

## **Market Update March 2012**

### **The Limitations of European solutions are concerning investors**

Global investor sentiment improved significantly in the New Year as closure of the European Greek solution, combined with a massive liquidity injection from the European Central Bank (ECB) and signs of improvement in the US economy, prompted an extended period of “risk on” in markets.

The market gains during this period were large and widespread, but were driven primarily by rising valuations (from very low levels), rather than any broad-based improvement in earnings expectations or reduction in capital costs.

### **Economic Overview**

In China, the annual National People’s Congress conference in March released 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 12<sup>th</sup> Five-Year Plan (2011-2015)

In US, the labour market continues to heal. The unemployment rate was steady at 8.3% in February, with 227,000 jobs added March 2012. 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.

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. 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. The terms of trade fell 4.7% for the quarter.

### **The market’s four month rally has faded**

More recently the continued disappointing European economic data combined with an end to the ECB’s liquidity injections (and the US Federal Reserve’s announcement that its quantitative easing II program has been suspended) saw the market’s four month rally peter-out fairly quickly.

Since Easter, the downtrend in global markets has intensified as a very soft US labour market report combined with rising Chinese inflation (which could limit the amount of policy support China can provide to its domestic economy) sparked concerns about the strength of the global recovery, and this has weighed heavily on risk assets.

Concerns about European government borrowing costs have strengthened weighing on investor sentiment before the start of the earnings season. Gold and US, German and UK Treasuries rallied as investors sought safety. Indeed UK 10-year government bond yields (currently 2.00%) are only 0.01% away from a 300-year low, whereas German 2-year government bond yields (0.09%) are less than Japan’s (0.11%) for the first time ever.

### **Europe’s troubles have spread into the bigger economies**

Despite all the talk of comprehensive solutions last year, solvency is once again an issue in southern Europe. The market’s primary European concern is not Greece, but Spain (particularly after it fresh fears that some banks might not survive a downturn exacerbated by the government’s austerity drive) Since its peak in early February 2012, the Spanish sharemarket has declined 16.5% with France and Italy also down heavily.

The latest forecast for Spanish public sector debt is for a jump from 69% last year to 80% in 2012, which is reasonable relative to its European peers and well below Italy’s near-120%. However, the acceleration of the debt rise is concerning investors as unemployment in Spain is 23% (and around 50% for those under 25 years of age) and the government is undertaking widespread austerity measures, which will prevent any economic recovery any time soon.

Some analysts have indicated that a deeper (than forecast) Spanish recession in 2012 could also adversely impact market perceptions about the quality of its private sector debt. In an environment characterised by declining house prices (which in recession could fall further), non-performing loans for the Spanish banks (currently 8% of total loans) are likely to place more pressure on regional bank balance sheets.

These funding pressures will eventually flow through to Australian banks. Fortunately, Australian banks have increased the amount of deposits on their balance sheets and this will partially negate the impact.

## **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 increase 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%.

## **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.

## **Global emerging markets**

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

## **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.

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 2012 helped bond yields rally at month end.

## **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 resulted in 10-year yields falling below 4% at month end.

The Reserve Bank of Australia (RBA) held the cash rate unchanged at 4.25% in March. 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.

## **Conclusion**

The magnitude of Spain's debt position has highlighted the limitations of the European Central Bank's long term refinancing operations (where it lent regional banks around £1 trillion at 1% for 3 years) where under-capitalised European banks were used to prop up over-leveraged governments. The market's attention is likely to swing to whether Spain can find a solution without a bail-out and, if not, whether the European bailout funds are large enough to cope with trouble in bigger economies such as Spain and Italy.

From an investment perspective, these global developments highlight the importance of capital preservation and income generation.