

Monthly market view

May 2011

- Equity markets and bond yields fell in May as financial markets reassessed the European debt situation, US economic growth outlook and the pace of economic slowdown in Asia.
- Commodities prices fell on a weaker outlook, at the same time as the US dollar index rose from recent lows.
- Oil (-9.9%) and gold (-0.8%) prices fell, along with nickel (-12.1%) and tin (-12.8%).

Economic overview

Financial markets became increasingly concerned over Greek Government debt in May. Although Greece has accepted bailout funds from the European Union (EU) and International Monetary Fund (IMF), more funding is required. This funding was conditional on budget deficit cuts, which Greece has not met. Over the month, Greek 10-year yields rose from 15.7% to 16.0%, but reached as high as 17.0% mid-month. Greece was supposed to return to financial markets in 2012 to issue debt, but the costs of this are now prohibitive.

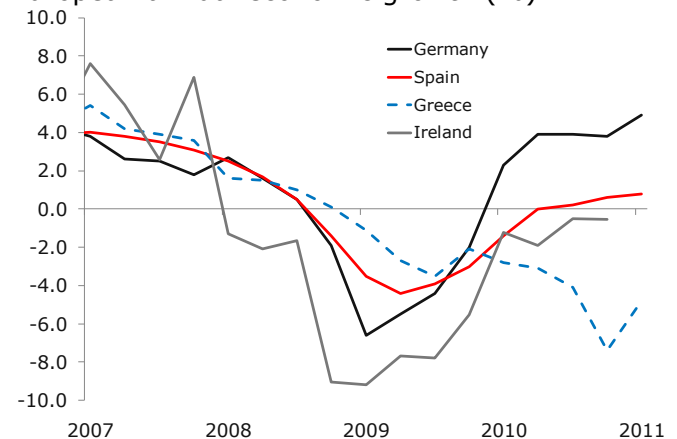
European Union (EU) and International Monetary Fund (IMF) officials are now focused on the short-term liquidity needs of Greece. Deep structural impediments remain in the economy and its debt situation, which will continue to place headwinds on growth and financial markets.

The credit rating of Belgium and Spain was placed on negative outlook, reflecting the growing political gridlock in both countries and a weaker economic outlook and fiscal situation. While better than Greece, Belgium has a budget deficit of 4.6% of GDP and Italy has a budget deficit of 4.5% of GDP (for 2010).

Data out of Europe was supportive with the EU economy as a whole recording growth of 0.8%/quarter and 2.5%/year. The German economy continues to show strong growth of 1.5%/quarter, while France (+1.0%), Austria (+1.0%) and the UK (+0.5%) recorded modest growth. The Greek economy did manage to grow 0.8%/quarter while Portugal contracted 0.7%/quarter (see chart 1).

Chart 1

European annual economic growth (%)



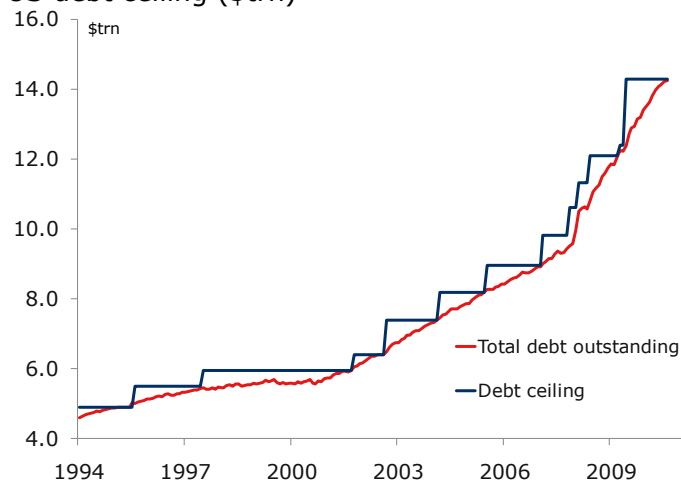
Source: Bloomberg. Data to 31 March 2011 except Ireland

Data released in the US over May indicated the economy had weakened in recent months. Some of the slowdown appears temporary, due to bad weather and supply chain disruptions as a result of the Japanese earthquake. GDP growth was confirmed at 1.8% for Q1 (annualised) and expectations for full year economic growth in the US have been revised lower to around 3%. However, downside risk for this forecast remains. The recent soft patch in the economy can be seen in higher unemployment benefit claims, weaker regional manufacturing indices and lower durable goods orders. The housing sector remains depressed with the S&P Case Shiller house price index falling 0.2% in March

and down 3.6% for the year. This continues to weaken home purchases, with existing home sales down 0.8% and pending home sales down 11.6% for the month.

US Government debt on issue hit the statutory debt limit of US\$14.294trn in May (see chart 2). From a legal stand-point, now that the debt limit has been breached the US Treasury no longer has the legal authority to issue debt to maintain the operation of government. This means the US Government can no longer increase its level of debt, until Congress approves a law to enable it to do so. The process forward is for Congress to increase the debt ceiling (a situation that has happened a number of times in recent years, the most recent in January 2010). The US Treasury Secretary has set a deadline of 2 August 2011 for the limit to be increased, however it is expected that political debate will take place for some time before this happens.

Chart 2
 US debt ceiling (\$trn)



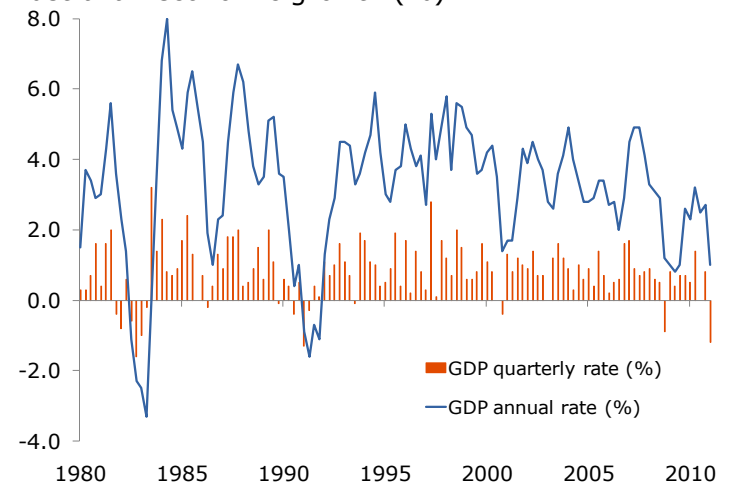
Source: Bloomberg. Data to May 2011

In China, the PMI Manufacturing Index fell from 52.9 to 52.0, its lowest level in nine months. Recent policy-tightening measures, including higher interest rates, reserve requirement ratio hikes and property specific measures, are having an impact on slowing activity levels. Power shortages are also likely to have played a role.

In Australia, Q1 GDP data was released on 1 June. The economy contracted by 1.2%, the largest decline in 20 years, driven by a 2.4% fall in net exports as a result of the Queensland floods (see chart 3). The annual pace of growth retreated to 1% from 2.7%.

Outside the mining and agriculture sector, the pace of growth was reasonable, led by a 3.2% increase in business investment. Other data released during the month showed a weaker economic picture, led by a fall in employment of 22,100. Other key data included weaker than expected wage gains of 3.8%/year, falling house prices, soft credit growth and continued depressed building approvals. On the upside was an upgrade to capital expenditure intentions for 2011/12, with A\$140bn worth of work now expected, compared to the last estimate of \$134bn.

Chart 3
 Australian economic growth (%)



Source: Bloomberg. Data to 31 March 2011

Australian shares

The Australian sharemarket lost ground in May, with the S&P/ASX 200 Accumulation Index declining in value by 2.0%. Offshore events had a major influence on investor sentiment during the month. In particular, investors appeared to become increasingly concerned about the threat of inflation in key regions. Accelerating inflation in China prompted fears that authorities would tighten monetary policy further and restrict growth. This would be expected to have a dampening impact on Australian export demand.

Commodity prices were volatile against this background. Oil fell by more than 8% in a single trading session during the month, highlighting the fragility of investor confidence. Chinese growth concerns also weighed on share prices in the materials sector, with most of the major mining stocks losing ground during the month. In contrast, more defensive areas of the market tended to outperform.

Corporate earnings results announcements were also a noteworthy feature of the month, with a wide range of US companies reporting quarterly earnings. Within Australia, semi-annual results announcements from some of the major banks dominated attention. The releases from Australian banks failed to generate anticipated earnings upgrades and as a result, the financial sector struggled during the month.

Global shares

Global equity markets fell during the month on a reassessment of the economic outlook and a move out of risk assets. The move comes after a supportive profit season in the US where earnings rose 13% over Q1. The fall in the global equity market over the month drove investors back into the relative safety of US Government debt (despite the US Government reaching its debt ceiling).

The MSCI World Net Index fell 2.5% in US\$ terms but rose 0.6% in A\$ terms, due to a fall in the Australian dollar in May. The Dow fell 1.9%, the S&P 500 was down 1.4% and the NASDAQ fell 1.3%.

European markets also recorded losses, although returns were mixed across the continent. Despite relatively strong GDP figures, Germany (-2.9%) and France (-2.4%) fell. Spain retreated 3.7% on political concerns after regional elections, Greece fell 7.8% on elevated concerns over the need for a restructure or re-profile of its government debt, but Portugal rose 1.6% with its bailout funds approved.

The UK FTSE fell 1.3%, with the economy struggling to record a meaningful improvement in economic growth, given a weak consumer environment.

In Asia, Japanese equity markets also fell, with the Nikkei and Topix both down 1.6%. Preliminary GDP data indicated a 0.9% fall in the economy over the first quarter, as a result of the natural disasters. While the rebuild is expected to boost growth over the medium term, power supply issues and restoring of production is expected to limit growth over the second quarter. Asia ex-Japan also recorded losses with China (-4.9%), South Korea (-2.3%) and Thailand (-1.8%) all falling. Singapore (-0.6%) and Hong Kong (-0.2%) recorded a more modest fall.

In terms of sector performance, defensives outperformed. Healthcare (+2.1%) and consumer staples (+1.7%) both recorded positive gains. Energy (-5.2%) and materials (-4.6%) both underperformed, given a risk-off mood to markets and as falls occurred in commodity prices.

Global emerging markets

Emerging markets underperformed developed global equity markets in May. The MSCI Emerging Markets Index fell 3.0% in US\$ and ended the month flat in A\$ terms.

Inflation remains an issue in most emerging markets. Examples include China (5.3%), India (8.7%), Brazil (6.5%), Russia (9.6%) and Indonesia (6.0%). Emerging economies continued to dominate movements in monetary policy, with Poland, India, Malaysia, Philippines, Vietnam, Chile, Colombia and Peru all lifting official interest rates in May.

The largest falls in equity markets occurred in Russia (-7.7%) and Turkey (-8.8%). Hungary (-3.3%) and Argentina (-4.1%) also recorded weaker returns. Sri Lanka (+0.8%) and Saudi Arabia (+0.4%) both recorded positive gains.

Fixed interest

Global bond yields fell for a second consecutive month, with US 10-year treasury yields declining by 23 bps to 3.01% in May. Investor risk aversion remained elevated as concerns over a possible mid-year moderation in global growth heightened, following the release of weaker-than-expected US macroeconomic data.

Investors also sought safe-haven assets as the peripheral European sovereign debt crisis intensified. Global markets and policy-makers continued to grapple with the uncertain effects of a potential Greek Government debt restructure. These worries limited risk appetite, causing investors to switch out of riskier assets into bonds backed by issuers with relatively strong fiscal positions.

Bond yields decreased across the larger European countries in May. German 10-year bonds decreased by 22 bps to 3.02%. In Japan, the 10-year government bond yield declined by 6 bps to finish the month at 1.15%. Economic data remained below trend in May in the aftermath of the devastating earthquake, tsunami and nuclear crisis. The

UK 10-year Government bond yield declined by 14 bps to 3.29% at month-end.

The Australian bond market rallied for a second consecutive month, with 10-year Government bond yields declining by 22 bps to 5.21%. Investor risk sentiment deteriorated following the release of a swathe of weaker-than-expected domestic macroeconomic data.

The RBA Statement on Monetary Policy (SMP) and minutes of the May board meeting confirmed the RBA's monetary policy tightening bias. The RBA left the overnight cash rate target at 4.75% in early May, but upgraded its inflation forecasts in the SMP. The 2013 underlying inflation forecast increased to 3.25% from 3%, above the Board's 2-3% target, signaling likely cash rate rises in the medium term.

The Federal Government released its 2011/12 budget, with the budget deficit estimated at A\$22.6bn, or 1.5% of GDP. This is down from the 2010/11 deficit of A\$49.4bn, or 3.6% of GDP. Most of the deterioration in 2010 was due to the natural disasters in Queensland and Victoria. A surplus of A\$3.5bn is expected in 2012/13.

The UBS All Maturities Composite Bond Index returned 1.28% for the month and 6.40% over 12 months.

Listed property

The Australian REIT sector outperformed the broader market by 2.0% in May, despite the total return on the S&P/ASX 200 REITs index being flat. This marked the fourth of the last five months where REITs have outperformed. Over those five months, REITs are up 4.0% relative to the market (0.9%). As at 31 May, the REIT sector was trading at a weighted average discount to our NAVs and NPVs of 8.5% and 6.3%, respectively.

The month was dominated by quarterly updates. GPT announced an on market buy-back of up to 5% of its securities. Charter Hall Office REIT is considering 28 expressions of interest and now intends to sell its entire US portfolio to return net proceeds to unit holders via a capital return. It was another healthy month for REIT debt issuance with further evidence of falling margins.

The UBS Global Property Investors' index (local currency) increased 1.5% during the month, with Singapore the top performing region (+2.8%) followed by the UK (+2.7%). The worst performing regions were Japan (+0.1%) and Australia (+0.1%).