QIC Outlook
Market & Economic
Dynamic Investment Solutions

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The Markets

International Equities

World equity markets sold-off sharply in May

Equity markets globally suffered sharp falls in May as the European sovereign debt crisis continued to weigh heavily on sentiment and investor risk appetite. The Morgan Stanley Capital International (MSCI) All Countries World Index (ex Australia) returned -7.26% in local currency terms, however, a broad-based sell-off in the Australian dollar (AUD) meant that the AUD unhedged benchmark return was 0.74%.

The steepest falls were at the beginning of the month, with fears that the Greek debt crisis would spread through other vulnerable European nations driving a flight towards the relative safety of the core sovereign bond markets. Despite a brief equity market rally following the announcement of a €750 billion European Union (EU) and International Monetary Fund (IMF) support facility and the beginning of a 'credit easing' program by the European Central Bank (ECB), the major indices were unable to hold ground. Again, economic data released throughout the month seemed of secondary importance; however, the tone remains positive and supportive of the global recovery story.

Not surprisingly, the European nations at the centre of the crisis were again the focus of selling, with Greece down a further 19.6% and Irish equities losing 13.1%. Equities fell across all developed nations though, with the least affected being Belgium (-0.1%) and Portugal (-1.3%) (however, this was heavily influenced by the positive performance of one index constituent, Portugal Telecom SGSP SA). Emerging market countries were not immune; however, in aggregate they fared better than developed countries. Peru (3%) and Chile (0.9%) managed gains, while Hungary (-13.7%) and Egypt (-11.5%) dragged performance.

There was little dispersion in returns across developed market sectors throughout the month, with the best relative performances from consumer staples (-4.1%) and telecommunications (-4.3%), while energy (-9.8%) and financials (-8.8%) were among the hardest hit.

The AUD lost ground against every major currency during the month, with the trade-weighted AUD index down 6.9%. This increased unhedged returns across the portfolio when translated to AUD.

Outlook: Increasing concerns about European debt are sending shivers of fear through equity markets. This sober outlook is leading to downgrades in company earnings growth, not only in the EU, which is a key market for China, but also globally. We believe that longer-term earnings will appreciate. The rate of recovery of earnings, however, has been of concern to us and we feel more comfortable with a slower improvement in earnings toward our long-run growth-rate expectations.

Lower earnings growth is just part of the story though, and the other theme driving equity markets lower is the fear of another global financial crisis. In the US, memories of the sub-prime crisis are fresh and the relationship between confidence and risk to financial institutions is clear. While we do not believe a European-led financial system breakdown is likely, the fear is pushing prices lower. On the plus side, it means that we are being paid more to take on equity risk and thus earnings and dividend yields are being pushed higher.

Looking forward, we continue to closely watch the relationship between the level of earnings downgrades and the extent to which they are being discounted by fear. It is this dynamic that will deliver opportunities.

Australian Equities

Domestic equities declined 7.51%

May was an extremely difficult month for the sharemarket as global concerns about the sovereign debt risks in Europe and moderating growth expectations in China saw a significant increase in risk aversion amongst global investors. The Australian market was also not helped by the announcement of a proposed Resources Super Profits Tax (RSPT) as part of the Henry Tax Review.

It was difficult to find any good news during the month as the bank earnings season was met with a cautious response from investors, with funding concerns brought to the fore and significant revisions announced by Virgin Blue and Sonic Healthcare, amongst others.

Outlook: The events of May have created significant uncertainty around the Australian sharemarket. Investors will remain risk averse until there is clarity around the sovereign debt issues in Europe, the impact of the moderating growth expectations in China and the final details of the RSPT are confirmed.

With the Reserve Bank of Australia (RBA) raising rates in May to 4.5%, expectations are for rates to remain unchanged in the near term. RBA meeting minutes indicated the latest rate increse will leave monetary policy well placed for the medium term. An unchanged official cash rate will not help global investors' view of the AUD over the next couple of months, although a lower dollar is a benefit for stocks with exposure to the US market. While global investors are focused on the fallout from Europe and are more interested in defensive assets, the AUD will remain weak and in a volatile trading range.

Australian banks will be closely watching the fallout from the European sovereign debt situation. While our banks do not have any material exposures to the troubled nations in Europe, the crisis has brought a return to heightened volatility and has seen ballooning interbank borrowing rates. This has increased investor concerns about the implications for the Australian banking sector given their significant wholesale funding tasks.

The resources sector will also remain volatile as it contends with the prospect of a cooling Chinese economy and as it negotiates with the government about the final details and implementation of the RSPT.

As we mentioned last month, while the Australian economy is less dependent on the performance of the European economy, general market weakness from that zone will continue to flow through to market sentiment in Australia. This will add to market volatility in the near term.

Global Fixed Interest

Global long bonds rallied sharply

In a volatile month for markets, core sovereign bonds rallied strongly as capital fled from riskier asset classes and the vulnerable European periphery. The yield on 10-year US treasuries came in 37 basis points (bps) to 3.28%, while Australian 10-year bonds moved lower by 34 bps to 5.37%. The European debt crisis has also supported German bunds, with the 10-year benchmark yield at 2.66% at the end of May, the lowest it has been in over a decade. Breakeven inflation (traded via ZCS markets) moved lower across Australia, Europe and the US.

In conjunction with the sell-off in equity markets, US credit spreads moved higher throughout May. The high-yield spread moved 131 bps higher to 6.79%, while investment-grade spreads are now 1.87% from 1.43% at the end of April.

Outlook: Eurozone developments will likely continue to be key drivers of markets in coming weeks, and further bouts of risk aversion cannot be ruled out.

While there is likely to be some headwind from tighter financial conditions and more aggressive fiscal policy (particularly in peripheral Europe), there are powerful offsetting forces at play, notably lower energy prices, risk-free interest rates and currency adjustments. Momentum in the global economy continues to build and elements of a self-sustaining recovery are becoming more pervasive. In reflection of this, Canada became the first G7 economy to lift its cash rate, albeit acknowledging that the path of future tightening would be very dependent on how recent European events evolve.

Although much of the recent Australian data has been more mixed, we continue to anticipate that solid regional and global growth, combined with rising incomes and a rising terms of trade, along with limited spare capacity and increasing inflationary pressures (from wage growth and the more recent decline in the AUD), will result in a number of further increases in official cash rates over the coming financial year.

Although the near-term outlook for credit remains less certain, with markets still sensitive to negative headlines, in the longer term we remain constructive on credit assets, favouring Australia and the US over Europe.

Currencies

The euro fell sharply in May

Ongoing concerns about European sovereign debt saw the euro fall by 8% in May, taking its total fall against the US dollar (USD) to 19% in the six months since early December last year. It reached a low point of 1.22 against the USD in late May, which is its lowest level since early 2006 when it troughed at US$1.18. Commodity currencies were also impacted by adverse investor sentiment, with the AUD falling by 8.4% to end the month at US$0.84 after reaching a low point of US$0.81 as the market scaled back its expectations due to the pace of monetary tightening by the RBA. In contrast, Canada started its tightening process in early June, as per market expectations. Consequently, the Canadian dollar fell by only 3% against the USD during May.

Outlook: The fall in the AUD this month has left it within its long-run fair-value range, based on purchasing power parity (PPP). 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 an improvement in commodity prices.

Financial markets (%)

Sharemarkets	Level as at 31-May-10	1 month return	3 month return	Financial YTD return	1 year return
Australia (S&P/ASX 200)	4429	-7.51	-3.54	16.15	20.80
Developed World (MSCI World ex Aust.)	798	-7.57	-1.17	16.41	16.17
World (MSCI AC World ex Aust.)	305	-7.26	-0.92	16.92	16.50
US (S&P 500)	1089	-7.99	-0.89	20.75	20.99
UK (FTSE 100)	5188	-6.11	-2.04	26.16	21.85
Europe (MSCI Europe ex UK)	856	-5.37	-0.10	17.61	16.35
Japan (Topix)	880	-10.79	-0.68	-3.76	-0.43
Currencies					
Australian Dollar/US Dollar	0.84	-9.89	-6.34	3.75	4.78
Australian Dollar/Euro	0.68	-2.36	4.17	18.60	20.87
Australian Dollar/Yen	76.36	-12.75	-4.05	-2.11	-0.07

Sharemarket returns are inclusive of dividends, in local terms.

Economist's View

Key Points

- European debt crisis drives market sentiment – EU and IMF package provides support
- Momentum slows in US and China – but economic activity remains robust
- Australian economy slows in the March quarter – trend growth expected in 2010

International Economies

European debt crisis drives market sentiment – EU and IMF package provides support

Concerns about sovereign debt continued to dominate financial markets during May as ratings agencies downgraded debt in several European countries. Over the month, equity prices fell by around 8% as measured by the MSCI World Index and bond yields in the major markets (US, Germany and UK) fell by an average of 33 basis points (bps). In currencies, the euro bore the brunt of the decline in investor sentiment, falling by 8% against the USD, taking its total fall against the USD to 19% in the six months since early December last year. It reached a low point of 1.22 against the USD in late May, which is its lowest level since early 2006 when it troughed at US$1.18.

While markets have been supported by intervention from the European Central Bank (ECB) and bailout packages from European governments and the International Monetary Fund (IMF), the austerity measures that have been announced will weigh on future growth. We agree with market sentiment that the fiscal contraction will dampen European growth prospects over the medium term, but expect that this will be largely offset by lower interest rates and a weaker exchange rate. The impact on the global economy should be relatively muted.

Although we expect the impact on the global economy from the recent fallout in Europe to be relatively mild, commodity markets reacted swiftly, with prices falling in response to the expected weakness in global growth emanating from Europe. Oil prices fell by almost 14% in the month, while the fall in metal prices was around half this.

Data continues to show Asian economies are leading the global upswing, with strong March quarter National Accounts data released for Japan, Taiwan, India, Thailand, Indonesia and Singapore this month. With little spare capacity in the region, the increase in demand is putting upward pressure on prices, leading authorities to begin the process of removing stimulus in several countries, including China and India. Chinese authorities increased the deposit reserve requirement ratio for financial institutions for the third time this year in May, while new measures to reduce speculative activity in the property market have also been announced.

Momentum slows in US and China – but economic activity remains robust

The global economy has recovered sharply in the wake of the global financial crisis due, in part, to strong growth in the two powerhouses of the global economy: the US and China. In both economies, government fiscal policy played an important role in driving the recovery in growth in 2009. However, fiscal stimulus is being curtailed in both economies and the driver of growth must now begin to shift away from the government if economic recovery is to be sustained.

Of critical importance in the US is household spending, as it accounts for around 70% of US real gross domestic product (GDP). After robust growth in the March quarter, household spending stalled in April, despite real personal income growing by 0.4% over the month. The elevated level of unemployment led consumers to increase their rate of savings from disposable income from 3.1% to 3.6%. Although conditions within the labour market have been slowly improving, with the economy creating around 1.1 million new jobs since January, the increase in employment has not been enough to offset the increase in the labour force, as discouraged workers re-enter the workforce as the recovery gains momentum. Consequently, the unemployment rate has remained around 9.7%.

We expect soft US consumer spending over the remainder of the year, despite relatively robust real income growth. While weak spending will be a drag on US growth over 2010, the consequent rise in the level of US household savings will place the US consumer in a strong position to maintain spending levels and support growth in 2011 to 2013, a period when the US government will be tightening fiscal policy.

Offsetting weak US consumer spending in 2010 is robust business investment. Incoming manufacturing data points to ongoing recovery in the US manufacturing sector. Monthly industrial production has been recovering since the middle of 2009 and capacity utilisation has slowly been increasing. Manufacturing surveys have remained higher than their historical long-run average and employment within the sector has slowly been improving since the start of the year. Company earnings have been strong and have consistently outperformed market expectations.

The Chinese economy has been extremely strong in the first quarter of the year, with real GDP growing at 11.9% on a year-ended basis, following 10.7% growth in the December quarter of 2009. To date, government-directed infrastructure spending and property construction have been the main drivers of growth. As the economy has picked up, the Chinese government has been slowing the rate of monetary stimulus and has placed restrictions on the availability of credit and investment in the property market.

April data for industrial production and fixed investment show signs of a peak in the Chinese economy, with both sectors recording a deceleration in growth rates. However, property construction has remained strong and export growth has also picked up. In addition, growth in nominal and real retail sales accelerated in April in line with job growth and the rise in consumer confidence. We expect a continuation of this trend, whereby a slower rate of government-sponsored infrastructure spending and activity in high-end, big-city property is offset by stronger consumer spending and export growth. Overall, we expect Chinese economic activity to slow from its first quarter peak rates, but to remain elevated resulting in a year-average Chinese real-GDP growth rate of 10.9%.

Interest Rate Forecast (%)

	Level at 07 Jun 2010	Jun-10	QIC forecast Sep-10	Mar-11
Australia	4.50	4.50	4.75	5.00
US	0.00 - 0.25	0.00 - 0.25	0.00 - 0.25	1.00
Canada	0.50	0.50	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 slows in the March quarter – trend growth expected in 2010

The Australian economy expanded by 0.5% in the March quarter, after growth in the December quarter was revised higher to 1.1%. The federal government's fiscal package offset the weakness in the private sector, with public demand contributing 0.9 percentage points to growth. Over the remainder of 2010, we expect private investment spending to rebound and offset a slowdown in the contribution to growth from the public sector as the fiscal stimulus fades. Below, we consider the outlook for the consumer, housing, business investment and the external sector.

Household consumption rose 0.6% in the March quarter and is expected to remain subdued for the remainder of the year as the impact of higher interest rates and a rising cost of living impact on spending. Until recently, consumer sentiment remained remarkably resilient in the face of six interest rate rises since October 2008, although confidence slid sharply in May.

While the 50% increase in dwelling approvals in 2009 means that work in the pipeline is likely to boost dwelling investment over the remainder of the year, the more recent sharp decrease in affordability, which has seen dwelling approvals fall in recent months, will reduce the rate of growth in dwelling investment in 2011.

Business investment fell by 3% in the March quarter after tax incentives boosted investment in the December quarter. Firms have downgraded their capital expenditure (capex) intentions for the 2010-11 financial year, implying nominal capex growth of 23%, down from 27% in the first estimate. Even though firms have lowered their capex intentions, a rate of intended increase of 23% is still very strong. We expect business investment to rebound strongly with growth averaging around 3% per quarter over the remainder of the year.

Net exports detracted 0.5 percentage points from growth in the March quarter. Export volumes dipped slightly while imports posted modest growth. April trade data suggests a recovery within export volumes, with the Australian Bureau of Statistics (ABS) estimating that coal and iron ore volumes rose by 26% and 2% (non-seasonally adjusted), respectively.

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