QIC Outlook
Market & Economic
Dynamic Investment Solutions

28 February 2011

The Markets

International Equities

Global equity markets posted another strong month of performance, with the Morgan Stanley Capital International (MSCI) All Countries World Index (ex Australia) adding 2.34% in local currency terms. A pick-up in the Australian dollar (AUD) relative to most major currencies meant returns were reduced to 0.7% when translated into AUD.

Investors continued to take comfort in the economic recovery through the first half of the month with the unemployment rate and the Institute for Supply Management (ISM) manufacturing index surprising to the upside in the US, while European data was more mixed. In the latter part of the month, concerns over unrest in the Middle East and North Africa, and rising commodity price inflation led to a coordinated global sell-off.

Of the developed markets, the strongest performers through February were Ireland (+5.9%) and Japan (+4.6%). At the other end of the spectrum, Finland (-7.0%) and Singapore (-5.7%) posted sharp declines. Emerging market countries were again weaker than developed, with most declining. On the positive front, Thailand and Morocco gained 4.7% and 3.7% respectively, while the weakest markets were Taiwan (-6.5%) and South Korea (-5.7%). All developed market sectors gained over the month.The energy sector was again the strongest (+5.7%), while utilities was weaker (+1.7%).

Outlook: February served as a reminder that extraneous factors are the enemy of complacency. Geopolitical events in the Middle East and North Africa caused markets to falter, particularly in response to the induced higher oil prices. While economic fundamentals continued to improve in February and were supportive of valuations, investors had been pricing in most of that improvement. Those circumstances leave markets vulnerable to disappointment, although the pull-back in late February/early March has created a margin of comfort in valuations.

From a long-term perspective, equity markets are trading at or below fair prices with some segments showing slightly better than average expected returns.

Australian Equities

February saw another positive month for domestic equities as investors continued to add riskier assets to their portfolios. The market overcame concerns regarding the ongoing unrest in the Middle East, higher oil prices and some profit-taking to focus on the positives from the reporting season.

Results from the reporting season were mixed at the sector level. Resources exceeded market forecasts, reflecting the strength in commodity prices, while industrials was lower, reflecting the continued variability in demand across the domestic economy. While the outlook comments remained subdued, dividends were better than forecast, reflecting the strength in corporate balance sheets.

The S&P ASX 200 Accumulation Index gained 2.35% for the month.

Outlook: Over the past few months, investors have supported risky asset classes, including domestic equities. This has occurred despite a mixed reporting season and rising geopolitical risk in the Middle East and North Africa. Over the medium term, the high AUD, weak consumer and business confidence and rising costs continue to be strong headwinds. Offsetting these concerns is the positive outlook for the resources sector, on the back of higher commodity prices and the strength of the Chinese economy. A continued expansion of the US economy would provide a further tailwind to domestic equities exposed directly to the US, or more broadly to global growth.

Global Fixed Interest

Global sovereign bonds sold off through the first half of February; however, markets recovered to finish the month relatively flat. The yield on 10-year US treasuries moved six basis points higher to 3.43%, while German Bunds stabilised at 3.17% after the sell off that began in September last year. Australian 10-year bond yields rallied two basis points to 5.49%.

Both US and Australian 10-year breakeven inflation moved higher over the month. Credit markets rallied with spreads at their tightest levels since November 2007. US high yield spreads are now at 4.63%, while investment grade spreads are at 1.39%. Emerging market spreads were steady through February.

The Reserve Bank of Australia (RBA) kept the cash rate target steady at 4.75% through February. In its Statement of Monetary Policy, the Board expressed comfort around its slightly restrictive monetary policy stance given the economic outlook. Cash returned 0.37% for the month.

Outlook: Recently there has been a significant upgrade to consensus US growth expectations. The possibility of an upside surprise in the US labour market (which has been very slow to gather traction) may act as a catalyst for markets to begin thinking about a shift in Federal Reserve rhetoric. However, the current economic momentum can be set back by negative influences, so the outcome of current geopolitical unrest will be crucial.

In Australia, the cash rate is expected to remain unchanged over the coming months as monetary policy is already modestly restrictive, the AUD is holding above parity with the US dollar (USD) and underlying inflation is at 2.25%, comfortably inside the RBA's 2-3% medium term target band. Nevertheless, the RBA's modest monetary policy tightening cycle is expected to recommence later this year.

The medium-term outlook for credit risk remains constructive; however, volatility is expected in the short term on ongoing sovereign debt concerns out of Europe and ongoing unrest in the Middle East and North Africa.

Currencies

Stronger global growth and geopolitical risk leaves commodity currencies stronger.

Over the month of February, the influence of rising geopolitical unrest and positive economic data had a positive impact on commodity prices and commodity currencies. While the situation in Egypt settled early in February, the outbreak of civil war in Libya later in the month sparked a sharp rise in oil prices as markets repriced the risk of violence spreading to the Middle East and affecting global oil supply. Oil prices spiked above US$100 per barrel during the month, but settled around US$97 by the end of February as Saudi Arabia announced it would meet the disruption to Libyan oil supply from reserves. As well as oil, other commodity prices also rose strongly during the month of February. This supported commodity currencies, with the Canadian and Australian dollars rising by 3.0% and 2.2% against the USD respectively.

Despite the rise in commodity prices, economic data remains solid, particularly in the US. With above-trend growth and falling unemployment in the US, Federal Reserve Chairman, Bernanke, remains optimistic that the low level of core inflation will allow US monetary policy to remain supportive of the economy. In Europe and the UK, however, rising inflation is putting pressure on monetary policymakers to tighten policy, despite growth being below trend. As a result, the euro and pound sterling rose against the USD over February, by 0.7% and 1.5% respectively, building on the rises in these currencies recorded over January.

With strong growth in the December quarter and rising inflation risk, policy tightening continues in Asia. The yuan rose by 0.4% against the USD over the month, similar to the rise in the yen. The NZ dollar fell by a sharp 2.7% against the

USD, as pressure mounts for the Reserve Bank of New Zealand to ease policy after a second major earthquake hit Christchurch in February.

Outlook: QIC's estimates of purchasing power parity (PPP) suggest that the USD is undervalued against all major currencies, likely reflecting cyclical weakness associated with quantitative easing (QE). The AUD is above the fair value range based on PPP. In the absence of QE2, we would expect downward pressure on the AUD in coming months. However, factoring QE2 into our estimates raises our forecast for the AUD to around parity, and extends the timeframe over which we expect the AUD to remain outside its PPP range into 2013. Like the AUD, the yen is also overvalued against the USD and outside its PPP fair value range. However, with Japan also participating in QE2, there will be less interest rate support for the yen and we may see pressure on the yen to weaken. Other currencies remain within their fair value ranges against the USD.

Financial markets (%)

Sharemarkets	Level as at 28-Feb-11	1 month return	3 month return	Financial YTD return	1 year return
Australia (S&P/ASX 200)	4830	2.35	6.30	15.63	8.65
Developed World (MSCI World ex Aust.)	941	2.94	11.03	24.57	17.92
World (MSCI AC World ex Aust.)	357	2.34	9.56	23.20	17.54
US (S&P 500)	1327	3.43	12.95	30.51	22.57
UK (FTSE 100)	5994	2.64	9.02	24.13	15.51
Europe (MSCI Europe ex UK)	979	1.88	10.13	16.96	15.53
Japan (Topix)	951	4.56	10.64	14.16	8.47
Currencies					
Australian Dollar/US Dollar	1.02	2.14	6.18	20.56	13.71
Australian Dollar/Euro	0.74	1.38	0.07	6.92	12.35
Australian Dollar/Yen	83.43	2.14	3.85	11.62	4.84

Sharemarket returns are inclusive of dividends, in local terms.

Economist's View

Key Points

- Brisk start to the year for financial markets despite geopolitical headwinds
- Will the crisis in the Middle East undermine the global economic recovery?
- Recovery gathers traction in US and euro area economies – China shows signs of slowing
- Australian GDP growth as expected in 2010 Q4 – fundamentals for strong growth remain

International Economies

Brisk start to the year for financial markets despite geopolitical headwinds

Global financial markets have been subjected to countervailing influences in the first months of the New Year. While geopolitical turmoil, rising global inflation and the prospect of tighter global macroeconomic policy have been negatives for markets, ongoing signs of recovery in advanced economies and continued robust growth in emerging market economies have provided offsets.

Year to date, the improved outlook for the global economy appears to be dominating geopolitical risks, with global equity markets higher by around 4 per cent (as measured by the MSCI World Index, local currency). As the global outlook has improved, inflation expectations have also increased leading to an increase in government bond yields. The US 10-year government bond yield has risen by 21 basis points from 3.29 per cent at the beginning of the year to its current level of 3.50 per cent, with the rise in inflation expectations (as measured by the difference between the US 10-year government bond yield and the 10-year government inflation-linked bond yield) explaining all but one basis point of the increase. Reflecting the combination of rising global demand and higher premia associated with the Middle East crisis, the West Texas Intermediate (WTI) oil price has risen by around 15 per cent from around US$91 per barrel (bbl) at the start of the year to its current level of almost US$105 per bbl.

Within these overall trends, however, there have been some significant regional variations. The Australian equity market has lagged its US and European counterparts, in part, suffering from the general underperformance of Asian stock markets in response to tighter monetary policy settings, the impact of adverse shocks from floods in Queensland and Victoria and a low beta to global equity markets. Year to date, the Australian equity market has increased by around 1 per cent compared to the increase in the MSCI World Index of around 4 per cent.

Will the crisis in the Middle East undermine the global economic recovery?

As tensions in the Middle East escalated with the outbreak of civil war in Libya, oil prices jumped sharply, with WTI rising from US$86 per bbl to above US$100 per bbl in early March, the highest level since September 2008. We have conducted simulations using our global macroeconomic model that test the sensitivity of economic activity to a permanent US$15 per bbl increase in the price of WTI. Our choice of shock (US$15 per bbl) can be thought of as the premium that would apply due to an expectation of ongoing turbulence, in one form or another, in the Middle East and reflects the hike in the price caused by the Libyan crisis.

The impact of a permanent increase of US$15 per bbl in the WTI oil price has long-lasting effects on the global economy. On average, global real GDP would be 0.5 per cent lower in 2015 Q4 in response to a permanent US$15 per bbl oil price increase and therefore, in our opinion, would not derail the global economic recovery. However, some countries would be hit much harder than the global average. Countries that have high levels of oil intensity in their production processes and/or high levels of net energy imports would be hardest hit by an oil price shock. The ten worst performing countries can be classified into three groups: emerging market economies of East Asia (India, Taiwan, South Korea and China), emerging market economies of Central and Eastern Europe (Czech Republic, Hungary and Poland) and a mix of advanced economies (US, Spain and Italy). The hardest hit nations are India, Taiwan and South Korea, where real gross domestic product (GDP) would be more than 1.0 percentage point lower by 2015 Q4 due to higher oil prices.

Our analysis also shows that not all countries suffer from the effects of high oil prices. Indeed, Norway and Russia experience increases in real GDP in response to a lift in oil prices. Among the ten best performing economies (excluding the OPEC countries) we find representatives of energy producers (Norway, Russia, Mexico, Australia, Denmark, UK and Brazil) and advanced European economies that have reduced the fossil fuel intensity of their production processes to very low levels (Sweden, France and Austria). Interestingly, although Denmark and the UK are small energy producers in terms of global markets, they each manage to supply their own energy needs, thereby benefiting from a low rate of energy import intensiveness.

Recovery gathers traction in US and euro area economies – China shows signs of slowing

US and euro area national accounts data showed that the world's two largest economies continued to expand in the last quarter of 2010. In addition, business sentiment indexes for February flag ongoing recovery in the new year and are reaching multi-year highs in both the US and euro area.

In the US, personal income is currently being boosted by payroll tax cuts, and, in further good news for the US household sector, a recovery in the labour market. In February, 192,000 jobs were created helping to lower the unemployment rate to 8.9 per cent, down from 9.4 per cent in December 2010. Despite the pick-up in labour market conditions and economic activity, inflation remains low in the US, with core inflation gradually rising to a yearly rate of 1.0 per cent in January. With inflation well contained, Chairman Bernanke of the US Federal Reserve (Fed) has reiterated his commitment to the Fed's purchase of US$600 billion of government and agency bonds, which is due to be completed in June. In contrast, rising energy prices are taking their toll on euro area inflation, with the region's CPI rising by 2.4 per cent on a year-ended basis in February. This was above market expectations and prompted a hawkish reaction from the European Central Bank (ECB) President, Trichet. The market is now anticipating the ECB to raise the repo rate at its next policy meeting in April.

National accounts data for the December quarter of 2010 showed the Chinese economy expanding at an unsustainably strong pace, with estimates of quarterly annualised growth exceeding 12 per cent. In response, Chinese authorities have been tightening monetary policy with the 12-month bank lending rate being raised to 6.06 per cent from 5.81 per cent and banks' reserve requirement ratio being raised by 100 bps year to date. With ongoing tightening of monetary conditions, it is unsurprising to see signs of a slowdown in Chinese economic activity. Recent releases of Chinese surveys of business sentiment fell in February for the third month in a row, weaker than market expectations.

Thus far, the global economy is fortunate to be in a position where the impact of the slowdown in the over-heated Chinese economy is being offset by recovery in the recessed US and euro area economies. However, policy tightening is edging closer in the US and the euro area, and for the current serendipitous state to persist, we must rely on Chinese authorities to relax policy in coordination with the timing of tighter policy in the West.

Interest Rate Forecast (%)

	Level at 07 Mar 2011	QIC forecast Mar-11	Jun-11	Dec-11
Australia	4.75	4.75	4.75	5.50
US	0.00 - 0.25	0.00 - 0.25	0.00 - 0.25	0.00 - 0.25
Canada	1.00	1.00	1.00	1.50
Europe	1.00	1.00	1.00	1.00
UK	0.50	0.50	0.50	0.50
Japan	0.00 - 0.10	0.00 - 0.10	0.00 - 0.10	0.00 - 0.10

Australian Economy

Australian GDP growth as expected in 2010 Q4 – fundamentals for strong growth remain

The release of the Australian national accounts data for the last quarter of 2010 showed that real GDP grew by 0.7 per cent, in line with our forecast of 0.6 per cent. The main driver of growth in the quarter was the increase in inventories, which is likely to be reversed during the flood-affected March quarter of 2011. The long-awaited mining investment boom failed yet again to materialise, with private new engineering construction (the category that incorporates mining investment) falling by 0.8 per cent. Australian economic data releases for January and February will continue to be influenced by the floods affecting Queensland and Victoria.

Floods notwithstanding, the prospects for the Australian economy beyond the first quarter look bright, with the stimulus from large-scale mining projects, such as the $43 billion Gorgon project, boosting growth. Consequently, our view is that the Reserve Bank of Australia will need to raise the cash rate in the second half of the year to 5.5 per cent if it is to avoid a surge in inflation. Currently, the market is anticipating only one rate increase to year end, taking the cash rate to 5.0 per cent.