Market Update

October 2010

October saw global share markets build on last month's strong gains, this time due to increasing speculation that the US Federal Reserve (Fed) will soon introduce further stimulus to the economy. Meanwhile, oil prices gained in line with stronger share markets, global bonds yields continued to move higher and the Australian dollar hit parity with its US counterpart for the first time in more than 25 years.

At a glance

- Global share markets continue to move higher
- Oil prices make further gains
- The Reserve Bank of Australia keeps interest rates on hold
- The Australian dollar finally hits parity with the US dollar

Bond yields rise

Global bond yields continued to move higher[1] throughout October as investors once again preferred riskier assets such as shares and listed property over the relative safety of government debt. Underpinning this theme was improving investor sentiment, which has strengthened amid expectations that the global recovery will be sustained, albeit at a slower pace.

In the US, the yield on 10-year government bonds rose nine basis points to close the month at 2.60% and it was a similar story in Australia, with the yield on our 10-year government bonds rising 24 basis points to close at 5.20%.

RBA keeps rates on hold

In a move that surprised pretty much everyone, the Reserve Bank of Australia (RBA) left interest rates on hold at 4.50% following its early October Board meeting, though it did concede that higher interest rates will likely be required at some point. The decision was surprising because the Bank had issued several warning shots leading up to the meeting that gave the distinct impression that a rate hike was imminent. The RBA admitted that the uncertainty surrounding growth in other economies, namely the US, was a factor in their decision.

The subsequent September quarter inflation report, which showed only a modest gain in prices, essentially vindicated the Bank's decision, though it also lowered the chances of a further rate hike in November. However, with inflation still at the top end of the Bank's target band and with the economy operating at near capacity, the RBA may still move again in December since the Bank would otherwise have to wait until February next year to tighten monetary policy.

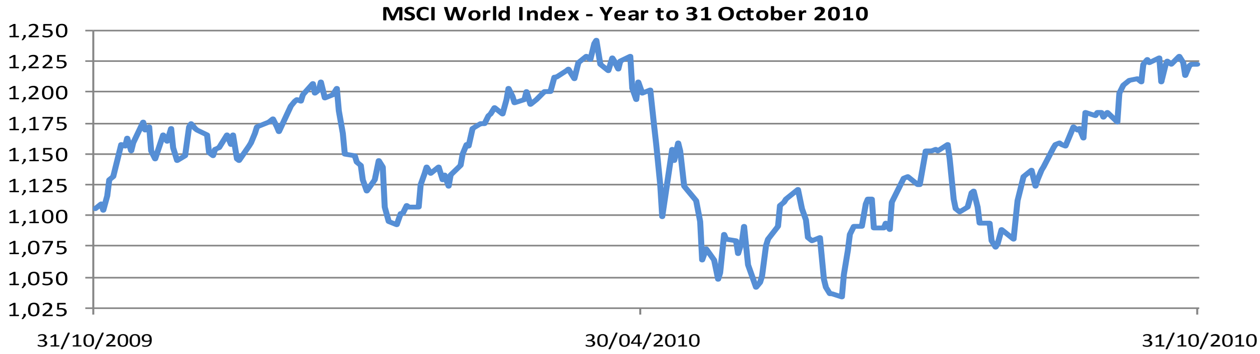
[1] Bond yields have an inverse relationship with bond prices, meaning that when yields rise, prices fall (and vice versa).

Global share markets rise

Global share markets moved even higher throughout October, this time on expectations that the US Federal Reserve will introduce further quantitative easing measures in an effort to help spur economic growth. Essentially, any quantitative easing would involve the Fed lowering bond yields and therefore interest payments for governments, businesses and consumers alike. However, opinion is mixed on the likely effectiveness of such a policy response, with some estimates suggesting a relatively modest impact on economic growth, i.e. gross domestic product. These actions would also increase the risk of higher inflation further down the track.

Also contributing to the gains over the month were some better than expected earnings results from the likes of McDonald's, EBay, Yahoo! and Boeing. In both the US and Europe, around 75% of all companies to have reported so far[2] have beaten analysts' expectations.

In the US, the benchmark S&P 500 Index closed the month 3.7% higher and this had a positive knock-on effect elsewhere, with share markets in Europe (+3.5%[3]) and the UK (+2.3%[4]) also closing higher. Japan went the other way (-1.8%[5]) while collectively global share markets ended October 3.6%[6] stronger (see following chart).

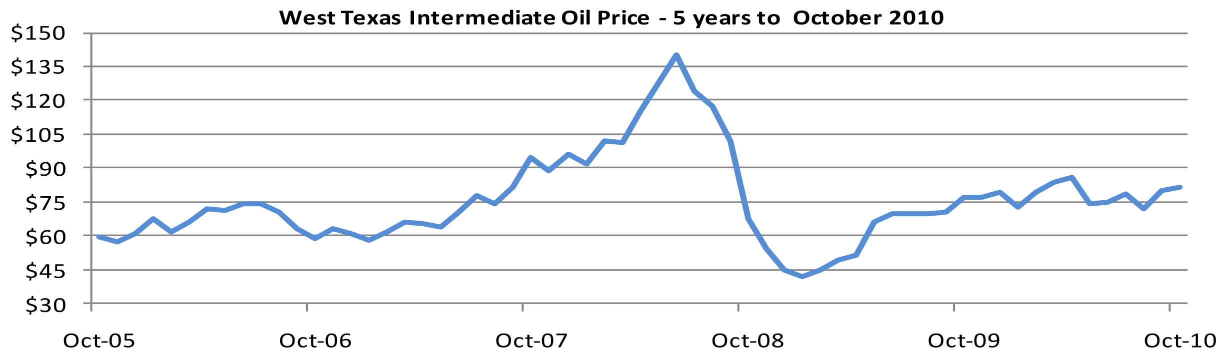


Source: Bloomberg

Oil prices gain

Oil prices made further gains in October due to a weaker US dollar (US$), improving investor sentiment and expectations that the US Federal Reserve (and potentially other central banks) will soon introduce additional quantitative easing measures.

Oil closed the month 1.8% higher at US$81.43 a barrel. After gaining 78% in 2009, oil prices are now 2.6% higher so far this year. Meanwhile, gold prices also moved higher on US$ weakness and ongoing budget difficulties in both Ireland and Portugal.



Source: Energy Information Administration

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[2] As at Thursday 28 October 2010
[3] European shares measured by the Dow Jones Eurostoxx50 Index
[4] UK shares measured by the FTSE 100 Index
[5] Japanese shares measured by the Nikkei 225 Index
[6] Global shares measured by the MSCI World Index

BoJ eases monetary policy

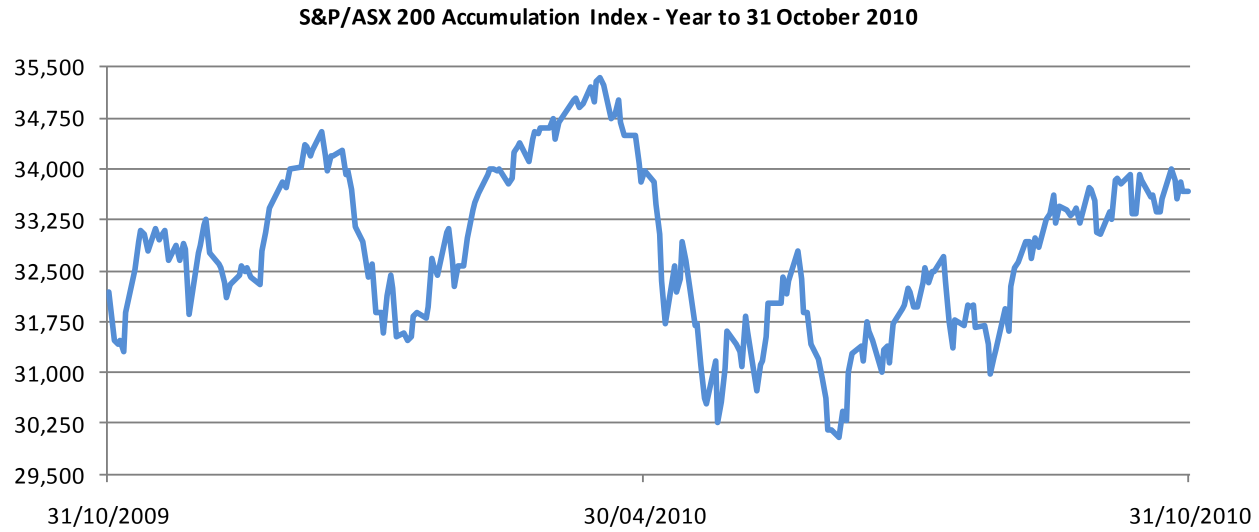
During the month, the Bank of Japan (BoJ) made the surprise decision to cut interest rates to “virtually zero” and established a ¥5 trillion (A$60 billion) fund to buy government bonds and other assets in a bid to revive its own economy. The move essentially came about as the yen’s surge to a 15-year high against the US$ was beginning to hurt exports and dampen prospects for economic growth. In all likelihood, the BoJ may have been the first to act in a new round of central bank action designed to prop up the global economy as recoveries in the major economies falter.

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

Australian market makes further gains

Australian shares moved higher in line with global share markets in October, with the S&P/ASX 200 Accumulation Index closing the month up 1.8%. Underpinning the gains were a combination of stronger economic data (notably employment numbers), higher commodity prices and another positive lead from global share markets. However, the gains were tempered somewhat by China's decision to raise its benchmark lending and deposit rates since any such tightening measures have the potential to impact on Chinese demand for our commodities.

Despite October’s gains, the local market remains in negative territory so far in 2010, having fallen 1.0% since the beginning of the year. This compares with +6.1% in the US, +4.8% in the UK, -4.1% in Europe and -12.7% 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.



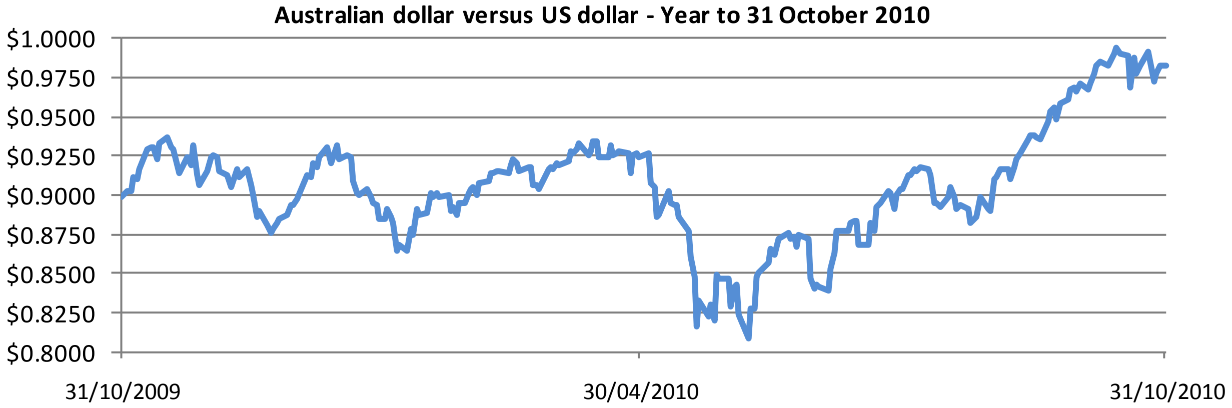
Source: Premium Data

Australian dollar hits parity

After flirting with parity last month, the Australian dollar (A$) finally hit the US$1 mark in October, albeit briefly. It was the first time since the A$ floated back in December 1983 that the local currency has traded on a par with the US$.

The Australian dollar's recent rise has largely been the result of weakness in the US$. That weakness has been underpinned by expectations that the Fed will embark on a stimulus program that would in essence mean printing more cash. And more US dollars in circulation would then have the effect of weakening the US$ against other currencies. Another contributing factor has been Australia's relatively high interest rates. Australia's official cash rate is 4.50% compared to the near-zero levels in many advanced economies, including the US and Japan.

The Australian dollar (A$) hit as high as US$1.004 cents in October before eventually closing the month 1.8% higher at US$0.9834 cents.



Source: Premium Data

Looking ahead

Concerns about a ‘double dip’ recession in the US have continued to ease, though there remains little doubt that the US recovery has slowed and economic data over the past month or so has confirmed this. In addition, there are increasing expectations that the US Federal Reserve will soon announce further quantitative easing measures in an effort to stimulate economic growth, which really goes to show how finely balanced growth there is even though its share market has continued to perform well in recent months. Whilst fears about Europe’s sovereign debt crisis have abated, the impact of government austerity measures are yet to take full effect and this will likely continue to weigh on investor confidence in the region over the coming months. Importantly, economic data there is beginning to show some signs of life.

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 clearly retains its hawkish view on domestic monetary policy, though it has been granted some breathing space in the wake of the recent September quarter inflation numbers which saw prices edge only slightly higher. That said, inflation still sits in the top half of the RBA’s target range, and with the economy operating at near capacity it’s still too early to rule out another rate hike by year’s end.

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