



Latest monthly commentary from the Investment Markets Research team at Colonial First State

- After strong gains in December and January, global equity markets were mixed in February.
- Political risk in Europe was reignited with the outcome of the Italian election, while in the US the focus was on commentary from the Federal Reserve and negotiations on budget cuts, officially called 'the sequester'.

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Economic overview

Italy went to the polls on 24 and 25 February to elect a new government. Initial expectations were for the centre-left alliance, led by the Democratic Party and Mr Bersani, to win a majority and form government. However while the Democratic Party won a majority in the Italian Chamber of Deputies, it failed to win a majority in the Senate, effectively leading to a hung parliament.

Instead Mr Berlusconi's centre-right coalition and Mr Grillo's Five Star Movement polled much better than expectations. At this stage, it appears that none of the three major parties are willing to form a coalition. The possibility of a second election is therefore rising.

Beppe Grillo, who gained popularity on an anti-austerity platform, has made comments about the seriousness of the economic and political situation in Italy. He has raised the possibility of a referendum on membership of the monetary union and single currency. While this remains a tail risk event, it has brought political risk back on the agenda. Concerns about the future of austerity and structural reform in Italy have resurfaced. As a result, Italian 10-year bond yields rose from 4.31% to 4.73% over the month, peaking at 4.90%.

In the US, political risk emanated from discussions around the sequester that was due to begin on 1 March 2013. The sequester budget

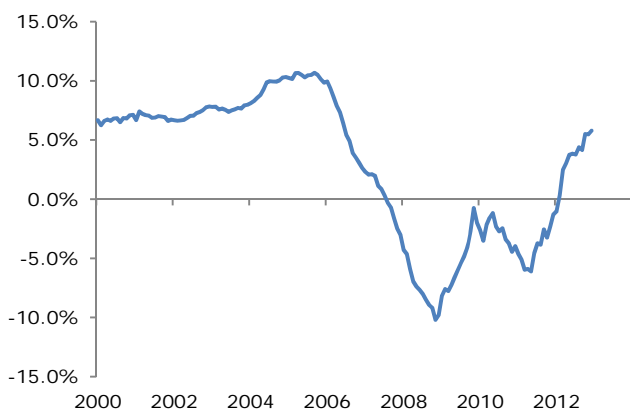
cuts are worth US\$ 1.2 trillion over 10 years, including US\$85 billion between March and October of this year. These cuts are split between defence and non-defence discretionary spending.

For 2013, the budget cuts are expected to reduce GDP growth by approximately 0.4%. There is still some hope, however, that the cuts will be watered down as part of the continuing resolution legislation that is due to be passed by 27 March.

Elsewhere in the US, economic data continued to show signs of positive momentum in the economy.

The housing market showed good growth in existing home sales (+0.4% per month) and new home sales (+15.6% per month). Indeed the inventory of existing homes now stands at 4.2 months, the lowest since April 2005. The inventory peaked at 11.9 months in July 2010. As a result, home prices continue to rise. The latest FHFA Home Price Index data showed rises of 0.6% per month and 5.8% per year. See chart below.

ANNUAL US HOUSE PRICE GROWTH (%)



Source: Bloomberg. Data to 31 December 2012

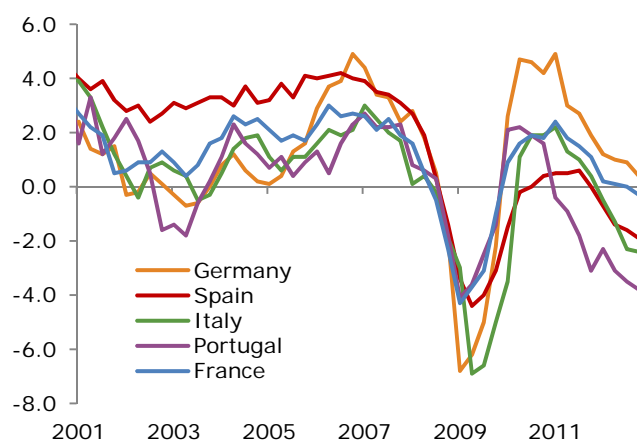
The ISM Manufacturing Index rose from 53.1 to 54.2, with an increase in the new orders component. Consumer confidence also recovered. It had fallen around the new year period, when payroll taxes rose due to the Fiscal Cliff.

Improvements in the US economy have led to discussions around whether the Federal Reserve will taper off its Quantitative Easing (QE) program. The Federal Reserve has confirmed that QE will be maintained until a "substantial improvement" in the labour market is seen.

There has been some renewed debate, however, on how long QE could last for. Minutes from the most recent Federal Reserve meeting indicated that "many" participants expressed concerns about the cost of QE. This compared to "a number" of participants at the previous meeting. While the benefits and costs of additional purchases of assets will likely be an ongoing discussion in 2013, Federal Reserve Chairman Bernanke confirmed his unwavering support for QE in a testimony to Congress in late February.

In Europe, Q4 2012 GDP data was released. Overall the Eurozone economy contracted 0.6% per quarter and 0.9% per year. On a country by country basis per quarter; Germany (-0.6%), Spain (-0.7%), France (-0.3%), Italy (-0.9%) and Portugal (-1.8%) all contracted. See chart below of annual GDP growth.

ANNUAL GDP GROWTH (%)



Source: Bloomberg. Data to 31 December 2012

In China, the focus was on New Year celebrations. There was also some scrutiny on March's National Party Congress meeting, where the new leaders officially take office and when new policy announcements are likely.

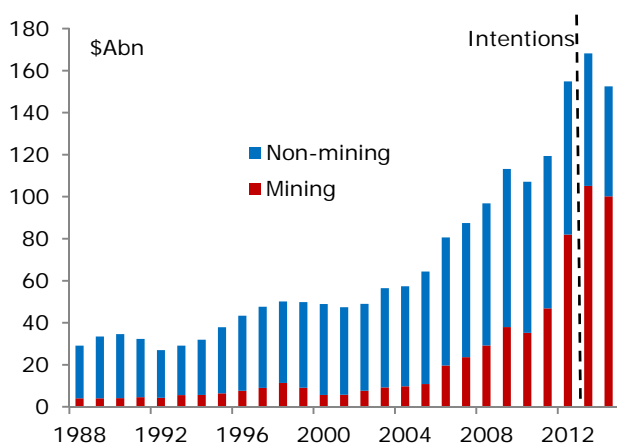
Liquidity remains abundant in China. Total social financing was recorded at RMB 2,540 billion, up from RMB 1,625 billion in December and stands at a record level.

In Australia, the Reserve Bank of Australia (RBA) left the official cash rate unchanged in February at 3%. The RBA also released its quarterly Statement on Monetary Policy. The RBA downgraded its near-term growth and inflation forecasts and now expects GDP growth

of 2.5% as at June 2013 (was 2.75%). Underlying inflation for the same timeframe is now forecast at 2.5% (was 2.75%). By the end of 2013, growth is now forecast in a 2% to 3% range (was 2.25% to 3.25%) while inflation is forecast within the 2% to 3% target range until mid-2015.

Private capital expenditure data was released for Q4 2012, with a fall of 1.2% quarter. Of greater importance was the first intentions survey for 2013/14. Currently A\$168 billion of capex is expected in 2012/13, compared to \$A155 billion in 2011/12. A total of \$A152 billion is anticipated in 2013/14. While the peak in mining investment is expected this year, this survey suggests the drop off in expenditure will be gradual rather than sudden. See chart below of capex intentions.

PRIVATE CAPITAL EXPENDITURE – ACTUAL AND INTENTIONS (\$ABN)



Source: ABS. Data as at February 2013

Australian shares

Investor attention towards Australian shares was dominated by the release of companies' results for the six months ending 31 December 2012. On the whole, reported earnings were slightly ahead of consensus expectations, which enabled the sharemarket to rise in value for a ninth consecutive month.

The S&P/ASX 200 Index rose above the psychologically important 5,000 level for the first time in nearly three years during the month. In February as a whole, the S&P/ASX 200 Accumulation Index added 5.4%.

Stocks with a relatively high dividend yield have tended to be well supported by investors in recent months. Indeed a notable aspect of the 'Reporting Season' was an increase in companies' dividend payments. Interim dividends from Commonwealth Bank of Australia and Rio Tinto, for example, were increased by 20% and 15% respectively. This trend is likely to increase the allure of equities in a low interest rate environment.

Investors' ongoing search for yield was reflected in sector performance in February. Stocks in the Consumer Staples and Financials sectors – which tend to offer a reasonable dividend yield – typically outperformed. Energy and mining stocks continued to struggle to keep pace with the broader market.

Gains made in February extended returns from Australian shares to more than 28% in the 2012/13 financial year to date. Whether the market can maintain this momentum will depend on whether companies can continue to grow their earnings and the tone of economic data, both within Australia and overseas.

The market could also benefit if Australian investors continue to reallocate their investments away from cash and back into the share market. We have seen some early evidence that this is starting to occur; a stronger asset allocation shift back into equities could provide the market with some further momentum in the remainder of the year.

Listed property

Australian listed property securities continued their upward course during February, underperforming the broader share market by 1.9%, but still rising by 3.5%. A-REITs announced their December 2012 results during February, which were generally in line with market expectations.

At a stock-specific level, Charter Hall Group (+10.6%) and Stockland (+9.0%) performed strongly. Charter Hall Group announced solid results for the first half of the 2013 financial year. It also established a new industrial property partnership with two institutional investors, with the intention of acquiring and managing core Australian logistics properties. Stockland shares

rallied despite the company announcing a A\$306 million impairment charge on its residential portfolio.

Following two months of outperformance, Office REITs lagged the buoyant market.

Commonwealth Property Office Fund (+0.5%) was impacted by concerns relating to current vacancy rates, and the number of its leases which are due to expire in the 2014 financial year. Investa Office Fund (+0.7%) also underperformed in spite of upgrading its earnings guidance for the current financial year.

Most A-REITs are in strong financial positions with healthy balance sheets. We expect the low interest rate environment, and the possibility of sector consolidation, to be supportive of share prices in the medium term.

Offshore, every region generated positive returns in February, and the UBS Global Property Investors Index (local currency) rose by 1.7%. Regionally, Japan (+7.1%) and the UK (+2.0%) performed most strongly. Singapore (+0.5%) and the US and Canada (+1.1%) underperformed.

Global shares

Global equity markets were mixed in February on a number of country specific issues.

The gains were strongest in Japan, reflecting expectations of the appointment of an aggressive Bank of Japan governor and continued expectations of a weaker yen.

In early March, Prime Minister Abe nominated Haruhiko Kuroda to become Bank of Japan governor. The expectation within financial markets is that Kuroda will be an aggressive governor, aiming to do whatever it takes to break deflation. This could include buying longer-dated Japanese government bonds.

The Nikkei rose 3.8% in February, with the yen depreciating a further 0.9% during the month.

US equity markets posted gains. The S&P 500 Index, Dow and NASDAQ added 1.1%, 1.4% and 0.6% respectively.

The Dow Jones rose above 14,000 for the first time since September 2007. US company earnings were broadly positive and helped support the market during the month.

European equity markets were predominantly weaker. Italy fell 8.7% on political risk from its election results. This spread through the rest of Europe, with France (-0.3%), Spain (-1.6%) and Germany (-0.4%) all falling. The UK FTSE 100 Index rose 1.3%.

Markets saw mixed returns in Asia. Chinese markets were weaker, with the Shanghai Composite Index down 0.8%. Elsewhere Hong Kong (-3.0%) and Singapore (-0.4%) were weaker. While Malaysia (+0.6%), Korea (+3.3%) and Thailand (+4.6%) were stronger.

Global emerging markets

Emerging market equities were weaker in February, down 1.3% in US dollar terms but up 0.6% in Australian dollar terms. There was profit taking in the sector after several months of gains. Commodity prices fell sharply in the month, led by nickel (-9.4%), lead (-6.2%) and oil (-5.6%). This worked against some of the commodity exporting countries.

The strongest falls were recorded in Argentina (-9.6%), Russia (-5.2%), Brazil (-3.9%) and Sri Lanka (-3.1%).

Shares in the Philippines (+6.6%) and Saudi Arabia (+7.1%) rose.

Global fixed interest

Long term global bond yields in the US, Germany, UK and Japan decreased in February.

Market participants sought 'safe haven' assets as fiscal concerns re-surfaced in both Europe and the US. Italy was the main exception, due to the outcome of the Italian general election.

The Italian 10-year government bond yield increased sharply from a low of 4.17% (after initial polls indicated a Bersani win) to a high of 4.92% when it became clear that a 'hung' parliament was the final outcome of the election.

However, Italy managed to sell €4 billion worth of 10-year bonds at a yield of 4.83% on February 27, which calmed financial markets somewhat. Eventually the yield finished the month at 4.73%, up by 42 bps.

The yield of the 10-year US Treasury bond fell from a high of 2.06% to an intra-month low of 1.84%, in response to political uncertainty in

Italy and the US. However, Federal Reserve Chairman Bernanke soothed market nerves somewhat by implying there was no impending end to Quantitative Easing. In aggregate, the yield decreased by 14 basis points (bps) to 1.85%.

UK gilt yields tracked the fall in US Treasury yields. The 10-year gilt yield decreased by 13 bps to 1.97% in February. Credit ratings agency Moody's downgraded the UK's sovereign credit rating by one notch from Aaa to Aa1.

The new Aa1 rating has a stable outlook. The Moody's UK downgrade is significant as the country had retained its AAA sovereign credit rating since 1978. The UK's weak medium-term economic growth outlook and the Cameron Coalition government's challenging fiscal

consolidation program contributed to the ratings action.

Domestic fixed interest

The Australian 10-year CGS yield decreased by 10 bps to 3.35% in February.

The yield reached a high of 3.61% on February 20, before rallying back down to a low of 3.33% on February 27, breaking a four-month period of bond price declines (yield increases). Australian sovereign debt had been on course to match a five-month losing streak recorded back in 1994.

Communication from the RBA during February confirmed that the central bank has retained a monetary policy easing bias, despite the cash rate being unchanged since December at 3%.