

August 2010

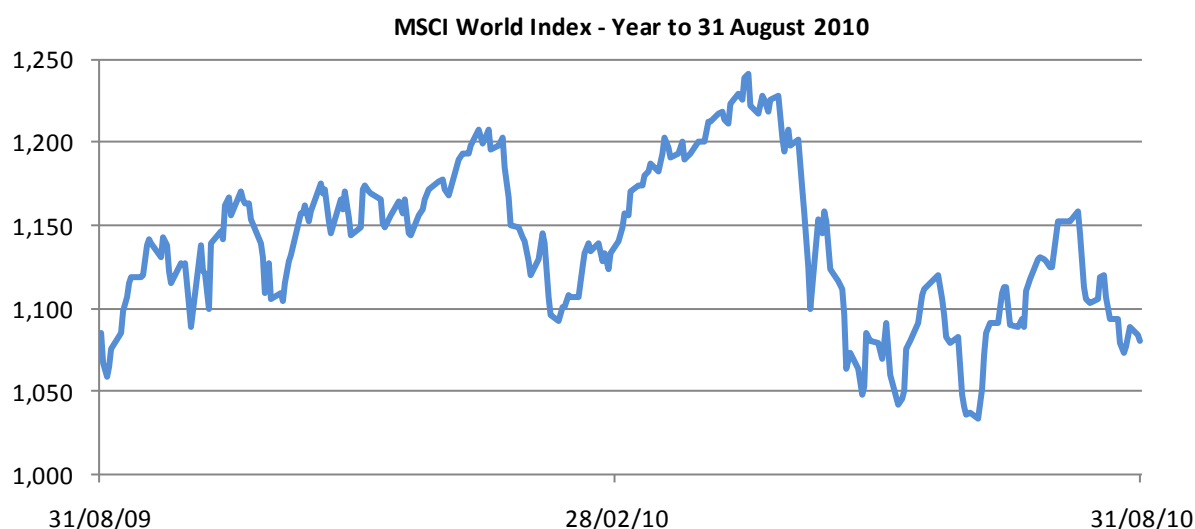
At a glance

- Global share markets fall back into the red
- Oil prices slumo
- The Reserve Bank keeps interest rates on hold...again
- Australian reporting season falls short of expectations
- Both the Australian share market and the Australian dollar weaken

Global share markets fall

After ending a three-month losing streak last month, global share markets returned to the red in August after weaker-than-expected economic data in the US and Europe prompted fears that global growth is beginning to slow. This was enough to overshadow positive merger and acquisition activity, including BHP Billiton's proposed takeover of Potash and Intel's bid for McAfee. It was also enough to overshadow easing concerns about Europe's sovereign debt crisis after positive bond auctions in Spain, Ireland and Portugal.

In the US, the benchmark S&P 500 Index closed the month 6.8% lower and this had a negative knock-on effect elsewhere, with share markets in the UK (-3.2%¹), Europe (-7.1%²) and Japan (-7.8%³) also closing lower. Globally, share markets closed August 3.9%⁴ weaker (see following chart). closed June 3.6%⁴ lower.



Source: Bloomberg

¹ UK shares measured by the FTSE 100 Index

² European shares measured by the Dow Jones Eurostoxx50 Index

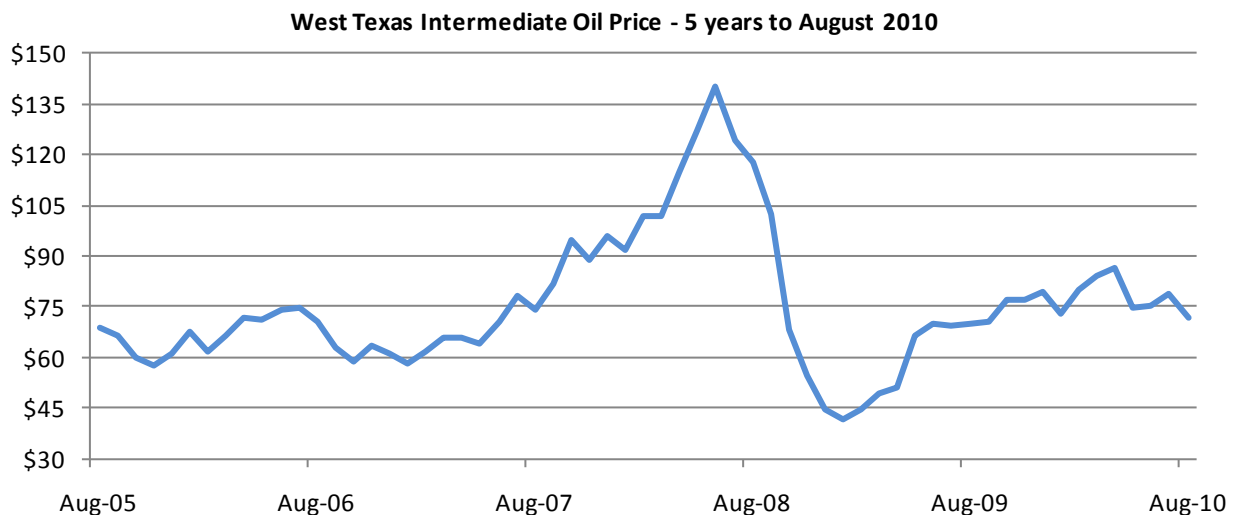
³ Japanese shares measured by the Nikkei 225 Index

⁴ Global shares measured by the MSCI World Index

Oil prices slump

Oil prices fell sharply in August amid weaker US economic data and concerns that a slowing global economy will impact demand. A stronger US dollar and a report showing that Chinese oil imports have slumped almost 20% since the end of July only added to the negative sentiment.

Oil closed the month 8.9% lower at US\$71.92 a barrel. After gaining 78% in 2009, oil prices are now 9.4% lower so far this year. Meanwhile, gold prices rallied as investors sought the precious metal's 'safe haven' status amid increasing economic uncertainty.



Source: Energy Information Administration

Interest rates on hold...again

The Reserve Bank of Australia (RBA) left the official cash rate on hold at 4.50% in August. Given the increasing doubt surrounding the outlook for the global economy, it's probably not surprising that the Bank sees no urgency in raising interest rates any time soon. However, with the RBA still forecasting domestic growth to rise above trend over the next two years and inflation expected to remain in the top half of its 2-3% target range, it's clear that the Bank retains a tightening bias. Whether the RBA moves again this year will now depend largely on how the global economic outlook unfolds. If things improve, the Bank could move as early as November. If things don't improve, it's likely that the Bank will wait until next year.

Elsewhere, the US Federal Reserve (0-0.25%), the European Central Bank (1.00%), the Bank of England (0.50%) and the Bank of Japan (0.10%) all kept their respective benchmark interest rates on hold in August

Bond yields fall sharply

Global government bond yields fell⁵ sharply throughout August as weaker share markets and renewed concerns about the global economy prompted a 'flight to quality', with investors offloading riskier assets such as shares and listed property in favour of the relative safety of government debt.

In the US, the yield on 10-year bonds fell 44 basis points to close the month at 2.47% and it was a similar story in Australia, with the yield on our 10-year bonds falling 44 basis points to close at 4.76%.

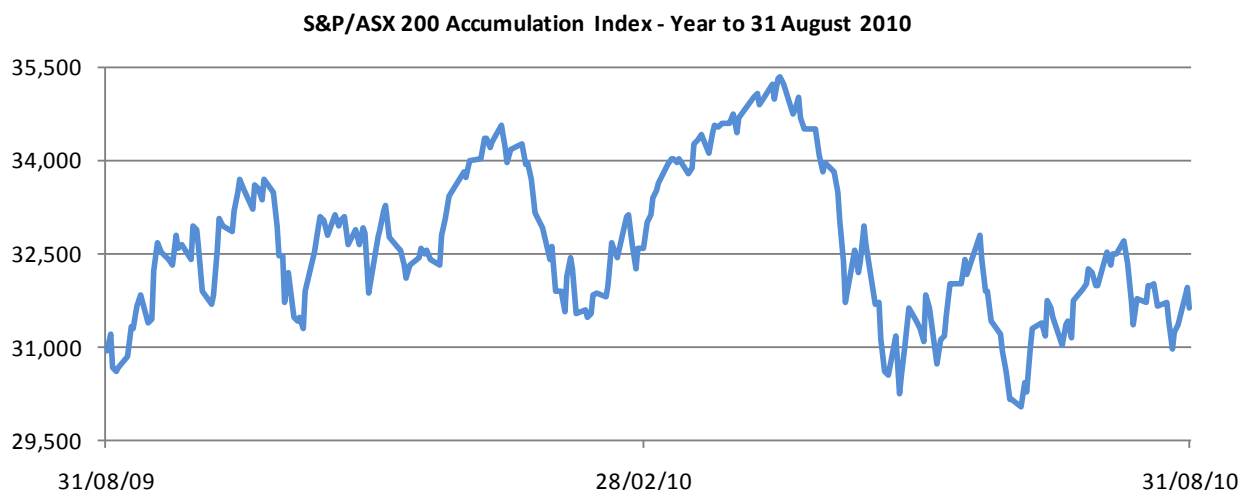
Reporting season disappoints

Australia was unable to replicate the strong US and European reporting seasons, with local June half earnings results falling a little short of expectations. That said, there was some improvement at least, with around 73% of all companies posting a rise in profits; though admittedly only 39% of those actually surprised on the upside. Whilst most companies were optimistic about future earnings, there were plenty that weren't, which led to a significant downward revision to 2010-11 consensus earnings expectations.

Australian market lower

Australian shares closed the month lower, with the S&P/ASX 200 Accumulation Index falling 1.2% on renewed concerns about the global economy and as the fallout from the Federal election weighed on investor sentiment. Less-than-inspiring earnings results and a poor lead from global share markets, particularly the US, also had an adverse effect.

So far this year, the local share market has fallen 7.0%. This compares with losses of -3.5% in the UK, -5.9% in the US, -11.6% in Europe and -16.3% in Japan. However, it is worth noting that global share markets, including our own, continue to trade well above the bear market lows they set back in March 2009.



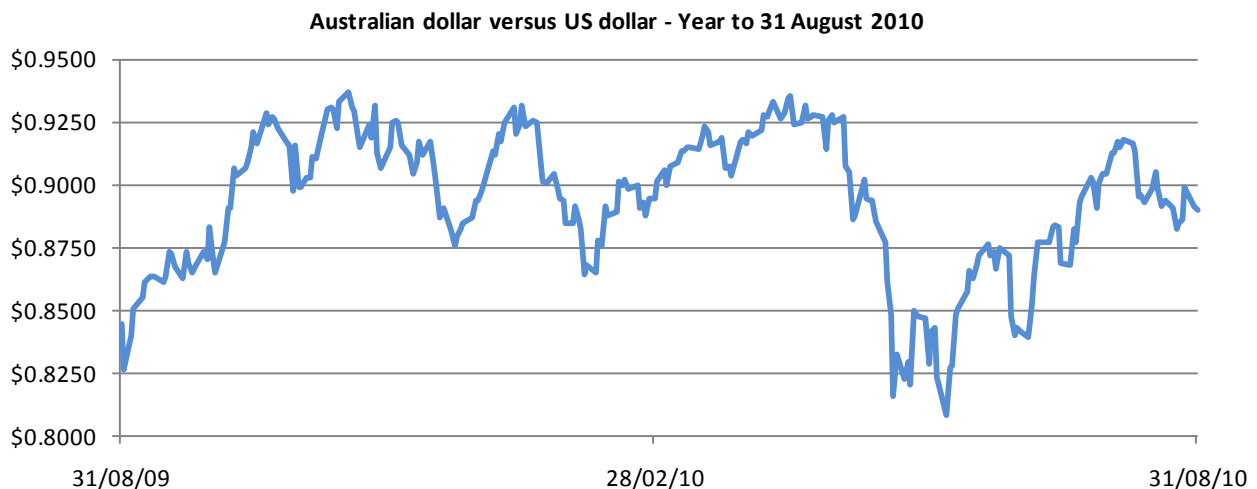
Source: Premium Data

⁵ Bond yields have an inverse relationship with bond prices, meaning that when yields fall, prices rise (and vice versa)

Australian dollar weaker

The Australian dollar (A\$) was lower against its US counterpart in August, losing 1.5% on concerns that slower global growth will impact demand for higher-yielding assets. Essentially, the A\$ is highly sensitive to growth expectations, so whenever doubt about the outlook for the global economy creeps in, our currency tends to take a hit.

The local currency closed the month at US\$0.8902 cents, though it remains well above the lows it set in October 2007, when it was trading at just US\$0.6012 cents. The A\$ will probably remain under some pressure in the short term because of heightened market volatility but the outlook for the local currency remains relatively positive. That's because Australia maintains a favourable interest rate differential against the major economies and because Chinese demand for our commodities doesn't look like letting up any time soon.



Source: Premium Data

Looking ahead

Concerns about Europe's sovereign debt crisis have eased in recent months and attention has now shifted to the US economy and the increasing threat of a 'double dip' recession. This is obviously causing greater market volatility, which in turn is weighing on investor sentiment. Not surprisingly, the likelihood of a double dip recession occurring has increased in recent weeks on the back of a string of poor US economic data. In fact, some economists have put the chances of a double-dip at as much as 40%. Overall, the US economy – and by default the global economy – faces an interesting next six months.

The Australian economy continues to be relatively well-placed compared to the likes of the US and should continue to benefit from strong Chinese demand for our raw materials. The uncertainty surrounding the outcome of the recent Federal election is also likely to be resolved soon and this should help to boost investor confidence.

In terms of domestic interest rates, it's likely now that the RBA will adopt a 'wait and see' approach in light of the deteriorating outlook for the global economy. That said, there's no real rush for the RBA to move any time soon as it's clear that inflation is easing and because previous rate hikes are beginning to have an impact on consumer spending. However, the Bank does retain its tightening bias, meaning that further rate hikes are still possible.

Contact

Standard Pacific Consulting Limited

Level 10, 321 Kent Street,
Sydney NSW 2000
GPO Box 1576 Sydney NSW 2001

Part of the Suncorp Group

Freecall 1800 232 001

Tel: (02) 8275 3697 **Fax:** (02) 8275 3820

Email: advice@standardpacific.com.au

Web: www.standardpacific.com.au

Australian Financial Services Licensee

AFS Licence No: 237635

ABN: 84 003 315 802

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