Market Update and Outlook

May 2012

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Markets Update – May 2012

May saw global share markets extend last month's losses on the back of increasing political instability in Greece and fears the troubled nation may yet pull out of the euro-zone. Meanwhile, the Australian share market ended a run of four consecutive monthly gains, oil prices fell sharply and the Australian dollar lost almost 7.0% against its US counterpart.

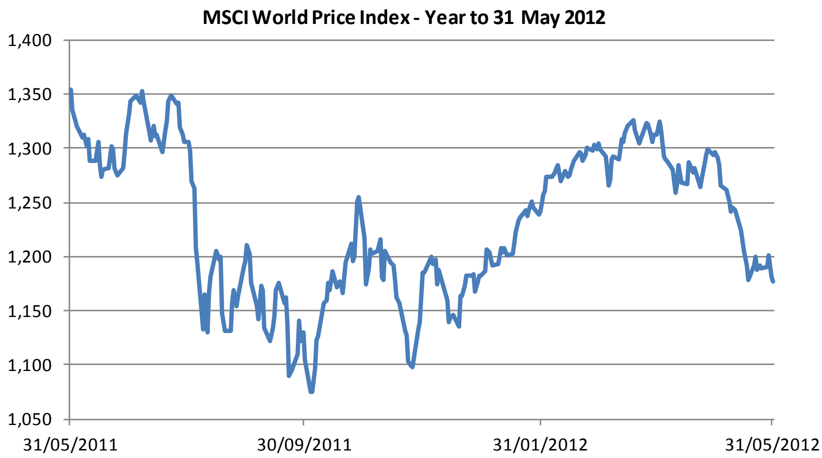
At a glance

- Global share markets extend April's slide
- Oil prices tumble
- Global bond yields continue to fall
- Australian share market gives back much of 2012's gains
- Australian dollar drops below parity

Global share markets continue to fall

Global share markets underwent a significant sell off in May as investors – spooked by rising uncertainty in Europe – reverted to a 'risk off' approach. Renewed political instability in Greece – where it remains unclear whether the next government will be pro- or anti-austerity – and increasing doubts about Spain's fiscal position combined to drive markets sharply lower. Whilst much of the recent focus has (rightly) been on Greece, the market is becoming more and more concerned about the health of the Spanish banking system. These worries were exacerbated late in the month by news that Moody's had downgraded no less than 16 of the country's banks, saying that asset quality was expected to deteriorate further in Spain over the next 12 months. Unfortunately, Europe's ongoing debt woes overshadowed some encouraging US economic and corporate earnings figures during the month, as well as news that Chinese officials will soon look to implement further stimulus measures aimed at boosting growth in the world's second-largest economy.

In the US, the benchmark S&P 500 Index came off recent four-year highs to close the month down 6.3% and this had a negative knock-on effect elsewhere, with share markets in the UK (-7.3%[1]), Europe (-8.1%[2]) and Japan (-10.3%[3]) all ending the month lower. Collectively, global share markets closed May 9.0%[4] lower (see following chart).

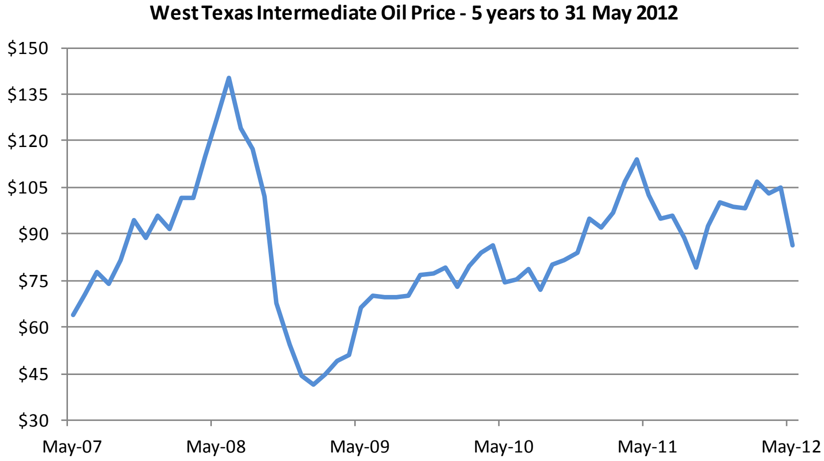


Source: Bloomberg

[1] UK shares measure by the FTSE 100 Index
[2] European shares measured by the Dow Jones Eurostoxx50 Index
[3] Japanese shares measured by the Nikkei 225 Index
[4] Global shares measured by the MSCI World Index

Oil prices slump

Oil prices fell heavily in May, closing the month 17.5% lower at US$86.53 a barrel. The loss was driven mainly by the general 'risk off' tone that dominated financial markets over the period. Other factors to weigh on oil prices were news that Saudi Arabia and Iraq had increased their output to counter any shortfall in Iran, Chinese growth concerns and a stronger US dollar[5].



Source: Energy Information Administration

Meanwhile, the price of gold continued to fall as investors worried that political instability in Greece will hamper the euro-zone's efforts to resolve its debt crisis and as Chinese demand stagnated – China is the world's second-largest consumer of the precious metal behind India. Whilst gold has traditionally been viewed as a 'safe haven' asset, its price movements now appear to be in lock-step with the euro and other, more risky, assets. As a result, investors now prefer the US dollar and German bunds as safe havens.

Reserve Bank slashes interest rates

The Reserve Bank of Australia (RBA) cut the official cash rate by 0.50% (to 3.75%) following its early May board meeting, citing slower domestic growth, renewed concerns about Europe and easing inflation among the key reasons behind its decision. The larger-than-expected move – the market consensus was for a 0.25% reduction – was also designed to ensure that customers of the Big Four banks got a greater level of relief than if the RBA had cut rates by the usual 0.25%. Interestingly, the rate cut was the biggest since the RBA lowered the official cash rate by 1.00% back in February 2009 – the height of the global financial crisis.

Meanwhile, the ECB (1.00%), the Bank of England (0.50%) and the Bank of Japan (0.10%) all left their respective benchmark interest rates on hold during the month. The US Federal Reserve (0-0.25%) did not meet in May.

Bond yields at record lows

Global bond yields continued to fall[6] in May as investors worried that a potential Greek exit from the euro-zone would have a significant and negative knock-on effect on the region's other troubled nations, namely Spain and Italy. This was a key driver of the risk-off tone that shadowed global financial markets over the month and prompted investors to seek the relative safety of major government debt. The yield on US 10-year Treasuries fell 36 basis points (bps) to 1.56% over the month and the yield on Australian 10-year bonds did likewise, falling 75 bps to 2.92%. Both US Treasuries and Australian bonds are now trading at historically low levels.

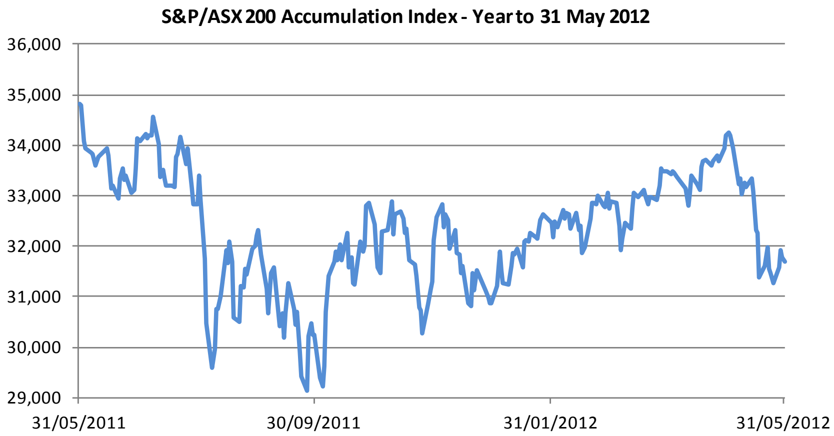
Importantly, Australian bonds – widely considered a safe haven investment on account of their AAA credit rating – continue to represent better value than many of their global counterparts, including US Treasuries. In fact, the yield differential between Australian 10-year bonds and their US equivalent is currently 136 bps (or 1.36%).

[5] Oil is priced in US dollars so a stronger US dollar makes oil more expensive for investors holding other currencies
[6] Bond yields have an inverse relationship with bond prices, meaning that when yields fall, prices rise (and vice versa)

Australian shares weaken

The Australian share market fell in May, with the S&P/ASX 200 Accumulation Index closing the month 6.6% lower and ending a run of four consecutive monthly gains. Like its global counterparts, the local market was spooked by fears of a potential Greek exit from the euro-zone as well as some less-than-inspiring Chinese economic data. Tempering the loss were expectations of further near-term interest rate cuts and news that the People's Bank of China had lowered its reserve requirement ratio by 0.50% in an effort to boost growth. Sadly, May marked one of the Australian share market's worst months since the global financial crisis.

So far this year, the Australian share market has returned 2.6%. This compares with 4.2% in the US, 1.0% in Japan, -4.5% in the UK and -8.5% in Europe.

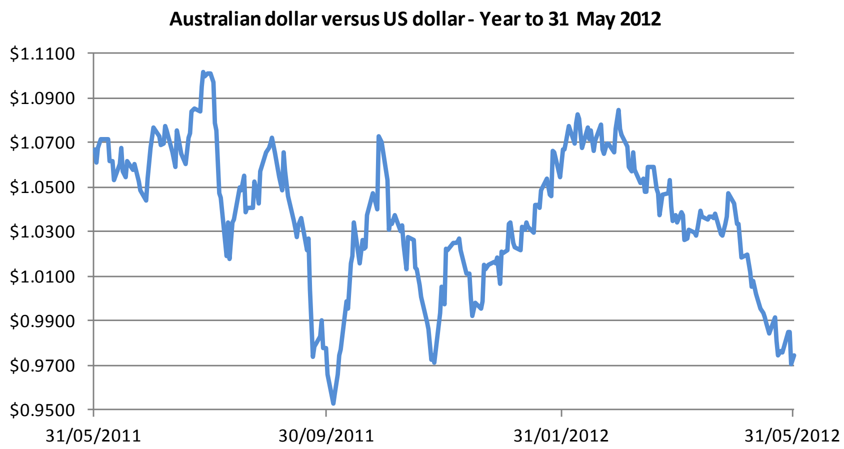


Source: Bloomberg

Australian dollar drops below parity

The Australian dollar (A$) weakened against its US counterpart in May, falling 6.6% and closing below parity for the first time since late December. The loss was driven mainly by the RBA's decision to cut interest rates by more than expected, political uncertainty in Europe and stronger demand for the US dollar. The A$ closed the month at US$0.9743.

Despite the high levels of market volatility over the past 12 months, the A$ has remained remarkably resilient against its US counterpart. Whilst the local currency will continue to face some headwinds in the near-term, it should nonetheless continue to be well supported by relatively high interest rates compared to those in the US and Europe, as well as strong demand for Australian bonds.



Source: Bloomberg

Looking ahead

The optimism that had driven global share markets higher at the beginning of the year has since given way to increasing uncertainty after Europe's sovereign debt crisis deteriorated even further. Recent moves by European officials to deal with the situation – namely the ECB's long-term refinancing operation – had provided investors with some hope that the worst of the debt crisis was over. But this is clearly not the case. In the past we've noted that a potential 'shock' event could derail the global recovery and it would appear that the potential exit of Greece from the euro-zone may well be that event. Importantly though, the US recovery remains on track and this should help to counter some of the negative news flow coming out of Europe. Further, risk assets such as domestic and international shares continue to look attractive from a valuation standpoint.

The Australian economy may have slowed but it nonetheless remains relatively well placed compared to the likes of the US and Europe. Moves by Chinese officials to ease monetary policy in the wake of recent softer inflation and growth numbers should continue to provide strong support to the Australian share market.

In terms of interest rates, recent downward revisions to the RBA's growth and inflation forecasts would imply that the central bank's bias is toward further easing; suggesting more rate cuts ahead. Importantly, with Australian interest rates still relatively high compared to those in other major countries, the RBA maintains the luxury of being able to cut rates more aggressively should the need arise.