30 April 2011

The Markets

International Equities

Global equity markets rallied in April recovering last month's losses. The Morgan Stanley Capital International (MSCI) All Countries World (ex Australia) Index added 2.14% in local currency terms however, a rally in the Australian dollar (AUD) meant that the unhedged return for the Index was -1.6%.

US economic data released through the month supported a continued improvement in prospects. The unemployment rate dropped to 8.8%, housing starts improved beyond economists' expectations and consumer confidence measures were robust. European data showed little change or improvement. Retail sales fell and consumer confidence measures remain weak.

Despite this, European developed countries experienced the strongest returns through April. In particular, Belgium (7.2%), Germany (6.3%) and Ireland (6.0%) surged ahead, while the heaviest losses among developed countries were sustained in Greece (-8.6%) and Israel (-5.9%). Emerging market countries underperformed developed countries through the month. Egypt (-7.0%) and Peru (-5.1%) were the poorest performers while the Turkish (8.6%) and Hungarian (6.6%) markets posted strong positive returns.

All developed market sectors gained through April, the healthcare sector (5.4%) the strongest performer. Consumer staples and consumer discretionary were also strong, while the energy and telecommunications sectors were comparatively weaker.

Outlook: Equity prices are pushing beyond fair value estimates as economic data continues to indicate the recovery in developed nations. US corporate earnings again surprised on the upside. The effects of quantitative easing and low interest rates also continue to be felt. In the shorter term, these positives for equity markets are balanced with the risk of inflation and high energy prices, which threaten to stifle the recovery. The looming end of quantitative easing and the market's reaction to this also pose a risk for equity prices in the shorter term.

Overall, while we expect positive returns, we remain cautious about adding equity risk.

Australian Equities

Ongoing strength in offshore markets following continued positive surprises in US corporate results saw the Australian market rally. However, selling on the back of the strong AUD saw the market finish down 0.29%.

Domestic investors were increasingly focused on earnings risk heading into May, which is often a period of profit warnings from companies. The risk was accentuated by the strong AUD and profit warnings by Goodman Fielder and Leighton Group, which highlighted the impact of higher commodity prices and adverse weather. The telecommunications and banks sectors performed strongly. Both sectors offer shelter from currency strength due largely to a domestic earnings base. Sales reports from Woolworths and Wesfarmers gave further evidence of soft retail trading conditions.

In company news, the Australian government rejected Singapore Exchange Ltd's bid for ASX Ltd. Computershare announced it will buy BNY Mellon's shareowner services business for $550 million, subject to US regulatory approvals.

Outlook: There remain some concerns around the impact of recent natural disasters and geo-political events on equity markets, although our Australian Equities boutique maintains a positive view. Nevertheless, the domestic market should reflect the dual speed growth in the Australian economy. The higher AUD and rising domestic costs will affect earnings for companies without pricing power. On the other hand, the world's ongoing economic recovery and strong growth in Asia should lead to continued strong earnings growth in the mining and energy sectors.

The market appears close to fair value based on our medium-term strategy model, and we expect good returns from this asset class over the medium term.

Global Fixed Interest

Sovereign bonds rallied through April as the market was somewhat disappointed by economic news. The yield on 10-year US treasuries moved 18 basis points lower to 3.29%, while the 10-year benchmark German Bund yield fell 12 basis points to 3.24%. Australian 10-year bond yields finished April at 5.43%, from 5.49% at the end of March.

Both US and Australian breakeven inflation pushed higher through the month. Credit markets were little changed with US high yield spreads now at 4.62% and investment grade spreads at 1.38%. Emerging market spreads widened through April.

The Reserve Bank of Australia (RBA) kept the cash rate target steady at 4.75% through April. In its Statement of Monetary Policy, the Board expressed comfort around its slightly restrictive monetary policy stance given the economic outlook. Cash returned 0.4% for the month.

Outlook: US bond yields have fallen to the bottom end of their range and US bonds look overvalued. It also seems markets have moved to price in too many rate hikes by the European Central Bank (0.75% by end 2011) and too few for the UK (no rate hike this year). QIC Global Fixed Interest portfolios are positioned accordingly.

In Australia, we continue to expect the RBA's modest monetary policy tightening cycle to recommence later in the year as strong investment intentions are reflected in actual data, as wage growth picks up further and as underlying inflation returns towards the top of the RBA's target band. In the near term, we expect cash rates to remain unchanged as the RBA carefully considers a complex set of factors. This includes weighing up firm global growth (in aggregate), high commodity prices and strong investment intentions against continuing consumer caution, slowly declining house prices and the adverse trade and growth impacts from a very strong currency.

Over the coming months we expect further modest tightening in credit spreads which remain wide of our fundamental valuation, even though they have recovered significantly.

Currencies

The US dollar (USD) suffered a broad-based fall of around 2.5% in trade-weighted terms over April, with cyclical and structural factors both playing a role in its weakness. On the cyclical front, it has become clear that the US Federal Reserve (Fed), along with the Bank of Japan, will be the laggard in the global monetary tightening cycle. The cycle started in Asia in the second half of 2010, and has now extended to Europe, with the European Central Bank (ECB) raising the refinancing rate by 25 basis points.

In terms of structural factors, fiscal policy developments remained at the forefront of analysts' thinking, but with the focus now shifting away from Europe and toward the US. Concern over the sustainability of US public finances led to Standard and Poor's placing the US sovereign debt rating on negative watch in case the US fiscal position 'fails to consolidate'. The requirement for fiscal consolidation will be a significant drag on US growth over the medium term. Muted growth will allow the Fed to gradually tighten monetary policy over a number of years. Low US interest rates present a significant headwind to the USD, despite our estimates of purchasing power parity (PPP) showing it to be undervalued.

Continued political unrest in the Middle East and North Africa puts further pressure on oil prices, while the contract prices for coal and iron ore also rose in April, pushing the RBA commodity price index higher by 7.6% in the month in special drawing rights (SDR) terms. Combined with interest rate support from higher than expected March quarter inflation in Australia and a generally weak USD, this provided substantial support for the AUD, which rose by 6.2% in April. This took the AUD to a new post-float high of USD1.10, substantially above the fair value levels in our PPP framework.

Outlook: Our estimates of PPP suggest the USD is undervalued against all major currencies, likely reflecting cyclical weakness associated with quantitative easing. In fact, the fall in the USD over April has left it outside its fair value ranges based on PPP for all currencies except the British pound.

We expect the USD to strengthen modestly from current levels, based on the valuation signal from our PPP models. Partly offsetting the strength of the valuation signal, however, is the relative interest rate outlook, which prevents a sharp rally in the USD over the forecast horizon.

Financial markets (%)

Sharemarkets	Level as at 30-Apr-11	1 month return	3 month return	Financial YTD return	1 year return
Australia (S&P/ASX 200)	4823	-0.29	2.73	16.07	4.58
Developed World (MSCI World ex Aust.)	946	2.37	3.96	25.80	11.37
World (MSCI AC World ex Aust.)	361	2.14	3.92	25.10	11.70
US (S&P 500)	1363	2.96	6.53	34.43	17.22
UK (FTSE 100)	6069	2.97	4.69	26.61	12.91
Europe (MSCI Europe ex UK)	982	3.78	3.35	18.64	11.02
Japan (Topix)	851	-2.01	-5.34	3.35	-11.81
Currencies					
Australian Dollar/US Dollar	1.09	5.82	9.76	29.56	17.56
Australian Dollar/Euro	0.74	1.22	1.43	6.97	5.37
Australian Dollar/Yen	88.80	3.60	8.71	18.80	1.47

Sharemarket returns are inclusive of dividends, in local terms.

Economist's View

Key Points

- Macroeconomic policy tightens globally – US the laggard
- US GDP growth disappoints in the March quarter – will the US recovery be sustained?
- Rising inflation and tight labour market lift expectations over RBA rate hikes

International Economies

Macroeconomic policy tightens globally – US the laggard

This month, we saw the European Central Bank (ECB) begin its tightening cycle by raising the refinancing rate by 25 basis points, as Euro area inflation reached a yearly rate of 2.7 per cent. In contrast, the US Federal Reserve (Fed) has kept rates on hold and has continued with its program of long-term asset purchases to inject additional liquidity into the financial system. This is despite headline inflation also reaching 2.7 per cent in the US. With the ECB and Asia-region central banks now in a phase of policy tightening, the Fed (along with the Bank of Japan) is clearly the laggard.

The US also trails in the cycle of fiscal tightening. It is not, however, immune from political and market constraints affecting its ability to continue with high deficits. Concerns over the state of US Federal government finances erupted over the month, as rating agency Standard & Poor's placed US sovereign debt's AAA rating on negative watch on concerns that policymakers would struggle to form an agreement on the appropriate path of fiscal tightening. In addition, the government barely managed to avoid shutdown as a short-term funding bill passed the Senate just before its midnight deadline. US policy makers have been busy formulating a program of fiscal restraint.

During the month, President Obama released details of a plan designed to reduce the US Federal government budget deficit by US$4 trillion over the next 12 years. The aim of the plan is to reduce the deficit to around 2.5 of GDP by 2015 and declining towards 2 per cent by the end of the decade. The current consensus view is that this tightening can be achieved with average annual GDP growth rates of 3.25 to 3.5 per cent from 2013 to 2015. Our view is that such a strong rate of GDP growth will be difficult to achieve with such a sharp improvement in the budget. Our modelling of US public finances suggests that a far more conservative average annual rate of growth of 2.5 per cent will be achieved in the US over this period as tighter fiscal policy lowers domestic demand. As a consequence, we expect a prolonged period of loose monetary policy in the US, leading to low government bond yields and a weak US dollar.

US GDP growth disappoints in the March quarter – will the US recovery be sustained?

Given that the medium-term outlook for US growth is constrained by the need for fiscal consolidation, it is imperative that the US economy continues its recovery over the coming year, while both fiscal and monetary policies are still accommodative. However, the release of March quarter national accounts revealed tepid growth in the economy, with real GDP growth for the quarter at a sub-trend annualised rate of 1.8 per cent. While the poor outcome was due partly to the impact of higher food and energy prices, which eroded consumer purchasing power, a number of temporary factors constrained activity in the quarter, including poor weather and a large cut in government defence spending. Consequently, a significant rebound in growth is expected in the June quarter as these temporary constraints lift.

Nonetheless, achieving above-trend growth over the remainder of the year (necessary to lower the output gap and the rate of unemployment) will continue to be a challenge for the world's largest economy. While the labour market is showing signs of improvement (private payroll employment has risen by an average of 250,000 per month over the past three months), the unemployment rate has eased only modestly from 9.4 per cent in December 2010 to 9 per cent in April 2011 and is suppressing wage growth. Anaemic wage growth and ongoing weakness in the housing market are headwinds to strong growth in US consumer spending over the remainder of 2011.

With a constrained consumer, the business sector must continue to drive the recovery over 2011. Corporate balance sheets are healthy and the low cost of capital and improved margins should continue to support profit growth. March quarter company earnings reports have been strong, with non-financial company sales revenue growth rising at a robust rate of 12 per cent. Furthermore, the introduction of a temporary allowance for businesses to expense 100 per cent of investment in 2011 provides an additional incentive to boost investment this year. We expect business investment to grow at an annualised rate of around 7 per cent over the remainder of 2011 and will be the catalyst for a sustained improvement in labour market conditions.

In summary, despite the slowdown in growth in the March quarter, our view is that the short-term outlook for the US economy remains solid. Real GDP growth is expect to average around 3.5 per cent (annualised) over the remainder of 2011.

Interest Rate Forecast (%)

	Level at 09 May 2011	QIC forecast Jun-11	Sep-11	Mar-12
Australia	4.75	4.75	5.00	5.50
US	0.00 - 0.25	0.00 - 0.25	0.00 - 0.25	0.00 - 0.25
Canada	1.00	1.00	1.25	1.50
Europe	1.25	1.25	1.50	2.00
UK	0.50	0.50	0.75	1.25
Japan	0.00 - 0.10	0.00 - 0.10	0.00 - 0.10	0.00 - 0.10

Australian Economy

Rising inflation and a tight labour market lift expectations over RBA rate hikes

The month of April saw the market reassess the timing of the next increase in the cash rate by the Reserve Bank of Australia (RBA). The release of the March quarter inflation report, which saw increases in both headline and core rates of inflation, followed by hawkish minutes from the RBA's May monetary policy meeting and an upgraded inflation forecast reported in their May Statement of Monetary Policy saw the market pull forward its expected timing of the next RBA rate hike from May 2012 to September 2011.

Data released over the month continued to be influenced by the Queensland floods, making assessment of the underlying state of the national economy difficult. Merchandise trade data revealed a larger than expected fall in export values as Queensland coal production following the floods resumed more slowly than expected. Floods also affected housing finance data, which fell in February following the decline in January. In a climate of uncertainty, consumers continued their cautious approach to spending, with retail volumes flat over the March quarter, despite a strong rebound in the labour market, which saw the unemployment rate slip below 5 per cent.

As the influence of the floods abates and mining investment ramps up, economic activity will rebound strongly. With labour market conditions already tight and wage growth rising, the RBA will need to consider raising the cash rate. Our view is that the RBA will implement two rate hikes by year end.

QIC Limited ACN 130 539 123 ("QIC") is a wholesale funds manager and its products and services are not directly available to retail investors. QIC is a company government owned corporation constituted under the Queensland Investment Corporation Act 1991 (Qld). QIC is regulated by State Government legislation pertaining to government owned corporations in addition to the Corporations Act 2001 ("Corporations Act"). QIC does not hold an Australian financial services ("AFS") licence and certain provisions (including the financial product disclosure provisions) of the Corporations Act do not apply to QIC. Please note however that some wholly owned subsidiaries of QIC have been issued with an AFS licence and are required to comply with the Corporations Act. QIC, its subsidiaries, associated entities, their directors, employees and representatives ("the QIC Parties") do not warrant the accuracy or completeness of the information contained in this document ("the Information"). To the extent permitted by law, the QIC Parties disclaim all responsibility and liability for any loss or damage of any nature whatsoever which may be suffered by any person directly or indirectly through relying on the Information, whether that loss or damage is caused by any fault or negligence of the QIC Parties or otherwise. The Information is not intended to constitute advice and persons should seek professional advice before relying on the Information. The QIC Parties are the owners of the intellectual property rights in the Information. Access to and use of the Information is limited to personal or non-commercial use unless you hold prior written approval.