# Monthly Market View

October 2011

- Global uncertainty continued
- Risk assets, like equities and commodities rallied sharply on expectations of a comprehensive resolution for the European banking and sovereign crisis and better than expected economic data in the US.
- The Australian dollar was also fairly volatile during the month. An increase in risk appetite among investors resulted in a sharp rebound in the dollar against other major currencies.

Stephen Halmarick
Head of Investment
Markets Research

Belinda Allen
Senior Analyst
Investment Markets Research

James White
Senior Analyst
Investment Markets

**Economic overview**

A new plan for the European sovereign and banking crisis was proposed in late October, with EU leaders agreeing on a raft of decisions. The four main decisions were:

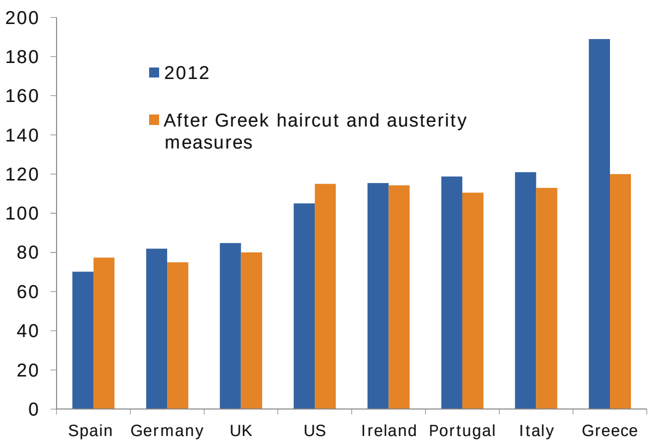
1. Greece. An agreement was reached to reduce Greece's debt to GDP ratio to an estimated 120% by 2020 by way of a 50% 'haircut' on Greek debt held by private investors. This deal is estimated to reduce Greek debt by €100bn.
2. Leverage the European Financial Stability Facility (EFSF). This is to be leveraged four to five times from €440bn (a figure which was finally ratified in October) to €1tr. This is to be achieved by an insurance mechanism and by a Special Purpose Vehicle. More details on these mechanisms should be released by 7 November 2011.
3. Banking system. The European banking system is to be recapitalised with €106bn of funds needed to lift the capital position of banks to a 9% Core Tier 1 ratio by June 2012. There will also remain in place a coordinated approach to longer-term funding needs.
4. Fiscal coordination and consolidation. A gradual move towards further fiscal union, especially for those countries under a funding program. This will be implanted through stricter controls and centralisation of budget policy.

The response by financial markets to these announcements was initially positive; however there has been growing concern over implementation risks, especially around the political situation in Italy and Greece. In early November markets have fallen.

Implementation risks emerged in early November with Greek Prime Minister, Papandreou announcing that a referendum would be required to vote on the terms of the rescue package and, by default, a vote on whether Greece remains in the euro. This vote is scheduled to take place in January 2012.

Italy continues to be a source of concern; Moody's downgraded the sovereign credit rating to A2. Italian Prime Minister, Berlusconi has committed to further austerity measures which, as part of the EU leaders' announcement, should see a decline in the debt to GDP ratio to 113% by 2014. See chart below of before and after debt to GDP levels for major economies post the EU summit and assumptions on austerity measures.

**Gross government debt to GDP ratio**



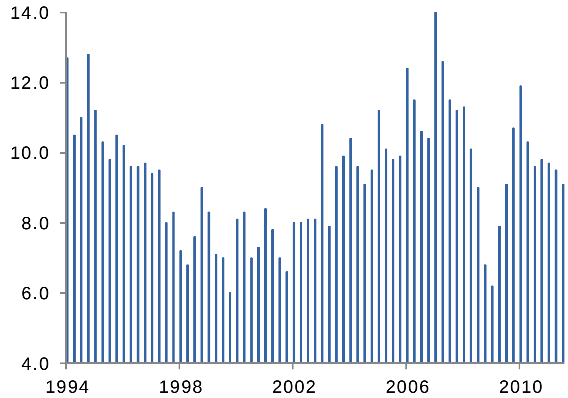

Source: IMF, EU leaders summit. Greece data to 2020, Italy to 2014, all others to 2016.

In economic data released in Europe in October, unemployment moved higher. The jobless rate is now 10.2%, up from 10% in the previous month. European inflation remains elevated (at 3%), while manufacturing activity continues to weaken.

In the US, economic data on the whole beat expectations in October. Q3 GDP rose to 2.5% on a seasonally adjusted annualised rate, up from 1.3% in Q2. The level of GDP surpassed its pre-recession peak, after 15 quarters. This is in contrast to employment levels, which remain 5% below the peak in 2008. The most recent data showed job creation of 103k and the unemployment rate steady at 9.1%.

In China, Q3 GDP data was released, which showed the pace of growth moderating to 9.1% from 9.5% in Q2 and 9.7% in Q1. While the slowdown was largely engineered by tighter monetary policy, much of the slowdown was experienced in the external sector. Economic growth in China remains robust, with partial indicators such as retail sales and industrial production pointing towards moderating growth rather than a much feared hard landing. See chart below of Chinese GDP.

**China – Annual GDP growth (%)**

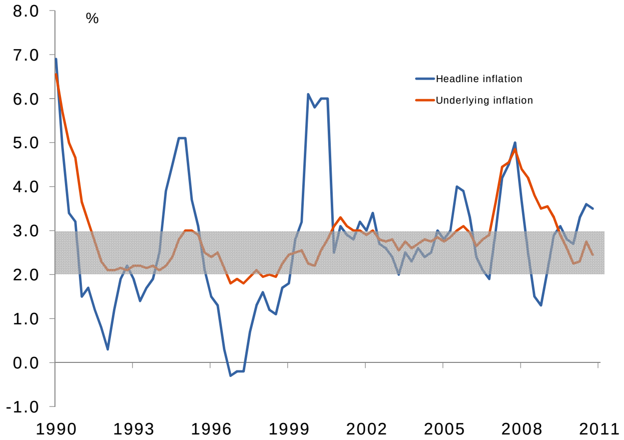



Source: Bloomberg. Data to 30 September 2011

There are reports that China is ready to loosen policy if required. Inflation for September eased to 6.1% from 6.2%, well below the peak in July of 6.5%. Chinese Premier Wen heightened market speculation by postulating that China 'would fine-tune macroeconomic policy at a suitable time and by an appropriate degree'.

In Australia Q3 inflation data was released, indicating the annual pace of inflation declined marginally to 3.5% from 3.6%. More importantly, the measures of underlying inflation rose by a lower-than-expected 0.3%/qtr, taking the annual rate of underlying inflation down to just 2.45% from 2.75% (within the RBA's 2%-3% target range). See chart below for details.

**Australia – Headline and underlying annual inflation (%)**




Source: ABS. Data to 30 September 2011

Retail sales data were released for August and showed sales rose by 0.6%/mth, to be 2.1% higher than a year ago. This was well-above market expectations of 0.2%/mth and was bolstered by an increase in discretionary spending. The unemployment rate in Australia unexpectedly fell from 5.3% to 5.2% after employment rose by 20,400 in September. However the pace of employment growth remains subdued.

House prices continued to fall in Q3 2011, with Sydney house prices proving more resilient than other capitals. The Australia House Price Index fell -1.2%/qtr and was down -2.2% for the year. Private sector credit growth released for September showed a better-than-expected improvement from August, up 0.5%/mth and 3.4%/yr.

**Australian shares**

Following several months of risk aversion, investors sought to add risk to their portfolios in October, enabling the Australian share market to record a solid gain. The S&P/ASX 200 Accumulation Index increased by 7.3% during the month. Cyclical sectors, such as Financials and Materials, performed well. The Energy sector also outperformed, buoyed by a 17% increase in the oil price.

Investors remained focused on events in Europe and potential solutions to the financial crisis in the region. The recapitalisation package that was proposed by the European Union late in the month was well received.

Within Australia, there was a significant focus on the future interest rate policy of the Reserve Bank of Australia. Borrowing costs have been unchanged for the past 12 months, but consensus expectations suggested interest rates would be lowered in early November following a lower-than-expected inflation reading for the September quarter. As expected, interest rates were lowered by 0.25% to 4.5% at the Reserve Bank of Australia’s Board meeting on 1 November 2011.

The Australian dollar appreciated by 9.0% against the US dollar. Currency strength reduces the value of the offshore earnings of Australian listed companies, but improves the returns from Australian equities for overseas investors.

**Global shares**

Global equity markets rose sharply in October on expectations of a resolution to the European sovereign debt and banking crisis. The MSCI World Net Index rose 10.3% in $US terms and is now down 0.4% over 12 months. In $A terms, the index rose 1.1% given the appreciation in the $A during the month.

The Dow rose 9.5%, the S&P 500 was up 10.8% and the NASDAQ rose 11.1%. All indices traded with considerable volatility over the month and intra-day.

European markets were stronger across the board. The German DAX rose 11.6%, the French CAC was up 8.8% and the Eurotop rose 8.0%. Spain (+4.8%), Greece (+1.0%) and Italy (+8.0%) also rose.

In Asia, markets also recorded gains, although Japan posted more modest returns than its neighbours. The Nikkei rose a modest 3.3% given the recent strength in the yen. This prompted further intervention by the Bank of Japan in early November.

The yen had reached a post-war high against the US dollar, hurting Japan's large export sector and its equity market. This follows the Swiss National Bank's decision to place a ceiling on its currency against the euro in September. Elsewhere in Asia, Hong Kong (+12.9%), Singapore (+6.8%), South Korea (7.9%), Taiwan (+5.0%), Thailand (+6.4%) and Malaysia (+7.6%) all recorded gains.

In terms of sector performance, the Energy sector was the clear outperformer, rising 17.1% in the month. Commodity prices across the board were stronger on renewed optimism, with the oil price rising to more than $US93/barrel. Other commodity prices to record gains included copper (+13.8%), nickel (+11.2%), tin (+8.1%) and zinc (+7.5%). This led the Materials sector to record a 14.6% gain.

Other sectors to perform particularly well included Financials (+11.5%) – despite some weaker than expected earnings results in the US – and Industrials (+11.9%). Underperforming sectors includes Utilities (+2.6%) and Health Care (+5.1%).

**Global emerging markets**

Emerging markets recorded sharp gains in October, rising 13.8% in $US terms and 3.7% in $A terms.

There was a significant divergence of returns within the sector. Russia (+22.3%) and Argentina (+20.4%) rose sharply. Russia was well supported by rising oil prices. Other major markets, including Brazil (+11.5%), Poland (+7.6%) and Israel (+7.1%) also rose. Sri Lanka (-6.8%), Turkey (-5.4%) and Czech Republic (-0.4%) all struggled.

Brazil cut interest rates to 11.5%. Indonesia also reduced interest rates by 0.25% in a surprise move. In contrast, India raised the official cash rate to 8.5%. Global issues have impacted on some emerging economies more than others. Brazil and Indonesia both cited weaker global economic conditions as a reason for the rate cuts. In other news, the Philippines announced a fiscal stimulus measure to assist local economic growth.

**Fixed interest**

Global bond markets saw yields rise (prices fall) in October. Most developed world bond markets weakened as participants became increasingly optimistic that European leaders could finally deliver a credible, comprehensive and well-targeted policy response to the euro area's sovereign debt and banking crisis.

Overall, US 10-year Treasury yields rose by 0.19% from 1.92% at the end of September to 2.11% at October month-end.

Prior to the European Summit announcement, both the European Central Bank (ECB) and Bank of England (BoE) 'took matters into their own hands'. This was in response to persistent dithering by other policy-makers and followed their counterparts at the US Federal Reserve ('Operation Twist') by announcing further monetary policy easing via 'unconventional measures'.

At its monthly policy meeting, the ECB kept interest rates on hold at 1.5%, but appeared to provide flexibility to new ECB head Mr Mario Draghi to reduce borrowing costs in early November. The ECB discussed an interest rate cut, but decided against this at this time. Much of the reason appeared to lie with region's elevated inflation levels. German 10-year bonds declined by 0.13% to 2.02% at October-end.

The Monetary Policy Committee (MPC) voted unanimously to leave the BoE base rate at 0.5%. However, the BoE also announced it was expanding its asset purchase programme by £75 billion to £275 billion, the first change in its monetary policy stance since late 2009. This is expected to take four months to complete. The UK 10-year government bond yield increased by 0.01% to 2.44% at month-end.

The 10-year Japanese government bond yield also increased by 0.01% to finish the month at 1.04%.

The Australian bond market saw yields rise and prices fall in October. 10-year Commonwealth Government Securities yield increased by 0.29% to 4.51% at October-end, having ended the previous month at 4.22%. This was the largest rise in 10 year yields since March 2010. Domestic bond yields generally moved in-sync with US Treasury yields.

The RBA eased monetary policy in early November, cutting the official cash rate by 0.25% to 4.5%. This was the first move in interest rates since November 2010, and the first easing of monetary policy since April 2009.

The RBA made the decision to begin returning monetary policy to ‘a more neutral stance’, noting that over the past year it had “maintained a mildly restrictive stance of monetary policy” given “concerns about inflation”. However, the RBA is now of the view that “with overall growth moderate, inflation now likely to be close to target and confidence subdued outside the resources sector, the Board concluded that a more neutral stance of monetary policy would now be consistent with achieving sustainable growth and 2%-3% inflation over time.”

**Listed property**

The UBS Global property investors' index (local currency) increased 9.9% in October, with the US and Canada the top performing regions (+13.9%) followed by the UK (+7.6%). The worst performing regions were Japan (-2.8%) and Australia (+3.8%).

The S&P/ASX 200 Property Accumulation index rose 3.8%, underperforming the S&P/ASX 200 Index by 3.4%. Global macro factors continued to drive REIT performance. During the month of September, active groups were the worst performers, driven by European debt concerns.

During October, however, improved sentiment on the back of a proposed solution to the European debt crisis saw active REITs outperform. Property transactions have been increasing and we believe this will continue. Mirvac Group announced the sale of five industrial assets. In addition to this, GPT Group announced it plans to sell its 50% stake in MLC Tower, which is an iconic tower that stands out in Sydney’s CBD skyline