

Market Update & Outlook

July 2010

- **Investor sentiment and markets continue to suffer under global growth concerns**
- **China's economy grows despite tightening monetary policy**
- **Aussie dollar continues rollercoaster ride**

What's inside?

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The pulse

- ↑ **GDP**
0.5% in March quarter
- **Cash rate**
steady at 4.5%
- ↓ **Unemployment**
0.2% to 5.2%
- ↑ **Australian Trade Balance**
to \$A1.65bn in May

Too much, too soon?

Extract from MLC's Head of Capital Markets Research, Susan Gosling's July Investment Briefing

The Global Financial Crisis (GFC) has gone through several stages, from terror to relief, and now to renewed unease as a new phase of the crisis focused on sovereign risk unfolds.

The policy response to the crisis was decisive and, for the US at least, successful.

In comparison to the aftermath of the 1929 market crash and 1930s slump, the path of US industrial production in the Global Financial Crisis is dramatically better. This has encouraged a belief that we're now on the path to normalisation.

Unfortunately, the world is still in serious economic trouble.

In the first quarter we said the environment was stable but fragile. That fragility has been more apparent in the second quarter. Considerable market volatility was seen during May, as concerns about Europe's debt problems intensified.

Escalating risk aversion led sharemarkets, commodities and the Australian dollar sharply lower.

A balancing act

Looking forward, the path remains highly uncertain and policy makers in much of the advanced world face a difficult problem.

As Martin Wolf of the *Financial Times* recently put it, they need to walk and chew gum at the same time.

While their fragile economies need more fiscal stimulus, they must build confidence in medium-term fiscal prudence.

This is difficult, with every large developed nation running an unprecedented fiscal deficit.

If they're prudent too soon there's risk of a Japan-style stagnation; too late and they risk the wrath of the bond vigilantes, such as happened to Greece.



There's a tightrope to be walked while they try to grow their way out of the current problems.

Our unease is growing in light of a new focus on tightening the macroeconomic stance.

We are of course concerned about the growing public debt burden and the risks of default, and about the possibility of loose policy eventually feeding into sharply higher inflation.

However it's a case of which is the lesser evil? We worry that this policy shift is too much too soon.

The lucky country

Despite some currency volatility, Australia has escaped the worst of the crisis.

The banking system was not as exposed to the excesses, the agriculture sector provided a timely boost and China's robustness have all assisted.

However, Australia is not invulnerable. A weaker than expected global economy and, in particular, policy mistakes in China are risks.

The susceptibility of the economy is increased by what looks like a seriously overvalued residential property market.

Thus far the Chinese have looked very shrewd, both economically and politically. The much anticipated announcement of increased currency flexibility is more about the latter—but may only delay a protectionist row with the US.

Of more immediate concern is the continued tightening to control a speculative Chinese property market. The fallout from this may not be positive for Australia.

Quality will prevail

In short, the easy money has been made.

Sovereign debt risks aren't going away any time soon. Pressure for spending cuts are only just beginning.

Policy makers have an impossibly difficult task and we're nowhere close to returning to a 'normal' growth cycle.

We're not expecting a tide that keeps lifting all boats; we're expecting that the strong will prosper and the weak will fail.

The good news is that a lot of quality companies are cashed up and the winners will be those with the ability to use that cash most effectively.

All this implies significant potential to outperform market indices as restructuring and industry consolidation proceeds.

And this is key to getting the medium-term outcomes investors need because we may be in for a period of lacklustre market returns.

Indeed, it's time investors realised: this is the new normal.

June market performance

Equity Markets – Price Indices	Index	At Close 30/6/10	% Change 1 Month	% Change 12 Months
Australia	All Ordinaries	4324.77	-2.9%	13.4%
Japan	Nikkei	9382.64	-4.0%	-1.5%
Hong Kong	Hang Seng	20128.99	1.8%	10.8%
UK	FTSE 100	4916.87	-5.2%	11.3%
Germany	DAX	5965.52	0.0%	20.7%
US	Dow Jones	9774.02	-3.6%	15.0%
EMU*	Euro 100	2086.51	-1.1%	13.0%
World**	MSCI – Ex Aus	763.77	-4.4%	9.4%

Property – Price Index	Index	At Close 30/6/10	% Change 1 Month	% Change 12 Months
Listed Trusts	ASX A-REITS	843.53	-2.2%	12.6%

Interest Rates	At Close 30/6/10	% Change 1 Month	% Change 12 Months
Aust 90 day Bank Bills	4.94%	2.7%	54.9%
Australian 10 year Bonds	5.09%	-5.3%	-6.5%
US 90 day T Bill	0.18%	9.4%	32.1%
US 10 year Bonds	2.93%	-11.1%	-15.3%

Currency	At Close 30/6/10	% Change 1 Month	% Change 12 Months	
US dollar	A\$/US\$	0.8407	-0.7%	4.9%
British pound	A\$/STG	0.5625	-3.3%	13.6%
Euro	A\$/euro	0.6872	0.0%	21.3%
Japanese yen	A\$/yen	74.37	-3.7%	-2.6%
Trade-weighted Index		67.30	-0.3%	6.3%

* Top 100 European stocks trading on the FTSE ** Price Index – Source: www.msci.com
Source: Iress Market Technology
Past performance is not a reliable indicator of future performance.

Global economies

June marked another month of concerns over economic growth worldwide, as the global recovery struggled to find a strong foothold.

What began as a Greek debt crisis spooking markets back in May seems now to have morphed into more generalised concerns over global economic growth.

Despite these concerns, manifesting from talk of double-dip recessions in Europe and the US, spot oil prices rose.

However, it wasn't all good news for commodities, with base metal prices declining.

In response to this, spot gold prices rose 2.5% in US dollar terms, as investors fled to traditional safe havens.

Overall, we're seeing lower commodity prices worldwide, as well as 10 Year US Treasury Bond yields now falling below 3% for the first time since the Global Financial Crisis; painting something of a gloomy global growth scenario.

And, with a general tightening of fiscal policy in many developed countries, growth is likely to be lower than anticipated in economies such as the UK and Europe.

All eyes will be on the upcoming second quarter US reporting season. This is seen as an important litmus test for market sentiment, and a test of whether the US recovery is on its way.

On the flip side, the China boom roars ahead, with recent data indicating continuing rapid growth in the economy.

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Somewhat surprisingly, household spending in China has increased markedly in recent months, bucking the trend of weak growth through 2009.

Real retail sales have so far risen by 4% in the June quarter which, if maintained, is more than twice the pace of growth in the March quarter.

On the domestic front, Australian economic data remained mixed throughout June.

On the downside, housing finance and consumer confidence were softer. Whereas on the positive, unemployment dropped by 0.2% to 5.2%.

Indicating a hesitance to push the economy too hard, the RBA left interest rates unchanged at 4.5%.

The rollercoaster ride of the Australian dollar (AUD) continued, rebounding slightly off the back of improving sentiment and finishing the month at 84.07 US cents.

Big movers in June

Going up – Telcos + 9.2%

Going down – Industrials -7.0%

Australian equities

	Index/Benchmark	1 Yr	3 Yrs	5 Yrs	7 Yrs
Australian	S&P/ASX 300 Acc.	13.05%	-8.05%	4.49%	9.70%
	S&P/ASX 50 Acc.	13.46%	-6.40%	5.03%	9.81%
	S&P/ASX Small Ordinaries Acc.	11.18%	-14.20%	2.74%	9.18%

In a historic moment, Julia Gillard replaced Kevin Rudd as Australia's first female Prime Minister and moved quickly to resolve the standoff with the mining industry over the Resources Super Profits Tax (RSPT).

In an agreement with the largest mining companies, she announced the former RSPT had been replaced by a Minerals Resource Rent Tax (MRRT) applying only to coal and iron ore.

Other resource industries would be exempt from the MRRT, as would coal and iron ore producers with profits of less than \$A50m.

In line with ongoing global problems, the Australian market fell for the third consecutive month in June, with the S&P/ASX 300 Accumulation Index down 2.65% for the month.

The S&P/ASX Small Ordinaries Accumulation Index was down 3.73%, taking the 12 month return below that of their large-cap counterparts.

In share-specific news, Telstra announced it signed a non-binding financial agreement to sell their copper network and associated infrastructure to the Government's national broadband network (NBN), pending approval from Telstra shareholders.

With Telstra comprising approximately 75% of the telcos index, this news boosted the sector's stellar performance for the month.

On the other hand industrials, financials and consumer discretionary were the biggest contributors to the S&P/ASX 300 market decline.

Sector	1 Mth	3 Mths	1 Yr
Energy	-2.9%	4.3%	-3.4%
Materials	-1.2%	23.4%	15.6%
Industrial	-7.0%	24.5%	10.0%
Consumer Discretionary	-6.9%	-3.5%	23.0%
Consumer Staples	0.6%	27.9%	15.8%
Health Care	-0.2%	-6.3%	2.5%
Financials	-5.4%	28.0%	17.2%
Info Tech	-2.3%	-29.3%	16.9%
Telcos	9.2%	7.0%	1.4%
Utilities	1.9%	11.0%	7.8%
Property	-1.0%	34.5%	20.3%

Global equities

	Index/Benchmark	1 Yr	3 Yrs	5 Yrs	7 Yrs
Global	MSCI World Ex Aus Acc (\$A)	5.22%	-11.47%	-2.16%	0.98%
	MSCI World Index Hedged (\$A)	11.73%	-12.85%	-1.44%	3.47%
	MSCI World Small Cap (\$A)	15.80%	-9.59%	-0.40%	5.06%
Emerging	MSCI Emerging Mkts Free	17.87%	-2.35%	10.44%	14.54%
	MSCI AC Far East Free (ex Japan)	15.73%	-2.25%	8.30%	11.41%

Sovereign debt concerns, especially those in Europe's peripheral countries such as Greece, continue to weigh on market sentiment.

On top of this, fears of European banks lacking capital reserves and news of China's monetary tightening policy created further headaches.

Global equity markets were largely negative over June, with emerging markets again

outperforming world markets as represented by the MSCI World ex-Australia Index.

In contrast to May, the AUD/USD exchange rate finished fairly flat by the end of June. This explains the minor difference between the MSCI World Index Hedged and Unhedged equivalent which fell 3.95% and 4.15% respectively.

Australian dollar (AUD)

The Aussie dollar rebounded against the USD in June, rising above 88 US cents on 21 June from the 10-month low of 80.69 US cents struck on 25 May.

This was attributed to improved investor sentiment, brought on by evidence of strong Asian economic growth and reasonable demand for Eurozone member government bond issues.

A-REITS/Property

	Index/Benchmark	1Yr	3 Yrs	5 Yrs	7 Yrs
Australian	S&P/ASX 300 A-REIT Acc	20.34%	-24.31%	-8.34%	-1.53%
Global	UBS Global Real Estate Inv Acc	38.00%	-11.32%	-1.58%	6.65%

Australian and Global Real Estate Investment Trusts (A-REITs and G-REITs) both declined in June along side their equity counterparts.

In the first half of 2010 the S&P/ASX A-REIT Acc Index was down 3.15%, while the UBS Warburg Global Real Estate index was slightly positive at 0.87%.

Fixed interest

	Index/Benchmark	1 Yr	3 Yrs	5 Yrs	7 Yrs
Australian	UBS Composite 0 + Years	7.86%	7.67%	6.06%	5.76%
	Australian 90 Day Bank Bill	4.03%	5.54%	5.79%	5.72%
Global	BarCap Global Aggregate Index	0.51%	6.95%	2.91%	1.88%
	BarCap Global Ag. Index Hedged	11.52%	9.78%	7.20%	7.35%

The traditional safe havens of cash and fixed interest managed to provide some protection for investors against equity market falls this month.

The BarCap Global Aggregate Index Hedged \$A gained 1.25% in June. The equivalent unhedged Index gained 0.82%.

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