31 January 2010

The Markets

International Equities

World equity markets weakened in January

Global equity markets retraced recent gains in January. The Morgan Stanley Capital International (MSCI) All Countries World Index ex Australia slipped 3.58% in local currency terms but had the slight benefit of a weaker Australian dollar (AUD) bringing the AUD return to -3.09%.

Equity investors tended to be driven more by sentiment than by hard economic figures over the month. Policy tightening in China, the Greek debt crisis and uncertainty about financial sector reforms in the US saw a move to longer-dated US treasuries, at the expense of equities.

US company results have started to flow through and continue to surprise to the upside. The most significant positive surprise has emerged from the financials sector, particularly at the big end in stocks such as Citigroup, Goldman Sachs and JP Morgan. Once again, more than half of companies are beating expectations and, importantly, companies are either meeting or beating revenue expectations. This bodes well for earnings growth and will support the strong earnings growth estimates currently being projected.

The information technology sector gave back much of its strong December quarter performance, falling 6.4%. The same cyclical concerns hit the materials and energy sectors, causing 7.8% and 4.7% falls respectively. Financials lost 3.8% with the market falling 3.6%. Consumer staples and healthcare sectors assumed their traditionally defensive characteristics and finished 0.6% and 0.2% weaker respectively.

Europe was hit particularly hard in January as concerns about Greek finances raised the possibility of contagion in the region. Greece lost 7.5% while Spain and Portugal, other Euro countries perceived to be in trouble, dropped by 8.9% and 7.3% respectively. Germany (-5.8%) and France (-4.4%) were similarly affected.

Asia was not unscathed as Hong Kong (down 6.4%) and Singapore (down 6%) followed China's 8.5% fall, following moves by policy makers to raise reserve requirements for banks and place limits on their lending. Other developed markets experienced more muted falls, including the United States (-3.5%) and the United Kingdom (-4.1%). Very few markets finished in the black. Those that did included Scandinavian markets Denmark (+6.5%), Finland (+5.6%) and Sweden (0.3%). Japan was down 0.8% for the month.

A mixed performance for the AUD compounded the falls across Europe but had the effect of improving returns from Asia, the United Kingdom and the United States.

Outlook: Economic data from the US indicates that its economy is recovering. Trade and inventories data provided a strong boost for the US economy in late 2009. However, as the inventory cycle turns, and as credit conditions remain tight and consumer spending loses the support of government stimulus programs, it is likely the recovery will be at a more subdued pace in 2010.

We consider that equity markets are close to fair value. The pull back this month reflects nervousness that the high expectations for earnings growth over this year are not without risk. In periods where economic data and policy developments do not support current expectations, these hiccups will occur with the high expectations leaving further room for such corrections. Our view is that earnings will recover considerably over the medium term and this is factored into our valuation estimates. We would like more comfort that expectations will be met over the next two years and, in the absence of such affirmation, we continue to adopt a cautiously optimistic approach.

Australian Equities

Domestic equities followed world equity markets down in January

The S&P ASX 200 Accumulation index fell 6.18% for the month. Concerns during the month were the prospect of China moderating its monetary stimulus, which impacted commodity prices and the local resources index (-9.4%), and President Obama's proposal to re-regulate US banking. This was seen as broadly negative for market sentiment, although it did not translate to underperformance by the local banks index (-4.3%).

Recent data confirms the strength of the Australian economy even as the impact of fiscal stimulus fades. Real consumer spending has remained resilient with retail sales and motor vehicle sales advancing strongly in the December quarter. While the impact of government support has begun to fade, a turnaround in the labour market and household wealth is beginning to underpin spending. Looking ahead, consumer spending is expected to remain robust in coming years.

Inflation data released in Australia showed a core rate outside the Reserve Bank of Australia's (RBA) 2% to 3% target. However, the outlook for inflation remains subdued over the next year due to excess productive capacity, softening wages and the recent appreciation of the exchange rate. This should ensure the RBA lift the cash rate only gradually over 2010.

Outlook: While economic data released will be mixed, the recovering US economy will be positive for market sentiment in Australia.

We remain optimistic about the outlook for 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 and, as the economy improves, we have high expectations for margin expansion in the worst affected sectors.

The significant amount of government stimulus 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 the benefits from the government stimulus and the 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 the induced demand.

Global Fixed Interest

Global bonds yields declined in January

Data released during the month showed that the global economy was continuing to recover. Despite this, January was a poor month for asset markets. This principally reflected rising concerns about increasing government debt levels, particularly in Europe, as a consequence of the global financial crisis (GFC) and government attempts to stimulate their economies. Policy tightening in China also hurt sentiment, as fears grew in some quarters that the "China miracle" might not be sustainable. Regulatory risk in the US banking sector also weighed on sentiment.

Global bond markets rallied in January, as equity and commodity markets fell. US 10-year bond yields moved from 3.84% to 3.58%, while 10-year German bund yields fell 0.19% to 3.2%. The long end of the Australian bond yields fell in January driven by large declines in US yields and global factors. 10-year bond yields fell from 5.64% to 5.38% and 3-year yields fell 0.15% to 4.51%, reflecting the influence of strong local economic data. The Australian yield curve also rallied.

In inflation markets, breakeven inflation moved higher in Australia but fell in Europe as reported inflation was lower than expected.

Despite favourable liquidity conditions and strong corporate earnings, credit markets suffered. US high-yield credit spreads widened from 6.17% to 6.36%. Investment-grade credit spreads contracted marginally from 1.72% to 1.69%, their lowest level since October 2007. Emerging-market credit spreads widened in January, in line with other risk markets.

Outlook: Domestically, strong economic growth, rising house prices and an only modest slowing in the inflation rate to date are expected to result in a number of further increases in the official cash rate by the RBA over the coming year. We expect that the cash rate will reach 4.75% to 5% by year-end.

In the US, we continue to anticipate a subtle but steady shift in rhetoric from the US Federal Reserve (Fed) as they prepare financial markets for eventual increases in the US Federal Funds rate. We also expect to see a significant improvement in the US labour market. As rate increase expectations grow, we continue to anticipate a significant flattening in the shape of the US yield curve.

While the pace of the rally will obviously slow, we think investment-grade credit spreads should continue to tighten against a backdrop of stronger corporate cash flows, supported by cost cutting and an improving global economy.

Currencies

The Australian dollar weakened on increased risk aversion

While data from developing economies over January continued to strengthen, data from advanced economies has been less robust and disappointed expectations, leading investors to question the durability of the economic recovery. Chinese economic data has been particularly strong, with excess liquidity leading to higher-than-expected inflation. During January, there were numerous press reports indicating that Chinese officials had asked banks to restrict lending to prevent the economy from overheating. The US dollar (USD) and yen benefited from increasing risk aversion that saw global bond yields, equity and commodity prices fall. The yen strengthened by around 3% against the USD in the month, reversing some of its weakness during the previous month.

The euro underperformed during January for a second consecutive month, falling by 3% against the USD over January due to increasing concern over fiscal irregularities in Greece. Spreads on Greek bonds widened considerably, and comments from the German Finance Minister suggest Greece will receive little support from the European Union to repay its expanding government debt. The euro has now fallen by more than 7% against the USD in the last two months.

Commodity prices fell during the month, weighing on commodity currencies such as the AUD and Canadian dollar (CAD). The AUD ended January at US $0.89, after rising as high as US $0.93 earlier in the month.

Outlook: Despite its modest fall over January, the AUD remains above long-run estimates of fair value, such as those based on purchasing power parity (PPP). Although the AUD appears overvalued on a PPP basis, 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.

Following its 7% fall over the last two months, 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 British pound and yen also remain within their fair value range against the USD. While there is only 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, pound and yen in coming months.

Financial markets (%)

Sharemarkets	Level as at 31-Jan-10	1 month return	3 month return	Financial YTD return	1 year return
Australia (S&P/ASX 200)	4569	-5.50	-1.60	15.50	29.10
Developed World (MSCI World ex Aust.)	800	-3.58	2.83	14.59	27.38
World (MSCI AC World ex Aust.)	305	-3.70	2.80	15.07	30.34
US (S&P 500)	1073	-4.70	3.60	16.80	30.00
UK (FTSE 100)	5188	-3.90	2.90	22.10	25.00
Europe (MSCI Europe ex UK)	885	-3.70	2.22	17.81	27.00
Japan (Topix)	901	-0.70	0.70	-3.10	13.50
Currencies					
Australian Dollar/US Dollar	0.89	-0.06	-2.36	9.90	39.05
Australian Dollar/Euro	0.64	2.76	3.80	11.13	28.24
Australian Dollar/Yen	80.65	-2.08	-3.12	3.38	40.16

Sharemarket returns are inclusive of dividends, in local terms.

Economist's View

Key Points

- Global economy to continue to recover in 2010
- Strong growth in US and Asia expected in 2010, UK and euro area to underperform
- Peripheral European economies face structural challenges and lag the global recovery
- Fiscal positions cloud the medium term outlook for many advanced economies
- Monetary policy to tighten despite subdued inflationary pressure
- Incoming data confirms robust outlook for the Australian economy 2010

International Economies

Global economy to continue to recover in 2010

The global economy recovered more strongly than expected towards the end of 2009, boosted by a sharp turn in the inventory cycle in the US and stimulatory policy settings. However, the pace of recovery is likely to slow over the course of 2010 as support from fiscal stimulus fades and the temporary boost from stabilising inventories is removed. We expect the global economy will expand at trend-like rates of 4.1% in 2010 and 4% in 2011.

Strong growth in US and Asia expected in 2010, UK and Euro area to underperform

Advanced economies are also expected to expand at a trend-like pace over the next two years. We expect average growth rates of 2.4% in 2010 and 2011 for advanced economies. The US economy is forecast to recover strongly during 2010, supported by substantial fiscal stimulus, but slow in 2011 as the stimulus package winds down. Recovery in the Euro area is expected to be subdued, hampered by a sharp fall in productivity during 2009 that will restrict private sector investment and employment. The UK economy is forecast to grow modestly in 2010 as the discretionary fiscal stimulus implemented in 2009 is removed. Emerging and developing economies, led by China, are expected to expand by 6% in 2010. Strong growth will continue in the Asian region, supported by robust domestic demand and an improvement in exports. As a consequence, robust growth is expected in the Japanese economy in 2010, supported by a rebound in exports.

Peripheral European economies face structural challenges and lag the global recovery

A number of European economies, which face significant structural challenges, are expected to lag behind the global recovery. Spain, Ireland and Greece will remain weak in 2010, constrained by required adjustments to their housing market, financial sector and public finances, respectively. Some Eastern Europe countries, such as the Baltic economies, will continue to struggle in 2010 after dramatic collapses in activity and capital inflows in late 2008 and early 2009.

Fiscal positions cloud the medium-term outlook for many advanced economies

Many major advanced economies also face significant medium-term challenges. The US and UK have experienced severe deteriorations in their fiscal positions and fiscal discipline from their respective governments will be required once the economic recovery is entrenched. Consequently, the recovery in these economies is likely to be subdued by historical standards. The Japanese economy also has a large stock of public debt, but this is less of a concern given the willingness of the Japanese household sector to finance this debt with domestic savings.

Monetary policy tightens despite subdued inflationary pressure

Inflation pressures are expected to remain subdued in the global economy during 2010 given substantial excess capacity. However, inflation is expected to pick-up in some emerging markets, particularly in Asia, prompting central banks to tighten monetary policy. We expect policy rates to be lifted by 125 basis points (bps) in South Korea, 75 bps in India and 54 bps in China during 2010. Chinese authorities are also likely to adopt other measures to slow their economy, including restrictions in credit growth and allowing a modest appreciation of the Chinese yuan.

Central banks in advanced economies will be slower to commence their tightening cycles. We expect the US Federal Reserve (Fed) will begin to lift interest rates in June, the Bank of England (BoE) towards the end of 2010 and the European Central Bank (ECB) and the Bank of Japan in 2011.

Interest Rate Forecast (%)

	Level at 05 Feb 2010	Mar-10	QIC forecast Jun-10	Dec-10
Australia	3.75	4.00	4.50	5.00
US	0.00 - 0.25	0.00 - 0.25	0.50	1.00
Canada	0.25	0.25	0.50	1.00
Europe	1.00	1.00	1.00	1.00
UK	0.50	0.50	0.50	0.75
Japan	0.10	0.10	0.10	0.10

Australian Economy

Incoming data confirms robust outlook for the Australian economy

Recent data confirm the strength of the Australian economy even as the impact of fiscal stimulus fades. Real consumer spending has remained resilient with retail sales and motor vehicle sales advancing strongly in the December quarter. While the impact of government support has begun to fade, a turnaround in the labour market and household wealth is beginning to underpin spending. Looking ahead, consumer spending is expected to remain robust in coming years.

The housing market continues to recover after a sharp deterioration in conditions during 2008. House prices have risen and are now above their early 2008 peaks. Housing construction activity continues to rebound, boosted by the first home owner grant and low interest rates. Despite a rebound in housing investment in 2010, the increase in construction is expected to be insufficient to meet underlying demand, contributing to a widening housing shortage problem and higher rents.

The outlook for business investment has improved markedly since early 2009. Business confidence has increased and firms' assessments of capacity utilisation have begun to increase. Part of the improvement reflects the stimulative policy settings and improved economic outlook. In particular, the prospect for continued strong growth in the Asian region has been underpinning investment intentions, particularly in the resources sector. The approval of the $43 billion Gorgon LNG project, with construction set to occur over the next four to five years, has boosted the long-term outlook for business investment. Overall, business investment is expected to expand at double digit rates in 2011 and 2012, underpinned by engineering construction activity in the resources sector.

As a consequence of the recovery in demand, conditions in the labour market continue to gradually improve. Employment has increased solidly since September and the unemployment rate edged down from 5.8% to 5.5% in December. While we expect employment growth to continue in 2010, solid labour force growth is expected to cause the unemployment rate to remain relatively unchanged over the year. On average, we expect the unemployment rate to average around 5.6% in 2010 and 5.3% in 2011.

The outlook for inflation remains subdued over the next year due to excess productive capacity, softening wages and the recent appreciation of the exchange rate. However, inflationary pressures will gradually build in 2011 as the influence of the exchange rate appreciation fades and wage growth begins to pick-up. Overall, we expect consumer price inflation to average 2.1% in 2010 and 2.8% in 2011.

Following the pause in February, we expect the Reserve Bank of Australia (RBA) to lift rates by 25 bps in March to 4%. We expect the RBA will continue to gradually lift rates to 5% by the end of 2010, 5.75% by the end of 2011 and 7% by the end of 2012 in the face of strong growth and mounting inflationary pressure.