Monthly Market View

December 2012

Latest monthly commentary from the Investment Markets Research team at Colonial First State

Economic overview

Most equities markets posted solid gains in December, although tensions were heightened with ongoing Fiscal Cliff negotiations in the US. Elsewhere, the focus was on new policy measures announced by the US Federal Reserve, elections and expectations of more quantitative easing in Japan, political uncertainty in Italy and, yet another, debt deal for Greece.

Through a combination of spending cuts and tax increases, the Fiscal Cliff had the potential to wipe out 4% of GDP growth from the US in 2013 – likely driving the economy back into recession. US politicians were able to come to a deal, in the early hours of 1 January 2013, which limited the fiscal policy tightening for 2013 to around 1.5%.

Stephen Halmarick
Head of Investment
Markets Research

Belinda Allen
Senior Analyst
Investment Markets Research

James White
Senior Analyst
Investment Markets Research

However, while some potential tax increases have been put off permanently and the deal did involve some pleasing aspects, significant spending cuts have only been delayed by two months.

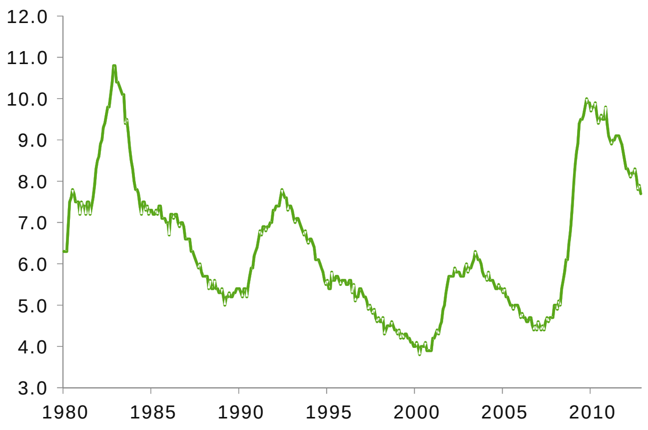
These spending cuts will need to be discussed and agreed upon in February, the same time as the $US16.394 trillion debt ceiling will need to be raised again. Negotiations around the spending cuts and the debt ceiling will likely, once again, be very acrimonious and the risk of volatility in markets remains high.

US economic data released in December showed a mix of weaker data on Fiscal Cliff concerns, with both business and consumer confidence numbers lower over the month.

However, US employment for November surprised on the upside, in spite of Super Storm Sandy. Over the month 146,000 jobs were created, with the unemployment rate falling to 7.7%. However much of this was driven by a fall in the participation rate.

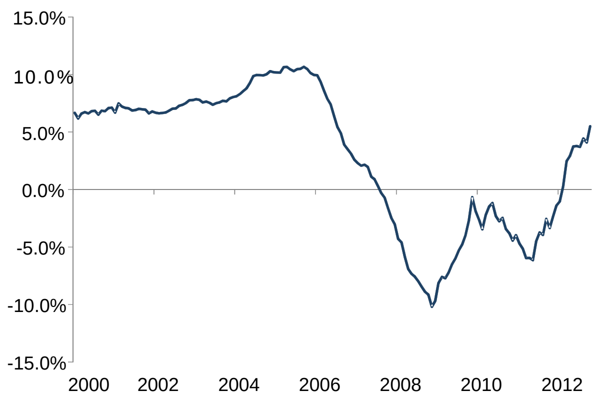
Favourable housing market data continued to flow, with existing home sales up 5.9% per month to their highest level since September 2009. This continued to support house prices, with the FHFA House Price Index up 0.5% per month and 5.5% per annum. The seasonally adjusted annual rate for Q2 2012 GDP was revised to 3.1%, up from its preliminary reading of 2.7%.

US UNEMPLOYMENT RATE (%)



Source: Bloomberg. Data to 30 November 2012

US FEDERAL HOUSING FINANCE AGENCY ANNUAL HOUSE PRICE GROWTH



Source: Bloomberg. Data to 30 September 2012

The Federal Reserve announced the rollover of its Operation Twist program into outright Treasury purchases at year-end. The Federal Reserve will now purchase US$45 billion of Treasury bonds per month in addition to its US$40 billion of Mortgage Backed Securities. The Federal Reserve's balance sheet will, therefore, expand by US$85 billion per month.

In addition, and in a surprise move, the Federal Reserve changed its zero-interest rate guidance from a timeframe, ie. mid-2015, to an economic framework, where zero-interest rates will be warranted at least as long as the unemployment rate remains above 6.5% and expected inflation is below 2.5%. Currently Federal Reserve economic forecasts anticipate the unemployment rate not falling below 6.5% until 2015.

In Japan, elections saw the Liberal Democratic Party overwhelmingly regain government, with Shinzo Abe (again) becoming Prime Minister. Abe has made reviving the economy his main objective, with large scale quantitative easing and a weaker yen on his agenda.

In Europe, news centred on Greece undertaking a buyback of its debt. Greece used a €10 billion loan from the European Financial Stability Facility to buy back over €30 billion of debt, helping reduce its debt to GDP ratio as part of its third debt bail-out package.

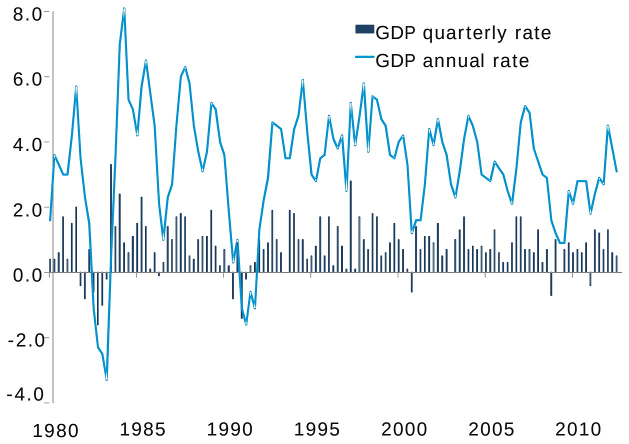
In Italy, technocrat Prime Minister, Mario Monti, announced his resignation after support for his government wavered. An election will now be held on 24-25 February. Mario Monti has stated that he would consider again becoming Prime Minister if asked by parties that support his reform agenda. There is concern, however, that reforms undertaken by Monti would be slow and that improvement in Italy's debt and fiscal fundamentals would be jeopardised.

Data in Europe appears to have stabilised at depressed levels. GDP for Q3 12 fell 0.1%, with annual growth of -0.6%. Much of the weakness continues in peripheral European countries; however the German economy has also shown weakness in recent months.

In Australia, the Reserve Bank of Australia (RBA) eased monetary policy in December, cutting the cash rate to 3.0%. The RBA remains concerned about future sources of economic growth and a possible weakening in the labour market in 2013.

Australian GDP data for Q3 2012 showed growth of 0.5% and annual growth returning to around trend pace to 3.1% from 3.8%. The mining sector continued to positively contribute to economic growth, although this contribution is expected to fall in 2013. The terms of trade also fell 4.0% per quarter, with income growth slowing in the Australian economy from falling commodity prices.

AUSTRALIAN GDP – QUARTERLY AND ANNUAL GROWTH (%)



Source: ABS. Data to 30 September 2012

Late in the month, the Federal Government announced it was unlikely to meet its budget surplus target in 2012/13 due to a sharp fall in tax revenue. This came as no surprise to financial markets.

Australian shares

Australian shares closed 2012 strongly, with the S&P/ASX 200 Accumulation Index adding 3.8% in December. This extended gains in 2012 as a whole to more than 20%. There was a fair amount of news from Australian listed companies, but sentiment towards the market as a whole was dominated by the looming Fiscal Cliff in the US.

Stocks in the industrials sector performed particularly well, while the major banking stocks also continued their recent good form. In the mining sector, various stocks were supported by the rising price of commodities, such as iron ore and coal.

Western Australia-based Fortescue Metals Group was in the headlines after announcing it was proceeding with an expansion of its iron ore operations. This is expected to see the company increase its annual production to its stated target of 155 million tonnes within the next 12 months.

Elsewhere, BHP Billiton announced it had sold its stake in the Browse liquefied natural gas project off the coast of Western Australia for US$1.63 billion. First discovered in 1971, a final investment decision on whether to develop this resource is expected within the next six months. Woodside Petroleum owns 31.3% of Browse and will be the operator of the project. If approved, construction of the project is estimated to take between five and six years.

Listed property

Stocks in the listed property sector performed slightly less well than the broader Australian share market in December, but nonetheless registered a solid return. The S&P/ASX 200 Property Accumulation Index added 2.9%, extending gains in 2012 as a whole to 33.0%.

There was a fair amount of news flow in the A-REIT sector during December. Stockland Group disappointed investors by announcing that full year earnings are likely to be towards the lower end of its already downgraded range. The company suggested activity in the Victorian residential market remains sluggish.

Dexus Property Group meanwhile announced it had acquired stakes in three prestige Sydney office buildings for a combined total of more than $A500 million. Australand Property Group was also in the news. The company received an unsolicited approach from GPT Group to acquire its commercial and industrials business. Separately, various commentators suggested that Mirvac Group was considering a merger with Australand. These suggestions saw the Australand share price rise more than 18% during the month.

International property security securities also added value in December, adding 3.0% in Australian dollar terms. It appears that investors continued to favour the relatively stable earnings and dividend yields available from property stocks.

Global shares

Global equity markets were generally stronger in December. The gains were strongest in Asia and Europe, while US markets were weighed down by the ongoing negotiations over the Fiscal Cliff. The MSCI World Index rose 1.75% in US$ terms and 2.17% in A$ terms.

US equity markets managed only modest gains, with the S&P 500 up just 0.7%, the Dow was up 0.6% and the NASDAQ added 0.3%. Despite some better signs for the US economy, the political impasse over the Fiscal Cliff and concerns over the coming debate on the Debt Ceiling are likely to remain negatives for the US market.

European equity markets were stronger; both Italy and Spain managed gains of 2.9%, while Germany (2.8%) and France (2.4%) also saw good gains. The UK FTSE 100 Index rose, however, by just 0.5%. Finalisation of another round of Greek debt restructuring again helped clarify the future of the EU, at least until German elections in late 2013.

Markets saw strong gains in Asia. The Nikkei rose 10.1% in the month on the change in government. The new Prime Minister, Shinzo Abe from the Liberal Democratic Party, is expected to push the Bank of Japan into significant quantitative easing and attempt to weaken the Yen.

Chinese markets were also strong, with the Shanghai Composite Index up 14.6% on expectations growth would accelerate in 2013. Elsewhere Thailand (5.1%), Malaysia (4.9%), Korea (3.3%), Singapore (3.2%), Hong Kong (2.8%) and Taiwan (1.6%) all rose. While the Indian market also rallied, it lagged behind with a gain of just 0.5%.

Global emerging markets

Emerging market equities also rose in December, up 4.8% in US$ terms and 5.2% in A$ terms, with most markets showing good gains.

Argentina jumped almost 15% on the month, with other solid gains also seen in Turkey (6.9%), Brazil (6.1%), Sri Lanka (5.5%), Poland (5.4%) and Russia (5.1%). Mexico (4.48%), Czech (4.2%), Saudi Arabia (4.1%) and the Philippines (1.6%) also gained ground, but losses were seen in Israel (-3.6%) and Hungary (-0.5%).

Global fixed interest

Global bond markets in the major economies (US, Germany and UK) were mixed in December. The 10-year US Treasury yield increased by 14 bps to 1.76%, propelled higher by positive sentiment associated with further accommodative monetary policy by the Federal Reserve.

Economic data released in the US during December, such as GDP, employment, retail sales and housing surveys surprised on the upside, further supporting risk appetite. Risk assets staged a strong rebound on New Year's Eve in the wake of a deal approved by the US Senate - with the blessing of the White House - to at least temporarily avert much of the Fiscal Cliff.

Developments in the Eurozone, particularly in Greece, led to a further compression of most peripheral sovereign bond spreads to German Bunds in December. Following a successful bond buyback, the Troika disbursed further aid to the fiscally stricken country, as risks of a 'Grexit' continued to recede.

The yield of the 10-year Italian government bond fluctuated during December, reaching an intra-month high of 4.89% following Italian Prime Minister Mario Monti's announcement of his intention to resign as soon as the 2013 budget was passed. Eventually, the yield finished the month unchanged at 4.49% with Mr Monti declaring that he would stand for elections in February 2013.

Despite the improvement in peripheral bond markets by year-end and some strong German consumer survey releases, German Bunds continued to be well bid as final Q3 2012 GDP data confirmed that the Eurozone was in a technical recession. The yield of the 10-year German Bund fell by 8 bps to 1.31% over the month.

Major changes are expected for the Bank of Japan after the election of the new Abe-led government. This could see significant quantitative easing through 2013. At month end 10-year Japanese Government Bond yields were at 0.79%, from 0.72% at the end of November.