QIC Outlook
Market & Economic
Dynamic Investment Solutions

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The Markets

International Equities

World equity markets rallied in July

July was a better month for global equity markets, with a positive start to the US reporting season and the relatively benign European bank stress-test results outweighing widespread concern about the possibility of a 'double-dip' recession in the major advanced economies. In local currency terms, the Morgan Stanley Capital International (MSCI) All Countries World Index (ex Australia) returned 5.83% over the month.

World equity markets entered July with a degree of trepidation, with fears recent weak economic signals would be reflected in the imminent June-end company reporting season. Unsurprisingly, as a positive reporting season unfolded in the US, with earnings meeting or beating targets, the market posted relief-driven results. Comfort was also taken from the fact that company revenues, while not as strong as earnings, were still at or marginally above estimates. The company news flow all but drowned out news and statistics depicting an economy that remained very subdued and sentiment surveys that predicted no immediate change to the state of affairs.

The United States rose almost 7%, but was outstripped by a surge in some European markets that formed the epicentre of debt concerns, including Greece (22.8%), Spain (14.7%) and Italy (8.9%). The UK was strong, rising 7.1%, as was Norway, with broad-based support driving that market up more than 10%. Japan underperformed in July, posting a modest 1.4% gain. Other debt-burdened European economies such as Ireland and Portugal posted moderate returns. Emerging markets beat developed markets by a small margin, with a 6.2% return. Leading the way were Brazil (8.6%), Russia (8.6%) and Taiwan (8.7%). India and China lagged, returning 0.6% and 4.1% respectively.

Energy and financials rebounded 7.14% and 8.3% respectively after struggling through June. Banks led the financials charge with a strong 8.3% gain. Consumer discretionary stocks in general outperformed, driven by a strong media sector that was up 8.5% based on advertising revenue gains. The information technology sector was up 6.1% in July, with solid returns attributed to a return of company information technology expenditure.

Outlook: While the second quarter US reporting season was seen as positive for the market, the outlook for the US economy remains the subject of debate, with a number of key leading indicators showing renewed signs of weakness. Equity markets are looking for clear direction on the earnings front to alleviate these concerns. Appetite for risk is tentative at best and there is little comfort from the messages in fixed income markets.

Economic concerns are real, with fiscal and monetary policy challenges across the developed world lacking a clear exit pathway. However, we believe that downside risks are limited. The main risk is enduring weakness rather than further negative shocks to markets. Renewed confidence could, conversely, lead to stronger equity market returns. Policy makers still have tools at their disposal to boost confidence, but they are waiting for confirmation that they would not be pouring precious fuel into a leaky tank.

We remain comfortable with our long-term positioning toward value stocks and emerging markets, as we expect they will pay us a premium for taking additional risk. We continue to see equities marginally undervalued, which adds to longrun risk premiums. More comfort on policy direction or excessive market discounting could provide a trigger for increasing allocations.

Australian Equities

Domestic equities followed world markets' lead in July

July was a positive start to the new financial year, with the ASX 200 rising 4.47%, claiming back its June losses and returning to the support levels set in May 2010. This was despite subdued trading volumes, as is often the case heading into the key August reporting period.

The improved sentiment for riskier assets reflects the improved outlook for some macro factors, such as the strong US second quarter reporting season, improving credit markets and the diminishing risk of slowing Chinese gross domestic product (GDP) growth. Investors in the Australian equity market took these factors, together with the Prime Minister's revised (and mining-company approved) resources tax, as very positive for the domestic market. Investors moved away from the defensive sectors such as telecommunications, consumer staples, Real Estate Investment Trusts (REITs) and healthcare.

While the Australian market had a strong month, it couldn't match the performance of most offshore markets. The US S&P 500 was up 6.9% and the Euro Stoxx 50 rose by 6.6% in July.

Outlook: The domestic economy should continue to grow close to trend. Concerns about global macro issues such as European debt issues and Chinese economic growth have subsided for now. Sentiment towards our banks is impacted by global funding costs and the outlook for credit growth. However, the stress test on European financial institutions' capital positions showed no major concerns. In the resources sector, the focus will remain on the growth of the Chinese economy. Although China's growth has slowed, stimulatory measures can be taken if growth slows more significantly.

Even with the market rebound in July, we believe that the Australian market valuations remain attractive to investors and are likely to do so for some time. There appears to be more certainty about the improving domestic economy compared to offshore economies, particularly the US. However, the outcomes for the August reporting season will be closely watched, as there are concerns for potential earnings downgrades for the 2010-11 financial year.

It is always difficult to predict the impact of an election result. Assuming the polls are correct and the current government is re-elected, and given the policy announcements to date, there appears to be no major changes on the horizon that would significantly impact the market. If there was a change of government, there could be changes to the National Broadband Network (which would impact the telecommunications sector) and the Mineral Resources Rent Tax (which would positively impact the resources sector).

Global Fixed Interest

Global long bonds weakened in July

In a month when equities and commodities rallied, fixed interest markets were mostly lower, putting a halt to the rally which began in mid-April. Australian 10-year bond yields moved 11 basis points (bps) higher to 5.2%, while German bund yields also crept higher, finishing the month at 2.67%. In contrast, US 10-year treasuries were 3 bps lower at 2.91%. After trending down over the last few months, breakeven inflation in Australia was essentially unchanged over the month, while it continued to move lower in the US.

Credit rallied throughout the month, with spreads tighter across the spectrum. US high-yield spreads were down to 6.42% from 7% in June, while investment-grade spreads were 18 bps lower at 1.75%. Emerging market spreads also narrowed.

For the second consecutive month, the Reserve Bank of Australia (RBA) Board left the cash rate unchanged at 4.5%. Given the volatility in financial markets and an uncertain outlook for the major advanced economies, the Board decided to wait for some clarity before making any deviations from what it considers to be a long-term average level of interest rates.

Outlook: Global bond yields should eventually rise from current levels as markets become more comfortable that the recovery can be sustained. However, as economic recoveries mature, growth momentum naturally softens, and this could prove challenging for markets over the next few months given current heightened risk aversion. As a result, it is possible that long-end yields may continue their recent downward momentum in the short term. Nonetheless, a further rally in the short term seems unlikely given rates are already at all-time lows and cash-rate-hike expectations have been pushed out to 2011-12.

In Australia, we continue to anticipate a few more official interest rate increases over the coming 12 to 18 months.

We remain constructive about credit markets over the medium term. Companies are generally reporting healthy profits and continue to reinforce their balance sheets. The outlook for the key credit risks of rating migration and default are both low. Importantly, credit investors remain well compensated for taking these risks. However, in the short term, we remain mindful that key Northern Hemisphere investors take holidays in August and market liquidity can therefore be limited. This often leads to sharp price moves driven by small changes in sentiment.

Currencies

Weaker economy and a fall in risk aversion drives down the US dollar in July

Within currency and commodity markets, prices have mostly recovered to the levels seen in March and April, prior to the severe bout of pessimism about the prospects for European sovereign debt and the banking sector. The exception is the yen, which is 8.5% stronger than it was three months ago. However, yen strength is consistent with a generally higher level of risk aversion that remains priced into asset markets, with bond yields and equity prices significantly lower than they were three months ago.

The rise in commodity prices over the month of July supported the Australian and Canadian dollars, which rose by 7.6% and 3.4% respectively, against the US dollar (USD). Australia's monetary policy expectations have been scaled back following a smaller-than-expected rise in the second quarter Consumer Price Index (CPI), with market pricing now suggesting the RBA will remain on hold until the end of the year. The Bank of Canada continued its tightening process, raising the overnight rate by 25 bps in July to 0.75%. However, it acknowledged that considerable uncertainty about the outlook for the global economy could restrain the pace of future interest rate rises.

Outlook: The rally in the Australian dollar (AUD) over July has pushed it back into over-valued territory against the USD, based on purchasing power parity (PPP). Despite this, we expect factors other than valuation to support the AUD in the near term. Such cyclical factors include interest rate differentials, stronger relative growth prospects and higher commodity prices. Other currencies remain within their fair-value ranges against the USD, although the strength of the yen in recent months has pushed it within one month's standard deviation of being overvalued against the USD.

Financial markets (%)

Sharemarkets	Level as at 31-Jul-10	1 month return	3 month return	Financial YTD return	1 year return
Australia (S&P/ASX 200)	4493	4.47	-5.87	4.47	10.14
Developed World (MSCI World ex Aust.)	807	5.78	-6.35	5.78	9.79
World (MSCI AC World ex Aust.)	310	5.83	-5.51	5.83	10.59
US (S&P 500)	1101	7.01	-6.69	7.01	13.84
UK (FTSE 100)	5258	7.07	-4.51	7.07	18.18
Europe (MSCI Europe ex UK)	888	5.27	-1.50	5.27	11.72
Japan (Topix)	849	0.97	-13.84	0.97	-9.05

Currencies					
Australian Dollar/US Dollar	0.91	7.17	-2.75	7.17	8.89
Australian Dollar/Euro	0.69	0.77	-0.75	0.77	18.50
Australian Dollar/Yen	78.45	4.96	-10.35	4.96	-0.87

Sharemarket returns are inclusive of dividends, in local terms.

QIC

Economist's View

Key Points

• Equity and commodity prices rally - bond markets remain flat
• Release of European bank stress tests – downside risks to European banking system are limited
• Mixed data from the US – employment and GDP growth disappoints, but second quarter company earnings are strong
• Australian inflation surprises on the downside – record trade surplus supports near-term growth outlook

International Economies

Equity and commodity prices rally - bond markets remain flat

Following two months of falling prices, global equity markets reversed course in July, rising by 5.7 per cent (as measured by the MSCI World Index) as a buoyant US company earnings' season and the release of European bank stress tests boosted investor sentiment. The general decline in risk aversion was also felt in commodity markets, which rallied 6.1 per cent (as measured by the Commodity Research Bureau (CRB) index) and currency markets, where the US dollar (USD) and yen fell against most major currencies.

The impact of reduced risk aversion was less noticeable in bond markets, where the yield on the US benchmark 10-year coupon bond fell marginally to finish three basis points lower for the month. Ongoing weakness in the US labour market kept the unemployment rate above 9.5 per cent and, combined with a declining trend in core inflation, has seen the 10-year US yield struggle to break through 3 per cent.

Release of European bank stress tests – downside risks to European banking system are limited

Instrumental in calming global financial markets in July was the release of the results of the European bank stress tests by the Committee of European Banking Supervisors (CEBS). The initial market reaction to the test results was sceptical due to the fact that the CEBS tests assumed no sovereign defaults would occur. However, subsequent analysis by the private sector, using test data made available by the CEBS, did assume Greek default and showed that the threat of major systemic risk to the European banking system is likely to be low. According to QIC's Senior Credit Analyst, Stephen Holmes, private-sector research shows that 17 banks are at risk, needing around €32 billion in capital, if the extreme stress scenario materialised. The required capital injection of €32 billion is a modest amount and could easily be absorbed by the market.

Receiving somewhat less publicity than the release of the bank stress tests, but potentially having a more significant impact on lowering financial spreads (i.e. opening up the flow of credit to the broader economy), was the Basel Committee's release of the revised Basel 3 proposals. While the key theme of the committee's recommendations - a tightening of capital and liquidity definitions - remains in place, the definitions have generally been watered down and the implementation schedule has been extended, giving several more years (i.e. as late as 2018, from 2012 previously) to phase-in and fine-tune the calibration of the new measures. This should significantly alleviate concerns that banks will need to issue large amounts of capital, raise substantial amounts of long-term funding, have limited options for managing their liquid assets and need to cut lending and/or charge much higher margins. Consequently, the key risk that tighter conditions could limit bank lending and stall the European economic recovery has been moderated.

Economic data in the European region has also been generally positive over the month. UK national accounts for the second quarter of 2010 (2010Q2) showed the economy growing at 1.1 per cent, about double market expectations and our estimate of equilibrium UK growth. In addition, the release of purchasing manager surveys for the euro area showed ongoing recovery in the region's manufacturing sector, consistent with gross domestic product (GDP) growth of around two per cent per annum.

Mixed data from the US – employment and GDP growth disappoints, but second quarter company earnings are strong

The release of July non-farm payroll data showed a continuation of the sluggish recovery in private sector employment. Non-farm private payroll employment has averaged 100,000 additions per month in 2010, which is barely enough to absorb the rise in jobseekers. Although the US unemployment rate has fallen from a peak of 10.1 per cent in the last quarter of 2009 to 9.5 per cent currently, the fall has been almost entirely due to discouraged workers, with around one million people having withdrawn from the labour force.

High rates of unemployment, combined with low rates of capacity utilisation, has seen three consecutive months of negative consumer price index (CPI) growth over the June quarter, raising fears of the US economy slipping into an extended period of deflation. In addition, GDP growth, released in the June quarter National Accounts, disappointed market expectations with quarterly annualised growth of 2.4 per cent, while housing market data shows the sector is continuing to languish at the bottom of its cycle.

On a brighter note, US companies have reported strong earnings outcomes in the current reporting season. Economy-wide US average annual corporate earnings growth is currently around 30 per cent and S&P company earnings growth is on track to record around 35 per cent growth in 2010. The sharp rebound in profits is encouraging resurgence in US business investment. Recent national accounts data showed that business investment grew at a quarterly annualised rate of 17 per cent in 2010Q2, following growth of nearly 8 per cent in the first quarter of 2010. These growth rates are very strong when compared with an equilibrium rate of around 2.8 per cent and are providing a significant offset to weak growth consumer spending. This should allow the US economy to avoid a double-dip recession in the second half of 2010 and 2011.

Interest Rate Forecast (%)

	Level at 05 Aug 2010	Sep-10	QIC forecast Dec-10	Jun-11
Australia	4.50	4.50	4.75	5.25
US	0.00 - 0.25	0.00 - 0.25	0.00 - 0.25	0.75
Canada	0.75	0.75	1.00	2.25
Europe	1.00	1.00	1.00	1.00
UK	0.50	0.50	0.50	1.25
Japan	0.10	0.10	0.10	0.10

Australian Economy

Australian inflation surprises on the downside – record trade surplus supports near term growth outlook

The Reserve Bank of Australia (RBA) left the cash rate unchanged at 4.5 per cent at its August meeting. The decision was anticipated following the release of the June quarter CPI figures, which showed that the headline rate rose by only 0.6 per cent, substantially lower than the 1 per cent gain expected by the market. Underlying measures of inflation were also soft, rising by 0.5 per cent in the quarter. At 2.7 per cent year-end growth, core inflation is now inside the RBA's 2 to 3 per cent target band for the first time in nearly three years. However, given the ongoing strength in the economy and labour market, and with inflation near the top of the RBA target band, we expect the pause in the current tightening cycle will be temporary and that the RBA will need to recommence raising the cash rate, most likely in the December quarter. Currently, we expect the RBA to raise the cash rate to 4.75 per cent by the end of the year and to 5.5 per cent by the end of 2011.

The near-term outlook for the economy was boosted with the release of strong export data for June. A 7 per cent increase in the value of goods and services exports led to a $35 billion trade surplus, the largest monthly trade surplus since records began in 1971. Higher iron ore prices, combined with increased volumes of coal, drove the gain. Preliminary estimates suggest that the trade outcome over the quarter should add around 0.5 per cent to 2010Q2 Australian GDP growth.