Monthly Market View

February 2012

Latest monthly commentary from the Investment Markets Research team at Colonial First State, Global Asset Management

- Expectations of a Greek sovereign debt deal and improving economic data in the US and China, as well as continued liquidity actions by the European Central Bank (ECB), supported risk appetite in February.
- Equity markets continued to rally, with the US Dow Jones moving above 13,000 for the first time since May 2008.

Economic overview

The details of the Greek sovereign debt deal were announced on 21 February. To progress the bailout, Greece identified a further €325m of austerity measures to close the fiscal gap in 2012 and the leaders of both coalition parties provided assurances the plan will be implemented beyond April's general elections.

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This allowed the provisional agreement to provide Greece with €130bn of funding to reduce its debt to GDP ratio to 120.5% by 2012, from current estimates of close to 190% based on the current trend. The package includes a 53.5% 'haircut' for private bond holders of Greek government debt. With lower interest rates, the total net present value loss is 70+%. This deal remains provisional on finalisation of the private sector involvement (PSI) agreement, to be finalised in the second week of March.

Other terms to the agreement include permanent presence in Greece of the 'troika' – the European Commision (EC), the International Monetary Fund (IMF) and the ECB - to provide technical assistance andas well as the creation of a segregated account to ensure Greece pre-pays each quarter's debt service. This is to be enacted in the Greek constitution.

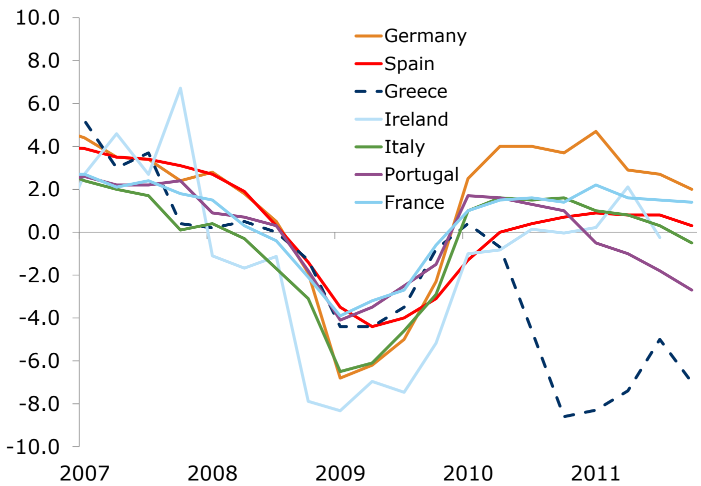
In the lead up to the 20 March 2012 bond-maturity deadline, the implementation risks include legislation of austerity measures by Greece, completion of the PSI deal and approval by certain EU member country parliaments of the package. The German parliament has already approved the package.

The ECB held the second longer-term refinancing operation (LTRO) on 29 February. This allowed EU banks to borrow money from the central bank for a 30 year period at 1%. A total of €529.5bn was taken up by 800 banks, compared to €489bn and 523 banks in

December. The LTRO program has effectively replaced the Securities Markets Program (whereby the ECB purchases sovereign bonds in the secondary market). No purchases were made in the last two weeks of February, with the program worth €225bn.

Q4 GDP data was released in Europe with the EU economy contracting by 0.3%, to be +0.7%/year. Within this, Germany (-0.2%), Spain (-0.3%), Italy (-0.7%) contracted, while France was the surprise, with GDP growth of +0.2% for the quarter. See chart below of annual GDP growth in the EU.

Annual GDP growth (%)

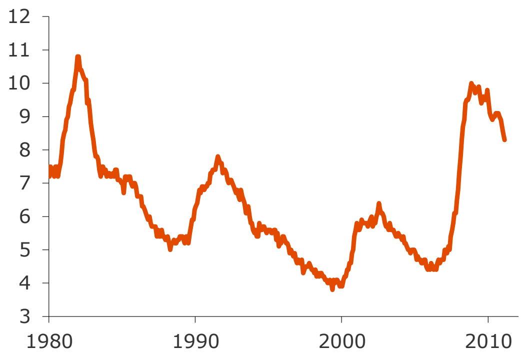


Source: Bloomberg. Data to 31 December 2011. Ireland to 30 September 2011

Sovereign credit rating downgrades continued in Europe with Moody's cutting the credit rating of Italy, Spain, Portugal, Slovakia, Slovenia and Malta. France and the UK were placed on negative outlook, but remain Aaa rated. Concerns have been rising about Spain's ability to meet its budget deficit target of 6% of GDP in 2012 and 4.4% in 2013. The current deficit is 8.5%. These optimistic budget deficit targets were predicated on GDP growth of 2+% in 2012, compared to the now expected -1%.

In the US, economic data continued to improve, although market expectations are quickly catching up to the improved outlook. Q4 GDP was revised upwards to 3.0% from 2.8%. This was driven by improvements to final sales, while income through wages was also revised higher for the second half of 2011. As a result the savings rate stood at 4.5% in Q4, revised up from 3.7%. The unemployment rate fell to 8.3% with 243,000 added in January. Further improvement is expected with the number of initial jobless claims reaching the lowest level since April 2008. See chart below of US unemployment rate.

US Unemployment rate (%)



Source: Bloomberg. Data to 31 January 2012

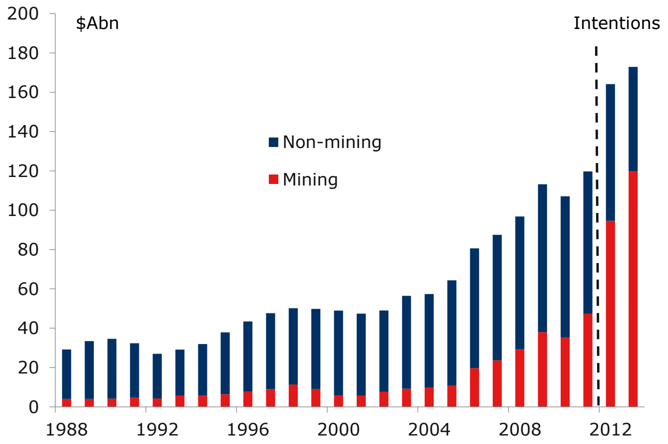
The housing market showed further signs of stabilisation with the NAHB Housing Index (a measure of builders' confidence) reaching the highest level since June 2007. Consumer confidence figures also improved, with the University of Michigan Index reaching 75.3, the highest since February 2011. The key to the outlook for consumer spending remains gasoline prices and the oil price.

During February the oil price rose 8.7% to USD108.84, placing upward pressure on US gasoline prices. The average pump price was USD3.72/gallon. A recent high of USD4.01 was reached in April 2011, leading to a consumer hiatus and downturn in the US economy.

In China, monetary easing continued with a cut to the reserve requirement ratio from 21% to 20.5%. Other data released in China showed resilience, with the PMI Manufacturing Index rising to 51.0 from 50.5.

Australian economic data also showed continued resilience. The unemployment rate fell to 5.1% with 46,300 jobs added (predominantly part-time). Consumer spending remained weak, rising 0.3%/month. In the lead up to Q4 GDP data, partial indicators included construction work done (-4.6%/quarter) and private capital expenditure (-0.3%/quarter), suggesting downside risks to the release. However, private capital expenditure intentions were revised higher again. In 2012, AUD164bn of capex is expected (58% in the mining sector alone) while AUD173bn is expected in 2013 (70% in the mining sector). This continues to highlight the large growth contribution expected from business investment in the next two years, but is at risk due to labour and materials shortages. See chart below of capex intentions.

Private capital expenditure work – actual and intentions ($Abn)



Source: ABS. Data as at March 2012

Australian shares

The release of earnings from listed companies for the period ending 31 December 2011 was the main focus for Australian equity market investors during February. On the whole, earnings came in broadly in line with expectations.

Mining services stocks continued to report solid growth – services companies tend to be among the beneficiaries of rising capital expenditure on projects in the mining and energy sectors. Results from a number of industrial stocks were less positive, with several companies reporting that margins remain under downward pressure.

The LTRO program in Europe and resilient data in both China and the US provided some support to the market. Domestic economic data was also broadly positive, particularly the unexpected decline in the unemployment rate to 5.1%.

The Reserve Bank of Australia (RBA) surprised the market by leaving interest rates unchanged at 4.25% (an easing of monetary policy had been anticipated). Although official interest rates were unchanged, all four of the major banks raised their borrowing costs slightly as they sought to maintain margins.

Towards the end of the month there was some political uncertainty as former Prime Minister Kevin Rudd challenged Julia Gillard for the leadership of the governing Labor Party. This attracted a significant amount of media attention, but did not appear to have any influence on the sharemarket.

In February the S&P/ASX 200 Index rose by 0.8%, extending its positive return in the 2012 year to date. The receipt of dividends increased the total monthly return from the Australian sharemarket to 1.9%.

Listed property

The UBS Global Property Investors' Index (local currency) increased 1.0% in February. Japan was the top performing region (+12.4%) followed by Singapore (+6.6%). The worst performing regions were the US & Canada (-0.8%) and Continental Europe (+0.8%).

The S&P/ASX 200 Property Accumulation Index rose 2.2% in February, outperforming the S&P/ASX 200 by 0.3%.

In stock specific news it was a busy month, with most A-REITs reporting their half-year results for FY12. To date, six A-REITs have upgraded earnings guidance for the full year.

The benefit of lower interest expense from revised hedge books and lower floating rates is paying clear dividends.

Global shares

Global equity markets posted gains, driven by the ECB's liquidity actions, hopes of a resolution in Greece and improvements in US economic data.

The MSCI World Index rose 4.7% in USD terms and 3.0% in AUD terms, although this masked considerable divergence between markets and industry sectors. The Australian dollar rose 1% against the USD to 1.0732.

In the US, the Dow Jones Industrial Average rose 2.5%, while the S&P 500 Index was up 4.1%. The NASDAQ rose 5.4%. All US markets continued to be assisted by Apple, which added 18.8% after a strong earnings result. Apple's market capitalisation is now above $US500bn.

European markets were generally positive. Spain was the exception, falling 0.5% on continued economic weakness and concerns over further austerity measures to meet budget deficit targets. Elsewhere the German DAX rose 6.2%, the French CAC was up 4.7% and the Italian market rose 3.3%. In the UK, the FTSE 100 rose 3.3% on a third round of quantitative easing by the Bank of England.

In Asia, markets were positive across the board with Japan outperforming most markets as the yen retreated from recent highs. The Nikkei rose 10.5% in the month. Elsewhere returns were also positive, with Hong Kong (+6.3%), Singapore (+3.0%), Korea (+3.8%) Thailand (+7.1%) and Taiwan (+8.0%) all rising.

In terms of sector performance, the IT sector outperformed – driven by Apple – rising 7.0% in February. The consumer discretionary sector also performed well, rising 6.1%. The energy sector rose 5.5% with the gains in the oil price, while the defensive health care sector underperformed, but still rose 1.6%.

Global emerging markets

Emerging markets outperformed the broader global equity market, gaining 5.9% in USD and 4.2% in AUD terms. There was a significant divergence of returns within the sector with Saudi Arabia (+9.8%), Turkey (+6.3%) and Russia (+5.5%) all performing well. The Chinese Shanghai B Index rose 9.0% in the month. Sri Lanka (-4.1%), Israel (-2.3%) and Argentina (-4.7%) all fell in February.

Inflation pressures continue to ease in emerging economies, allowing for further easing of monetary policy. Indonesia and the Philippines have both eased policy during the past month.

Global fixed interest

Amid a generally bearish month (prices fell) for global sovereign markets, the exceptions were Spain and Italy. Continuing to benefit from the ECB policy of large scale liquidity injection, a second round of which was announced in late February, these two markets saw bond prices rise (yields fall) to their lowest levels since early September. Concerns over the sustainability of public debt subsided. Most other markets sold off (yields rose) in February as risk appetite continued to increase.

Despite the strong rebound in global equities and credit markets in recent months, bonds in large offshore developed markets, such as the US, UK and Germany, have held up well. Easy monetary and unconventional policy settings in those countries have anchored long-term bond yields below 2%. 10-year US Treasury yields ended February up 14 bps to 1.94%.

The Italian 10-year bond yield decreased by 76 bps to 5.17% at February month end from 5.93% at January month end. The yield on 10-year Spanish bonds increased by 3 bps to 4.97% at the end of February from 4.94% at January end.

Over the past few months, central banks in advanced economies have embarked on a renewed bout of monetary easing. In February, the Bank of England increased its gilt purchase program by a further £50bn to £325bn and the Bank of Japan decided to undertake a further ¥10trn worth of purchases of long-dated Japanese government bonds (JGBs).

These moves were sandwiched between the US Federal Reserve's extension of its commitment (subject to economic conditions) to low rates through to late 2014 announced in late January, and the second three-year LTRO announced in February, with an expansion in the pool of eligible collateral.

The ECB left its main refinancing rate at 1.0% for a second consecutive month, citing further evidence of a stabilisation in the Eurozone economy. German 10-year bunds increased by 3 bps to 1.82%.

The UK 10-year gilt yield increased by 9 bps to 2.06%. The 10-year JGB yield decreased by 1 bp to finish the month at 0.95%.

The Australian bond market sold off sharply (yields rose and prices fell) in February. The RBA's decision to leave the official cash rate unchanged surprised market participants, who had universally expected a further easing in monetary policy.

Further communication from the Board later in the month signalled that the RBA appears reticent to ease policy in the near term, unless domestic and global economic conditions deteriorate sharply. This led to an unwinding of expectations, particularly in the short end of the curve.

Three-year Commonwealth Government Securities (CGS) yields increased by 45 bps to 3.61%, and longer-dated 10-year CGS yields were up by 25 bps to 3.97% in February. The rise in yields in domestic sovereign bonds was also triggered in part by a stronger-than-expected domestic employment report, together with increasing risk appetite globally.

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