Monthly Market View

January 2013

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

- Most equity markets posted solid gains in January, following on from gains in December. Negotiations on the US Fiscal Cliff appear to be largely resolved for the time being and overall global economic data continued to show improved momentum.
- While there remain some risks on the horizon, financial markets continue to feel comfortable that the possibility of a tail risk event has been removed. Central banks appear to be largely in control of events and politicians appear to be aware of the required policy responses in key regions.

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- Issues in 2013 include elections in Italy (February) and Germany (September/October), while the US must deal with the sequester (automatic spending cuts) by 1 March 2013 to avoid a larger than anticipated fiscal drag for 2013. The US must also address its debt ceiling and negotiate a budget during the first half of 2013.

Economic overview

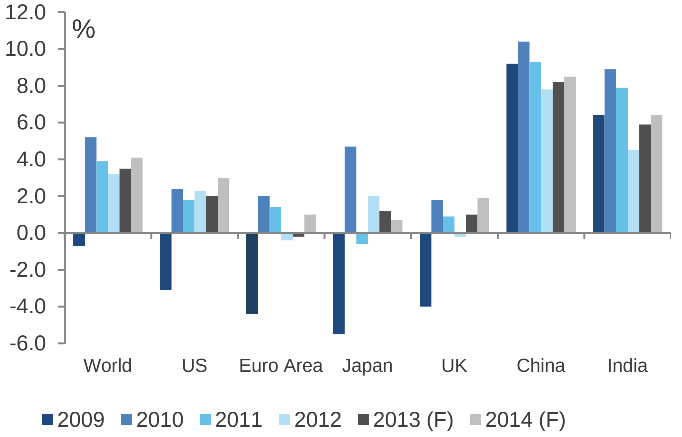
The International Monetary Fund (IMF) released updated global growth forecasts in January. The IMF now expects global growth of 3.5% in 2013 and 4.1% in 2014. This compares to previous forecasts of 3.6% and 4.2% from October 2012.

The IMF highlighted that “global growth will strengthen in 2013…as the constraints on economic activity start to ease this year. But the recovery is slow and….policies must address downside risks to bolster growth.”

The IMF expects the US economy to grow 2.0% this year, a -0.2% contraction in the Euro Area, growth of 1.2% in Japan, 8.2% in China and 5.9% in India.

See chart on the next page for details.

IMF WORLD GROWTH FORECASTS



Source: IMF World Economic Outlook January 2013

In the US the focus early in the month was on the Fiscal Cliff. Politicians were able to come to a deal in the early hours of 1 January 2013, which limited the fiscal policy tightening for 2013 to around 1.5% of GDP. However, while some potential tax increases have been put off permanently and the deal did involve some pleasing aspects, significant spending cuts have only been delayed by two months to 1 March 2013.

In terms of economic data in the US, advance Q4 2012 GDP data was released, showing a disappointing rate of -0.1% on a seasonally adjusted annualised rate. The fiscal drag and Superstorm Sandy led to the contraction, while residential investment and personal consumption contributed positively to growth.

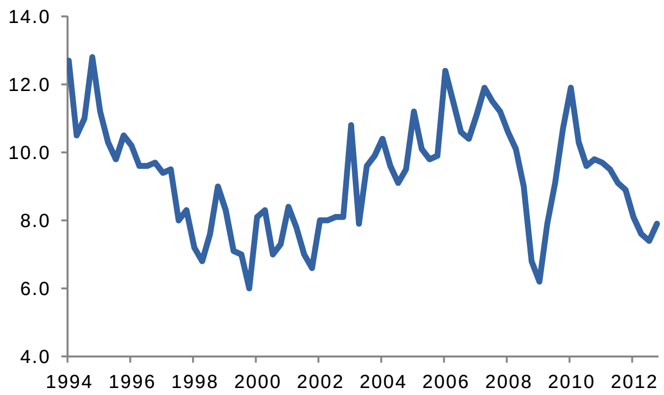
US employment figures showed that 157,000 jobs were created in January. The unemployment rate increased slightly to 7.9%. The average job creation for the past three months has now moved to 200,000 per month, compared with 138,000 for the six months prior.

There has been some discussion as to what this means for the Federal Reserve and its open-ended Quantitative Easing program. Following its January meeting, the Federal Reserve maintained its purchases of Mortgage Backed Securities and Treasury Securities at a pace of US$85 billion per month. This program is expected to continue until there is 'substantial improvement' in the labour market.

In Japan, the Bank of Japan (BoJ) announced a number of new measures to spur economic growth, produce inflation and to weaken the yen. The BoJ pledged to achieve a 2% inflation target (up from its previous guide of 1%) and announced an open-ended asset purchasing program that is due to commence in 2014. At this stage the measures remain relatively timid; further enhancements are possible when a new Governor is appointed in April. The expectation of further changes saw the yen depreciate 6.7% against the US dollar in January.

In China, the release of Q4 GDP data confirmed a modest acceleration in activity. Growth of 7.9% was recorded, up from 7.4% in Q3. See chart below for details.

CHINA ANNUAL GDP GROWTH (%)



Source: Bloomberg. Data to 31 December 2012

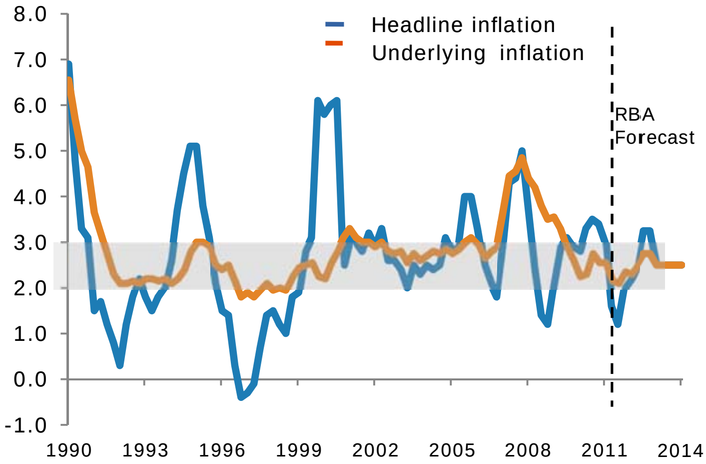
In Europe there has been a mild improvement in the economy, although conditions remain subdued. Market sentiment has improved with bond yields falling in countries like Spain and Italy.

European banks were able to make early repayments on any funds they received from the European Central Bank's Longer Term Refinancing Operation in January. A total of €137 billion was repaid from 278 banks, which was more than expected of the €1,019 billion borrowed.

PMI Manufacturing data has improved in most European countries, with Germany (49.8), Italy (47.8) and Spain (46.1) all rising. France's PMI fell to 42.9.

In Australia Q4 2012 inflation data was released. Headline inflation rose 0.2% per quarter, taking the annual rate to 2.2% from 2.0%. Underlying inflation was recorded at 0.55% per quarter and 2.3% per annum. Prices of vegetables and audio visual goods fell, while domestic holiday travel and fuel prices rose. See chart below for details.

AUSTRALIA – QUARTERLY AND ANNUAL INFLATION (%)



Source: ABS. Data to 31 December 2012. RBA forecasts as at November 2012

Australian employment data showed 5,500 jobs were lost during December, pushing the unemployment rate up to 5.4%. Consumer confidence rose by 0.6% to hover around its five-year average, while business confidence also improved.

Prime Minister Julia Gillard announced the next Federal Election will be held on 14 September 2013.

The RBA Commodity Price Index rose 2.1% in Australian dollar terms in January.

Australian shares

Australian shares maintained their positive momentum in January. After rising in value by more than 20% in 2012, the S&P/ASX 200 Accumulation Index added a further 4.9% in the first month of 2013. Following the rally in the past few months, the valuation of Australian shares has returned to its long-term average level.

In the second half of January the market enjoyed an unbroken 10-day run of positive returns; the longest run since late 2003. This highlights that investor sentiment towards Australian equities remains favourable, in spite of the recent strong run in share prices.

Some stocks have benefited from recent interest rate cuts and others have been supported by an improvement in economic data in China. The most recent economic growth and industrial production data in China have exceeded expectations and augur well for Australian companies.

Stocks in the Financials sector tended to perform well, as did various consumer discretionary stocks following some encouraging pre-Christmas retail trading data.

The Materials sector fared less well – albeit still rose in value – despite ongoing strength in commodity prices such as iron ore and coal. Various mining companies issued production reports for the fourth quarter of 2012 during the month. Few of these reports held any real surprises for investors.

There was a fair amount of stock-specific news from various companies, but most investors began looking forward to semi-annual earnings announcements in February.

Most Australian listed companies will update the market with their results for the six months ending 31 December 2012 during the next few weeks. The tone of these announcements could have an important influence on share prices in February.

Listed property

Having performed strongly throughout 2012, Australian listed property securities added a further 4.4% in January. A-REITs, which are supported by a background of sustained low domestic interest rates, were boosted by an increasingly optimistic mood across global financial markets.

At a stock-specific level, a number of office and retail A-REITs outperformed. Commonwealth Property Office (+8.8%) was the top performer for the month. The stock has benefitted from capital flows into the office sub-sector.

Shopping Centres Australasia Property Group (+8.7%), which owns Woolworths-anchored shopping centres, also performed strongly following an announcement that it had secured financing on favourable terms. Stockland Group (-2.3%) and Australand (+1.5%) lagged the index. Shares in Stockland Group dipped due to ongoing concerns relating to its residential portfolio.

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.

Overall, offshore listed property markets also generated positive returns in January. The UBS Global Property Investors Index (local currency) rose by 3.5%. Regionally, Japan (+10.4%) and the US and Canada (+3.4%) performed most strongly. Continental Europe (-0.6%) and the UK (+0.5%) underperformed.

Global shares

Global equity markets rose in January on improved sentiment, strong inflows and improved economic momentum. The gains were strongest in the US following a resolution to the Fiscal Cliff. The MSCI World Index rose 5.0% in US$ terms and 4.5% in A$ terms.

US equity markets posted gains. The S&P 500 Index, Dow and NASDAQ added 5.0%, 5.8% and 4.1% respectively. The S&P 500 Index rose above the 1500 level for the first time since December 2007. On the whole, the US corporate earnings reporting season to date has been better than the market had anticipated. The equity market responded positively to a deal around the Fiscal Cliff and a postponement of the debt ceiling, which removed sources of near-term risk for markets.

European equity markets were stronger with Italy up 7.2%, despite the near term risks possible from the election in February. Elsewhere in Europe, share markets in France (+2.5%), Spain (+2.4%) and Germany (+2.2%) saw gains. The UK FTSE 100 Index rose 6.4%.

Markets saw mixed returns in Asia. The Nikkei rose a further 7.2%, following a 10.1% gain in December. This followed a change in government and announcements from the Bank of Japan. In particularly the equity market is responding to a weaker yen, which should help the export sector. In contrast, South Korea saw a 1.8% fall in its equity market during the month.

Chinese markets were also stronger, with the Shanghai Composite Index up a further 5.1%. Elsewhere Thailand (+5.9%), Singapore (+3.7%), Hong Kong (+4.7%) and Taiwan (+2.0%) all rose. The Malaysian market fell 3.6%.

Global emerging markets

Emerging market equities also rose in January, up 1.3% in US$ terms and 0.8% in A$ terms.

Argentina jumped a further 22% in January, following a 15% gain in December. A combination of significant underperformance in 2012, improving sentiment, planned increases in electricity and gas tariffs and the resultant inflation issues has led to the strong gains.

Other gains occurred in Saudi Arabia (+7.8%), Mexico (+3.6%), Russia (+5.1%) and Hungary (+6.6%). Losses were experienced in Israel (-2.7%) and the Czech Republic (-1.7%).

Global fixed interest

Longer maturity high grade global bond yields in the major markets (US, Germany and UK) increased in January. Yields have risen since the US Federal Reserve announced a third phase of Quantitative Easing ‘QE3’ in September, aimed at lowering interest rates and spurring growth through asset purchases.

10-year US Treasury yields rose above 2.0% for the first time in nine months during the month. Investors continued to sell US government debt following the release of better-than-expected US economic data (durable goods orders, housing starts, ISM Non-Manufacturing and employment data). Yields were also propelled higher by stronger corporate earnings in the US. The 10-year US Treasury yield rose 23 bps to 1.99% in January as a whole.

News that the ECB was expecting early repayment of three-year debt by banks which borrowed funds under its Long Term Refinancing Operations (LTRO) was seen as an indicator that Europe was on the mend. This helped trigger a retreat from safe-haven assets, such as bonds.

The yield of the 10-year German Bund increased to a four month high of 1.62% in January. The January ECB bank lending survey added to the growing evidence of stabilisation in the financial sector, but the repair of the bank lending channel in the Euro area remains a work in progress. 10-year Spanish and Italian bond yields fell by 18 bps and 28 bps respectively.

In Japan, risk appetite was boosted by new Prime Minister Abe's promise of more accommodative monetary policy and stimulatory fiscal policy. The Bank of Japan's easy policy continues to support government bonds, with the 10-year yield declining by 4 bps to 0.75% in January.

Australian 10-year government bond yields increased by 18 bps to 3.45% in January. This was the fourth consecutive month that yields have risen. The yield reached a high of 3.47% on 30 January 2013 – its highest level since May 2012.