

31 October 2011

The Markets

International Equities

Equity markets staged an impressive relief rally in October as sentiment improved for global risk assets. The Morgan Stanley Capital International (MSCI) All Countries World (ex Australia) Index strengthened 8.67% in local currency terms over the month. In unhedged Australian dollar (AUD) terms, returns were 1.23% for the month.

In October the market remained driven by developments in the Euro zone. European leaders managed to put in place a plan to solve the European sovereign debt crisis; the key factor being a substantial increase in the size of the European Financial Stability Facility (EFSF). Initially, markets rallied strongly on news of the deal, which appeared to exceed expectations and remove uncertainty. European markets were the largest beneficiaries as it sought to address systemic risk within the European banking sector. The deal also attempted to alleviate Greek budget pressures by allowing a write down of a portion of its sovereign debt.

Global economic data released during October showed a global economy growing modestly and remaining resilient. US third quarter gross domestic product (GDP) was in line with expectations at 2.5%. Chinese data showed that the economy remained strong with retail sales (17.7% year on year) and industrial production printing (13.8% year on year) ahead of expectations.

Most countries in developed markets enjoyed a strong rally during the month. The major outperformers were Hong Kong (12.3%), Germany (11.7%) and the US (10.9%). Countries with high sovereign risk continued to underperform over the month with the Greek market falling 7.8% and Portugal remaining flat. The Japanese market (0.9%) failed to participate significantly in the rally as the strong yen held down export-related stocks. Emerging markets performed broadly in line with developed markets over the month. Peru (15.2%), China (14.9%) and Russia (12.9%) were the strongest performers with Turkey (-7.5%) and Morocco (-1.8%) the only markets to post negative returns.

At the sector level, it was industries exposed to global growth that outperformed energy (14.4%), materials (10.7%) and industrials (10.5%) all led the market higher as investors took a more positive view on the global economy. Defensive sectors were the underperformers with utilities (1.9%) and telecommunication services (3.5%) underperforming the benchmark.

Outlook: We continue to live in a world of volatile investment markets driven as much by news as fundamental developments. October was no exception, when news of a plan to address the consequences of fundamental problems (sovereign debt and fiscal deficits) in the European Monetary Union saw a major relief rally in global equities. At the time of writing, uncertainty remains on the practicalities of the 27 October Greek rescue plan, in particular the size of the private sector investors' haircut. It is also unclear whether the massive austerity measures required will be socially palatable and lead to political instability. Moreover, there is a strong risk of a debt-recession down spiral, accentuating the risk of default. Finally, contagion to other fragile Euro zone economies is a risk.

QIC Strategy maintains a focus on longer-term valuations and sees volatility as opportunity. Global equity valuations are generally attractive but mixed across the various countries and regions. Valuations are affected by events and the focus now is to distinguish market noise from real fundamental developments. This underscores our continuing cautious approach of exploiting opportunity as and when it presents.

Australian Equities

The ASX 200 returned 7.25% during October. The local market bounced strongly in line with global risk markets and continued to be driven by news of the European sovereign debt crisis.

On the domestic front, soft inflation figures increased the chance of an interest rate cut by the Reserve Bank of Australia (RBA). The retailing environment also showed signs of improvement with retail sales increasing by 0.6% in August ahead of expectations of a 0.2% rise and positive revisions to July figures. This led to strong performance in the retail sector. Over the month WTI crude prices rose 17.6% in US dollar terms, supporting companies in the energy sector. Strong economic data from China helped alleviate fears in the domestic market of a slowdown in Australia's key trading partner.

All sectors in the market (with the exception of telecommunication services) delivered positive performance in October. The energy (12.3%) and financial (9.3%) sectors led the market higher. Defensive sectors such as telecommunication services (-0.1%), consumer staples (0.3%) and healthcare (0.9%) were the underperformers.

While the market's attention was focused on the global economy, October's domestic economic data was also supportive of a reasonably firm domestic growth outlook. The unemployment rate dropped back to 5.2% in September, as the economy added 20,400 jobs.

Outlook: Despite the October bounce, Australian equities continue to be attractively priced relative to many of their global counterparts. This market, however, is not immune to Europe and the risk of a shock to the financial system persists. Europe remains a key export market for China and its weakness influences on Chinese growth. We still maintain our positive long-term view of China and believe it will continue to support Australian shares, in particular our key resource exports. We do not, however, believe that it will be a smooth ride, and there will be speed bumps along the growth path, with potential excesses including the current suspected property bubble. These concerns are not exclusive to QIC and are reflected in the subdued performance of Chinese shares over recent months.

These fears have had an impact on the Australian sharemarket, and in particular the resources sector by keeping downward pressure on the valuations of those stocks. In the meantime both financials and industrials have been hampered by concerns of domestic growth. As a consequence, equity valuations remain subdued, and we continue to approach Australian equities with cautious optimism.

Global Fixed Interest

After rallying for six consecutive months, global bonds retraced in October while risk assets gained across the board. US 10-year Treasury yields increased by 20 basis points (bps) to 2.11%, while German Bunds sold off by 14 bps to 2.03%. Australian 10-year bonds were not removed from the sell-off, with yields rising by 29 bps to 4.51%.

Inflation expectations increased over the month, with breakeven levels moving higher in Australia and the US. Credit spreads narrowed as confidence improved, with US high yield credit spreads moving in 140 bps to 6.67%, a level not seen since early August. Investment grade credit spreads also tightened, moving in 36 bps to 2.02%. USD - denominated emerging market debt similarly rallied.

The RBA kept its target rate steady at 4.75% in October, although in early November the cash rate was cut by 25 bps. RBA 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: Despite the October sell-off, there remains little pressure for core bond yields to rise materially despite yields being close to record lows. In Australia we saw an interest rate cut and there is the potential for further stimulus if the global growth situation continues to deteriorate. With continued uncertainty in the Euro zone, the European Central Bank (ECB) also cut rates by 0.25% in November. The US Federal Reserve (Fed) previously pledged to keep rates around zero until the middle of 2013 and continues to employ unconventional monetary policy to keep yields low.

In the shorter term, the US Congress Debt 'super committee' is due to make its recommendations for deficit reduction by the end of the month. Its bipartisan nature is expected to result in little agreement about the path forward, which could have implications for the US Government's credit rating and growth outlook. Nevertheless, the adverse impact this would have on risk assets is more likely to see core bond markets gain support.

Overall, expected medium and long-run returns from the core sovereign bond markets remain depressed and are expected to struggle to keep pace with inflation. Bonds are now priced for limited gains.

Currencies

Following the sharp rise in risk aversion in the September quarter, sentiment improved markedly during October, with global equity prices recovering. The decline in risk aversion led to a fall in the traditional safe-haven currencies of the USD and yen. On a trade-weighted basis, the USD fell by 3% in October (and by almost 6% peak to trough), while the yen fell by 1.1% against the USD. The improvement in market sentiment largely hinged upon the announcement of the plan by EU leaders to prevent a banking collapse in the European region and provide further support for Greece, which was received favourably. However, economic data releases from the US were also supportive, with September quarter GDP accelerating to an annualised rate of 2.5% and non-farm payrolls exceeding expectations to rise by 103,000 in September, both indicating that the US economy remains far from recessionary at this stage.

As a result of the improved data and sentiment toward Europe (including the EU Greek rescue plan), commodity prices recovered, with the price of oil rising by nearly 18% to around US\$93 per barrel over the month, and metals prices also rising strongly. This strengthened the commodity currencies, with the AUD rising by 9.2% and the Canadian dollar (CAD) up by 4.9% in the month. The AUD has been exceptionally volatile recently, trading from a low point of US\$0.952 in early October to US\$1.073 at the end of October. This volatility was highlighted by the RBA in its statement following the 25 bps rate cut in early November. Such volatility makes the task of setting monetary policy more difficult, as forecasts for growth and inflation vary significantly depending on the exchange rate path. For example, if the AUD were to sustain a level around its highs of US\$1.10 which it reached in July, the theory is growth and inflation will be weak enough to justify a further rate cut from the RBA. However, if the AUD were to fall below parity for a sustained period, then growth and inflation would likely be sufficiently solid to keep rates on hold, or require a tightening of policy. Volatility such as we have seen recently increases the chance of the RBA keeping rates on hold, so as not to further add to volatility. Our view is that the AUD will remain overvalued on a purchasing power parity (PPP) basis against the USD over the medium term, supported by the favourable interest rate differential, creating a necessary brake on growth and inflation.

The heightened level of uncertainty, particularly over the outlook for Europe, continues to impact the US/euro exchange rate, which also traded in a relatively wide range throughout October. While rising by 4% over the month, the euro traded from a low of US\$1.33 in early October to a high of US\$1.42 after the announcement of the European Union (EU) package. The Great British pound (GBP) rose 3.6% against the USD in October, despite the Bank of England's announcement that it would expand quantitative easing in the UK by purchasing an additional £75 billion of gilts over the next four months.

Outlook: Our estimates of purchasing power parity (PPP) suggest that the USD remains slightly undervalued. The USD 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 USD 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 USD over the forecast horizon, especially against the AUD where the valuation signal is strongest.

Financial markets (%)

Sharemarkets	Level as at 31-Oct-11	1 month return	3 month return	Financial YTD return	1 year return
Australia (S&P/ASX 200)	4298	7.25	-1.25	-5.18	-3.65
Developed World (MSCI World ex Aust.)	841	8.60	-5.08	-7.59	0.43
World (MSCI AC World ex Aust.)	320	8.67	-5.25	-7.53	-0.50
US (S&P 500)	1253	10.93	-2.47	-4.45	8.09
UK (FTSE 100)	5544	8.20	-3.74	-5.79	0.99
Europe (MSCI Europe ex UK)	801	7.59	-8.60	-13.71	-10.46
Japan (Topix)	764	0.38	-8.25	-9.10	-3.54
Currencies					
Australian Dollar/US Dollar	1.06	9.16	-3.41	-0.90	8.24
Australian Dollar/Euro	0.76	5.01	-0.49	3.01	7.86
Australian Dollar/Yen	82.73	10.43	-2.43	-4.32	4.78

Sharemarket returns are inclusive of dividends, in local terms.

Economist's View

Key Points

- Investor sentiment improves in October, but market volatility remains elevated
 - EU develops new rescue plan, but Greece continues to undermine regional stability
 - US to avoid recession, but test to growth prospects in 2012 is fast approaching
 - RBA lowers cash rate as inflation drops and global economic outlook deteriorates
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International Economies

Investor sentiment improves in October, but market volatility remains elevated

Having reached a year low on 3 October, global equity markets rebounded strongly over the rest of the month, prompted by European policymakers' plans to recapitalise banks, augment the European Financial Stability Facility (EFSF) and provide further support to Greece. Market sentiment was also buoyed by positive economic data from the US, easing fears that the world's largest economy was poised to lapse into recession. The reduction in risk premia was felt across all asset classes, with government bond yields, equity prices, commodity prices and commodity-related currencies experiencing increases.

Despite this, market volatility remains elevated. The VIX index, a measure of volatility in the US market, remains around 30, about twice its pre-August level. So although equity markets have been trading slightly above the high point of the post-July range in the last two weeks, investor confidence is still extremely shaky.

EU develops new rescue plan, but Greece continues to undermine regional stability

Three key factors originally drove market sentiment lower: (i) the US debt ceiling debacle and the resulting downgrade of US sovereign debt by Standard & Poor's, (ii) the fear of the US slipping back into recession and (iii) concerns over sovereign defaults in Europe.

Of these three risks, the market is now clearly focused on the problem of sovereign default in Europe. In October, European Union (EU) policymakers made gradual progress in designing a package that bolstered European banks and provided relief to Greece's debt problems. The new measures include: (i) further support to Greece with a new €100 billion EU–International Monetary Fund (IMF) program to be implemented by the end of the year and an agreement by private sector creditors to take a 50 per cent hair cut on their holdings of Greek debt, (ii) an increase in the EFSF to limit the spread of contagion by providing insurance to private investors of new sovereign debt, and/or the creation of a Special Purpose Vehicle with additional funding coming from private and public investors to increase the firepower of the EFSF, and (iii) a scheme to recapitalise banks across the region, lifting banks' core tier 1 capital ratio to 9 per cent.

While the plan is a welcome sign that EU policymakers are coming to grips with the severity of the problem and should help reduce current market dislocations, it is not a permanent solution to the crisis. A number of European countries, notably Greece, Portugal, Ireland, Spain and Italy have to continue to implement severe fiscal austerity programs to place their public finances back on a sustainable basis. Politicians will come under increasing pressure from a disgruntled public about the extent of the cutbacks. For instance, towards the end of October we witnessed Greek Prime Minister Papandreou propose a referendum on whether to accept the EU-IMF funding program and associated fiscal austerity measures associated with it. Confronted with German and French pressure, dissent among cabinet ministers and the opposition's eventual support of the bail-out, the Greek Prime Minister reversed his decision to hold the referendum. However, the inability of European governments to guarantee unconditional adherence to austerity plans will continue to threaten EU stability. As a consequence, the risks of sovereign default and associated market instability are likely to remain with us for the next few years.

US to avoid recession, but test to growth prospects in 2012 fast approaching

As we expected, a rebound from temporary factors, such as the hit to the auto industry from the Japanese tsunami, has been occurring. September quarter gross domestic product (GDP) accelerated to an annualised rate of 2.5 per cent, and data for October indicates the economy is holding up well into the end of the year. We expect US real GDP to grow at an annualised rate of 2.7 per cent in the December quarter, with the result that the US economy will have grown slightly above trend in the second half of the year.

The next test for the US economy looms in the first quarter of 2012. Here, the critical issue is whether or not President Obama manages to pass his US\$447 billion Jobs Plan stimulus package through Congress. If he is successful in at least getting the proposed US\$245 billion payroll tax cuts passed, the outcome will be enough to sustain US growth at around trend pace in the first half of the year; if not slightly above trend. If he is unsuccessful, activity will fall below trend, the unemployment rate will rise and concerns over the growth prospects of the US economy will once again weigh on market sentiment.

Interest Rate Forecast (%)

	Level at 07 Nov 2011	Dec-11	QIC forecast Mar-12	Sep-12
Australia	4.50	4.50	4.50	4.75
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	1.25	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

RBA lowers cash rate as inflation drops and global economic outlook deteriorates

At its November Board meeting, the Reserve Bank of Australia (RBA) cut the official cash rate by 25 basis points (bps) from 4.75 per cent to 4.5 per cent. The RBA cited the moderation in inflation and confidence (outside the resource sector) as reasons for lowering the official cash rate. While the RBA is concerned with weak economic activity outside the mining sector, retail trade data showed that consumer spending is not collapsing as some commentators had feared. Retail sales volumes grew at a quarterly rate of 0.6 per cent over the September quarter, with monthly data showing ongoing momentum into the end of the year. Given the pick up in auto sales and estimates of household purchases of services, we estimate that real personal consumption expenditure will grow at around trend over the second half of 2011. Combined with ongoing strength in business investment from the mining sector, economic activity in Australia should remain robust and we are forecasting that real GDP growth will remain slightly above trend for the remainder of 2011 and over 2012 and that the RBA will keep rates on hold until towards the end of 2012.

Although our central view is that the RBA will not need to cut rates further, we recognise that the potential exists for another rate cut by early next year. The RBA's latest forecasts have underlying inflation (ex carbon price) averaging 2.5 per cent over the next 18 months. Consequently, any further deterioration in the global growth outlook is likely to prompt the RBA to lower its inflation outlook towards the bottom of the 2-3 per cent target band and trigger another 25 bps rate cut.

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