

28 February 2010

The Markets

International Equities

World equity markets recover some of their January losses

Global equity markets recovered some of their January losses over the course of the month. The Morgan Stanley Capital International (MSCI) All Countries World Index (ex Australia) gained 1.64% in local currency terms in February, however, with a stronger Australian dollar (AUD), this translates to 0.45% in AUD terms.

Despite continuing sovereign debt concerns in Europe and a tightening of liquidity conditions in China and the US, equity markets held up in February. Economic releases continue to be mixed, with the Japanese gross domestic product (GDP) number surprising to the upside, while European numbers were generally weak.

The US fourth quarter earnings season is now all but over, with a record number of companies beating analysts' earnings estimates (on a dollar-weighted basis, earnings beat expectations by 9%), particularly those in the financial and consumer discretionary sectors. Importantly, this time there have been signs of improvement in the revenue line. The market has placed a premium on these companies as opposed to those improving margins through cost measures. Overall, this reporting season has provided some support for the strong growth implied by forward earnings estimates.

With the exception of utilities (-0.6%), there were gains across all developed market sectors in February. The materials sector was the strongest, up 3.4%, while information technology gained 2.9% after its poor performance in January. Unlike the previous month, there was no distinct cyclical/defensive sector trend with consumer staples up 2.6% but healthcare relatively weak, up just 0.7%.

European developed markets were again subject to a sharp sell-off in February. Greece was the worst performer, down another 8.1%, while Spain (-5.6%) and Portugal (-4.3%) were also under pressure as the fiscal position of Euro-zone countries came under further scrutiny. Norway also performed poorly, down 4.8%. The Anglophone nations led the index northward, with US markets up 3%, the UK up 3.7% and Canada gaining 4.9%.

Emerging equity markets were generally down over the month, with Turkey (-9.3%) and Russia (-6.3%) lagging. Peru and the Philippines, which were the best performers, up 7.9% and 4.8%, respectively.

The AUD gained against most major currencies over the month, while the trade-weighted index increased by 0.4%. This had the effect of reducing unhedged returns across a majority of the portfolio when translated to AUD terms.

Outlook: Equity markets continue to linger close to fair value. While jittery in January, the market has recently shown that it can shrug off the potential concerns from sovereign risks such as Greece. The latest earnings results from the US have rewarded investors for staying positive and support prospects for solid earnings growth into 2011. The big swing factor continues to be the US consumer, where one in ten people are looking for work. A strengthening of job prospects will allow policy markets to step back from their stimulatory stance and start sending positive messages to investors. Until then, we remain wary of the market's ability to meet the bullish embedded earnings estimates.

Australian Equities

Domestic equities followed world equity markets up in February

The S&P/ASX 200 Accumulation Index reclaimed part of the losses from January, with a 2.16% rise in February, although the market was volatile during the month.

Company's earnings were on balance slightly ahead of expectations but not reassuring enough to overcome concerns about global growth and sovereign risk. Banks gained 3.5% following positive earnings news while the resources index, up 2.1%, made back some ground after its weak start to the year. The telecommunication sector, down 10.2%, was the clear underperformer as Telstra reported disappointing results.

The Reserve Bank of Australia (RBA) surprised the market by leaving rates unchanged at its February meeting. Volatility in financial markets may have influenced the RBA not to act and adopt a wait and see approach, for February at least.

Outlook: We remain optimistic about the outlook for the Australian sharemarket returns over the medium to long term, as we expect the market will continue to recover ahead of global economic growth, albeit off a lower base. In the near term, we expect volatility will remain at above-average levels as the recovery in the real economy is likely to experience several 'false dawns' and markets will trade heavily around this.

In 2010, we expect margin expansion to feature despite revenue growth remaining fairly subdued. The previous two years of soft economic growth have focused companies on reducing their cost bases as the economy improves.

The significant amount of stimulus enacted by the government will positively impact consumer behaviour and has effectively capped unemployment levels at much lower levels than anticipated. The upcoming reporting season is likely to see a range of company upgrades as benefits from government stimulus and stronger economic growth flows through to company balance sheets. However, the interest rate cycle is once again on the rise and will mitigate a large proportion of induced demand.

Global Fixed Interest

Global bond yields mixed in February

After a weak start to the year, February was a better month for most asset classes. The latest US quarterly reporting season again resulted in the majority of corporations exceeding expectations, and this supported sentiment. The commitment by the US Federal Reserve (Fed) to keep cash rates "exceptionally low" for "an extended period" also assured markets that policy support would remain in place for some time to come, despite some shorter-term concerns around some of the Fed's other activities (such as increasing the discount rate).

With equities and commodities posting gains this month after January's losses, sovereign bond markets were mixed. US 10-year bond yields moved from 3.58% to 3.61%, while the Australian long-end rose 0.06% to 5.44%. German government bonds were stronger with the 10-year benchmark Bund rallying from 3.20% to 3.10% at the end of February on concerns over Greece. In inflation markets, breakeven inflation moved higher in Australia but fell in Europe.

US high-yield credit spreads widened again in February, moving out 0.19% to 6.57%. Investment-grade credit spreads also widened slightly, from 1.69% to 1.73%, while emerging market spreads contracted. Credit spreads have stabilised now at levels similar to those seen in late 2007/early 2008.

Outlook: Domestically, we expect further increases in the cash rate over the course of the year given Australia's strong underlying economic position and the growth in the economies of our major trading partners. Short-maturity bond yields also appear too low given the outlook for improving economic conditions.

In the US, we continue to look for a slow but steady improvement in the labour market and the commencement of a monetary policy tightening cycle by the Fed, beginning later in the year. We view short-maturity bond yields as being too low, and we continue to look for a significant flattening of the yield curve.

Robust inflows into credit should sustain the bid for bonds, despite occasional pullbacks in market risk sentiment. The net supply of investment-grade credit is likely to be limited, further adding to the favourable technical dynamic. While the pace of the rally seen last year will obviously slow, we think investment-grade credit spreads should continue to tighten against a backdrop of stronger corporate cashflows supported by cost cutting and an improving global economy.

Currencies

Euro and pound weighed down by fiscal concerns

Data from advanced economies continued to be mixed in February, with Asian economies clearly leading the global recovery. This benefited the yen, which strengthened by around 1% to 2% against the US dollar (USD) in the month and by around 4% this year.

Concerns over the fiscal outlook in Greece continued to pressure asset prices in February, with European equity prices underperforming and the euro depreciating by another 2% against the USD in February. The euro has now fallen by almost 8% against the USD in the last three months. In February, the British pound (GBP) fell by a sharp 5% against the USD (and by 3% against the euro) due to a combination of relatively weak economic data, poor public finance figures and the looming risk that a hung parliament may result from the upcoming elections. The risk that this will lead to further fiscal slippage and a downgrade to UK credit ratings could be seen in the performance of the GBP and UK bonds over the month.

Commodity prices reversed January's weakness, rising strongly during the month. This supported commodity currencies such as the AUD and Canadian dollar (CAD), which rose by 1% to 2% against the USD in February. The AUD gained 1.2% in February, ending the month just below US\$0.90, despite the RBA surprising the market by leaving the cash rate unchanged early in the month.

Outlook: The AUD remains above long-run estimates of fair value, such as those based on purchasing power parity (PPP). Despite this, it is likely to remain at, or above, current levels over coming months as increasing interest rate differentials, stronger relative growth prospects and an improvement in commodity prices continue to support the currency.

While the GBP remains within its fair value range against the USD, its 5% fall over the month has made it our second most favoured currency. The GBP is relatively cheap against the euro, and it is likely that the risk premium associated with the upcoming election will dampen the currency only temporarily. The euro has moved back within its fair value range against the USD and is no longer significantly overvalued. Our PPP estimates suggest that the yen and CAD also remain within their fair value range against the USD. While there is minimal support for the USD from valuation factors, we expect the relative momentum in the US economy and rising interest rate differentials to provide cyclical support for the USD against the euro and yen in coming months.

Financial markets (%)

Sharemarkets	Level as at 28-Feb-10	1 month return	3 month return	Financial YTD return	1 year return
Australia (S&P/ASX 200)	4637	2.16	-0.56	20.41	44.70
Developed World (MSCI World ex Aust.)	814	1.92	1.97	17.79	46.05
World (MSCI AC World ex Aust.)	310	1.64	1.63	18.00	48.02
US (S&P 500)	1104	3.10	1.31	21.84	53.62
UK (FTSE 100)	5354	3.77	3.86	28.79	45.47
Europe (MSCI Europe ex UK)	878	-0.77	0.59	17.73	45.65
Japan (Topix)	894	-0.74	6.45	-3.10	20.37

Currencies					
Australian Dollar/US Dollar	0.90	0.75	-2.17	10.77	40.17
Australian Dollar/Euro	0.66	2.61	7.63	13.85	30.45
Australian Dollar/Yen	79.58	-1.24	0.92	2.02	27.31

Sharemarket returns are inclusive of dividends, in local terms.

Economist's View

Key Points

- Financial markets stabilise – risk aversion abates
 - The US economic recovery – consumer spending and business investment
 - The underperforming euro area – twin deficits to squeeze European peripheral economies
 - Australian economy maintains solid growth in 2009q4 – RBA raises rates
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International Economies

Financial markets stabilise – risk aversion abates

After a shaky start to the month, financial markets stabilised following an announcement by European Union (EU) heads of state and government in support of the Greek government's efforts to restore the health of its public finances. Having fallen by around 5% to that point since the start of the year, global equity markets (as measured by the MSCI World Index, local currency) rallied by 1.8% to the end of the month, cutting calendar year-to-date losses to 2%. Also consistent with a fall in risk aversion were price movements in oil (9.5% increase), commodities (2.8% increase) and commodity currencies (Australian dollar and Canadian dollar up 1.2% and 1.6% against the US dollar, respectively).

The US economic recovery – consumer spending and business investment

Despite signs of improvement in the second half of 2009, US households remain under pressure. January retail sales and personal income and consumption data continue to show the tepid nature of recovery in consumer spending. This is to be expected given the state of the US labour market, which has an unemployment rate close to 10%, continues to shed jobs (albeit, at a slowing rate) and is generating year-on-year wage growth of only 1.5%. Weak growth in wage income combined with the expiration of fiscal support, a plateau in equity prices and risks that house prices might slump again (housing data over the month was particularly weak), leaves us with a subdued outlook for US real consumer spending over the coming two years. We expect tepid growth at an average annual rate of 1.5%, well below an equilibrium growth rate of around 2.5%.

While the outlook for the US consumer is weak, a consequence of US labour market adjustments is very low unit labour costs. Recently released productivity and unit labour cost data for the December quarter show non-farm productivity growing at an extremely strong annualised rate of around 7% (compared to a trend rate of around 1.8%) and unit labour costs falling at a year-on-year rate of around 6%. This is delivering extremely favourable cost conditions to US businesses, which combined with a gradual pick up in sales revenue, is generating a positive profit outlook over the coming two years. Consequently, our outlook for US real business investment is robust, with growth expected to average around 6% over the next two years. Revised national accounts data released in February show business investment growing at an annualised rate of 6.5% in the December quarter. The pick-up in business investment will provide an offset to weak consumer spending and allow the recovery in US gross domestic product (GDP) to continue throughout 2010 and 2011, even as support from macroeconomic policy and the stock cycle fade. We expect US GDP to grow at an above-trend rate of 3.4% in 2010, before slipping back to a more trend-like rate of 2.6% in 2011.

The underperforming euro area – twin deficits squeeze European peripheral economies

Euro area economic data continues to show weak recovery in the region, lagging the recovery in North America and the Asia regions. Weak GDP and industrial production data for the last quarter of 2009 reveal the reliance of the earlier recovery in the region on fiscal support (especially the car scrappage schemes). In contrast to the US, business investment appears slow to recover in the euro area as institutional support of euro area labour markets comes at a cost of poor productivity and rising unit labour costs.

In addition, the region's prospects are being adversely affected by developments in peripheral economies, which we expect to continue to impact the region over the next two years. The Greek, Portuguese, Irish and Spanish economies will remain pressured for some time as twin deficits in government budgets and current accounts on the balance of payments limit growth prospects. The risks associated with high levels of public debt are elevated for the small European economies, compared with other countries with high levels of public debt such as the US, Japan, UK and France (see Figure 1), due to their reliance on foreign sources of debt. Figure 2 shows that Greece, Spain, Ireland and Portugal (along with Hungary) are heavily reliant on foreign funding, with their respective net foreign debt levels roughly matching their government debt levels. Not only do these economies have high levels of foreign debt, but their rates of accumulation of foreign debt (as measured by their respective current account deficits) are also very high. The reliance on external funding means that these economies are very susceptible to fluctuations in international investor confidence. A fall in confidence among international investors that restricts the inflow of foreign funds compromises the ability of these countries' governments to finance their deficits and threatens the solvency of their public sectors.

There are two fundamental avenues by which these economies can stabilise their debt ratios: (1) by improving the economy's international competitiveness, thereby improving their current account deficits and reducing their reliance on foreign debt funding, and (2) by increasing the domestic savings rate. The single currency within the euro area limits the ability of these countries to improve their economies' levels of international competitiveness through currency devaluation. Hence, to stabilise rates of debt accumulation, they must rely on improving domestic savings rates through tighter fiscal policy.

The Greek government recently announced plans to reduce its government deficit by 4% of GDP this year. However, to stabilise the government debt/GDP ratio, the budget deficit would need to improve by around 7% of GDP. This would mean that the Greek budget deficit would need to have two years of tightening of around 4% of GDP just to stabilise the government debt at close to 100% of GDP. Analogous calculations for Spain, Portugal and Ireland reveal that these economies are facing fiscal tightening of a similar order of magnitude to Greece to stabilise public finances. Such amounts of fiscal austerity will challenge the political will-power of these governments, and we expect the peripheral euro area economies will be an ongoing source of market volatility for another two years and will weigh on euro area growth prospects.

Figure 1. Government budgets and debt ratios

External and government debt (2009 estimate)

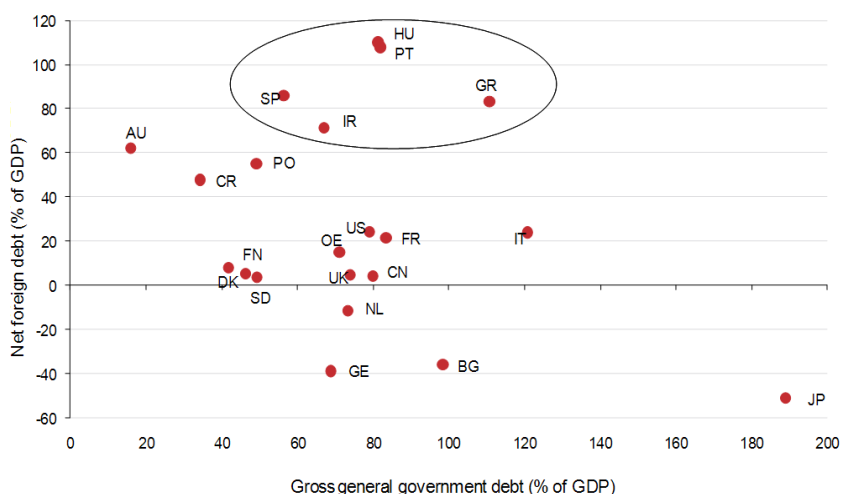
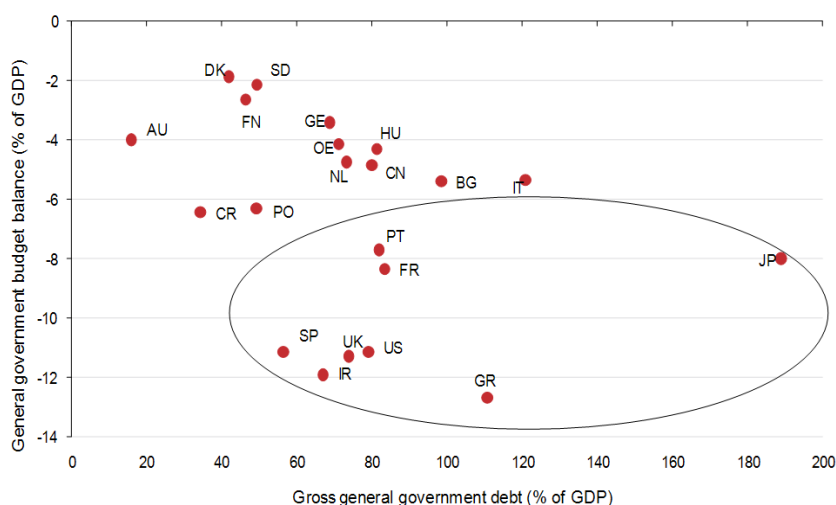


Figure 2. Government debt and net foreign debt ratios

Government debt and budget positions (2009 estimate)



Interest Rate Forecast (%)

	Level at 05 Mar 2010	Jun-10	QIC forecast Sep-10	Mar-11
Australia	4.00	4.50	4.75	5.00
US	0.00 - 0.25	0.00 - 0.25	0.50	1.00
Canada	0.25	0.25	0.50	1.50
Europe	1.00	1.00	1.00	1.00
UK	0.50	0.50	0.50	1.00
Japan	0.10	0.10	0.10	0.10

Australian Economy

Australian economy maintains solid growth in 2009q4 – RBA raises rates

National accounts data for the December quarter show the Australian economy is growing at a slightly above-trend quarterly rate of 0.9%, in line with our expectations. The economy continues to move in line with other economies of the Asian region, which are leading the global economic recovery (the economies of China, Thailand, Taiwan, Malaysia, and Hong Kong all posted quarterly real GDP growth rates in excess of 2% for the December quarter, while Japan grew in excess of 1%).

GDP growth was boosted by a 0.6% contribution from public investment spending as the federal government rolls out its schools building program. In other sectors, private investment expenditure grew at a solid quarterly rate of 4.9%, while net exports detracted 1.3% from GDP growth, despite robust export growth, as import-intensive investment lifted the quarterly rate of import growth by almost 8%. The ongoing strength in the Australian economy also features in labour market data, which shows the economy created a further 52,700 jobs in January and the unemployment rate fell to 5.3%.

Not surprisingly, the Reserve Bank of Australia (RBA) raised the cash rate by 25 basis points at its March board meeting after pausing in February. Our view is that the prospects for the economy are continuing to improve, supported by recovering investment expenditure. The first estimate of 2010/2011 Australian private capital expenditure intentions suggests nominal investment growth of around 20% as the construction of large-scale mining projects commences. Given firm growth prospects, we expect the RBA will continue to lift rates to 5% by the end of 2010.

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