Market Update and Outlook

December 2011

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Outlook and Market Update – December 2011

Looking ahead

Market volatility looks set to remain at elevated levels throughout 2012, driven mainly by events in Europe. Whilst a European recession would appear somewhat inevitable, officials, including the ECB, can nonetheless act to prevent a more serious downturn within financial markets. By contrast, recent economic data would suggest that the US recovery is beginning to gather steam and this should help to minimise Europe's impact on global growth next year. That said, if Europe's debt woes were to deteriorate significantly, the effects of this would obviously be felt in the US and therefore the rest of the world also.

The Australian economy remains relatively well placed compared to the likes of the US and Europe – highlighted by the strong domestic growth seen in the September quarter – and should continue to benefit from robust Chinese demand for our raw materials. However, any further deterioration in Europe and/or additional monetary tightening in China – our largest trading partner – will have an adverse effect on the local market.

In terms of interest rates, it would seem that events in Europe remain the key focus for the RBA; particularly as inflation is now at a level the Bank is comfortable with. Importantly, with Australian interest rates still relatively high compared to the US and Europe, the RBA does have the luxury of being able to cut the cash rate more aggressively should the euro zone crisis (and therefore the global growth outlook) deteriorate further.

Market update at a glance

The month of December brought with it renewed hopes of a resolution to Europe's sovereign debt crisis, though investors were ultimately disappointed. Meanwhile, oil prices gave back some of their recent gains, domestic shares weakened and the Australian dollar pushed back above parity with its US counterpart.

At a glance

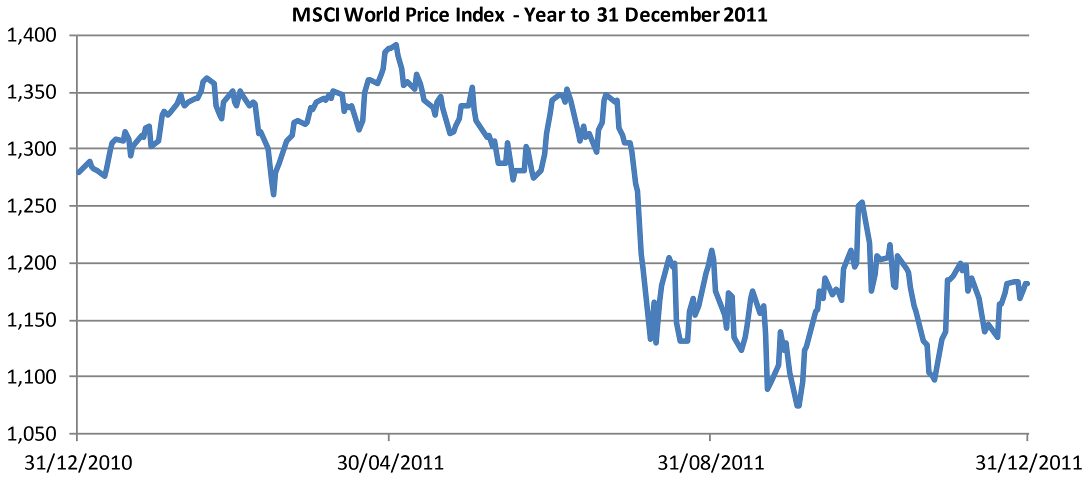
- Global share markets mixed
- Oil prices give back recent gains
- The Reserve Bank cuts interest rates for a second consecutive month
- The Australian share market falls
- The Australian dollar strengthens

Global share markets mixed

Most major share markets were able to manage only modest gains in December, driven mainly by renewed hopes of a resolution to Europe's persistent debt woes. However, whilst various summits and high level meetings between Europe's heavyweight nations did yield some results, investors are still yet to see any meaningful solution to the crisis. In fact, one credit rating agency – Fitch Ratings – went as far as saying that a comprehensive solution was beyond reach and that without the European Central Bank (ECB) acting as a backstop the crisis had the potential to engulf the region's solvent members.

Meanwhile, some stronger economic data in the US, China and India – particularly in the key manufacturing space – did provide investors with some relief.

In the US, the benchmark S&P 500 Index closed the month 0.9% higher and this had a positive knock-on effect elsewhere, with markets in the UK (1.2%[1]) and Japan (0.2%[2]), also ending the month stronger. By contrast, stocks in Europe (-0.6%[3]) weakened while collectively global share markets closed December down 0.2%[4] (see following chart).



Source: Bloomberg

Global bonds maintain rally

Global bonds continued to rally in December after the failure of European officials to resolve the region's ongoing debt crisis saw investors again dump 'risk' assets such as Australian and international shares in favour of the relative safety of US Treasuries and other major government bonds.

The yield on US 10-year Treasuries fell[5] a further 20 basis points to 1.88% over the month and it was a similar story here in Australia, with the yield on our 10-year bonds falling 34 basis points to just 3.67%.

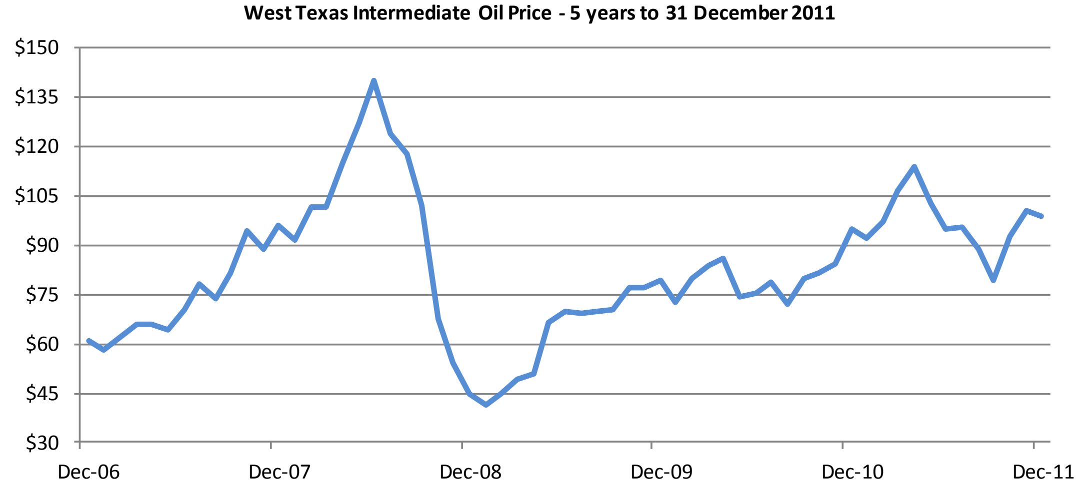
Importantly, Australian bonds – widely considered a safe haven from Europe's debt problems – continue to represent better value than many of their global counterparts, including US Treasuries. The yield differential between Australian 10-year bonds and their US equivalent is currently 179 basis points (or 1.79%).

[1] UK shares measure by the FTSE 100 Index
[2] Japanese shares measured by the Nikkei 225 Index
[3] European shares measured by the Dow Jones Eurostoxx50 Index
[4] Global shares measured by the MSCI World Index
[5] Bond yields have an inverse relationship with bond prices, meaning that when yields fall, bond prices rise (and vice versa)

Oil prices ease amid growth concerns

After several months of good gains, oil prices eased throughout December as Europe's debt crisis weighed on the global growth outlook. Also impacting returns were profit taking and rising US stockpile levels, while geopolitical tensions in the Middle East, better US economic data and political uncertainties in the wake of the death of North Korea's Kim Jong Ill helped to limit the losses.

Oil closed the month 1.6% lower at US$98.83 a barrel, taking its return for the 2011 calendar year to 4.3%.



Source: Energy Information Administration

RBA cuts interest rates again

The Reserve Bank of Australia (RBA) followed last month's rate cut – its first since April 2009 – with another in December; taking the official cash rate from 4.50% to 4.25% as concerns regarding Europe's sovereign debt crisis continued to mount. Whilst Australia's direct exposure to Europe is minimal compared to countries like Japan and the US, we nonetheless remain indirectly exposed to the region by way of any downturn in demand from our Asian trading partners, namely China and India.

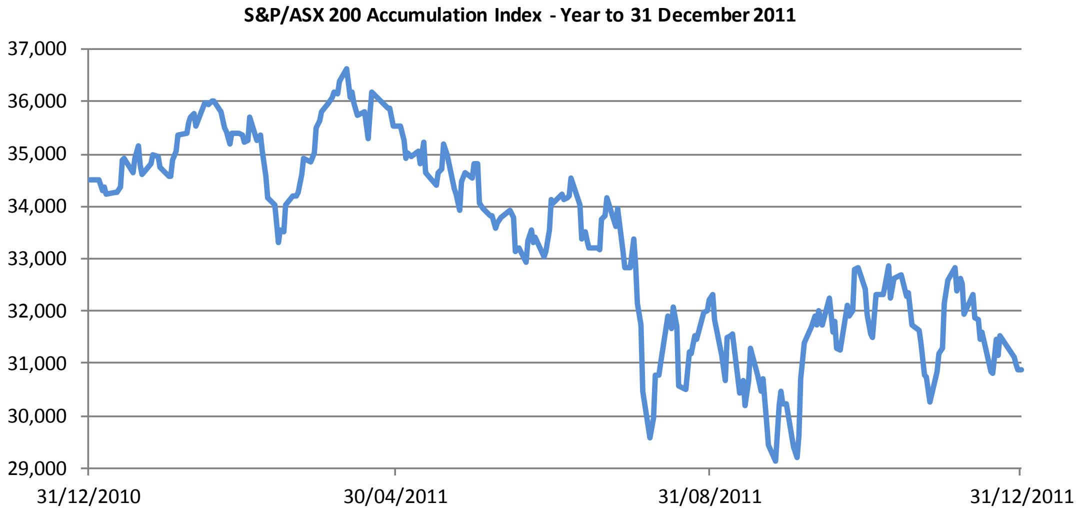
The ECB also cut its benchmark interest rate – from 1.25% to just 1.00% – in December as the region's debt crisis escalated even further. Meanwhile, the Bank of England (0.50%), the US Federal Reserve (0-0.25%) and the Bank of Japan (0.10%) all left their respective benchmark interest rates on hold during the month.

Australian share market weakens

Despite a strong start to the month – the local market gained 4.9% in the first three trading days – the Australian share market fell in December, with the S&P/ASX 200 Accumulation Index closing 1.4% lower.

Underpinning the loss were increasing fears about Europe's sovereign debt crisis, a modest rise in the domestic unemployment rate, weaker commodity prices – the result of renewed jitters about the state of the global economy – and a mixed lead from major overseas markets.

On an annual basis, the Australian share market closed 2011 10.5% lower; erasing last year's 1.6% gain. This compares with a flat (0.0%) return in the US, -5.6% in the UK, -17.1% in Europe and -17.3% in Japan. Collectively, global shares ended the year 7.6% lower.



Source: Premium Data

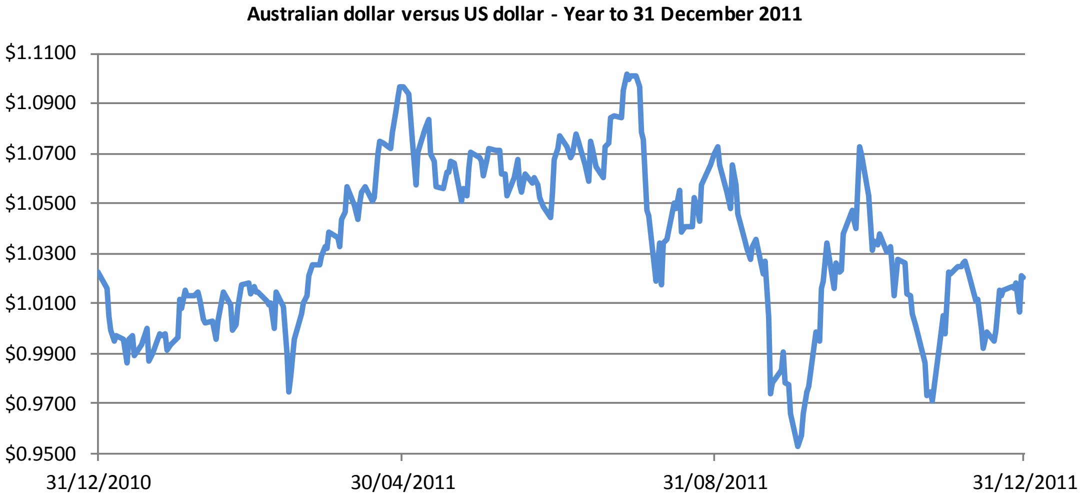
Australian economy expands in the third quarter

The Australian economy grew by 1.0% in the September quarter, led by a strong jump in mining investment, post-flood construction activity and (perhaps surprisingly) household spending. However, the outcome, whilst clearly positive given the events in Europe, did highlight Australia's relatively narrow growth base, with the bulk of the improvement in domestic activity concentrated in the Resources and related sectors.

Australian dollar strengthens

The Australian dollar (A$) made good gains against its US counterpart in December, closing the month 2.3% higher on the back of stronger-than-expected domestic growth data and speculation late in the period that the US economy is recovering. The local currency ended the month above parity at US$1.0205, though on an annual basis the A$ closed 2011 relatively flat (-0.2%) against the US dollar.

Given that market volatility remains at elevated levels and that the global growth outlook remains soft, it's likely that the A$ will continue to face strong headwinds in the near-term. Any further rate cuts by the RBA will also have an adverse effect on the local currency.



Source: Premium Data

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