

Market Update for May 2010

Eric Moses
Director
Standard Pacific Consulting Limited
Authorised Representative (No 273813)

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**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 3899
Fax: (02) 8275 3820
AFS Licence No: 237635
ABN: 84 003 315 802

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The month of May was characterised by a significant jump in market volatility. The ongoing European debt crisis proved to be a major drag on global share markets, prompting a 'flight to safety' reaction from investors concerned about the outlook for global growth. Oil prices declined in line with global share markets, bond yields fell sharply and the Australian share market followed the rest of the world lower.

At a glance

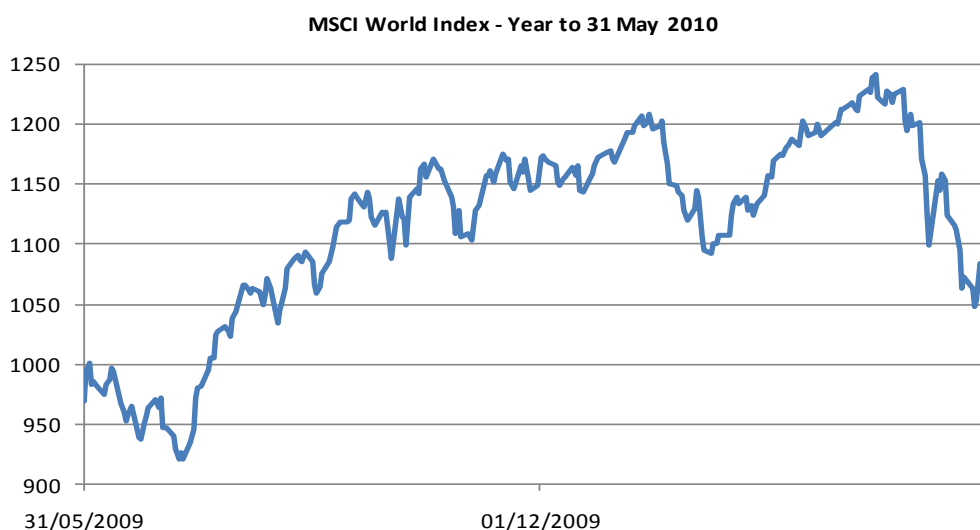
- Global share markets fall sharply amid concerns about global growth
- Oil prices crash, losing almost 14%
- European authorities bail out Greece
- The Reserve Bank of Australia (RBA) lifts the official cash rate to 4.50%
- The Australian share market falls in line with global markets

Global share markets sharply lower

Global share markets ended the month sharply lower after concerns about Europe's debt crisis intensified, US and European authorities took steps toward tougher banking regulation and Chinese officials did little to allay fears that interest rates there may soon begin to rise.

In addition, Australian investors had to contend with concerns that the Government's recent 'super tax' on miners will make us less attractive to investors, as well as the fact that our economy is more exposed than most to any downside risk in China. As was the case last month, all of this negative news flow overshadowed a series of improving economic data in both the US and Europe.

In the US, the benchmark S&P 500 Index closed the month 8.2% lower while share markets in Europe (-7.3%¹), the UK (-6.6%²) and Japan (-11.6%³) were also significantly weaker. Globally, share markets closed May 9.9%⁴ lower (see following chart).



Source: Bloomberg

¹ European shares measured by the Dow Jones Eurostoxx50 Index

² UK shares measured by the FTSE 100 Index

³ Japanese shares measured by the Nikkei 225 Index

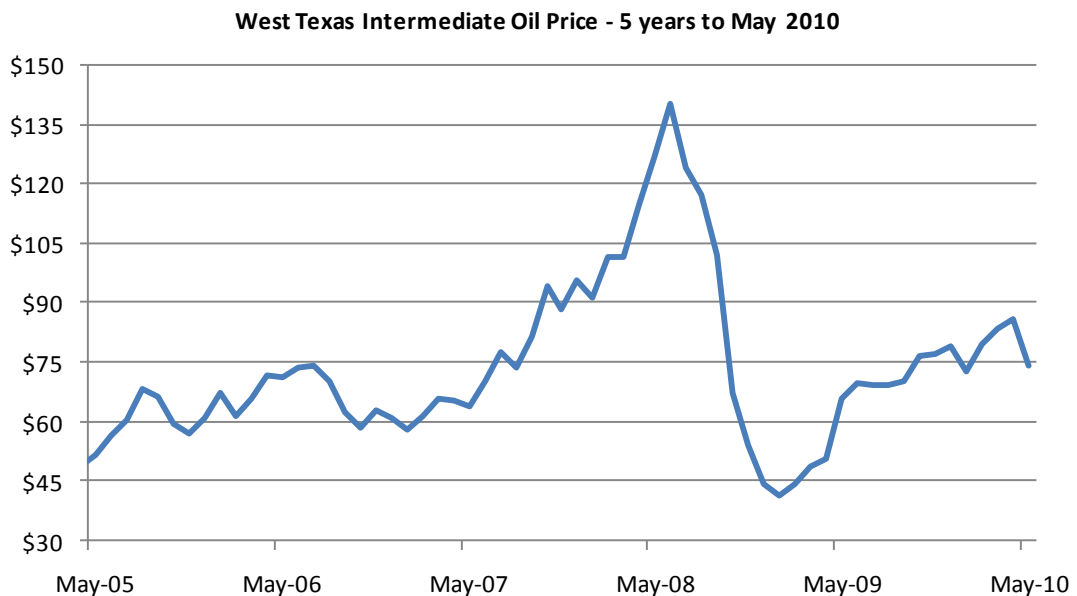
⁴ Global shares measured by the MSCI World Index

Oil prices tumble

Oil prices crashed in May, dropping 13.6% to US\$74.44 a barrel on the back of increasing fears over the outlook for the global economy, a stronger US dollar (US\$) and expectations that China will soon begin to lift interest rates in a bid to cool rising inflation.

The falls might have been even greater if it wasn't for a jump in 2010 demand forecasts from both the Energy Information Administration and the Organisation of the Petroleum Exporting Countries (OPEC).

After gaining 78% in 2009, oil prices have now fallen 6.2% so far in 2010.



Source: Energy Information Administration

Europe bails out Greece

In the wake of the Greek debt debacle, European authorities announced a €750 million bailout package designed to prevent Greece's problems from spreading to other vulnerable European nations, namely Spain and Portugal. The upshot of the package is that Greece and other troubled European countries will have access to badly needed funding while at the same time the European Central Bank (ECB) will initiate a plan to buy public and private securities throughout the euro-zone.

Essentially, the package means that Greece won't have to tap bond markets for three years, giving it little reason to default on its debt in the short-term. The ECB's commitment to buy public sector debt will also go a long way to keeping a lid on bond yields. However, in return for being bailed out, Greece has had to agree to a rigorous austerity program which includes, among other things, salary reductions for employees of state-run companies, cuts to civil servants' bonuses, an increase in sales taxes and a cut in public investment.

If successful, the package will help stabilise the public debt situation in the region and contribute to the ongoing global recovery.

The Reserve Bank moves again

The RBA raised interest rates by a further 0.25% following its May Board meeting, taking the official cash rate to 4.50%. It was the RBA's sixth rate increase in the past seven meetings, with the Bank still clearly concerned about the current level of domestic inflation. Although the minutes from the RBA's meeting hinted at further rate hikes to come, particularly as economic growth moves above average, events in Europe suggest that interest rates here will remain on hold in the near-term; or at least until the dust begins to settle in Europe.

Meanwhile, the US Federal Reserve (0-0.25%), the Bank of England (0.50%), the European Central Bank (1.00%) and the Bank of Japan (0.10%) all left their respective benchmark interest rates on hold during the month.

Bond yields lower

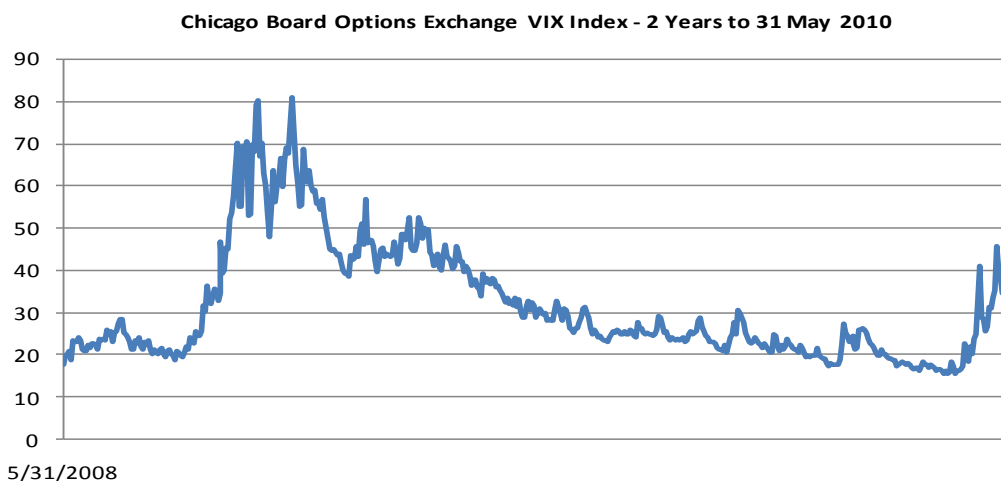
Global bond yields fell considerably throughout May as investors offloaded riskier assets like shares and listed property in favour of the relative safety of government debt; specifically government debt outside of Southern Europe. The recent spike in market volatility that's resulted from the ongoing European debt crisis has obviously taken its toll on investor confidence, and this was reflected in lower yields.

In the US, the yield on 10-year bonds fell 37 basis points to close the month at 3.28% and it was a similar story here in Australia, with the yield on our 10-year bonds falling 33 basis points to close at 5.38%.

Market volatility jumps

Market volatility jumped significantly in May amid increasing concerns that the European debt crisis will worsen and potentially lead to a second global financial crisis in as many years. The Chicago Board Options Exchange's Volatility Index, or VIX as it's more commonly known, spiked as high as 45.79 during the month – a jump of 191% from its post-global financial crisis low set in April 2010 – before eventually closing at 32.07.

The jump in volatility provides a timely reminder of just how quickly investment markets can change.



Source: Chicago Board Options Exchange

Australian market gets hammered

The Australian share market ended the month firmly in the red, with the S&P/ASX 200 Accumulation Index falling 7.5% on the back of weaker commodity prices, expectations of Chinese monetary tightening and a very, very poor lead from global share markets. The loss was the local market's worst monthly performance since October 2008.

So far this year, the Australian share market has fallen 7.5%. This compares to -12.0% in Europe, -7.4% in Japan, -4.1% in the UK and -2.3% in the US. 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

Australian dollar plunges

The Australian dollar (A\$) fell sharply against the US\$ in May, losing 8.4% amid weaker share markets, falling commodity prices and expectations that the European debt crisis will derail the global recovery. Unfortunately, the local currency is very sensitive to global growth expectations, which means it gets hit particularly hard when the outlook for growth becomes clouded. Another factor contributing to the fall was increasing expectations that the RBA will likely keep interest rates on hold over the coming months.

The A\$ hit a low of US\$0.8065 cents on 25 May – a drop of 14% from its recent April 2010 peak – before eventually closing the month at US\$0.8468 cents. However, the outlook for the A\$ remains fairly positive given that Australia maintains a favourable interest rate differential against the major economies, and because Chinese demand for our commodities is likely to remain strong.



Source: Premium Data

Looking ahead

Increasing concerns about the European debt crisis is beginning to weigh quite heavily on investor confidence in the euro-zone and this is having a negative impact on other key markets, including the US. Whilst it's perhaps too early to call the bottom in global share markets just yet, it's likely that the recent downturn is nothing more than a 'correction' and not the beginning of a new bear market. Economic data and earnings results in the US, Europe and Asia have actually been pretty positive while global interest rates remain very low, which is somewhat inconsistent with a downturn.

That said, there are a couple of things investors will need to keep an eye on in the near-term. The first is for any signs of a return to a global 'credit crunch', though so far there has been very little impact on the current flow of money. The second thing to keep an eye on is for any negative shift in global business conditions. At the moment, business conditions indicators in both the US and Europe remain pretty positive, which is good news.

In Australia, underlying economic data remains relatively robust and consistent with further economic growth. Business conditions and the labour market continue to strengthen and commodity prices are likely to move higher over the near-term, particularly if concerns over global growth do begin to ease. Obviously the knock-on effects from what's happening in Europe is being felt locally, however the Australian economy remains relatively well-placed compared to many of its global counterparts. A key factor to keep an eye on in the coming months will be whether or not Chinese officials decide to lift interest rates, as this will have an adverse effect on our all-important resources sector.

In terms of interest rates, the RBA is likely to hold fire while it waits to see how events in Europe unfold. It's also becoming more and more apparent that the Bank's recent rate hikes are beginning to bite, highlighted by a sharp drop in consumer confidence in April. However, barring any major negative global event, the trend in interest rates will in all likelihood remain up.

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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

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