31 March 2010

The Markets

International Equities

World equity markets rallied in March

Global equity markets posted strong gains in March, rounding out a positive quarter for most regional markets. The Morgan Stanley Capital International (MSCI) All Countries World Index (ex Australia) gained 6.51% in local currency terms over the month and 4.32% for the March quarter. Continued Australian dollar (AUD) strength meant that in AUD terms returns were 3.78% for the month and 1.02% for the quarter.

Sovereign debt concerns in Europe dominated market sentiment at the beginning of the quarter, with equity markets selling off and investors moving to longer-dated US and German government bonds. However, these concerns abated through March and increasing risk appetite saw equities, commodities and other risky assets gain favour.

Results from the US fourth quarter reporting season were encouraging with a record number of companies announcing earnings that exceeded analysts expectations. There are now signs that growth is returning to the revenue line, relieving pressure from cost-cutting measures and adding some basis for the strong growth implied by forward earnings estimates.

All developed market sectors gained in March with almost all sectors also up over the quarter. Growth-sensitive sectors found favour through the quarter, with industrials (+10.4%) and consumer discretionary (+8.2%) the strongest sectors, while healthcare (2.4%), energy (0.4%) and utilities (-1.3%) sectors lagged.

Most developed equity markets rose over the quarter, with the significant exceptions of Spain (-10.2%), Greece (-7.9%) and Portugal (-4.8%), all of which were subject to concerns about high sovereign debt levels. While Norway's market gave ground over the quarter, the other Scandinavian countries were strong with Finland, Denmark and Sweden increasing by18.7%, 16.4% and 8.4% respectively.

Emerging country markets were also very strong over the quarter, with Taiwan (-4.5%) and China (-1.4%) the only markets that fell. The strongest performers were Hungary (+17.4%, with most gains occurring in March), Egypt (+12.3%) and Morocco (+12%).

The AUD gained against almost every major currency over the month and the quarter, with the trade-weighted index gaining 3.2% and 2.9%, respectively. This had the effect of reducing unhedged returns across most of the portfolio when translated to AUD.

Outlook: We consider equity markets to be fairly valued based on our long-run models and expectations. Short-term pricing is volatile though and we see risks that equity market strength is vulnerable to the downside. This is due to the forward-looking nature of equities and the high expectations for corporate earnings growth that are currently factored in. Economic recovery must materialise, particularly in the US, if these shorter term expectations are to be met.

While we have some confidence in the long-term growth potential of China and India, equity markets and global gross domestic product (GDP) remain heavily influenced by the US, where sustained economic recovery continues to be clouded by reticent consumers and strained government finances. Recent Federal Open Market Committee (FOMC) minutes cited a potential "extended period" of low interest rates highlighting the uncertainty within the US Federal

Reserve (Fed) about the strength of the recovery. Continuing concerns emanating from Europe regarding the level of support required for economies such as Greece also keeps us cautious.

In the current environment our caution is mitigated somewhat by our positioning toward value and emerging market equities. We maintain our focus on key indicators of recovery such as US labour force and bank lending figures.

Australian Equities

Domestic equities continued to recover in March

The ASX200 had its best month since September 2009 and came very close to the 12-month high that was struck in January 2010. The Australian market was helped by global equity markets posting a strong performance for March, on the back of generally stronger economic data. The losses of January have been more than recouped over February and March, with the ASX 200 returning 1.36% over the quarter.

US economic data appeared to support the view of an emerging recovery that drove the US equity market higher (5.4% over the quarter). US consumer confidence and personal spending increased, as did industrial production and capacity utilisation. The Institute for Supply Management (ISM) index, at 56.5, is pointing to significant continued expansion.

Although broad commodity price indices were down over the quarter, the Reserve Bank of Australia (RBA) commodity price index, which is a better representation of Australian resources export prices, rose 2.5%. The resource sector was a positive contributor to Australian share market performance over the quarter, with the ASX 200 materials index returning 1.09%.

The RBA increased the official cash rate to 4% in March, 1% higher than the beginning of October. Full-time employment increased for the sixth consecutive month and the unemployment rate decreased from 5.5% in December 2009 to 5.3% in February. However, rising interest rates have begun to impact the consumer, with retail sales falling by a sharp 1.4% in February.

Outlook: We remain optimistic about the outlook for Australian share market 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. However we expect that as revenue growth returns, corporate profitability is likely to show considerable operating leverage for a diverse range of companies that have actively reduced costs and conserved capital.

More specifically, 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 such as the economy improves, we have high expectations for margin expansion in the worst-affected sectors.

Global Fixed Interest

Global bond yields were mixed

Global long sovereign bonds produced mixed performance over the March quarter, despite a rally in equities and other risk assets. Benchmark 10-year US treasuries performed well through the early part of the quarter, however continued heavy issuance and weak auctions sparked a sell-off in March. Over the quarter yields fell by just one basis point to 3.83%. Australian 10-year bonds rallied during January, but then sold off through the remainder of the quarter, with yields finishing modestly higher at 5.78%. German bunds benefited from a flight to quality amid the sovereign debt concerns at the European periphery, with the yield on the 10-year German benchmark coming in 0.30% to 3.09%. Breakeven inflation (traded via ZCS markets) moved higher in Australia over the quarter, but fell in the US and Europe.

Despite some widening early in the quarter, by the end of March US credit spreads had contracted to new lows. High yield spreads are now at 5.7%, a two-year low, while investment grade credit spreads are 1.5%, their lowest since

November 2007. Emerging market credit spreads also contracted through the quarter, consistent with the rally in most risky assets.

The RBA lifted the cash rate at its meeting in early March after leaving rates on hold through February (no meeting was held in January). The central bank cited strong domestic conditions and growth in the global economy as justification for lessening monetary policy stimulus and moving interest rates closer to their long-term average.

Outlook: In coming months, the US Federal Reserve (Fed) should remove the commitment to maintain “exceptionally low levels of the federal funds rate for an extended period.” While there may be little need for central banks to tighten aggressively during 2010, central banks’ rhetoric could change.

In the UK, while the upcoming election provides some uncertainty and while some questions about the pace of recovery remain, we believe that heightened inflationary concerns post-election will prompt the Bank of England (BoE) to lift cash rates in the second half of this year. This inflation risk is being driven by the flow-on effects of currency depreciation.

We continue to anticipate a number of further official increases in the cash rate over coming quarters in Australia.

An increasingly stronger technical picture continues to support the improvement in credit markets. The majority of investment-grade companies have been reporting good results, positive cashflow and improved balance sheets. Credit spreads continue to be priced inexpensively relative to the underlying default and downgrade risks, and spreads are expected to tighten further over the medium-term.

The willingness of investors and banks to refinance existing deals has been a strong catalyst for the sharp improvement in the default outlook for the high-yield sector. We expect defaults to fall sharply in the coming year based on the ability of issuers to refinance as well as the improving fundamentals.

Currencies

Continued global recovery assists commodity currencies

During the March quarter, the global economy continued to improve. While data from most advanced economies show only a tepid recovery, especially in Europe, Asian economies are clear leaders of the global upswing. With little spare capacity in the region, the increase in demand has been met with upward pressure on commodity prices, leading authorities to begin the process of removing stimulus in several countries.

Rising commodity prices benefited the AUD and Canadian dollar (CAD), which appreciated by 2.2% and 3.6% respectively over the March quarter. Tighter monetary policy, or the prospect for an imminent change, has also supported these currencies. In Australia, the RBA raised rates by 0.25% at consecutive meetings in March and April to take the cash rate to 4.25%. The Bank of Canada (BOC) has committed to keep policy settings unchanged until the end of the second quarter, however growth and inflation have both surprised on the upside in recent months, raising the likelihood of more imminent tightening.

A constant theme throughout the March quarter has been rising sovereign default risk in Europe, which has weighed on the euro and Great British pound (GBP). During the quarter, the euro fell by 5.7% against the US dollar (USD), while the pound fell by 6.1%. While Greece and Portugal were the countries causing most concern to investors over the March quarter, there are other countries at risk of a downgrade to their sovereign credit ratings, including Spain, Ireland and, to a lesser extent, the UK. In addition to the increase in sovereign risk, these currencies were pressured by generally weak economic data in both Europe and the UK. The GBP also reacted negatively to political risk associated with the upcoming elections.

The yen fell slightly against the USD over the March quarter, with a rally in the first two months of the year more than offset by a fall in the value of the yen during the month of March. During March, the yen fell by almost 5% against the USD as continued global recovery lead to rising risk appetites, a strong rally in world equity prices and a shift away from the relative safety of Japanese assets.

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 around US$0.90 over coming months as increasing interest rate differentials, stronger relative growth prospects and an improvement in commodity prices continue to support the currency.

Following the fall in the euro and pound over the last four months, these currencies have moved from being overvalued and are now within their fair-value ranges against the USD. Our PPP estimates suggest that the yen and CAD also remain within their fair-value range against the USD. Despite the lack of direction from valuations, we expect modest cyclical support for the USD from the relative momentum in the US economy over 2010 and rising interest rate differentials.

Financial markets (%)

Sharemarkets	Level as at 31-Mar-10	1 month return	3 month return	Financial YTD return	1 year return
Australia (S&P/ASX 200)	4875	5.75	1.36	27.33	41.71
Developed World (MSCI World ex Aust.)	865	6.56	4.77	25.52	46.41
World (MSCI AC World ex Aust.)	329	6.51	4.32	25.68	47.72
US (S&P 500)	1169	6.03	5.39	29.19	49.77
UK (FTSE 100)	5679	6.50	5.99	37.15	50.42
Europe (MSCI Europe ex UK)	938	7.24	2.53	26.25	50.21
Japan (Topix)	978	10.41	8.81	6.99	28.47
Currencies					
Australian Dollar/US Dollar	0.92	2.50	2.06	13.53	32.10
Australian Dollar/Euro	0.68	3.37	8.22	17.69	29.62
Australian Dollar/Yen	85.76	7.77	2.44	9.95	24.97

Sharemarket returns are inclusive of dividends, in local terms.

Economist's View

Key Points

- Ongoing rally in equity markets: economic outlook dominates sovereign debt concerns
- Global themes remain unchanged: solid recovery but subdued by historical standards
- Australian investment boom to continue: with the re-emergence of the two-speed economy?

International Economies

Ongoing rally in equity markets: economic outlook dominates sovereign debt concerns

Over March and the first week of April, price movements in global financial markets followed a classic response to an increase in risk appetite with bond yields rising in major global markets and a rally in global equity markets (as measured by the Morgan Stanley Capital International (MSCI) World Index, local currency) of 7.6%. Commodity prices rose, with the price of oil increasing by 7.5%, which boosted commodity currencies such as the Australian (AUD) and Canadian (CAD) by 3.5% and 4.5% respectively against the US dollar (USD).

Given the rally in equity prices over March and the beginning of April, global equity market returns are now positive for the year, with the MSCI index up 5.5% year-to-date (YTD). The price of oil is up by 8.0% YTD and the AUD and CAD are up by 3.3% and 5.8% (YTD).

Over the past month, financial markets have been subject to three main influences: (i) a flow of generally positive economic data, (ii) rhetoric from various US Federal Reserve (Fed) officials downplaying the likelihood of imminent tightening of monetary policy, and (iii) ongoing concerns over Greek and Portuguese sovereign debt. The first two influences have been positive for equity and commodity markets and negative for bond markets. The last influence is generally negative for equities and commodities, positive for safe-haven bond markets (such as the German market) and negative for bond markets in Greece, Portugal and Spain.

In terms of the economic data, market participants and commentators have been focusing on the sustainability of the global economic recovery in the absence of perceived temporary influences, such as unseasonal weather, the strong rebound in the inventory cycle and stimulatory macroeconomic policy. Consequently, data that show recovery in labour markets (that can drive recovery in consumer spending), and in sectors outside the inventory-driven manufacturing sector, are looked upon with particular favour as providing evidence of sustainability in the global economic recovery. Hence, the two most recent US payroll reports covering labour market conditions in February and March that confirmed the ongoing positive trend in US employment, were enthusiastically received by markets and commentators.

In addition to positive US labour market data, surveys of business sentiment signalled a broadening of the economic recovery in the US and Europe from the manufacturing sector to the services sector. While manufacturing sectors globally have been showing signs of strong growth, as international trade recovers and an improving inventory cycle boosts production, the service sector, which is dependent on consumer spending and business investment, has lagged the recovery evident in manufacturing. Signs that the service sector is now experiencing robust growth are evidence that the economic recovery is broadening beyond the manufacturing sector and is on a more sustainable footing.

Global themes remain unchanged: solid recovery but subdued by historical standards

Recent data have been consistent with our key theme of solid recovery for the global economy, albeit subdued by historical standards, especially given the magnitude of the downturn. We continue to expect emerging markets to continue to outperform advanced economies, leading to rising inflation in emerging markets, which will lead to ongoing pressure on policy makers to tighten monetary and fiscal policy in 2010.

Advanced economies face divergent outlooks over 2010-2011. Australia will continue to outperform due to its strong links to Asia and limited structural problems. The US will outperform Europe, due to its more flexible labour market which has boosted productivity and profitability. Within Europe, a number of economies face significant structural problems and will lag behind global recovery in particular Greece, Spain, Ireland and the Baltics. The UK also fits into this category. Conversely, we expect Norway, Germany, Switzerland and Sweden to outperform within the euro area, given their exposure to ex-euro area trade and their relative lack of structural problems.

Interest Rate Forecast (%)

	Level at 09 Apr 2010	Jun-10	QIC forecast Sep-10	Mar-11
Australia	4.25	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	1.25
UK	0.50	0.50	0.50	1.00
Japan	0.10	0.10	0.10	0.10

Australian Economy

Investment boom to continue: with the re-emergence of the two-speed economy?

Recent Australian economic data has been modestly stronger-than-expected and consistent with our real gross domestic product (GDP) growth forecasts of 3.3% in 2010 and 3.9% in 2011. Further fiscal-related infrastructure investment is forecast to boost growth in the coming year, while a sharp recovery in business investment and exports, particularly in the resources sector, will boost growth to an above-trend rate of around 4% over 2011-2013.

The outlook for business investment has improved markedly over the past twelve months. Business confidence has increased to 8 year highs and firms' assessments of capacity utilisation have begun to pick-up. 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. Recent capital expenditure intentions are consistent with nominal capital expenditure growth of 23.5% in 2010/2011, based on realisation ratios experienced over the past 5 years, including growth of almost 65% in the mining industry. Overall, we expect business investment to expand by 6.9% in 2010, 10.7% in 2011 and 8.7% in 2012, underpinned by engineering construction activity within the resources sector.

In addition, the housing market continues to recover after a sharp deterioration in conditions during 2008, and will likely provide further support to the Australian economy in 2010. Building approvals have risen by around 50% over the past year, boosted by the first home owners grant (FHOG), low interest rates and a large increase in public housing. Higher interest rates and the reduction in the FHOG will dampen the recovery in housing investment over 2011. However, with the increase in construction expected to be insufficient to meet underlying demand, the housing shortage problem will continue, resulting in higher rents and prices. House prices rose 13.6% in 2009, driven by low interest rates, strong population growth and a lack of supply. While house prices are expected to continue to rise due to the underlying supply problem, the pace of appreciation is expected to slow as interest rates climb. Overall, we expect house prices to rise a more modest 5.8% over 2010 and 1.4% over 2011.

The Reserve Bank of Australia (RBA) has responded to the improving economic outlook by lifting the cash rate by 125 basis points over the past 7 months. We continue to expect the RBA to lift rates to 5.0% by the end of 2010 and 5.75% by the end of 2011. Thereafter, we expect the RBA will need to tighten rates further to slow the economy and contain inflation within its target band. We expect rates to reach around 6.75% in 2012/2013.

Higher interest rates and fading fiscal stimulus signal rising costs and lower demand for many Australian industries; particularly those not related to the resource sector. However, other factors that helped cushion the effects of the global financial crisis (GFC) on the Australian economy have also unwound or are in the process unwinding. Two such factors are the cost of labour and the exchange rate.

A well-documented feature of the Australian labour market during the GFC was the strength of employment. Another feature was the sharp fall in the cost of labour, which declined from an annual growth rate of around 4.0% in 2008 to less than 3% by the end of 2009 and greatly eased the cost burden on Australian businesses. However, with the stabilisation and subsequent fall in the unemployment rate, labour costs will begin rising and we expect growth rates of around 4.0 to 5.0% to re-emerge by 2011.

As well as enjoying lower labour costs, Australian exporters and import-competing industries benefitted from a surge in international competitiveness during the GFC as Australia's trade-weighted exchange rate fell by around 30% from mid-July to end-October 2008. Subsequently, the exchange rate has retraced almost all of the fall experienced during the GFC, thereby unwinding the competitive advantage enjoyed by Australia's trade-exposed industries.

Higher labour costs, wage rates and exchange rates will weigh on those industrial sectors that have a weak connection with the mining sector, are exposed to import competition and/or rely on foreign demand or on interest-sensitive household spending.