Market Watch

September /October 2011

above the line

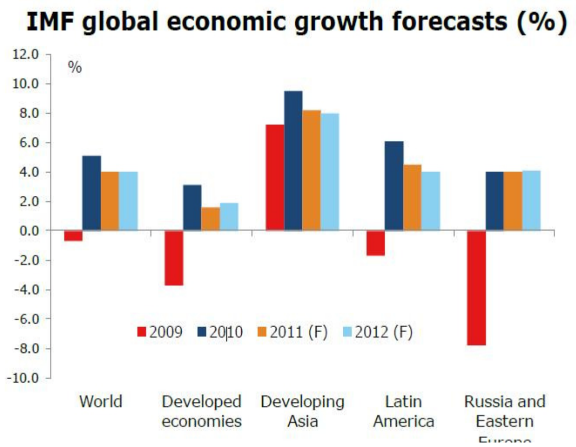
MODORAS Financial Performance Group

Key Points

- Global economic growth downgrades, heightened concern about European sovereign debt and further stimulus by the Federal Reserve dominated news in September.
- Risk assets continued to sell off given the macroeconomic environment, with investors flocking to US Treasuries and German bunds.
- The gold price also sold off, falling 11.2% to US$1,628/ounce. It had reached a high of US$1,900/ounce on 5 September 2011.
- Other safe haven assets included both the yen and Swiss franc. Both countries announced currency intervention measures to lower the value of their currencies.
- The US dollar rallied over the month, with the spot index rising 6% in September, to the highest level since January this year.

Economic overview

The International Monetary Fund (IMF) downgraded global economic growth in 2011 and 2012 to 4% (was 4.3% and 4.5% respectively). This is down from 5% in 2010. In particular, these downgrades were focussed on weaker growth in the US and Europe with the IMF describing the situation as “the global economy is in a dangerous new phase”. See chart of forecasts.



In Europe, the European Central Bank (ECB) continued with unconventional measures with the reopening of USD swap lines as some European banks struggled to attract USD financing. The ECB continued its Securities Market Program, now owning €160bn of Greece, Italian, Irish, Portuguese and Spanish government bonds to assist liquidity in government bond markets.

This was not enough to prevent heightened concern over Italian government debt, with 10- year yields rising from 5.14% at end of August to 5.49% at end of September. Both Moody’s and Standard & Poor’s downgraded the sovereign rating of Italy. Moody’s downgraded Italy by three notches to A2 after a lengthy review. S&P downgraded Italy from A+ to A.

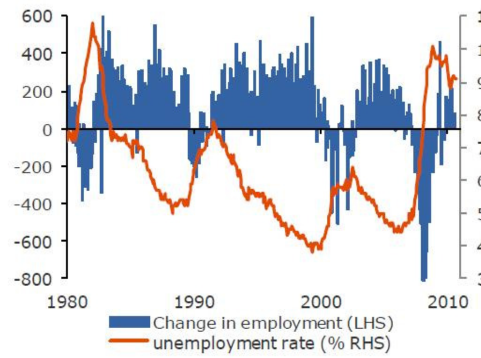
Greece continued to make headlines, with the next tranche of bailout funds now delayed until mid-November to ensure compliance with IMF/EU requests. Greece admitted it would miss budget deficit targets for 2011 and 2012. Greece’s 2011 deficit is now expected to be 8.5% of GDP (versus the 7.6% target) with 2012 expected to be 6.8% of GDP (versus the 6.5% target). The economic outlook has also worsened with a contraction of 5.5% in 2011 versus projections of 3.8%. Further austerity measures have been announced in Greece, including new property taxes, pension reforms and public sector job cuts.

There is growing expectation within financial markets of an orderly Greek default given the inability to implement austerity measures in a deteriorating economic environment.

President Obama announced plans for a US$447bn jobs package, including extension to the payroll tax holiday, extension of unemployment benefits, aid for state and local governments and infrastructure spending. Debate over this package continues between the Democrats and Republicans, with no certainty the package will be passed.

Economic data out in September reflected the lower economic growth outlook now expected in financial markets. One clear indicator of this was a flat US employment number with no jobs created in August. The unemployment rate held steady at 9.1%. See chart for details.

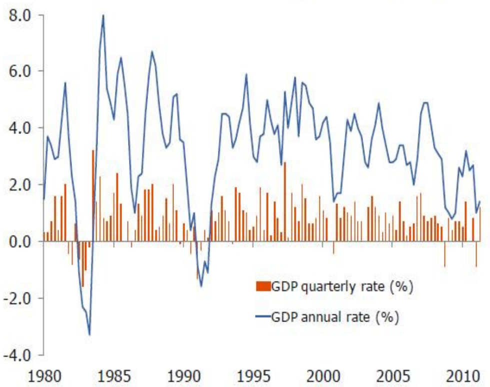
US employment growth and unemployment rate (%)



Source: Bloomberg. Data to 30 June 2011

In Australia, Q2 GDP data was released, indicating the Australian economy grew by 1.2%. This followed a 0.9% natural disaster induced contraction in Q1. Economic growth during the quarter was driven by household final consumption spending up 1.0% (contributing 0.5% points to growth), private sector capital spending also up 1.3% (contributing 0.1% to growth), while public sector capital spending fell 3.8% as stimulus spending wound down. The annual growth rate remains a sluggish 1.4%. See chart for details.

Australian economic growth (%)



Source: ABS. Data to 30 June 2011

The unemployment rate in Australia increased to 5.3% over the month, up from 4.9% earlier in the year. The pace of employment growth has slowed considerably and led to question marks about the pace of wages growth outside the mining and gas sectors. Trade data continues to surprise on the upside, with the trade surplus for August the second highest on record at $3.1bn. This was largely driven by an increase in the volume of iron ore and coal exports, as well as non-monetary gold exports.

Australian shares

September saw the sixth consecutive monthly decline in the Australian share market. The S&P/ASX 200 Accumulation Index traded in a fairly wide range and declined by 6.1% in the month as a whole.

Sentiment continued to be dominated by offshore events rather than domestic economic indicators and company news flow. Defensive areas of the market continued to outperform, while those companies whose earnings are more correlated with economic activity tended to struggle.

The Materials sector was a notable example, declining in value by 12.5% during the month. The Energy and Industrials sectors were other notable underperformers.

Since most companies had updated the market in August during the earnings reporting season, there was limited company news released.

Foster's Group did, however, accept an improved takeover proposal from UK-based brewer SAB Miller, while the proposed takeover of toll road operator ConnectEast Group was approved by shareholders. The stock will be delisted in early October.

Conglomerate Wesfarmers sold a small part of its coal business during the month, while National Australia Bank was rumoured to be considering a sale of its Clydesdale business in the UK.

Global shares

Global equity markets fell sharply in September on continuation of sovereign debt concerns and lower economic growth forecasts. Investors continued to move out of risk assets and into US Treasuries, despite further stimulus by the Federal Reserve, with US bond yields falling sharply over the month.

Equity market volatility led to Spain, Italy and France extending the short selling ban that was implemented in August in an attempt to restore calm to markets.

The MSCI World Net Index fell 8.9% in US$ terms. Over the past three months the Index is 17.1% lower. In A$ terms, the Index returned 0.4% given a sharp 9.2% fall in the A$ over the month.

The Dow fell 6.0%, the S&P 500 was down 7.2% and the NASDAQ fell 6.4%, with all markets trading with considerable volatility over the month and intra-day. Out of 21 trading days, there were 14 days of moves greater than 1% in either direction.

European markets were weaker; with the Financial sector the hardest hit with rising concerns in particular over French banks. The CAC Index fell 8.4%, after falling 11.3% in August. French banks are among the largest holders of Greek government debt.

The German DAX fell 4.9% after recording losses of 19.2% in August, the largest loss since September 2002. Spain (-2.0%) and Italy (-4.2%) also experienced falls.

Economic growth in Europe has stalled with many economists now expecting a recession late in 2011 and into 2012. EU GDP growth was just 0.2%/quarter and 1.6%/year. The Greek sharemarket fell 12.8% in September after falling 23.9% in August on further austerity measures and a weaker growth outlook.

In Asia, markets recorded losses across the board. Japan (-2.9%), Hong Kong (-14.3%), Singapore (-7.3%), South Korea (-5.9%), Taiwan (-6.7%), Thailand (-14.4%) and Malaysia (-4.2%) all recorded losses.

In terms of sector performance, the Materials sector was the worst performer, down 17.7%. Commodity prices fell sharply on lower global economic growth forecasts and concerns that the Chinese economy was slowing faster than expected.

Commodity price moves included copper (-24.3%), lead (-23.1%), nickel (-20.7%), zinc (-18.9%) and tin (-17.9%). There were expectations that some of this selling was driven by ETFs and margin calls for equities.

Other sectors to record sharp falls included Energy (-12.5%), with the oil price falling 10.8% over the month. Financials fell 11.5%. Defensive sectors such as Utilities (-2.5%) and Telecommunications (-4.8%) outperformed but still fell.

Global emerging markets

Emerging markets fell sharply lower in September and significantly underperformed developed equity markets. There were rising concerns over the impact of emerging economies from developments in the US and Europe, particularly the outlook for Chinese economic growth.

The MSCI Emerging Markets Index fell 14.8% in US$ and 6.1% in A$ terms. The largest falls in emerging equity markets occurred in Russia (-19.5%), Argentina (-17.5%) and Hungary (-14.6%). Other falls included the Czech Republic (-10.9%), Brazil (-7.4%), the Philippines (-6.0%) and Mexico (-6.2%). Turkey (+10.4%) and Saudi Arabia (+2.2%) both rose.

Fixed interest

Global bond markets saw sharp falls in yields (prices rose) in September. Most developed world bond markets were boosted by the continued „flight to safety‟ from riskier assets as investors‟ confidence continued to be eroded by a vicious circle of declining equity markets, falling liquidity and credit availability, and a deteriorating global economic outlook.

Market participants continued to focus on the policy makers‟ responses to the European sovereign debt crisis and recessionary concerns in the US.

The Europeans continued to ratify the increase to the European Financial Stability Fund (EFSF) to €440bn, although there is growing expectation this will eventually need to be lifted to €2trn through leverage to cope with bank recapitalisations, a Greek default and assistance for liquidity in Italian government bonds.

However, the slow response to the crisis in Europe and concerns over the credibility of some policies contributed to ongoing market disappointment with investors driving down 10-year US Treasury yields to a record low of 1.72% on 22 September. Eventually, yields finished the month at 1.92%, down by 30 bps from August month-end.

The ECB kept its key policy rate unchanged at 1.5% in September, but signalled a change in its stance to neutral from its previous tightening bias. The change was a product of the recent turmoil in eurozone financial markets and declining upside inflation risks. German 10-year bunds declined by 33 bps to 1.89% at September month-end.

In the UK, the Monetary Policy Committee voted 9-0 to leave the Bank of England rate at 0.5%. The Committee signalled a clear bias towards further quantitative easing (QE2) as “most members thought that it was increasingly probable that further asset purchases to loosen monetary conditions would become warranted at some point”. The UK 10-year gilt yield decreased by 39 bps to 2.43% at month-end.

The Australian bond market saw yields fall (prices rise) in September for a ninth consecutive month (including a virtually unchanged June) with the downtrend in yields driven largely by weak sentiment about the domestic and global economic outlook, together with concerns over European sovereign debt risk.

Over the month, domestic bond markets continued to price in aggressive monetary policy easing by the Reserve Bank of Australia (RBA).

Furthermore, the bond market continued to be supported by demand from overseas central banks and offshore institutional investors lured by the developed world’s highest government bond yields, strong liquidity and the relative safety of the AAA-rated Australian government bond market, given the country’s sound fiscal position.

Australian 10-year Commonwealth Government Security (CGS) yields fell by 15 bps to 4.22% at September-end, having ended the previous month at 4.37%.

The downward movement in 10-year CGS yields tracked global market movements, which were driven by events in Europe and the US.

During the month, amid the offshore market turmoil, ratings agency Standard & Poor's (S&P) affirmed Australia's long-term sovereign rating as AAA with a stable outlook.

The RBA retained its official cash rate at 4.75% as widely expected at its September meeting. The post-meeting statement and minutes highlighted the risks to the global growth outlook given, the recent bout of uncertainty in financial markets and the prospects for weaker economic growth in both Europe and the US.

The early October meeting signalled a move to an easing bias highlighting that "an improved inflation outlook would increase the scope for monetary policy to provide some support to demand, should that prove necessary".

Listed property

A-REITs (-4.5%) outperformed the broader S&P/ASX 200 (–6.1%) by 1.5% in September, although still recorded a negative return.

The REITs were more defensive than the wider market in a volatile period for equity markets. To date in calendar year 2011, A-REITs have outperformed Australian equities by 7.4%.

September was a fairly quiet month for stock specific news. Key A-REIT news included Mirvac Group's announcement of the sale of 50% of its Hoxton Park project for $97.4m on 7.5% yield in addition to announcing plans to sell off four further assets.

In other stock news, Westfield Group opened its £1.8bn Stratford City retail project and Australand Property Group announced $550m of new bank debt at an average term of 4.3 years.

The UBS Global property investors' index (local currency) decreased 9.4% over the month of September, with Japan the top performing region (-4.2%) followed by Australia (-4.5%). The worst performing regions were the US & Canada (- 10.6%) and Continental Europe (-8.9%).

Index Returns

	Index Level in Base Currency	1 month	12 month
S&P/ ASX200 Index	4,009	-6.7%	-12.5%
S&P / ASX 200 Accumulation Index	30,239	-6.1%	-8.6%
Sector		0.7%	-4.7%
MSCI World Net Index AUD Hedged		-6.0%	-1.6%
Dow Jones Index	10,913	-6.0%	1.2%
UK FTSE 100	5,128	-4.9%	-7.6%
German DAX Index	5,502	-4.9%	-11.7%
France CAC Index	2,982	-8.4%	-19.7%
Japan – Nikkei	8,700	-2.8%	-7.1%
Hong Kong – Hang Seng	17,592	-14.3%	-21.3%
MSCI Emerging Markets Net Index (AUD)		-5.9%	-16.5%
US 10 year bond yield	1.92%	-31bps	-59bps
Australia 10 year bond yield	4.22%	-15bps	-74bps
UBS All Maturities Composite Bond Index	6,787	0.9%	9.0%
90 Day Bank Bill Index	4.92%	5bps	-9bps
UBS Australian Bank Bill Index	7,353	0.4%	5.0%
S&P / ASX 200 - A-REIT Accumulation Index	18,386	-4.5%	-6.2%
UBS Global Real Estate Investors Index (Net TR) AUD Hedged	1,116	-9.8%	0.0%
AUD/USD (end of month)	0.9662	-9.8%	-0.1%
Oil price	$US79.2/barrel	-10.8%	-1.0%
Gold price	$US1623.97/ounce	-11.1%	24.1%

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