Market Update and Outlook March 2011

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Outlook and Market Update– March 2011

Global share markets fell in March as rising tensions in the Middle East and North Africa weighed on investor confidence. Meanwhile, Australian shares posted a modest gain, oil prices jumped almost 10% and the Australian dollar continued to rally against its US counterpart.

At a glance

- Global share markets weaken
- Oil prices surge on civil unrest in the Middle East and North Africa
- The Reserve Bank of Australia leaves interest rates unchanged at 4.75%
- The Australian share market ekes out a modest gain
- The Australian dollar continues to rally against the US dollar

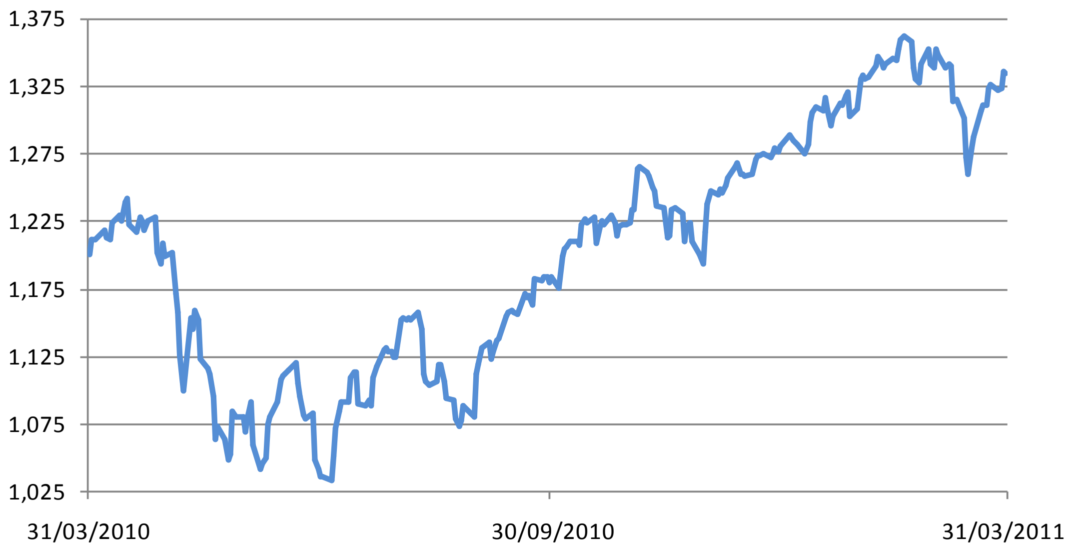
Global share markets weaker

Global share markets reversed last month's gains amid uncertainty caused by increasing geopolitical tensions in the Middle East and North Africa (MENA), the devastating 8.9 magnitude earthquake in Japan and the introduction of further cooling measures in China. The impact of the Japan earthquake was particularly severe, with the Japanese share market[1] losing 6.2% and around US$285 billion in equity value in a single day.

Investor sentiment was further impacted by comments from European Central Bank (ECB) officials who hinted that several interest rate hikes were in the pipeline as economic conditions in the region improve.

In the US, the benchmark S&P 500 Index closed the month 0.1% lower while share markets in Japan (-8.2%), Europe (-3.4%[2]) and the UK (-1.4%[3]) also finished in the red. Collectively, global share markets ended March 1.2%[4] lower (see following chart).

MSCI World Index - Year to 31 March 2011



Source: Bloomberg

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

Oil prices surge

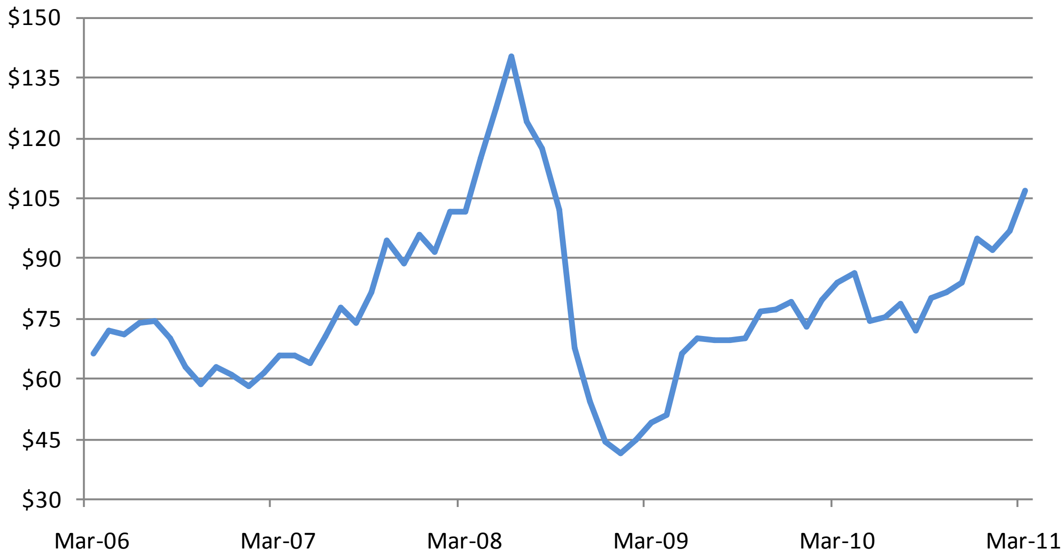
Oil prices surged in March on speculation that civil and political unrest in MENA would disrupt supplies. Indeed, tensions in Libya escalated to the point where various countries, including the US, Britain and France, intervened militarily to enforce a ‘no fly’ zone. At the same time, similar unrest has begun to emerge in nearby Bahrain, Yemen and Saudi Arabia.

At current levels, oil prices are unlikely to have a prolonged impact on the global recovery. However, if prices were to rise to US$110 a barrel and remain at this level for some time, then we could see as much as 0.4% knocked off global growth this year[1].

Fortunately, OPEC – the Organisation of the Petroleum Exporting Countries – produces around five million barrels a day of spare oil capacity, meaning it can more than pick up the slack caused by lost oil production in Libya (1.8 million barrels a day). However, should civil unrest in the region cause disruption to the likes of Kuwait, Iran or parts of Saudi Arabia, then this spare capacity would be wiped out completely, causing a significant jump in prices. Oil closed the month up 9.9% at US$106.65 a barrel.

Meanwhile, gold prices continued to rise due to its ‘safe haven’ status as investors fretted about the geopolitical uncertainty in MENA.

West Texas Intermediate Oil Price - 5 years to March 2011



Source: Energy Information Administration

RBA leaves interest rates on hold

The Reserve Bank of Australia (RBA) left interest rates unchanged at 4.75% following its early March Board meeting, judging its "mildly restrictive stance on monetary policy" to be appropriate. The RBA also noted that global growth continues to expand and that while the rise in commodity prices is "pushing up" inflation in most countries, "financial conditions for the global economy remain accommodative". In addition, domestic inflation is expected to remain "consistent" with the Bank’s target range of 2-3%, which has been aided considerably by the appreciation of the Australian dollar (A$). The upshot of all of this is that the RBA is likely to keep rates on hold at least for the next few months.

Elsewhere, the US Federal Reserve (0-0.25%), the ECB (1.00%), the Bank of England (0.50%) and the Bank of Japan (0.10%) all left their benchmark interest rates on hold in March. The Bank of Japan also announced that it would inject record cash into money markets and limit bond purchases to help maintain financial stability in the wake of the recent earthquake. Further, the central bank decided to double its asset purchase program to ¥10 trillion yen; an increase that’s about one-tenth the size of the US Federal Reserve’s Treasuries-buying effort.

[1] Source: *International Monetary Fund*

Bond yields rise

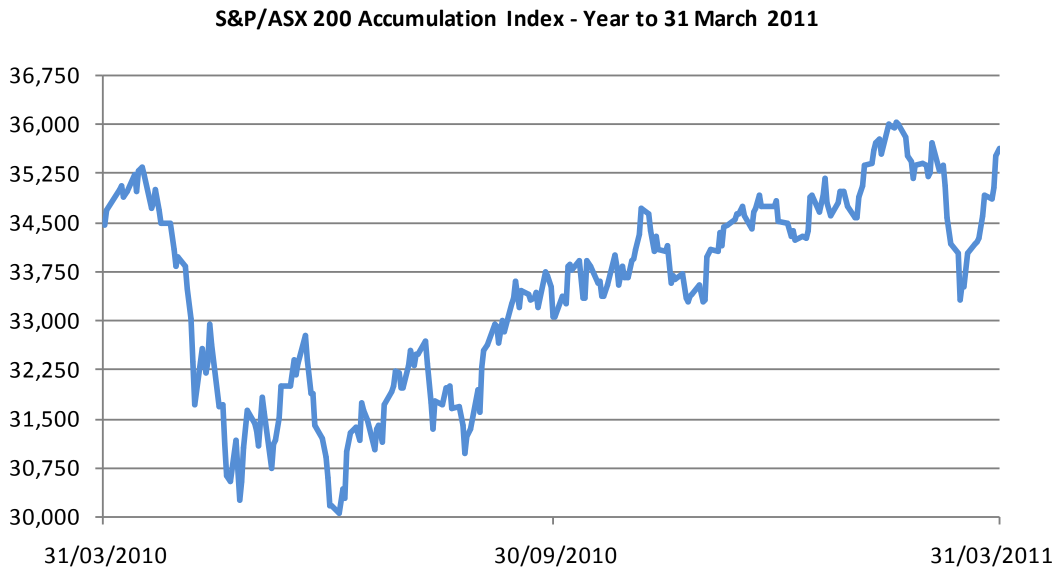
After falling[1] early in the month amid the rising tensions in MENA, global bond yields ended March slightly higher as investors regained their appetite for risk and offloaded government debt in favour of riskier assets such as shares and listed property.

In the US, the yield on 10-year bonds rose four basis points to close the month at 3.46% and it was a similar story here in Australia, with the yield on our 10-year bonds rising five basis points to close at 5.53%.

Australian share market up slightly

The Australian share market managed to eke out a modest gain in March, with the S&P/ASX 200 Accumulation Index up 0.7% for the month as some stronger-than-expected economic data – notably February's retail trade figures – and rising commodity prices overshadowed the uncertainty in MENA.

So far this year, the local market has gained 3.2%. This compares with +5.4% in the US, +4.2% in Europe, +0.1% in the UK and -4.6% in Japan.



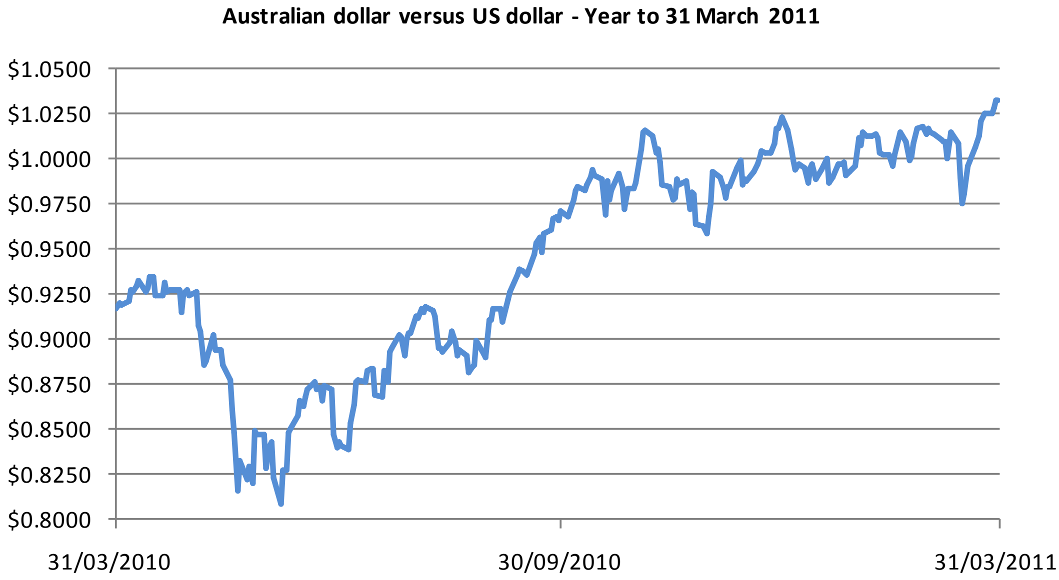
Source: Premium Data

Australian dollar remains above parity

The A$ made further gains against its US counterpart in March, this time on general US dollar weakness and expectations that the RBA will look to raise interest rates in the second half of the year. The gains might have been even better if not for the civil unrest in MENA, which had the effect of dampening demand for higher-yielding assets like the Aussie. The local currency hit as high as US$1.0372 late in the month before eventually closing March 1.4% higher at US$1.0323.

Looking ahead, the A$ is likely to trend higher against the US dollar this year as interest rates here remain relatively high compared to those in the US, and if stronger global growth pushes up commodity prices.

[1] *Bond yields have an inverse relationship with bond prices, meaning that when yields fall, prices rise (and vice versa).*



Source: Premium Data

Looking ahead

Political tensions throughout MENA are likely to remain at the forefront of investors' minds in the short-term, particularly given the region's considerable influence on oil prices. However, tensions in MENA aside, investors remain increasing optimistic about the prospects of a sustained global recovery. Improving economic data in both the US and Europe continues to point to a pick-up in activity on both sides of the Atlantic and this should bode well for corporate earnings in 2011. That said, investors will no doubt remain cautious about Europe's ongoing sovereign debt issues, particularly the fiscal positions of Spain, Greece, Portugal and Ireland.

The Australian economy remains relatively well-placed compared to the likes of the US and Europe and should continue to benefit from strong Chinese demand for our raw materials. Further, unemployment remains relatively low, business confidence is still high and leading indicators suggest further positive growth ahead. Of course, any additional monetary tightening in China – our largest trading partner – will obviously have an adverse effect on the Australian economy.

In terms of interest rates, the RBA retains its hawkish view on domestic monetary policy and we expect interest rates to start rising early in the second half of 2011, particularly as the mining boom starts to add significantly to economic growth.

Important note

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