

30 June 2011

The Markets

International Equities

Equity markets were under pressure again in June, rounding out a negative quarter for risk assets. The MSCI All Countries World (ex Australia) Index fell 1.6 per cent in local currency terms over the month and 0.8 per cent over the quarter. In unhedged Australian dollar (AUD) terms, returns were -2.1 per cent for the month and -3.1 per cent for the quarter.

The Greek debt crisis was again in the headlines, with investors concerned about austerity measures being passed through the Greek parliament and the ongoing risk of a sovereign default or restructure. Equity markets were also affected by some deteriorating macro data, with the Citigroup Economic Surprise Index falling again in June. European retail sales and PMI manufacturing data surprised to the downside. In the US, the unemployment rate climbed above 9 per cent and several widely observed economic activity indices (including Empire Manufacturing, Philadelphia Fed and ISM Manufacturing Index) fell sharply early in the month. On the positive side, housing data stabilised somewhat and the S&P/Case Shiller home-price index ticked upwards for the first time in eight months. Some positive releases towards the end of the month saw momentum rapidly shift and equity markets rally.

Only a small number of developed country markets managed positive returns in June. Ireland regained 2.7 per cent, while Austria and Germany gained a little over 1 per cent. Switzerland and Denmark underperformed (both down 5.6 per cent) as Europe was swept further into the sovereign debt crisis. Over the quarter, Ireland was the strongest performer (5.3 per cent) followed by Germany (4 per cent), while Greece (-18.3 per cent) and Finland (-9.8 per cent) fell sharply. Emerging markets (EM) underperformed developed markets over both the month and the quarter. Mexico, Malaysia and Indonesia were the strongest performers in June, each gaining around 2.3 per cent, while Peru (-11.8 per cent) and Morocco (-4.3 per cent) were among a number of markets that fell in excess of 3 per cent. Chile and Indonesia each gained around 6 per cent over the quarter, while Peru (-15.2 per cent), Brazil (-7.9 per cent) and Russia (-7.1 per cent) led the EM index lower.

The consumer discretionary and utilities sectors showed some resilience in June, both managing positive returns, while information technology (-2.5 per cent) and financials (-2.2 per cent) were considerably weaker. Over the quarter, defensive sectors like health care (6.4 per cent) and consumer staples (4.7 per cent) outperformed. Energy and financials fell 5.4 and 4 per cent respectively.

Outlook: The reversal in equities over the month provided some relief from the pressure of high expectations. A dampening global economic outlook and European financial concerns, while troubling, are not terminal. Caution is warranted; however, equity prices now include some margin for error, particularly in non-US markets. The US market was affected more from the downgrade of their own domestic growth outlook than from Europe centric factors and thus remains susceptible to an escalation of European Union (EU) debt worries. Overall our view is that equities are currently priced to provide reasonable long-term returns.

Australian Equities

The S&P/ASX 200 Accumulation Index returned -1.8 per cent during the month of June and -4 per cent for the quarter. During the quarter, evidence began to emerge of weaker global growth, and uncertainty over Greece's public finances led investors to reduce risk.

Early June saw poor labour market data in both the US and Australia disappoint the market. The Australian economy added 7,900 jobs, which was well below expectations. The Reserve Bank of Australia (RBA) maintained its cautious stance on inflation, citing strength in the resources sector. Housing related activity was weak with housing construction rising just 0.4 per cent and housing finance increasing 3.4 per cent.

The consumer staples and utilities sectors outperformed over the month, returning 2.4 and 3.9 per cent respectively, while energy (-6.6 per cent) and information technology (-3.5 per cent) led the benchmark lower. Over the quarter, utilities (8.9 per cent) and telecommunications (7.1 per cent) were the best-performing sectors, while energy stocks slumped, down 7.1 per cent.

Outlook: Global markets are experiencing a period of increased volatility that has caused the Australian equity market to fall over recent months. There are a number of issues that could continue to weigh on the market, including the continuing sovereign debt crisis in Europe, weakening global growth and domestic uncertainty surrounding growth and inflation.

We view the Australian share market as slightly undervalued at current pricing. It is priced on relatively low earnings growth expectations. The earnings outlook has been dampened in recent times by a convergence of factors including a lower GDP growth outlook, softening housing market and the high Australian dollar, which has affected the resources sector. There is a probability of positive surprise in this market and, notwithstanding short-run volatility, we see investors in the Australian equity market earning above long-run average returns.

Global Fixed Interest

Global sovereign bonds rallied during the June quarter in conjunction with a sell-off across risk assets, including equities and commodities. Despite a sharp reversal in the final few days of June, the yields on benchmark 10-year US Treasuries fell 31 basis points (bps) in total over the quarter to finish at 3.16 per cent. German Bund yields were 33 bps lower at the 10-year point, down to 3.03 per cent. Australian 10-year Commonwealth Treasury bonds also rallied, with yields moving 28 bps lower to 5.21 per cent.

Breakeven inflation traded lower in both Australia and the US over the quarter. US credit spreads widened across the quality spectrum. High yield spreads moved out 60 bps to 5.25 per cent while investment grade spreads were more resilient, moving just 11 bps wider to 1.53 per cent. Emerging market spreads were steady over the quarter.

The RBA kept the cash rate target steady at 4.75 per cent throughout the June quarter. In its most recent Statement of Monetary Policy, the Board expressed comfort around its mildly restrictive monetary policy stance given the economic outlook. Cash returned 0.40 per cent for the month of June and 1.23 per cent over the quarter.

Outlook: While not conclusive, the latest data has been consistent with momentum starting to turn positive again. Following early reports that US auto sector production was ramping up more quickly than expected late in the month, a large upside surprise to the June manufacturing ISM provided some comfort that conditions in the sector appear to be improving. While there are likely to still be some lingering impacts of these disruptions in coming weeks, our Global Fixed Interest team believes the balance of risks has now shifted and the lows in yields are now behind us. Yields should continue to move higher through the course of the next quarter as more optimism returns.

Domestically, the RBA has repeatedly stated that cash rates are likely to rise further at some point. Navigating the patchy sectoral growth outlook is particularly challenging, but the RBA is an 'inflation-targeting' central bank and has reminded the community that it will be guided by unemployment and inflation data, which will 'net out' these sectoral divergences.

The underlying inflation rate has likely troughed, with a return towards the top of the RBA's 2-3 per cent target band likely by the end of the year.

The medium-term outlook for credit markets remains positive. Loans in particular are expected to continue to perform in an environment where interest rates are rising, as they are a floating rate and have been favored by investors. Moreover, the fundamentals of credit are expected to improve over coming months.

Currencies

The June quarter saw a substantial slowing in global growth expectations, as economic data disappointed, real incomes and spending were affected by the rise in commodity prices until April, and the earthquake and tsunami that hit Japan at the end of March disrupted the global supply chain. In addition, fears over sovereign default in Europe continued to escalate as the Greek government moved to pass strict austerity measures, leading to widening interest rate spreads in the peripheral European markets. As risk aversion rose and global growth expectations were revised lower, commodity prices fell: the oil price was down 11 per cent over the June quarter, while metal prices fell by over 5 per cent. The price of gold rose by around 5 per cent, reflecting its safe-haven status.

Against this gloomy backdrop, currency markets were surprisingly stable. Typically, periods of rising risk aversion and falling commodity prices result in strength in the safe-haven currencies (yen, US dollar and Swiss franc), and weakness in the commodity currencies, while the risk of sovereign default should weigh on the euro. During the June quarter, the yen rose by 3.3 per cent against the US dollar, while the Swiss franc appreciated by a sharp 9.3 per cent against the US dollar.

However, the US dollar suffered a broad-based fall as cyclical and structural factors began to weigh more heavily on the currency. The US dollar fell by 2.2 per cent against the euro, and by 3.8 per cent against the Australian dollar (AUD) during the quarter.

- On the cyclical front, it became clear that the US Federal Reserve will be the laggard in the global monetary tightening cycle, which started in Asia in the second half of 2010 and has now extended to Europe. In addition to monetary policy dynamics, the short-term cyclical slowing in the US has been pronounced, with data indicating that the pace of growth slowed to below trend in the US in the first and second quarter of the year.
- In terms of structural factors, fiscal policy developments remain a concern with the US government narrowly avoiding shutdown in April by passing a short-term funding bill, and the debt ceiling needing to be renegotiated by August. Further, Standard and Poor's placed the US sovereign debt rating on negative watch due to the risk that the US fiscal position would 'fail to consolidate'. Our forecasts incorporate a significant improvement in the US government fiscal position over the medium term. This is achieved, but at a cost to economic growth, which keeps unemployment high, and inflation, and hence interest rates, lower than they otherwise would be. This prevents a sharp rise in the US dollar, despite it being significantly undervalued according to our estimates of purchasing power parity (PPP).

Our assessment has been that the current soft patch in global growth will prove temporary, with some leading indicators already starting to show signs of improvement. Growth is being held back by factors such as the Japanese earthquake and tsunami, which severely disrupted the global supply chain and reduced motor vehicle production by around 50 per cent. In addition, the spike in commodity prices earlier in the year has pushed up inflation and reduced real household disposable incomes. As we move into the second half of the year, however, these factors will reverse, and help lift growth in the global economy. Despite headwinds from fiscal policy over the coming years, monetary policy will likely remain accommodative and balance sheets are in a healthier state than this time last year, both for households and businesses. This will help support a self-sustaining recovery in the global economy over the medium term.

Outlook: Our estimates of PPP suggest the US dollar is undervalued against all major currencies, likely reflecting cyclical weakness associated with quantitative easing. The US dollar is outside its fair value ranges based on PPP against the commodity currencies and the yen, but remains within its fair value range against the euro and Great British pound.

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

Financial markets (%)

Sharemarkets	Level as at 30-Jun-11	1 month return	3 month return	Financial YTD return	1 year return
Australia (S&P/ASX 200)	4608	-1.80	-4.02	11.73	11.73
Developed World (MSCI World ex Aust.)	915	-1.59	-0.49	22.28	22.28
World (MSCI AC World ex Aust.)	349	-1.63	-0.80	21.49	21.49
US (S&P 500)	1320	-1.67	0.10	30.69	30.69
UK (FTSE 100)	5945	-0.40	1.58	24.90	24.90
Europe (MSCI Europe ex UK)	933	-2.12	0.17	14.52	14.52
Japan (Topix)	849	1.37	-2.22	3.12	3.12
Currencies					
Australian Dollar/US Dollar	1.07	0.47	3.52	26.75	26.75
Australian Dollar/Euro	0.74	-0.37	1.33	7.08	7.08
Australian Dollar/Yen	86.46	-0.12	0.88	15.68	15.68

Sharemarket returns are inclusive of dividends, in local terms.

Economist's View

Key Points

- Greek austerity package passes parliament – Greek default averted for the time being
 - US and Japanese manufacturing improves, commodity prices ease – soft patch fading?
 - Market predicts RBA on hold to year-end 2012 – RBA to lag the Fed in raising rates?
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International Economies

Three key developments affected global financial markets and the world economy in June: (i) the new austerity package was passed through the Greek parliament, which allowed for the ongoing funding of Greek sovereign debt, (ii) signs emerged that the US manufacturing sector is stabilising and that Japanese manufacturing is recovering from the impact of the March tsunami, and (iii) commodity prices decreased. We begin our discussion with a review of the situation in Greece.

Greek austerity package passes parliament – Greek default averted for the time being

Relief swept through global financial markets at the end of June as Greek politicians resisted the temptation of populist appeal and voted for Prime Minister Papandreou's new fiscal austerity package. The fiscal package removed the immediate obstacle to Greece obtaining funding in July, thereby staving off the prospect of imminent default. European Union finance ministers can now work towards agreeing a new Greek bailout package, allowing Greece to remain solvent for at least another year. In further good news, German and French banks have agreed to extend their holdings of Greek government debt.

Even with a new bailout package and restructured debt, the events of the last year show how difficult it is for a country like Greece to resolve its public finance problems. A major difficulty is the effect of an austerity package on economic growth. By undermining economic growth, austerity measures shrink the government's tax base, leading to falling tax revenues. Falling tax revenues offset the impact on the budget of the austerity package's higher tax rates and spending cuts, making it difficult to achieve budget targets.

In addition, countries such as Greece are hampered by monetary policy that is set independently of their economic circumstances. In setting monetary policy, the European Central Bank (ECB) responds to the overall growth and inflation performance of the Euro area, rather than any one individual country. Within the region, it is the core economies of Germany and France that drive overall growth and inflation. The ECB has therefore raised rates as the region's economy has recovered in aggregate and in response, the euro has strengthened. However, for the peripheral economies struggling with the impact of austere fiscal policy, the strong euro renders their economies less competitive on international markets and is yet another headwind to economic growth.

US and Japanese manufacturing improves, commodity prices ease – soft patch fading?

Economic data released towards the end of the month revealed tentative signs that the soft patch in growth, which has plagued the global economy in the first half of the year, may be fading. A strong rise in Japanese industrial production in May, which included a 60 per cent increase in passenger car production, is evidence that the Japanese auto industry may be recovering more rapidly than expected. Indicators of US manufacturing sentiment echoed the better news from Japan with the Richmond Fed Manufacturing Index, the Chicago Purchasing Managers Index (both from auto intensive regions) and the Institute of Supply Management Manufacturing Index unexpectedly rising in June. Improved sentiment in the manufacturing sector was also evident in Europe, where the German IFO business climate index remained close to its historical highpoint in June, despite expectations of a fall.

Other good news for global growth comes with the moderation in commodity prices. Oil, mineral and metals prices appear to have peaked in late April, when the West Texas Intermediate (WTI) oil price reached a high point of US\$114 per barrel (bbl). WTI is currently trading at around US\$95 per bbl, pushed lower by weaker economic growth and the International Energy Agency's recent announcement to release oil supplies from its strategic reserves. Similarly, the London Metal Exchange Index, which peaked at 4469 in mid April, has since fallen by around 10 per cent to its current level of 4000. Food prices have also moderated since April, with the United Nation's Food and Agricultural Organisation's global food price index falling by one per cent over May.

Our view is that the soft patch in global growth will pass as the impact of transitory factors fades. However, the requirement for many governments to impose tight fiscal policies will act as a significant headwind to global growth over the medium-term. Hence, the rebound in economic activity from the global financial crisis will continue to be sluggish and extended. It will also be characterised by a split between those economies carrying large public sector debt burdens (e.g. US, UK, peripheral European economies) and those without (e.g. China, emerging Asian economies, Australia), with the former experiencing an extended period of weak growth and high unemployment and the latter establishing robust growth accompanied by inflationary pressure.

Interest Rate Forecast (%)

	Level at 06 Jul 2011	Sep-11	QIC forecast Dec-11	Jun-12
Australia	4.75	4.75	5.00	5.50
US	0.00 - 0.25	0.00 - 0.25	0.00 - 0.25	0.50
Canada	1.00	1.00	1.25	1.50
Europe	1.25	1.50	1.75	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

No rate hikes to year-end 2012 according to the market – RBA to lag the Fed?

With the domestic economy adversely affected by the loss of exports associated with the floods, and conditions in the global economy and financial markets shaky, the Reserve Bank of Australia (RBA) has kept rates on hold this year, despite rhetoric of the need for higher interest rates in the not-too-distant future. The rationale for higher interest rates is the expectation of a sharp surge in domestic demand, which will accompany capital expenditure programs by mining companies. Indeed, most economic forecasters expect that business investment will grow by approximately 15 per cent in 2012. With the economy already operating at close to full capacity, a surge of 15 per cent in business investment will drive the economy into an inflationary environment in the absence of higher interest rates.

Consumer caution has already featured in the economic backdrop, as households anticipate higher interest rates. Recently, the savings rate has increased to 11.5 per cent from 9.7 per cent at the start of the year: its highest level since the mid 1980s. We have also seen crowding out of the housing market, which has slumped due to an increase in mortgage rates late last year.

It is widely agreed by economic commentators and forecasters that the unemployment rate — currently at 4.9 per cent — is heading to a level below 4.5 per cent by year-end 2012. This will see wage growth climb closer to 4.5 per cent. History has shown that, in the absence of interest rate hikes, these levels of unemployment and wage growth will lead to a strengthening housing market and growth in real consumer spending in excess of 4 per cent per annum. This rate of

growth, when combined with 15 per cent growth in business investment, is incompatible with inflation being contained at 3 per cent per annum. Hence, the RBA must raise rates to dampen consumer spending as expanding economic activity drives down the unemployment rate. Current market pricing is for the RBA to keep rates on hold until the end of 2012. Our view is that the RBA will need to raise rates over the second half of 2011 and to continue raising rates in 2012. We expect the RBA to raise rates by 25 basis points by year-end, from 4.75 per cent to 5 per cent, and to raise rates to 5.75 per cent by the end of 2012.

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