

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

The new calendar year started with a rally in risk assets, with improvements in US economic data, improved sovereign bond auctions in Europe and new forecasts by the Federal Reserve suggesting zero interest rates to late 2014.

### Economic overview

Evidence of this renewed optimism was the measures undertaken by the European Central Bank in December through providing European unlimited funds over 3-years in a program called a Longer-Term-Refinancing-Operation. This appears to have made a significant step towards improving bank funding in Europe and stabilising sovereign bond yields in Spain and Italy.

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However, implementation risks continue with the Greek bond haircut through the Private Sector Involvement (PSI) deal yet to be finalised and growing concerns that Portugal will require a second bailout. Expectations are the PSI deal will result in a Net Present Value loss for private Greek bondholders of more than 70%, meaning they'll get repaid less than 30 cents in the dollar.

Late in January, the 16<sup>th</sup> EU emergency summit concluded with further moves to a fiscal compact signed by 25 out of 27 EU countries (UK and Czech Republic did not sign the agreement). It was also announced that the two bailout funds, the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) would be combined from 1 July 2012 with a joint capacity of €750bn. In other EU news, Standard and Poor's downgraded nine EU countries, with both France and Austria downgraded from AAA to AA+. The EFSF subsequently was also downgraded to AA+.

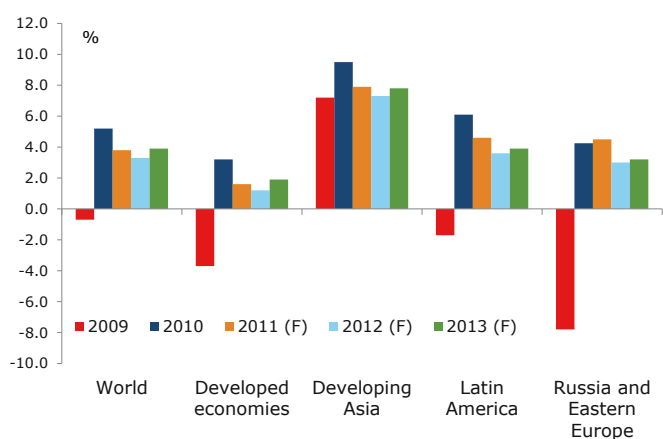
Economic data in Europe was mixed, with labour market weakness continuing. Unemployment rates at the end of December 2011 stood at: Germany (6.7%), Ireland (14.5%), Spain (22.9%), France (9.9%) and Italy (8.9%). Inflation pressures continued to moderate, with annual inflation recorded at 2.7%, from a peak of 3%. Survey measures of manufacturing and services activity showed stabilisation. The PMI Manufacturing index rose to 48.7 from 46.9, while PMI Services rose to 50.5 from 48.8. The

German economy was largely responsible for the improvements.

In the UK, Q4 GDP contracted 0.2%, taking the annual rate of growth to 0.8%. Unemployment rose to 8.4% with fiscal austerity and a weak financial sector leading to a benign UK economy.

The International Monetary Fund (IMF) downgraded global economic growth forecasts for 2012 and 2013. For 2012 growth of 3.3% (was 4%) and for 2013 growth of 3.9% (was 4.5%) is now expected. Most of the downgrade was due to Europe, with a mild recession now forecast for 2012. See the chart below for updated forecasts. Inflation forecasts were also lowered.

### IMF Global growth forecasts



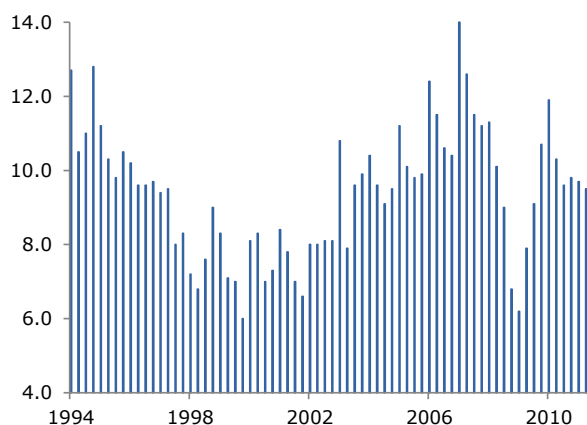
Source: IMF World Economic Update January 2012

In the US, economic data continued to improve, although market expectations are quickly catching up to the improved outlook. Q4 GDP was recorded at 2.8%, up from 1.8% in Q3 on a seasonally adjusted annualised rate. However the composition of growth was less supportive, with growth driven by a large contribution from inventory accumulation, while business investment fell. The US labour market continued to improve with the unemployment rate falling to 8.5% at end of December and 200k jobs created. However, seasonal distortions were evident, due to retail and courier employment.

In China, annual GDP growth slowed to 8.9% to December 2011, from 9.1% (see the chart for details), with net exports detracting from growth due to the global slowdown and China's transition into a consumption-based economy. Inflation

pressures continued to ease, with inflation falling to 4.1%/yr from 4.2%/yr. The PMI Manufacturing index held up, rising to 50.5, from 50.3. Data analysis was complicated this month with the Chinese New Year in January, compared to February last year. This saw a strong jump in retail sales, up 18.1%/yr in December, from 17.3%/yr in November.

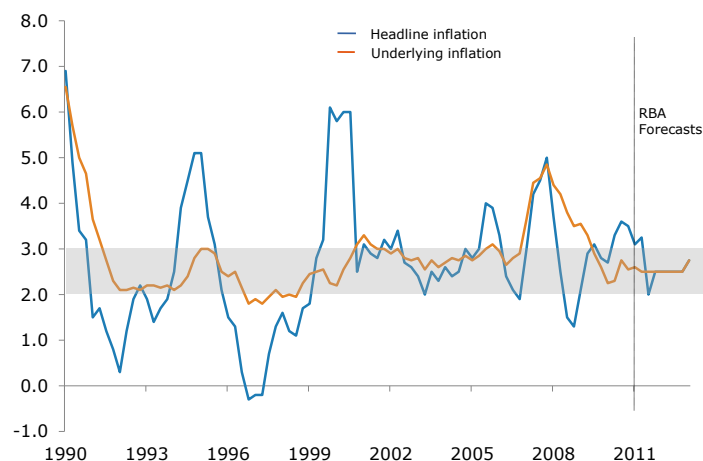
### China annual GDP growth (%)



Source: Bloomberg. Data to 31 December 2011

In Australia, CPI data was released, with headline inflation flat in Q4 11, taking the annual pace of inflation down to 3.1% from 3.5%. See chart below. Measures of underlying inflation rose by an average of 0.55%/quarter, which was above market expectations but lower than in Q1 and Q2 2011. This took the annual rate of underlying inflation up to 2.60% from a revised 2.55% – still within the RBA's 2% to 3% target band.

### Australia inflation – annual and quarter (%)



Source: ABS. Data to 31 December 2011. RBA forecasts from November 2011

In other economic data, employment fell by 29,300 jobs, however the unemployment rate fell to 5.2% from 5.3% as the participation rate fell sharply. This was driven by lower than normal part-time employment during the December period, particularly for women aged 15 to 24. Soft consumer spending is now leading to weaker employment levels in the retail sector.

The Australian dollar rose sharply against the major currencies in December. This continued to be driven by inflows into Commonwealth Government Securities (CGS) with its relatively attractive yield attractiveness and safety. The Australian dollar rose 4.1% against the USD, 2.7% against the pound, 3.2% against the euro and 3.2% against the yen.

### **Australian shares**

The Australian sharemarket enjoyed a strong start to 2012, with the S&P/ASX 200 Accumulation Index rising 5.1% in January.

Most of the issues which impacted the market during 2011 – including concerns about the global economic outlook, sovereign debt issues in Europe and subdued consumer confidence – remained in place, but the market was nevertheless able to post a solid gain.

Unsurprisingly, stocks in cyclical areas of the market – such as Materials and Energy – tended to be among the best performers as investors' risk appetite increased. A number of mining companies published quarterly production reports in January.

Releases from the major diversified players, including BHP Billiton and Rio Tinto, showed continued strong iron ore production. A cyclone passed through the major mining areas of Western Australia during the month, although this did not appear to have had a major impact on production.

There was a limited amount of commentary from companies in other areas of the market, as most were in 'blackout' ahead of earnings releases in February.

The majority of Australian listed companies will update the market with their earnings for the

period ending 31 December 2011 over the next few weeks.

### **Global shares**

Global equity markets posted a solid gain in January as markets tried to look beyond the impact of near term issues. The MSCI World Index rose 4.9% against the USD and 1.5% in AUD terms, although this masked considerable divergence between markets and industry sectors.

The Dow Jones Industrial Average rose 3.4%, the S&P 500 was up 4.4% and the NASDAQ rose a sharp 8.0% with Apple rising 12.7% after a strong earnings result.

European markets were generally positive, with Spain the exception, falling 0.7%. Sentiment improved across the board towards European banks with the Stoxx 50 Index rising 6.2%. Elsewhere the DAX rose 9.5%, the French CAC was up 4.4% and the Italian market rose 4.9%. In the UK, the FTSE 100 rose 2.0%.

In Asia, markets recorded mostly positive returns, apart from Malaysia which fell 0.6%. The Korean market rose 7.1% despite concerns continuing about the geopolitical risks surrounding the leadership transition in North Korea, as well as signs the South Korean economy is slowing. Q4 GDP data was released with the economy slowing to 3.4%/year, from 3.5% and 4.7% in Q4 2010. Elsewhere returns were positive; Hong Kong (+10.6%), Singapore (+9.8%), Thailand (+5.7%) and Taiwan (+6.3%) all rose.

In terms of sector performance, the Materials sector outperformed after a poor December, rising 11.0% on sharp increases in commodity prices. Tin (+26.8%), zinc (+14.2%), nickel (+11.5%), gold (+11.1%) copper (+9.5%) and lead (+8.8%) all rose over January. In terms of other sector performances, Financials (+8.6%), Consumer Discretionary (+7.4%) and Industrials (+7.2%) all rose with the rally in risk assets. Defensive sectors underperformed with Consumer Staples (-1.1%), Telcos (-2.4%) and Utilities (-1.6%) all down.

## **Global emerging markets**

Emerging markets outperformed the broader global equity market, gaining 11.2% in USD and 7.8% in AUD terms given the rally in risk assets over January.

There was a significant divergence of returns within the sector, with Brazil (+11.1%), Hungary (+11.3%) and Turkey (+11.0%) all performing well. Sri Lanka fell 6.3% over January while Mexico rose 0.9%.

Emerging markets continued to ease monetary policy in January on lower inflation pressures and a deteriorating growth outlook. Brazil, Thailand and the Philippines all cut rates in January, while the Reserve Bank of India cut the cash reserve requirement ratio to assist the banking sector and promote lending into the real economy.

The focus for emerging markets in 2012 will be to monitor activity indicators for signs of slowing growth, due to the sovereign debt crisis in Europe and weaker financing activity. Policy can be eased further in most emerging economies and will be a key feature in early 2012.

## **Fixed interest**

Most major developed global bond markets ended modestly lower in January, however, yields in peripheral Europe decreased sharply.

Despite protracted negotiations on Greek debt restructuring, growing pressure on Portugal and downgrades to the debt ratings of nine Eurozone nations (including France to AA) by Standard & Poor's (S&P), market sentiment towards the larger Eurozone peripheral bond markets improved.

Market participants reacted positively to the large-scale liquidity injection announced by the European Central Bank (ECB) in late December, which meaningfully reduced the near-term default risk of troubled banks. It also reduced the pressure on European banks to sell bonds in the peripheral countries. Together with several successful peripheral governments' bond auctions, this propelled 10-year yields in Italy and Spain significantly lower.

Elsewhere, US Treasuries were fairly resilient in the face of stronger risk appetite. Ten-year US

Treasuries decreased by 8 bps to 1.80% at January-end, driven down by the US Federal Reserve's projection that it expects to keep interest rates at exceptionally low levels to the end of 2014. This followed the first release of the Federal Reserve's own forecast of the Fed Funds rate (depending on economic conditions). Officials also released an explicit long-term target for inflation – 2% on the Personal Consumption Expenditure price index.

The ECB left its main refinancing rate at 1.0% at its first policy meeting of 2012. The unanimous decision was widely expected by market participants. German 10-year bunds decreased by 4 bps to 1.8% at January-end. The success of Italian bond auctions helped fuel a rally in Italian bonds over the month with the 10-year Italian yield decreasing by 110 bps to 5.93% at January-end. Similarly, the Spanish 10-year bond yield fell by 40 bps to 4.9% over the month ended 31 January 2012. However, 10-year Portuguese bond yields rose from 13.4% to 16.4%.

Across the Channel, the Monetary Policy Committee (MPC) again voted unanimously to leave the Bank of England (BoE) rate unchanged at 0.5% and retained its £275 billion asset purchase programme. The UK 10-year gilt yield decreased by 1 bp to 1.97% at month-end.

The Australian bond market was mixed in January. Ten-year CGS yields posted a modest 5 bps increase to 3.7% at January-end from a record low of 3.7% at December month-end. The RBA Board did not meet in January, however, in early February the RBA left the official cash rate on hold at 4.25%.

## **Listed property**

The S&P ASX 200 Property Accumulation index rose 5.4% in January 2012, outperforming the S&P/ASX 200 by 0.3%.

In terms of stock specific news, Charter Hall Office announced that it had entered into an agreement with a consortium to acquire the Australian portfolio for \$2.49 per unit. The independent directors have unanimously recommended the proposal subject to the

independent expert finding the proposal in the best interests of unitholders.

The UBS Global Real Estate Investors Index (local currency) increased 6.0% over the month of January, with the US and Canada the top performing region (+6.4%) followed by Singapore (+5.9%). The worst performing regions were Japan (+2.4%) and Continental Europe (+3.9%).

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