30 November 2011

The Markets

International Equities

Equity market volatility continued during November. The MSCI All Countries World (ex Australia) Index fell -1.55% in local currency terms over the month. In unhedged Australian dollar (AUD) terms, returns were 0.32% for the month.

During November, the crisis in Europe continued to weigh on investor's risk appetite. With the Greek Prime Minister stepping down and the government committing to austerity measures, investors were initially optimistic that the Eurozone plan, the European Financial Stability Facility (EFSF) would stabilise markets. However, the focus moved to Italy and its large sovereign debt burden. Yields on Italian government bond debt rose sharply above 7% and as a result, the Italian Prime Minister was forced to stand down. European bond auctions saw weak demand with even Germany failing to generate sufficient interest in its debt. Equity markets fell sharply and by mid-month markets were down 7.5% in local terms. A bounce finally came late in the month as six major central banks including the European Central Bank (ECB) and the US Federal Reserve (Fed) announced measures to increase US dollar liquidity.

On the economic front, US unemployment fell to 9% and US consumer confidence rose sharply to 56 (historically still a very weak level). During the Thanksgiving period, retail sales rose to a record high, which supported US equity markets. Data out of Europe showed that austerity measures and poor confidence are now impacting the real economy. European retail sales fell 0.7% and German factory orders fell 4.3%. In emerging markets, economic data suggests that growth is also weakening. Brazilian gross domestic product (GDP) was flat in the third quarter and industrial production fell 2% in September. In China, overall growth remained strong; however, some manufacturing indicators weakened indicating mild contraction in the sector.

Most countries in developed markets weakened during the month. The exceptions were Denmark (6.6%), Ireland (5.1%) and Belgium (1.0%). The Greek market was again the worst performer (-18.2%). The Asian region was weak with Japan (-4.8%), Hong Kong (-7.2%) and Singapore (-6.0%) all underperforming. The UK (-0.2%) and US (-0.4%) markets slightly outperformed the broader market. Emerging markets underperformed developed markets over the month. South Africa (2.8%), Mexico (1.1%) and Russia (1.0%) were the only markets to post positive returns during November. India (-9.9%), China (-8.3%) and Egypt (-9.9%) were the worst performing markets.

Due to the close link to the European debt crisis, the financial sector (-5.8%) severely underperformed the broader market. Defensive sectors were the outperformers with utilities (0.3%), health care (0.6%) and consumer staples (1.84%) all posting positive returns. With the price of crude oil remaining high, the energy sector also managed to outperform.

Outlook:

The rather stable overall return outcome for global equities in November masks some high volatility driven by the ongoing concerns about the European debt crisis. At one stage, Europe was down almost 10% but rallied to finish the month almost flat. This degree of price movement is finding a way into share prices in the form of lower valuations. The US periodically appears as a safe haven only to be buffeted by concerns such as the Super Committee's inability to arrive at a bipartisan solution to its own deficit and debt situation. Similarly, the beacon of China has dimmed in recent times, with a range of data suggesting that growth there is waning.

Most equity markets now appear to offer reasonably solid long run returns however the risk of a systemic breakdown continues to lurk in the shadows. Quantification of this risk is impossible to do in a meaningful way. We believe the prudent approach is to adopt a cautious stance and be vigilant for fundamental changes whilst exploiting price volatility to our advantage.Most equity markets now appear to offer reasonably solid long run returns however the risk of a systemic breakdown continues to lurk in the shadows. Quantification of this risk is impossible to do in a meaningful way. We believe the prudent approach is to adopt a cautious stance and be vigilant for fundamental changes whilst exploiting price volatility to our advantage.

Australian Equities

The ASX 200 returned -3.49% during the month of November. Global uncertainty continued to drive the local market as European leaders struggled to put in place a credible plan to deal with their sovereign debt and banking crisis.

The ASX 200 returned -3.48% during November. Global uncertainty continued to drive the local market as European leaders struggled to put in place a credible plan to deal with their sovereign debt and banking crisis.
Once again global risk appetite played a key role. The first half of November saw the Australian market consolidate the strong gains made in October on the back of the EFSF announcement. However, late in the month, the market had fallen by 6.6% as yields on Italian government bonds surged above 7%, indicating investors were concerned with an Italian sovereign default. On the domestic front, the market was supported by the Reserve Bank of Australia (RBA) cutting the cash rate to 4.5%.

Economic data for Australia was mixed during the month. Positive releases included the creation of 10,100 jobs, a stable unemployment rate and positive retail sales (0.4% in September). Negative releases included weak credit growth (3.4% over the year to October) and declining home prices (-1.2% in the September quarter).

At the sector level it was defensive sectors such as health care (2.2%) and telecommunications (1.9%) that provided support to the market. The consumer discretionary (-3.8%) and energy (-4.3%) sectors modestly underperformed the market. The materials sector led the market lower, falling -6.4% on the back of concerns that the Chinese economy will expand at a slower rate in the future, as a result of weakening demand in Europe and a slowing domestic property market.

During November, Qantas grounded its entire fleet in retaliation to rolling strikes by its unionised workforce. This was the most dramatic form of industrial relation action seen in Australia in recent years. It served as a reminder that with domestic labour costs rising (5.3% year on year) and a strong Australian dollar, Australian companies will need to increase productivity in order to maintain their competitive advantage and profit margins.

Outlook:

Global factors are expected to continue to drive the local market. Australia is seen as a commodities exposure on the global investment stage, highlighted by the strong correlation between the domestic equities market and the Australian dollar. Indeed, even the perceived 'safe-haven' status is only as good as the largely resource-based fundamentals that underpin the country's economic strength.

In the long term, we are comfortable that domestic equities offer better than average returns. What will continue to weigh on prices in the short term though is the ongoing question mark over global growth, and thus demand for resource commodities. China - as one of Australia's largest customers - is the most immediate concern with slowing fundamental growth. The Chinese Government is committed to maintaining a strong headline GDP growth rate and therefore is becoming increasingly dependent upon its internal capital spending to maintain that rate.

The other major concern is Europe. The market now expects a sharp pullback in growth, but recent signs offer some hope that concrete and coordinated policy initiatives will eventuate and help stabilise the region.

Global Fixed Interest

Sovereign bonds were generally well supported through the month as prospects for global growth and risk assets remained highly uncertain. US 10-year Treasury yields moved 5 basis points (bps) lower to 2.07% and Australian 10-year bonds rallied 58 bps to 3.93%. In Europe however, a failed Bund auction pushed the German 10-yield up to 2.28% from 2.03% at the end of October.

Breakeven inflation levels moved lower in the US and Australia over the month and credit spreads widened. US investment grade credit spreads are now at 2.43%, while high yield spreads widened by 67 bps to 7.34%. Emerging market spreads also increased.

The RBS cut the cash rate by 25 bps to 4.50% in early November. The Governor, Glenn Stevens, noted in the interest rate decision that global growth is moderating and conditions are consistent with a more neutral monetary policy stance, as opposed to the mildly restrictive positioning over the past 12 months.

Outlook:

While yields across the core sovereign bond markets remain low and well bid through periods of equity market weakness, the failed Bund auction towards the end of November was the first sign of some core vulnerability. Despite coordinated central bank action to keep rates low, there remains limited further upside for these bonds and returns in the medium and long term are expected to be low.

During the month, breakeven inflation moved to levels at which it was attractive to add exposure. Going forward, further volatility in risk assets may bring more opportunities. Similarly, credit spreads are now at levels that imply a higher than normal level of defaults, despite strong corporate balance sheets. Further dislocation in these markets in the period ahead might provide some opportunity for good risk-adjusted returns.

Currencies

The rise in financial market risk aversion supported the safe-haven currencies of the yen and US dollar (USD) over the month, with both currencies appreciating against most major currencies. The British pound fell 2.6% against the USD, affected by quantitative easing by the Bank of England, while the euro fell by 3.5%, as European Union policy makers struggled to address the euro area debt crisis. With market confidence over the outlook for global growth undermined by developments in Europe, the Australian dollar (AUD) fell below parity against the USD, reaching a low of US$0.97. However, later in the month the AUD rallied, as German Chancellor Merkel and French President Sarkozy rekindled hopes that EU leaders would deliver substantive policies at the Brussels summit on 8-9 December.

Outlook:

Our estimates of purchasing power parity (PPP) suggest that the US dollar remains slightly undervalued. The US dollar is outside its fair value ranges based on PPP against the AUD and yen, and remains within its fair value range against the euro and GBP.

We expect the US dollar to strengthen only modestly from current levels, based on the valuation signal from our PPP models. Offsetting 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 where the valuation signal is strongest.

Financial markets (%)

Sharemarkets	Level as at 30-Nov-11	1 month return	3 month return	Financial YTD return	1 year return
Australia (S&P/ASX 200)	4119	-3.48	-2.83	-8.47	-5.99
Developed World (MSCI World ex Aust.)	829	-1.20	0.79	-8.70	-0.49
World (MSCI AC World ex Aust.)	315	-1.55	0.31	-8.96	-1.65
US (S&P 500)	1246	-0.22	2.90	-4.67	7.83
UK (FTSE 100)	5505	-0.15	2.93	-5.93	3.19
Europe (MSCI Europe ex UK)	785	-1.77	0.90	-15.24	-8.61
Japan (Topix)	728	-4.65	-4.52	-13.33	-13.37
Currencies					
Australian Dollar/US Dollar	1.03	-3.17	-4.08	-4.04	7.12
Australian Dollar/Euro	0.76	0.33	2.60	3.35	3.58
Australian Dollar/Yen	79.75	-3.60	-2.62	-7.76	-0.73

Sharemarket returns are inclusive of dividends, in local terms.

Economist's View

Key Points

- Markets push for response from EU policy makers
- Merkel and Sarkozy seek solution to debt crisis ahead of EU summit
- Australian economic growth recovers from floods as mining expenditure ramps up
- RBA cuts rates in fear of headwinds from Europe

International Economies

Markets push EU policy makers to respond

Financial market uncertainty rose over November, as Europe's political stalemate continued to drag on without a satisfactory solution and the US Joint Select Committee on Deficit Reduction failed to agree on US$1.5 trillion in budget savings by the November 23 deadline. The crisis in Europe led to the fall of the Greek and Italian governments and their replacements with technocratic governments charged with implementing fiscal austerity packages.

However, changes of governments in Italy and Greece were not sufficient to calm markets and sentiment was shaken as European banks faced escalating funding costs and as ratings agency Standard and Poor's downgraded financial institutions across the global economy. The growing crisis led to coordinated central bank action to enhance liquidity in the global financial system. The intervention by central banks buoyed sentiment, with global equity markets recovering around 3per cent in response. Market sentiment continued to improve over the final week of November, following positive labour market and business sentiment reports from the US, announcements of further fiscal austerity measures by Italy and growing optimism that European Union (EU) policy markers will push closer towards binding agreements over fiscal policy at their 8th – 9th December summit meeting.

Merkel and Sarkozy seek solution to debt crisis ahead of EU summit

As the deadline for the EU summit approaches, German Chancellor Merkel and French President Sarkozy sought to find agreement over terms to impose greater fiscal control over EU member states, as well as set conditions over funding arrangements for the EU. Tension over funding arrangements had been a sticking point between the two largest countries in the EU, with the French favouring the establishment of a common Eurobond, but against private sector involvement (PSI) in debt restructures, while Germany opposed the Eurobond but favoured PSI. A compromise was reached whereby the French dropped their demand for the Eurobond and the Germans retracted their call for PSI.

The summit now seems focused on achieving legally binding agreements over fiscal policy in an attempt to impose fiscal discipline on member states and to move closer to fiscal union. In terms of funding arrangements for distressed sovereigns, the emphasis is on moving forward the long-term European Stability Mechanism (ESM) from 2013 to 2012. Greater clarity on the role of the European Central Bank (ECB) is also emerging. It seems clear that the ECB's mandate is to secure the stability of the banking system, rather than moving towards a position of lender-of-last-resort to EU governments. ECB President Draghi reinforced this message during his press conference following the ECB Governing Council's decision to lower the main refinancing rate by 25 basis points (bps). With the ECB seemingly out of the picture, in terms of providing ongoing support to the bond markets, and the establishment of Eurobonds sidelined for the time being, the question remains, 'how will the EU provide funding for distressed governments?'

Interest Rate Forecast (%)

	Level at 09 Dec 2011	QIC forecast Mar-12	Jun-12	Dec-12
Australia	4.25	4.25	4.25	4.25
US	0.00 - 0.25	0.00 - 0.25	0.00 - 0.25	0.00 - 0.25
Canada	1.00	1.00	1.00	1.00
Europe	1.00	0.75	0.50	0.50
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 economic growth recovers from floods as mining expenditure ramps up

Recent economic data confirmed that the mining investment boom has commenced. National accounts data for the September quarter showed that real gross domestic product (GDP) increased by 1 per cent, with revisions to previous quarters lifting annual GDP growth from 1.9 per cent to 2.5 per cent. Mining expenditure led to 12.9 per cent growth in business investment, while household consumption increased by a solid 1.2 per cent; despite a rise in the savings rate.

However, not all data depict compellingly positive prospects for the economy. The economy unexpectedly shed 6,300 jobs in November, lifting the unemployment rate to 5.3 per cent. The decline in jobs and the rise in the unemployment rate more likely flagged employer caution in response to the crisis in Europe, rather than an indication of a weakening in domestic economic activity. Consistent with this interpretation is the composition of employment that saw businesses transition 39,990 full time jobs into 33,600 part-time jobs. The housing sector also continues its sluggish performance with building approvals slumping by nearly 11 per cent in October, extending the 14 per cent fall in September. However, recent rate cuts by the Reserve Bank of Australia (RBA), which have been passed on to mortgage holders by the banks, should help stabilise the housing market in the New Year.

While we recognise the risks to global growth from a break up of the euro area and the crowding out effects of the mining boom, we expect consumer spending and mining investment to continue to drive strong growth in the last quarter of 2011. Based on retail sales data, consumer spending is on track to rise by around ¾ to 1 per cent in the December quarter. Combined with ongoing strength in business investment, our forecast for real GDP growth in the December quarter is a solid 1 per cent.

RBA cuts rates in fear of headwinds from Europe

Despite its firm assessment of the domestic economy, the RBA decided to lower the official cash rate by 25bps to 4.25 per cent at its December Board meeting, marking the second consecutive month of policy easing. Ongoing uncertainty in financial markets, particularly in light of European sovereign debt and banking problems, and the benign inflation outlook afforded scope for the Bank to cut rates. In terms of the outlook, the prospect for further rate cuts at RBA's next meeting in February depends on developments in Europe. If the situation in Europe stabilises, we expect the RBA to remain on hold. Clearly, if the situation deteriorates, the RBA will once again lower rates.

QIC Limited ACN 130 539123 ("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(Cth) ("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. 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. Past performance is not necessarily indicative of future performance. 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. Copyright QIC Limited, Australia 2011. All rights are reserved. Do not copy, disseminate or use, except in accordance with the prior written consent of QIC.