond yields rose. Investors questioned the sustainability of the global economic recovery and the likely timing for withdrawal of monetary policy stimulus.

The RBA lifted the official cash rate to 3.25%, from 3.00%, the first rate rise since March 2008. In making its decision, the RBA noted that the cash rate had been lowered very quickly in anticipation of very weak economic conditions and considerable downside risks. The RBA also noted "that the basis for such a low interest rate setting has now passed" and "it is now prudent to begin lessening the stimulus provided by monetary policy".

The RBA chose to raise the cash rate despite continued uncertainty over the characteristics of the global recovery, particularly in developed economies, relatively subdued inflationary pressures and the availability of credit to business. In the statement it indicated it would take a gradual approach to normalising the cash rate; with the market expecting rate rises of 25bps would occur relatively regularly over the next six months so that the cash rate rests around 4.0% by first-quarter 2010.

Financial markets had already begun to price in tightening of the official cash rate in Australia prior to the rate rise. At the end of October, 10-year Australian government bond yields stood at 5.54%, down from 5.36% at the end of September and a low of 3.85% in mid-January 2009. 90 day bank bills also rose sharply over the month, yielding 3.94% at the end of October, versus 3.38% at end of September. The elevated underlying inflation data did lead to expectations that interest rates may move higher at a faster pace than originally thought.

In early November, the Federal Government released its Mid-Year Economic and Fiscal Outlook (MYEFO), upgrading economic growth forecasts and downgraded budget deficit forecasts for 2010-11 till 2012-13. Total bond issuance is now expected to be A\$50bn less than the forecast contained within the May Budget.

The UBS Australian Composite Bond Index returned -0.08% over October as yields rose. Over 12 months the index has returned 4.89%. The UBS Australian Bank Bill index returned 0.26% in October and 3.83% over 12 months.

In the US, 10-year bond yields continued to trade in a wide range, starting at 3.31% and reaching as high as 3.55%, and as low as 3.18% before finishing at 3.38%. The Federal Reserve is expected to stay on hold until well into 2010, to ensure the US economic recovery is self-sustaining. Rising bond yields also coincided with large US government debt issuance over October, although demand has held up well with around average, if not better bid to cover ratios.

Elsewhere, 10-year bond yields rose in the Euro area, Japan and the UK. They stand at 3.62% in the UK, 1.42% in Japan and 3.23% in Europe. With the release of disappointing GDP figures in the UK, this raises the possibility of the Bank of England raising its Quantitative Easing program.

Listed property

The listed property trust sector experienced falls over October, following sharp gains since May. Rising bond yields, expectations of further capital gains and tight financing conditions weighed on the sector. The Property Trust sector fell 9.0% to be down 7.3% over 12 months.

The listed property index was impacted by falls in GPT Group (-14.6%), Charter Hall Group (-13.5%) and Westfield Group (-11.7%). The office sector was the better performer, rising 1.6%, while retail (-10.4%), diversified (-9.5%) and industrial (-7.7%) subsectors all fell.

Global property markets also moved lower in October. The main areas of weakness included Germany, Japan, China, Australia and the US. Some parts of Europe rose with positive gains in Italy and France. The UBS Global Investors Index (Net TR) A\$ fell 3.3% in the month to be 5.8% higher over 12 months.