Colonial First State

Monthly Market View

October 2012

Latest monthly commentary from the Investment Markets Research team at Colonial First State

- Investors maintained their appetite for risk in October.
- This followed the Federal Reserve's announcement of open-ended quantitative easing in September and as economic data improved in the US and China.

Economic overview

The International Monetary Fund (IMF) downgraded global growth forecasts. Growth in 2012 is now anticipated to be 3.3%, accelerating to 3.6% in 2013. These forecasts have been revised down from 3.5% and 3.9% respectively. These forecasts assume that European policy makers will implement policies to improve financial conditions in periphery economies and that US policy makers will scale back the impact of the 'fiscal cliff'.

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There was minimal news flow in Europe compared to recent months, with no major policy announcements. The Troika (European Central Bank / International Monetary Fund / European Commission) wrapped up its visit to Greece to determine compliance with the bailout program. The Greek parliament needs to pass a package of budget and structural messages agreed with the Troika to receive the next tranche of funding worth €31.5 billion. Approval to release these funds is expected in mid-November.

The other focus in Europe remains if and when Spain will formally request a bailout from the European Financial Stability Facility / European Stability Mechanism, which would allow the European Central Bank to start buying Spanish government bonds. Prime Minister Rajoy has delayed asking for assistance thus far, stating to the Spanish parliament "sometimes the hardest decision is not to take any decision".

There is support for a Spanish bailout from external parties. Such a move would demonstrate the full power of the mechanisms in place to assist indebted nations, particularly the European Central Bank's new policy of Outright Monetary Transactions.

Spanish economic data continues to deteriorate, with the unemployment rate rising to 25.0% for the September quarter. GDP contracted by 0.3% per quarter and is running at an annual pace of -1.6%.

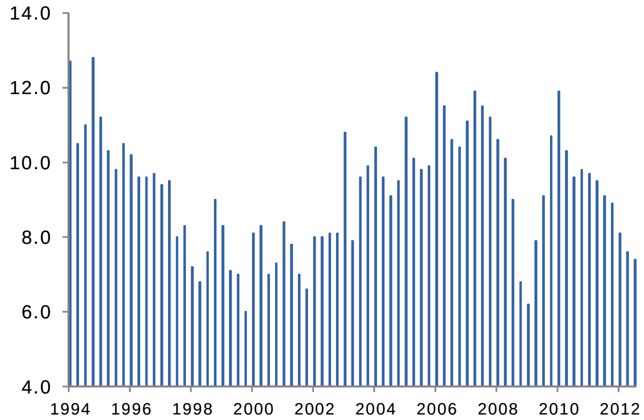
In the US, investors focused on the 6 November 2012 Presidential Election, but Hurricane Sandy increasingly dominated attention. The storm passed through the north-eastern states of the US, including New York. At this stage it is expected that Hurricane Sandy could detract anywhere from 0.2% to 0.7% from GDP in Q4, although the extent of the damage is still being assessed.

Economic data releases continued to show positive momentum in the US economy. Once again the housing market continued to show signs of recovery. Housing starts rose 15% in September to 872,000, the highest since July 2008. Both multi-family apartments and single dwellings contributed to the improvements. New home sales rose 5.7% per month and house prices are increasing at an annual pace of 4.8%. As a result, consumer confidence remains at reasonable levels.

An advanced reading of Q3 GDP was released. The US economy is growing at a seasonally-adjusted pace of 2.0% per year, which was higher than consensus expectations. Growth over the quarter was driven by residential investment as well as government and consumer spending. Exports and business investment detracted from growth.

In China, there are growing expectations that the economy has entered a period of stabilisation and possibly improving momentum. This was reflected in an increase in the official Chinese PMI index, which rose above 50 for the first time since July (to 50.2). Q3 GDP data was released, with growth of 2.2% and annual growth of 7.4%. Inflation remains well contained at 1.9%. The focus now turns to the beginning of the political leadership transition on 8 November 2012. Commodity prices – including iron ore, which added 14.5% – were supported by improvements in Chinese data. See chart below of Chinese GDP.

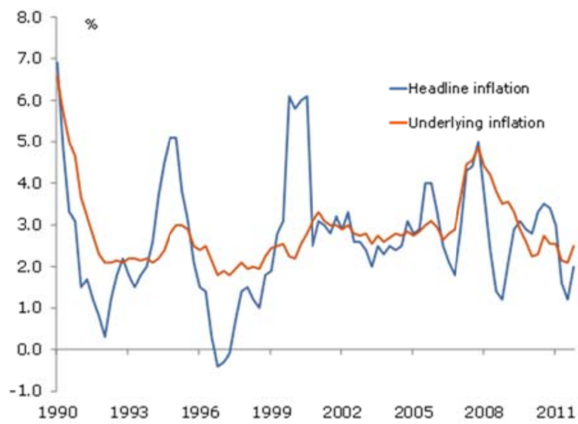
CHINA ANNUAL GDP GROWTH (%)



Source: Bloomberg. Data to 30 September 2012

In Australia, inflation data was released. Headline inflation increased by a higher-than-expected 1.4% per quarter in Q3 2012, pushing the annual pace up to 2.0% from 1.2% in Q2. Some of this larger-than-expected increase is a reflection of the new carbon price. Both electricity and gas have increased sharply in price. Underlying inflation rose by 0.75% in Q3 2012, taking the annual pace of underlying inflation up to 2.5% from a revised 2.1% per year in Q2. See chart below for details

AUSTRALIA – HEADLINE AND UNDERLYING INFLATION (%)

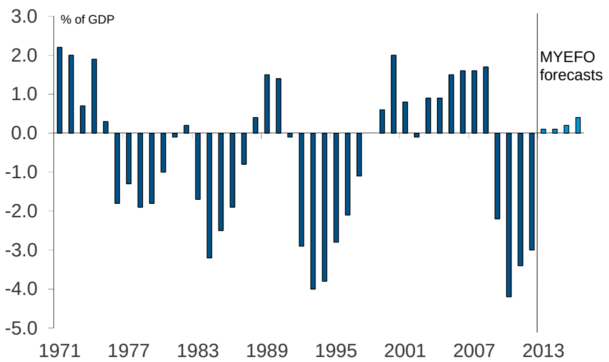


Source: Bloomberg. Data to September 2012

The RBA lowered interest rates by 0.25% to 3.25% in early October. In spite of the higher inflation reading, further interest rate reductions are anticipated in the next few months.

The Federal Government also released its Mid-Year Economic and Fiscal Outlook (MYEFO). The government tightened fiscal policy a little further, offsetting some deterioration in the underlying budget position. The Government is now anticipating a budget surplus of $1.1 billion in 2012/13, revised down from $1.5 billion. See chart below for details.

AUSTRALIA – BUDGET DEFICIT AS % GDP



Source: Commonwealth Treasury

Australian shares

The recent favourable performance of the Australian share market continued in October, with the S&P/ASX 200 Accumulation Index adding 3.0%. The rally was broad-based, with all sectors of the market recording gains.

Share prices continued to benefit from the general improvement in risk appetite globally. A series of more encouraging economic data releases in China augured well for an improvement in global economic activity.

A wide range of Australian companies held Annual General Meetings during the month, while two of the major banks – ANZ Banking Group and National Australia Bank – released their earnings for the full year ending 30 September 2012.

A number of mining and energy companies announced quarterly production reports. There were few surprises in the production reports themselves, but revenues for several mining companies were impacted by lower commodity prices.

There was a fair amount of corporate activity during the month. Steel maker Arrium and grain handling company Graincorp both received takeover bids, for example, while Woolworths announced a plan to spin off some of its property assets to form SCA Group. This new property trust is expected to list on the ASX in December.

In the airline sector Virgin Australia Holdings announced that Singapore Airlines had acquired a 10% stake in the company, while Qantas Airways announced plans to expand its freight network. Qantas is effectively swapping its 50% stake in ground transport company StarTrack for the 50% stake in air freight business Australian Air Express which it does not already own. Both entitles are currently jointly owned by Australia Post.

Listed property

Australian listed property securities appreciated in value by 5.3%, outperforming the broader share market by 2.3%. The decision by the Reserve Bank of Australia to cut interest rates early in October increased the appeal of the sector's income-generating nature.

At a stock specific level, Goodman Group (+11.9%) and Charter Hall Group (+10.8%) performed most strongly. Goodman Group announced a large capital raising within one of the funds that it manages. Goodman Group itself is not participating in the raising, which will dilute its exposure to the fund. This is expected to free up capital, enabling Goodman to engage in immediately earnings accretive activities. Charter Hall Group announced a new joint venture with Telstra Super to acquire several Bunnings Warehouse-anchored properties on favourable terms.

The underperformers also generated positive returns over the course of the month. CFS Retail Property Trust Group rose by 1.3%, following the announcement of mixed quarterly results. Australand Property Group, which had a quiet month with no material news announcements, rose by 2.4%.

A-REITs offer an attractive yield, and are in strong financial positions with healthy balance sheets. The low interest-rate environment should be supportive of the sector in the medium term.

Offshore listed property markets generated largely positive returns in October. The UBS Global Property Investors Index (local currency) returned 1.3%. Regionally, Continental Europe (+6.4%) and Australia (+5.3%) performed most strongly. The US & Canada (-0.9%) and Singapore (+3.1%) underperformed.

Global shares

Global equity markets were mixed in October. The US market underperformed following several months of outperformance. Most European equity markets were stronger, while Asian markets were mixed.

The MSCI World Index fell 0.8% in US$ terms and 0.7% in A$ terms, dragged lower by the US market. The A$ was almost unchanged against the US$ in October, hovering around US$1.04.

US equity markets fell, led by NASDAQ (-4.5%). The Dow Jones (-2.5%) and S&P 500 (-2.0%) also retreated. A weaker Q3 corporate earnings reporting season led markets lower. As at the end of October, 63% of S&P 500 companies had beaten earnings expectations, while 37% missed expectations. The disappointment came from the revenue side, with only 36% companies beating revenue expectations.

European equity markets were typically stronger; Italy (+2.9%), France (+2.2%), Spain (+1.7%) and Germany (+0.6%) all rose. The UK FTSE 100 Index rose 0.7%.

Markets were mixed in Asia. The Nikkei rose 0.6%, with the Bank of Japan announcing another round of asset purchases. Elsewhere Hong Kong (+3.9%) and Malaysia (+2.2%) rose. Korea (-4.2%) and the China (-0.8%) both fell.

Among the sectors, Financials (+2.2%) outperformed while IT (-5.7%) underperformed.

Global emerging markets

Emerging market equities fell 0.7% in US$ terms, and 0.6% in A$ terms, broadly in line with the global equity market.

Russia fell 3.2% reflecting weakness in the oil price, which fell 6.5% US$86.2 per barrel. Brazilian equities declined 3.6%, while Poland (-1.2%) and Sri Lanka (-7.7%) and were also weaker.

On the positive side were Turkey (+8.6%), Hungary (+5.4%) and Czech Republic (+1.8%).

Fixed interest

US, Germany and UK bond yields increased in October. This was in response to a lower risk from Europe and the release of better-than-expected global macroeconomic data.

Expectations of external assistance for Spain, prompted credit ratings agency Moody's to retain Spain's (Baa3) investment grade rating. The yield of 10-year Spanish government bonds decreased by 30 bps to 5.60%.

In the US, longer dated Treasury yields were boosted (yields rose) by the release of improving economic data. However, this ran out of steam towards month-end. This was on the back of risk aversion associated with poor Q3 US corporate earnings releases and the impact of Hurricane Sandy. Market participants also turned their attention towards the outcome of the US Presidential election and implications for the 'fiscal cliff'. The yield of the 10-year US Treasury bond increased by 6 bps to 1.69% in October.

The ECB left monetary policy unchanged at its October meeting. German 10-year bund yields rose 2 basis points to 1.46%.

The Bank of England's Monetary Policy Committee retained its bank rate at 0.5% and its asset purchase program at £375 billion. 10-year UK Gilt yields rose 12 basis points to 1.85%.

The Australian 10-year bond yield increased by 16 bps to 3.06% in October, despite the first interest rate cut in four months. This was driven by a mixture of positive domestic and offshore news flow, which boosted market sentiment.

Australian yields followed the lead of yields in global bond markets, which rose in response to a reduced risk in Europe and better-than-expected US macroeconomic data. Long-dated CGS yields also increased following the release of Chinese GDP data, which was in-line with market expectations.

The other trigger for a higher yields was the higher than expected Australian inflation reading for Q3 2012.However, yields fell into month-end following subdued US corporate earnings results and concerns over Hurricane Sandy in the US.