

Market Update & Outlook

November 2010



Outlook

Whilst concerns about a 'double dip' recession in the US have clearly eased in recent months, renewed fears of a second European sovereign debt crisis on the back of Ireland's financial woes have kept investors wondering. Although European authorities have moved quickly to bail out Ireland, there are now increasing concerns regarding the finances of Portugal, Spain and even Belgium.

In addition, the impact of government austerity measures in other European countries, including the UK, is yet to take full effect and this will likely continue to weigh on investor confidence throughout the region over the coming months. Importantly, though, economic data continues to show improvement, particularly in key countries like Germany, which suggests that Europe's underlying economy is strengthening, albeit very slowly.

The Australian economy remains relatively well-placed compared to the likes of the US and Europe and should continue to benefit from strong Chinese demand for our raw materials. In addition, unemployment remains relatively low, business confidence is high and leading indicators suggest further positive growth ahead.

In terms of interest rates, the RBA obviously retains its hawkish view on domestic monetary policy, though it's likely that the Bank will now adopt a 'wait and see' approach regarding any future interest rate hikes; particularly in the wake of November's increase and recent developments in Europe.

Market update at a glance

November saw global share markets retreat as increasing concerns of a second European sovereign debt crisis and geopolitical uncertainty in Asia offset further quantitative easing measures by the US Federal Reserve. Meanwhile, oil prices continued to rise and so too did global bond yields. In Australia, the share market followed its global counterparts lower and the Australian dollar fell against the greenback.

Key points

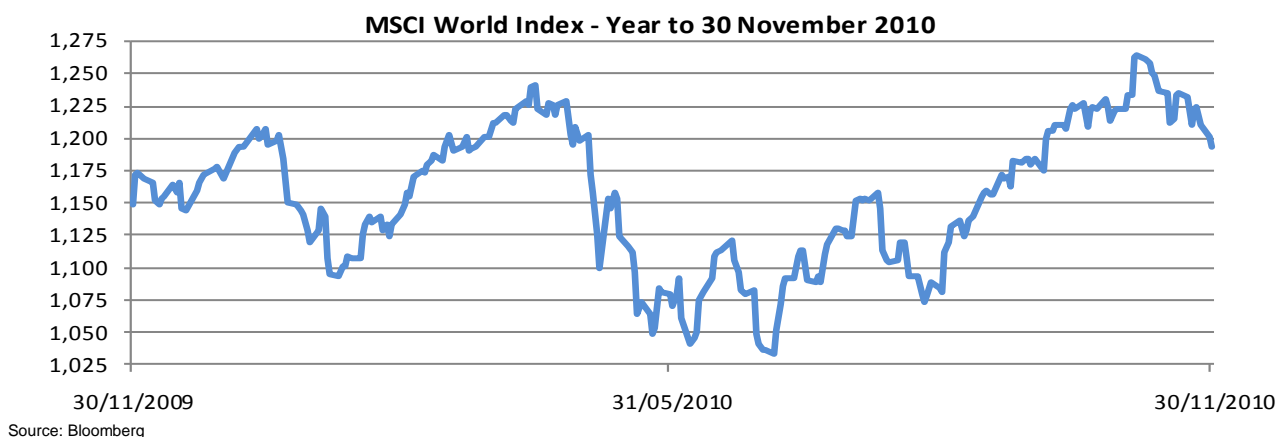
- Global share markets reverse last month's gains
- Oil prices move higher
- Ireland requests a bailout
- The Reserve Bank of Australia raises interest rates
- The Australian dollar fades against its US counterpart

Global share markets retreat

Global share markets all but reversed the previous month's gains in November. After rising early in the month following the US Federal Reserve's announcement of a second round of quantitative easing measures, global bourses began to fall steadily as speculation mounted that Ireland would (and eventually did) request financial assistance.

In addition, North Korea's surprise missile attack on South Korea created some serious geopolitical uncertainty, with the Chinese obviously siding with the North and the US backing the South.

In the US, the benchmark S&P 500 Index closed the month 0.2% lower and this had a negative knock-on effect elsewhere, with share markets in Europe (-6.8%¹) and the UK (-2.6%²) also closing lower. Japan went the other way (+8.0%³) after the yen weakened significantly against the US dollar, while collectively global share markets ended November 2.3%⁴ lower (see following chart).



Ireland bailed out

After much initial denial, Ireland's government finally announced late in the month that it had requested (and been granted) financial aid from European authorities. Essentially, the €85 billion rescue package has been agreed in principle, with the Irish state contributing €17.5 billion in the form of austerity measures, and the European Financial Stability Mechanism and International Monetary Fund (IMF) each contributing €22.5 billion. In addition, a further €22.5 billion will come from a combination of the European Financial Stability Fund and bilateral loans from the UK, Sweden and Denmark.

The package is split into €35 billion for bank recapitalisation – of which €10 billion will be used immediately with the remaining €25 billion provided on a contingency basis – and €50 billion to cover the financing of the state; so that Ireland won't have to access financial markets. The duration of the program will be three years even though the average length of the loans is seven years, and Ireland will pay an interest rate of around 5.8%.

¹ European shares measured by the Dow Jones Eurostoxx50 Index

² UK shares measured by the FTSE 100 Index

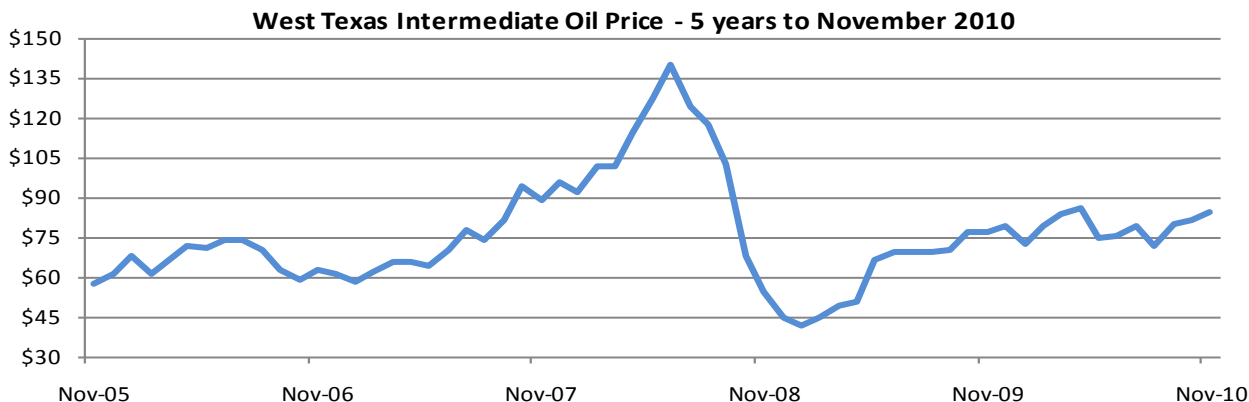
³ Japanese shares measured by the Nikkei 225 Index

⁴ Global shares measured by the MSCI World Index

Oil prices rise

Oil prices continued to move higher in November after the Secretary General of the Organisation of the Petroleum Exporting Countries (OPEC) said that US\$90 a barrel would not constrain global growth. Some better than expected economic data in Europe and the US, and a jump in US stockpile levels also contributed to the gains.

Oil closed the month up 3.4% at US\$84.21 a barrel. After gaining 78% in 2009, oil prices are now 6.1% higher so far this year. Meanwhile, gold prices also moved higher, this time on the geopolitical tensions in Asia and fears that Portugal and Spain may soon follow Ireland in asking European authorities for financial assistance.



Source: Energy Information Administration

Bond yields continue to rise

Global bond yields moved higher⁵ for a third consecutive month in November.

In the US, the yield on 10-year government bonds rose 20 basis points to close the month at 2.80% and it was a similar story in Australia, with the yield on our 10-year government bonds rising 22 basis points to close at 5.42%. Whilst this result appears surprising given the decline in global share markets and quantitative easing in the US, these bond yield increases are more likely due to increased inflation expectations in Australia and slightly improving domestic economic conditions in the US.

Reserve Bank raises interest rates

After a lengthy five-month pause and much market speculation, the Reserve Bank of Australia (RBA) finally moved on interest rates, raising the official cash rate from 4.50% to 4.75% following its early November Board meeting.

Strengthening economic activity and gradually rising inflation were the key factors behind the Bank's decision. In their own words, "The Board judged that the balance of risks had shifted to the point where a modest tightening of monetary policy was prudent." The RBA surprised everyone when it kept interest rates on hold last month, but that only served to heighten expectations of a move in either November or December, as the Bank doesn't meet in January.

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 November.

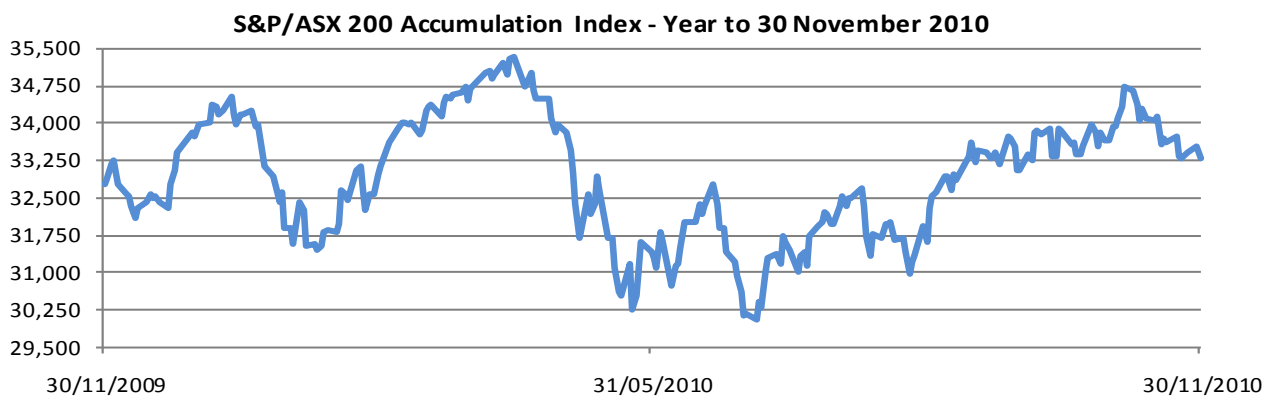
⁵ Bond yields have an inverse relationship with bond prices, meaning that when yields rise, prices fall (and vice versa).

Australian market falls

Australian shares fell in line with global share markets in November, with the S&P/ASX 200 Accumulation Index closing the month down 1.1%. Contributing to the losses were some weaker than expected economic data in China and increasing expectations that Chinese officials will continue to act to slow its economy, which would obviously have an adverse effect on Australia's own resource-based economy.

Another poor lead from global share markets also impacted on returns while a modest gain in commodity prices at least helped to temper the fall.

November's loss means the local market remains in negative territory so far in 2010, having now fallen 2.0% since the beginning of the year. This compares with +5.9% in the US, +2.1% in the UK, -5.8% in Japan and -10.6% in Europe. 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.

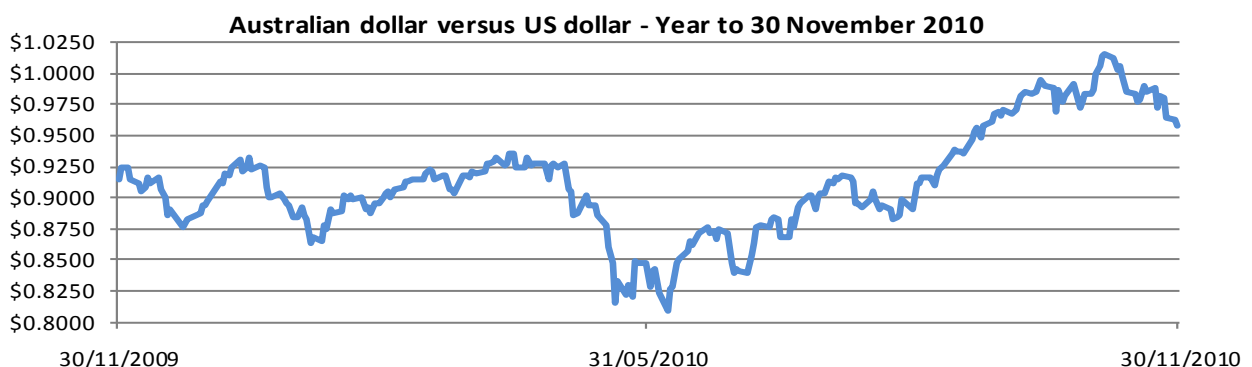


Source: Premium Data

Australian dollar weakens

After hitting parity with the US dollar last month, the Australian dollar fell sharply in November as mounting concerns that some European countries will struggle to repay their debt triggered declines in higher-yielding (or riskier) assets. In addition, improving consumer confidence in the US and expectations that growth in Europe will slow prompted speculation that demand will shift back toward US dollar-denominated assets.

The Australian dollar hit as high as US\$1.0182 cents in November before eventually closing the month 2.5% lower at US\$0.9586 cents.



Source: Premium Data

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