

31 May 2011

The Markets

International Equities

Equity markets fell in May as the European debt crisis rattled investors globally. The Morgan Stanley Capital International (MSCI) All Countries World (ex Australia) Index fell 1.28 per cent in local currency terms. In unhedged Australian dollar (AUD) terms the index gained 0.60 per cent.

Most developed markets posted negative returns in May. Of those, Greece (-8.7 per cent) and Ireland (-3.3 per cent) were unsurprisingly among the largest detractors, being at the centre of the sovereign crisis. Italy fell 4.3 per cent and Finland was down 6.6 per cent. Israel and New Zealand managed gains of 4.2 per cent and 3.3 per cent respectively. Emerging markets (EM) again underperformed developed. Egypt (10.6 per cent) and Morocco (5.6 per cent) experienced strong gains, while the broader EM index was dragged lower by Turkey (-8 per cent), Russia (-4.7 per cent) and Hungary (-3.5 per cent), among others.

Defensive sectors showed strength in May, with consumer staples (2.4 per cent) and health care (2.8 per cent) outperforming. Energy, in contrast, fell 3.8 per cent, alongside financials, materials and industrials, which also underperformed.

Outlook: The brakes have been applied to global equities as investors are increasingly worried about the medium-term macro outlook. Of particular concern are the continuing sovereign debt crisis in Europe, signs that China's growth is slowing, and economic releases indicating a muted recovery in the developed world despite higher inflation and energy prices. That aside, there remains considerable optimism built into analysts' earnings forecasts which, in our opinion, require a more sober view. We remain cautious about adding risk given the potential for earnings revisions and further market turbulence.

Australian Equities

The S&P/ASX 200 Accumulation Index fell 1.97 per cent during May, in conjunction with a sell-off across most global risk assets. Sectors that performed well in the domestic market had a defensive flavour with telecommunications, consumer staples, utilities and REITs beating the index. Banks and consumer discretionary underperformed, reflecting nervousness over the local economy.

With the June half-end approaching, many companies updated the market on earnings prospects. The balance was tilted firmly to downgrades with APN, Fairfax, Bluescope, OneSteel and David Jones among those which lowered expectations. The major banks reported earnings that were largely as expected.

Outlook: The market tested investors' positive view towards equities during May, reflecting increasing concerns around global growth and inflation risks. We maintain our positive view towards the Australian equity market, although we expect to see ongoing divergence between the growth rates of individual companies and sectors.

At the end of the quarter, the ASX 100 was trading at a one year forward price-to-earnings multiple of 12.5, which is 1.5 times cheaper than its average for the previous decade. While we anticipate a reduction in this discount over time as global economies recover, we expect equity markets will reflect the dual speed growth in the Australian economy. Lower

domestic growth, coupled with the higher Australian dollar and rising domestic costs including labour and energy costs, will affect domestic and offshore earnings for companies that do not possess pricing power compared with those that do, such as the higher growth mining and energy sector related companies.

Global Fixed Interest

Sovereign bonds rallied through May as risk appetite evaporated and equities and commodities suffered heavy falls. The yield on 10-year US Treasuries moved 23 basis points (bps) lower to 3.06 per cent, while 10-year German Bunds rallied 22 bps to 3.02 per cent. Australian 10-year bonds moved similarly, with yields falling 22 bps to 5.21 per cent.

Australian breakeven inflation remained steady; however, in the US it fell sharply. Credit spreads widened. US high yield spreads moved 30 bps to 4.92 per cent, while investment grade spreads were more resilient, moving 8 bps wider to 1.46 per cent. Emerging market spreads also widened through May.

The Reserve Bank of Australia (RBA) kept the cash rate target steady at 4.75 per cent through May. In its Statement of Monetary Policy, the Board expressed comfort around its mildly restrictive monetary policy stance given the economic outlook. Cash returned 0.42 per cent for the month.

Outlook: We believe that when US economic data begins to surprise relative to the market's now more subdued expectations, yields will rise from current levels – particularly if that stronger data is accompanied by gradually rising inflationary pressures. The unwinding of the US Federal Reserve's (Fed) extremely accommodative monetary policy should also put upward pressure on yields. Unless the latest softer patch of US data is indicative of a more serious and sustained period of weak growth, US 10-year yields under 3 per cent can only be sustained if growth remains below 2 per cent for the rest of the year.

Domestically, we believe the RBA will look to stay ahead of the curve, and consequently we expect two rate increases by year's end. Thus, given that Australian yields are stretched beyond our Global Fixed Interest team's 'fair value' assessment and look very expensive, we remained meaningfully positioned for further official increases in cash rates and for bond yields to push higher.

While we remain constructive on credit and expect modest tightening to resume over the coming months, we expect credit markets to be volatile in the short term. US economic releases may also affect credit spreads in the short term; however, we believe this will be a temporary phenomenon.

Currencies

A slowing in global growth, combined with fears over sovereign debt, especially in peripheral Europe, drove risk aversion higher in financial markets in May. As a result, safe-haven currencies, such as the US dollar, yen and Swiss franc benefited at the expense of the more risky currencies or those related to peripheral Europe, with the Euro falling by 3.1 per cent against the US dollar over the month. Commodity currencies also weakened due to a sharp turnaround in commodity prices as global growth expectations fell. This saw the oil price fall by 10 per cent in the month, and left the AUD and Canadian dollar (CAD) lower by 2.7 per cent and 2.5 per cent respectively.

National accounts data for the first quarter of 2011 indicated the pace of growth had slowed to below trend in the US, and subsequently, there has been a sharp deterioration in leading indicators and in labour market data, with the unemployment rate rising from 8.8 per cent to 9.1 per cent over the last two months. The slowing in the US has been exacerbated by the temporary weakness in the Japanese economy, which contracted by 3.7 per cent annualised in the first quarter, partly in response to the earthquake and tsunami in March. The near-term prospects for Japan remain quite bleak as the economy struggles to recover; however, production gains are highly likely from the third quarter of 2011. Europe, in contrast, remains on a firm footing, with gross domestic product (GDP) growing by an above-trend quarterly rate of 0.8 per cent in the first quarter, led by the core economies of Germany, France and the Netherlands. Despite some slowing in leading indicators in the second quarter and rising interest rates (especially in the periphery), the European economy continues to outperform expectations. Concerns over sovereign debt remain high, although further austerity measures in Greece appeared to reduce investors' concerns toward the end of the month.

Our assessment is that the current soft patch in global growth will prove temporary, and the leading indicators should start to improve shortly. Growth is being held back by factors such as the Japanese earthquake and tsunami, which have severely affected 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 caused by political uncertainty in the Middle East and North Africa (oil), and adverse weather conditions affecting food prices, 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 encourage 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 purchasing power parity (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. After its rally against the euro in May, the US dollar has moved back within its fair value range against the euro.

We expect the US dollar 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 US dollar over the forecast horizon.

Financial markets (%)

Sharemarkets	Level as at 31-May-11	1 month return	3 month return	Financial YTD return	1 year return
Australia (S&P/ASX 200)	4708	-1.97	-1.60	13.78	10.84
Developed World (MSCI World ex Aust.)	931	-1.22	-0.25	24.26	19.02
World (MSCI AC World ex Aust.)	355	-1.28	0.24	23.50	18.91
US (S&P 500)	1345	-1.13	1.84	32.91	25.95
UK (FTSE 100)	5989	-0.95	1.03	25.40	19.12
Europe (MSCI Europe ex UK)	955	-1.39	0.03	17.00	15.68
Japan (Topix)	838	-1.56	-10.89	1.73	-2.68
Currencies					
Australian Dollar/US Dollar	1.07	-2.63	4.64	26.15	27.04
Australian Dollar/Euro	0.74	0.48	0.53	7.49	8.43
Australian Dollar/Yen	86.57	-2.51	3.76	15.82	13.37

Sharemarket returns are inclusive of dividends, in local terms.

Economist's View

Key Points

- Global economic growth stalls leading into the second half of 2011 – déjà vu?
 - Tsunami-induced slump in Japanese economy worse than feared
 - Robust March quarter growth in the Euro area economy despite debt problems
 - Australian exports hit by floods, but domestic demand remains robust
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International Economies

Global economic growth stalls leading into the second half of 2011 – déjà vu?

Recent economic data points to a global economy that is slowing as summer approaches in the northern hemisphere: a situation reminiscent of the global economy one year ago. Globally, the manufacturing sector has been at the forefront of the post global financial crisis (GFC) recovery, and while commentators and markets expected some slowing in the pace of manufacturing activity, recent data releases of manufacturing indexes in the US, Euro area and China confirmed the sector is slowing more rapidly than expectations. Global indexes of manufacturing sentiment, such as the JP Morgan Global Manufacturing PMI, have slumped to lows last seen this time last year. In response, global financial markets have lowered their risk appetites, with yields on 10year US Treasuries falling by around 70 basis points (bps) from their high point in early February, equity prices (as measured by the MSCI World Index in local currencies) falling by around 5 per cent and the US dollar devaluing by around 5 per cent against the major currencies.

While the recovery in global economic and financial markets experienced over the second half of 2010 was driven by a sharp expansion in US monetary and fiscal policy, US fiscal policy is now being determined by the need to stabilise public finances, and the US Federal Reserve (Fed) appears determined to end its second round of quantitative easing (QE2) on schedule in June. European fiscal policy is also being set to stabilise public finances and the European Central Bank has begun raising interest rates. Chinese and Indian authorities are tightening policy as they attempt to bring inflation under control. In the absence of a boost from fiscal and monetary stimulus, can the global economy sustain its post-GFC recovery?

To answer this question, we must first recognise how transitory factors such as the Japanese earthquake, adverse global weather conditions and political unrest in Northern Africa and the Middle East have contributed to the current soft spot in global economic growth. The passing of these factors will ease pressure on economic growth and investor sentiment, particularly in the second half of the year.

It should also be noted that the underlying economic fundamentals of the global economy today are considerably stronger than they were one year ago. For example, the increase in US private non-farm payrolls in the first five months of 2011 have averaged 2½ times the increase in experienced in the first five months of 2010. In capital markets, low interest rates and stable inflation expectations have reduced real interest rates, which are now negative along the US yield curve to 5 year maturity, and are providing a low real cost of borrowing to US businesses and households. In contrast, real yields were positive and rising one year ago.

Our view is that the current slowdown will not undermine the sustainability of the post-GFC economic recovery, and that growth will pick up in the second half of the year. However, as we have consistently maintained, this recovery will be tepid when compared to previous recessions, and the US government's need to reduce its budget deficit will create serious headwinds for the global economy for several years to come.

Tsunami-induced slump in Japanese economy worse than feared

Japanese national accounts data for the tsunami-affected March quarter showed a far worse impact than previously feared. Real GDP fell by 3.7 per cent on an annualised basis, compared to market expectations of a 1.9 per cent fall. With the likelihood of a similar hit to Japanese growth in the second quarter, and with ongoing problems with power supply, the near-term outlook for the world's third largest economy remains bleak.

However, there are some positive signs emerging. Motor vehicle production is starting to rebound, with Toyota, Nissan and Honda plants all reopening in mid-April. Car production in Japan is currently around 40-50 per cent of capacity, but car manufacturers expect production to return to normal by around November/December. While this is some time off, the implied growth rate in production over the remainder of the year is very high, given the current low level of output. Apart from the rebound in production, the rebuilding of destroyed capital stock will also boost growth in Japan in the second half of the year and in 2012.

Overall, our estimate is that the Japanese earthquake has shaved an annualised 0.2-0.5 per cent off global growth in the first half of the year, but will add 0.2 per cent to growth in the second half of the year and 0.1 per cent to growth in 2012.

Robust March quarter growth in the Euro area economy despite debt problems

While US March quarter national accounts data disappointed expectations, Euro area national accounts data for the March quarter showed the region enjoyed surprisingly strong economic growth with GDP growing at 0.8 per cent on a quarterly basis, significantly above market expectations. Core European economies Germany, France and the Netherlands all enjoyed robust growth and even Greece registered positive growth for the quarter.

Despite this growth, sovereign debt concerns in the European peripheral countries escalated over the month, with the risk that the European Union and International Monetary Fund may withdraw funding to Greece. The risk of sovereign debt meltdown among the peripheral European economies appears to have been averted for the time being, with the focus on the Greek government's plans for asset sales, reduction of public-sector employment and other austerity measures required to reduce debts.

Interest Rate Forecast (%)

	Level at 07 Jun 2011	Sep-11	QIC forecast Dec-11	Jun-12
Australia	4.75	5.00	5.25	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	0.75	1.00	1.50
Japan	0.00 - 0.10	0.00 - 0.10	0.00 - 0.10	0.00 - 0.10

Australian Economy

Australian exports hit by floods, but domestic demand remains robust

The March quarter national accounts showed the extent to which the Queensland floods affected the Australian economy, with coal exports falling by over \$5 billion in the quarter. The fall in national real GDP of 1.2 per cent surprised most forecasters, who, on average, were expecting a fall of 0.3 per cent two days before the data was released. We had expected a fall of 0.6 per cent.

The fall in export volumes of 8.7 per cent, which drove the decline in GDP growth, overshadowed robust growth in the components of domestic spending. Despite high household savings rates, personal consumption expenditure managed to increase by 0.6 per cent, only slightly below trend. Mining-led business investment experienced strong growth, with

expenditure on machinery and equipment rising by 6 per cent and non-residential construction up by 1.3 per cent. In aggregate, the components of domestic spending grew at an above-trend pace, highlighting the underlying strength of the domestic economy.

The outlook for consumer spending received a further boost, with April retail sales data showing a strong rebound in nominal sales of 1.1 per cent. Trade data also showed signs of recovery in the external sector with exports values rising by 1 per cent over the month of April. While the fall in coal exports of 6 per cent was disappointing, it must be placed in the context of the 37 per cent increase in the value of coal exports in March. As floodwater is cleared from Queensland coal mines and production is restored to capacity, coal exports will rebound and make a solid contribution to growth over the remainder of 2011.

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