Colonial First State

Monthly Market View

March 2012

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

- The finalisation of the Greek sovereign bond restructure, a lower GDP growth target in China and mixed economic data led to diverse results in financial market returns.
- Equity markets largely recorded positive returns, although lower than previous months.
- The focus of investors was on the moves recorded in US Treasuries and Bunds which sold off (yields rose) in the early part of the month, with some commentators calling the start of a bear bond market. This was sparked by improving US economic data and revised expectations of the chances of a third round of quantitative easing by the Federal Reserve.

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Economic overview

The largest sovereign debt restructuring in history was finally announced, with Greece receiving 95.7% participation among investors after it received approvals to activate collection action clauses.

Prior to this, investor participation was recorded at 85.8% for Greek law bonds. This restructure largely removed Greece as a near-term risk for markets, with ongoing focus to remain on the implementation of austerity measures, the upcoming election in early May and the economic growth outlook.

The International Swaps and Derivatives Association (ISDA) announced that the use of collective action clauses will trigger Credit Default Swap contracts.

Elsewhere in Europe, Italian Prime Minister Mario Monti progressed with significant labour market reforms, such as removing the mandatory reinstatement for unfair dismissals, reducing disincentives to hire labour on temporary contracts and measures to extend the safety net.

Markets become more concerned about Spain, with the government having to renegotiate its budget deficit forecasts for 2013, with 5.3% of GDP set for 2013, from the original plan of 4.4%. Economic data continues to deteriorate in Spain, with the unemployment rate reaching 22.85% in Q4 2011.

In the US, momentum continued although question marks remain about the impact of a warm winter on activity levels. The most likely sectors to have benefited include the labour market, housing, construction and retail. The US labour market continues to heal. The unemployment rate was steady at 8.3% in February, with 227,000 jobs added in the month. This has taken the total number of jobs added to the US economy to over 2 million in the past 12 months.

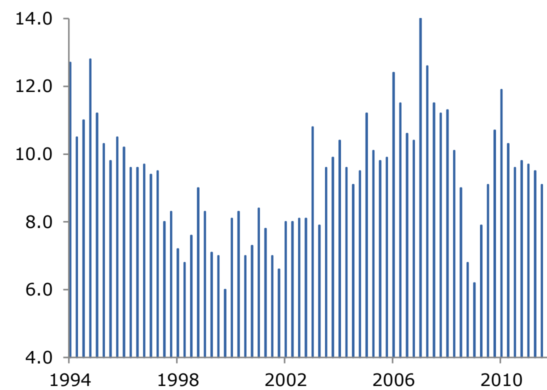
One area of focus for the US economy has been concerns over the oil price. While the price of oil actually eased marginally over March, down 3.7%, political tensions in the Middle East continue to weigh on the market. The US consumer is most exposed through rising gasoline prices. Retail sales rose 1.1% for the month, however ex autos & gas retail sales rose less, up 0.6%.

Elsewhere, the recovery in the US housing market remains problematic, with a stabilisation of activity at best. US existing home sales (-0.9%), new home sales (-1.6%) and housing starts (-1.1%) were all weaker in February. There is the expectation that the mild winter brought activity in the housing market forward to December and January. The test for the US economic momentum will be in coming months where warmer weather is the norm.

China dominated economic headlines in March with the annual National People's Congress conference releasing details about the economic objectives.

The GDP growth target for 2012 has been lowered to 7.5%, down from 8% in previous years. This is in line with the government target to average 7% growth during the 12th Five-Year Plan (2011-2015). See chart below of China's GDP growth. This surprised some observers and comes with the continual aim to rebalance China's growth to higher quality domestic consumption, driven by technology and human capital.

China GDP growth (%)



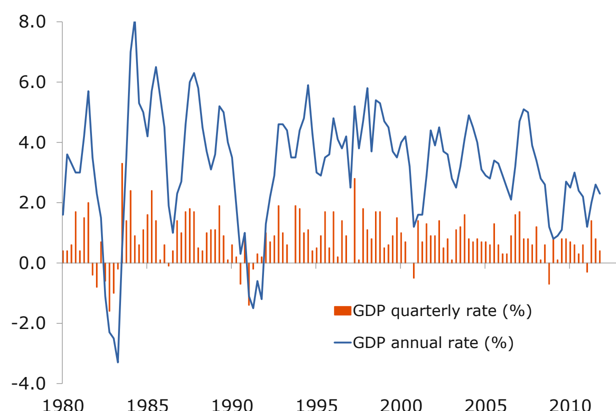
Source: Bloomberg. Data to 31 December 2011

Premier Wen also discussed the view that RMB/USD was close to equilibrium and the reform of the exchange rate would continue through allowing a wider trading band.

Significant policy easing is unlikely in the near term, especially within the property market. The view the NPC has is that China's home prices were still far above reasonable levels.

In Australia, Q4 2011 GDP data was released showing growth at a below-trend pace of +0.4% for the quarter and 2.3% for the year. See chart overleaf for details. Growth in the quarter was driven by an increase in household spending, inventory build-up and net exports. In contrast to the past 12 months, the income side of the economy was soft, driven by the first fall in the terms of trade since Q3 2010 and the largest fall since Q2 2009. The terms of trade fell 4.7% for the quarter.

Australia GDP – quarterly and annual change (%)



Source: ABS. Data to 31 December 2011

The household savings ratio fell to 9%, down from 9.6% in Q3 2011. There are signs of improvements in household consumption, but once again this is flowing through into non-retail areas such as travel, cars and domestic services rather than retail stores, which are suffering from structural changes in the sector.

The labour market shed 15,000 jobs in February and the unemployment rate rose to 5.2%, from 5.1%. Weak hiring conditions continue to hold down consumer confidence, which fell 5% to a below-average level.

Australian shares

The Australian share market recorded a third consecutive month of gains in March, extending 2012 to-date gains to 8.4%. This was the highest quarterly return from the S&P/ASX 200 Index since Q3 2009.

The Australian market was largely driven by offshore economic data over the month. Favourable news in the US supported cyclical stocks, especially those with exposure to US economic recovery. In contrast, concerns about growth momentum in China weighed on sentiment towards materials stocks, and shares in the materials sector lagged those in other areas of the market. Shares in the energy sector tended to be dragged down by the softness in the oil price. The defensive telecoms sector also underperformed as investors increased their risk appetite.

As well as some cyclical stocks, financials shares were notable outperformers, as major lenders demonstrated an ability to increase borrowing costs even when official interest rates are unchanged.

Company news was mixed; retailer David Jones, contractor Leighton Holdings and coal haulage company QR National all downgraded earnings expectations. The significant underperformance of these stocks highlighted the importance of careful stock selection within the Australian sharemarket.

Listed property

The UBS Global Property Investors' Index (local currency) increased 3.7% in March, with Europe the top performing region (+5.3%), followed by the US & Canada (+4.9%). The worst performing regions were Australia (-0.7%) and Singapore (+0.7%).

The S&P/ASX 200 Property Accumulation Index declined 0.7%, underperforming the S&P/ASX 200 Index by 1.9%.

In stock specific news, Stockland downgraded its FY12 earnings guidance by 3.5% due to deterioration in residential markets, while Charter Hall Office unit holders approved the consortium's proposal to acquire its Australian portfolio.

Global shares

With some notable exceptions, global equity markets posted gains in March, driven by investor inflows into equities, and some resilience in economic news.

The MSCI World Index rose 6.9% in $US terms and 4.9% in $A terms, although this masked considerable divergence between markets and industry sectors. The Australian dollar fell 3.6% against the $US to $US1.0346.

The Dow Jones Industrial Average rose 1.8%, while the S&P 500 Index was up 2.8%. The NASDAQ rose 3.9%, with all markets assisted by further strong gains in Apple.

European markets were mixed; Spain was down 6.5% on continued economic weakness and escalating concerns over its sovereign debt

outlook. Elsewhere, the German DAX rose 0.4%, the French CAC was down 2.2% and the Italian market fell 5.5%. In the UK, the FTSE 100 declined 2.4%.

In Asia, markets were mixed with Japan outperforming (Nikkei up 3.1%) as the yen continues to retreat from recent highs. Chinese markets were weaker on the revised GDP growth target and expectations that any policy easing will be gradual. Other Asian markets were mixed, with Hong Kong (-4.7%), Singapore (+0.6%), Korea (-1.0%), Thailand (2.7%) and Taiwan (-2.6%).

Global emerging markets

Emerging markets underperformed the broader global equity market, declining 3.5% in $US, but up 0.2% in $A terms.

There was a significant divergence of returns within the sector, with Saudi Arabia (8.7%), Israel (3.4%) and Turkey (2.5%) performing well, while Russia (-5.6%) and Argentina (-2.7%) were weak.

India continued to ease policy through cutting the cash reserve requirement ratio for banks. Elsewhere, the Philippines and Brazil eased official cash rates in March.

Global fixed interest

Global bond markets were mixed in March, ranging from higher yields in the US and Spain to lower yields in Germany, France and Italy. Yields rose sharply in the first half of the month and then declined during the second half.

10-year US Treasury yields increased by 23bp to 2.17% at March-end, but peaked just shy of 2.4% mid-month. German bund yields finished the month 3bp lower at 1.79%, but not before rising to 2.08% early in the month.

In the US, better economic data buoyed market sentiment in risk assets, but confirmation from the US Fed that monetary policy would remain exceptionally stimulatory into 2014 helped bond yields rally at month end.

In Europe, the restructuring of privately-held Greek government debt proceeded, enabling Greece to source another tranche of bailout funds. The second round of the European Central Bank's (ECB) Long-Term Refinancing Operation eased tensions in bank funding and public debt markets.

However, concerns over the pace of economic growth in Europe and fears of a more aggressive slowdown in China both limited risk appetite later in the month.

Spanish government bonds came under pressure during the month (up 36bp to 5.33%) with the Spanish government announcing that it would not be able to meet the EU's budget deficit target in 2012.

EU Finance Ministers agreed at month-end to effectively raise the ceiling on the European Stability Mechanism (ESM) to €700bn from €500bn. In addition, Finance Ministers unexpectedly allowed €240bn in unused funds in the current rescue fund – the European Financial Stability Facility– to be accessed during the transitional period until the ESM is fully capitalised in the first half of 2014.

The ECB left its main refinancing rate at 1.0% for a third consecutive month in March. A rate cut was not discussed at the meeting despite the announcement of a downward revision to GDP forecasts.

In the UK, the Monetary Policy Committee kept the fixed rate unchanged at 0.5% and maintained its stock of asset purchases (ie, its value of quantitative easing) at £325bn.

The 2012 UK Budget was considered to be 'fiscally neutral' by most market participants, with the public deficit projected to fall to £120bn (7.6% of GDP) from £126bn (8.3%), courtesy of further expenditure restraint.

One of the major credit rating agencies, Fitch, affirmed the UK's sovereign credit AAA rating, but cut the outlook from 'stable' to 'negative'. The UK 10-year gilt yield increased by 4bp to 2.10% at month-end.

The Bank of Japan held policy steady in March after the further round of quantitative easing in February. 10-year JGB yields ended the month unchanged at 0.95%.

Monetary policy easing in Asia ex-Japan continued with the Central Bank of the Philippines cutting its overnight borrowing rate by 25bp to 4.00% and the Reserve Bank of India reducing its cash reserve ratio by 75bp to 4.75%.

Australian fixed interest

The Australian bond market followed the global trend in March, with yields rising in the early part of the month, but then declining into month end. 10-year CGS yields initially sold-off to a high of 4.28%, but with fears of a softening in Chinese economic growth and the resurfacing of peripheral European concerns taking 10-year yields back below 4% at month-end.

Bonds with a short time to maturity were more impacted by Chinese data weakness, as markets moved to price-in another cash rate cut from the RBA. Three-year CGS declined by 13bp to finish March at 3.48%.

The Reserve Bank of Australia (RBA) held the cash rate unchanged at 4.25% in March, consistent with consensus. Further communication from the RBA indicated that it retained an easing bias, but was awaiting a further deterioration in economic data and/or better news on inflation before cutting rates again.

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