

Market Update & Outlook



November 2011

Looking ahead

Despite the rally in global share markets in October, market volatility returned with a vengeance in November and will undoubtedly remain high for some time yet as European officials continue to battle to resolve the region's debt crisis. With Greece still a major concern, Italy now firmly in the mix and France not far behind them, there's a very real chance that things will get worse before they get better. Of course, the frustrating thing is that Europe's leaders have the tools needed to resolve the crisis but for political reasons they haven't yet been able to agree on a plan acceptable to all parties. With the knock-on effects of the crisis already being felt elsewhere, including Australia via softer commodity prices, the urgency for Europe to get its affairs in order is increasing by the day.

The Australian economy remains relatively well-placed compared to the likes of the US and Europe and should continue to benefit from robust Chinese demand for our raw materials. However, any additional monetary tightening in China – our largest trading partner – will have an adverse effect on the local market.

In terms of interest rates, it would seem that the catalyst for any further cuts will likely come from Europe; particularly as domestic inflation is now at a level the RBA is comfortable with. Fortunately, with Australian interest rates still relatively high compared to the US and Europe, the RBA does have the luxury of being able to cut the official cash rate significantly should the euro zone crisis (and therefore the global growth outlook) worsen.

Market update at a glance

October's strong rebound proved to be a short-lived one as global share markets resumed their downward trend in November amid fears that Europe's debt crisis would soon engulf the likes of Italy and even France. Meanwhile, oil prices strengthened, domestic shares fell and the Australian dollar weakened against its US counterpart.

At a glance

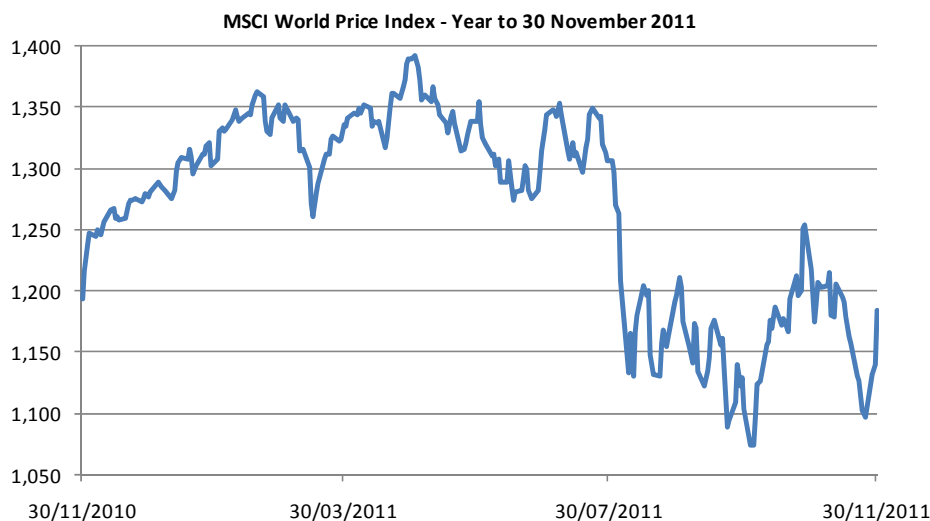
- Global share markets give back some of last month's gains
- The Reserve Bank of Australia lowers the official cash rate to 4.50%
- Oil prices continue to firm
- Australian shares fall in line with global bourses
- The Australian dollar weakens amid increasing risk aversion

Global share markets weaken

Last month's strong rebound turned out to be nothing more than a blip on the radar as global share markets fell further on concerns that Europe's sovereign debt woes had worsened despite efforts by officials to contain the crisis. The news flow from the region was less than positive for much of the period, beginning with the surprise announcement by Greece's Prime Minister, George Papandreou, that he would seek a referendum on accepting financial aid. Under pressure from other European leaders, Mr. Papandreou subsequently backtracked on the idea and was replaced shortly after. Also weighing on investor sentiment was news that Italy was on the verge of becoming the next victim of the region's debt crisis, increasing speculation that France – Europe's second-largest economy – was at risk of losing its AAA credit rating, and comments from the European Commission suggesting that growth in the region had in fact already stalled.

Away from Europe, markets were further impacted by a sharp downward revision to US September growth numbers; though it's worth pointing out that other US economic data continues to show signs of improvement.

In the US, the benchmark S&P 500 Index closed the month down 0.5% and this had a negative knock-on effect elsewhere, with markets in Japan (-4.0%¹), Europe (-2.3%²) and the UK (-0.7%³) all ending the month weaker. Collectively, global share markets closed November down 2.7%⁴ (see following chart).



Source: Bloomberg

¹ Japanese shares measured by the Nikkei 225 Index

² European shares measured by the Dow Jones Eurostoxx50 Index

³ UK shares measure by the FTSE 100 Index

⁴ Global shares measured by the MSCI World Index

RBA cuts interest rates

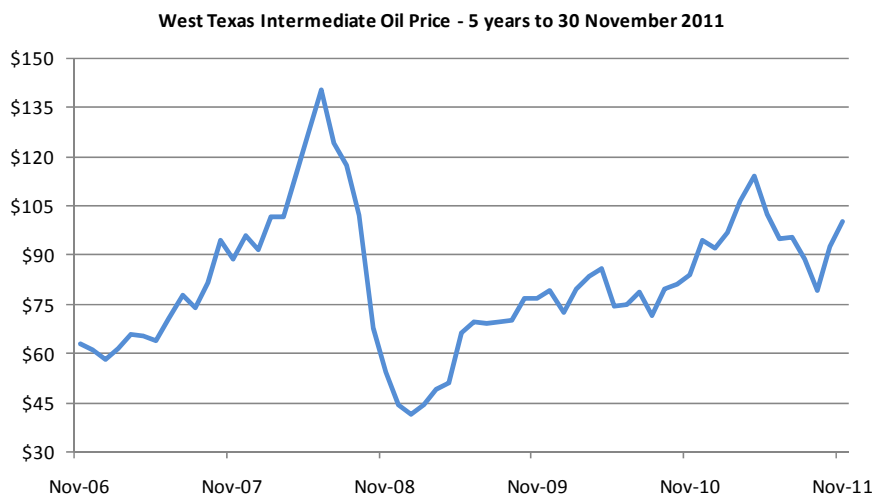
The Reserve Bank of Australia (RBA) lowered the official cash rate from 4.75% to 4.50% following its early November meeting, citing slower domestic growth and increasing concerns regarding Europe's debt crisis among the key reasons for its decision. It was the first time since April 2009 – when the RBA acted in response to the global financial crisis – that the central bank has lowered interest rates. Whilst the move had been considered a real possibility by the market, the subsequent minutes from the RBA's meeting revealed that the decision was in fact a close call. As it turns out, the RBA probably would have left rates on hold if not for the strong improvement in domestic inflation in the September quarter.

The European Central Bank (ECB) also cut its benchmark interest rate – from 1.50% to 1.25% – in November as the region's debt crisis continued to deteriorate. Meanwhile, the Bank of England (0.50%), the US Federal Reserve (0-0.25%) and the Bank of Japan (0.10%) all left their respective benchmark interest rates on hold during the month.

Oil prices hold onto recent gains

Oil prices continued to firm throughout November, benefiting mainly from the ECB's decision to cut interest rates, geopolitical tensions in the Middle East and a further, albeit modest, improvement in US economic data. Also helping the gains were hopes late in the month that European officials' plan to bypass complex and timely treaty changes could expedite a possible resolution to the region's debt crisis.

Oil closed the month 8.4% higher at US\$100.43 a barrel, taking its return so far this calendar year to 6.0%.



Source: Energy Information Administration

Global bonds rally

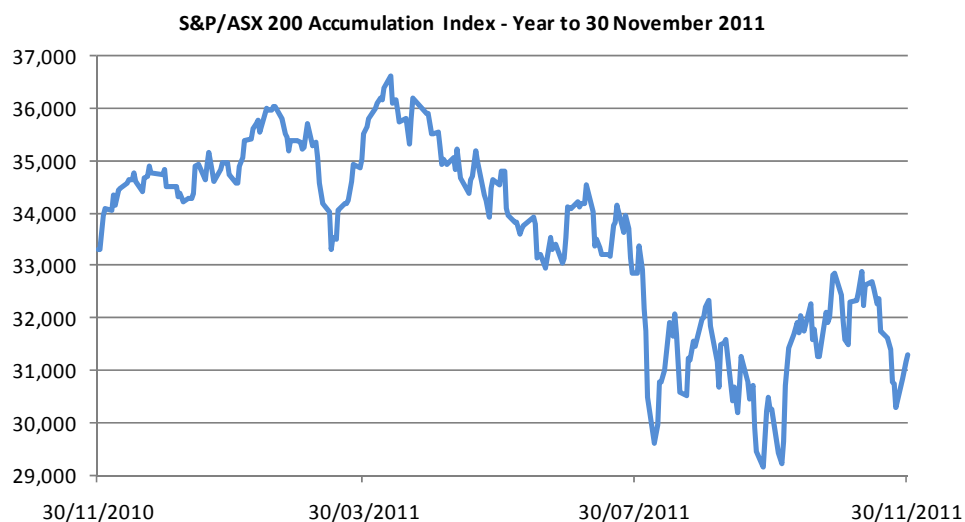
Last month's weakness in bond markets – the result of a strong rally in 'risk' assets such as Australian and international shares – reversed in November as investors were once again spooked by Europe's persistent debt troubles. The yield on US 10-year Treasuries fell five basis points to 2.08% over the month and it was a similar story here in Australia, with the yield on our 10-year bonds falling 40 basis points to just 4.01%. Germany, however, was a notable exception. The yield on 10-year German bunds went the other way, rising 29 basis points to 2.29% amid concerns that the country may yet become a victim of the region's escalating debt crisis.

Importantly, Australian bonds – widely considered a 'safe haven' from Europe's debt problems – continue to represent better value than many of their global counterparts, including US Treasuries. The yield differential between Australian 10-year bonds and their US equivalent is currently 193 basis points, or 1.93%.

Australian share market falls

The Australian share market fell in November, with the S&P/ASX 200 Accumulation Index closing the month 3.5% lower on the back of escalating fears over the euro zone's debt crisis. The European Union is Australia's third-biggest trading partner, so any slowdown in growth in that part of the world will have a significant impact on the domestic economy. Also contributing to the loss were weaker commodity prices, increasing concerns about a slowdown in China and yet another poor lead from global markets.

So far this year, the local market has fallen 9.3%. This compares with +5.0% in the US, -0.4% in the UK, -12.1% in Europe and -13.2% in Japan.



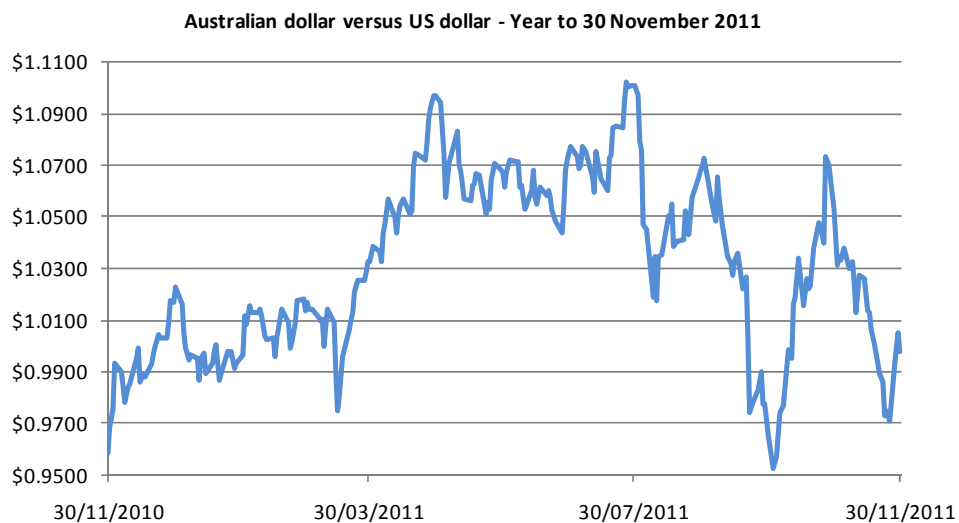
Source: Premium Data

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

Australian dollar tumbles

The Australian dollar (A\$), like all commodity-based currencies, weakened against the US dollar in November amid increasing doubts about the outlook for global growth and the sharp spike in risk aversion caused by Europe's ongoing debt crisis. Closer to home, the local currency was also impacted by speculation the RBA's decision to cut interest rates will be the first of many should Europe's debt woes continue.

After having hit a high of US\$1.037 early in the month, the A\$ eventually fell below parity, closing the month 5.3% lower at US\$0.998 cents. Given that market volatility remains at elevated levels, it's likely that the A\$ will continue to face strong headwinds in the near-term.



Source: Premium Data

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