Quarterly Market Outlook – June 2011

The Global Economy

Investment Sectors

Introduction

The first quarter of 2011 was marked by a series of international developments which created short-term uncertainties and volatility within financial markets. Uprising across Northern Africa and the Middle East as well as natural disasters around the globe were added to an increasing list of concerns, including inflationary pressures in China and European sovereign debt woes. While many of these issues still require time to play out, they are set against the backdrop of an overall improvement in global economic activity. The International Monetary Fund (IMF) forecasts global economic growth of 4.4% in 2011.

Australia

GDP figures released over the March 2011 quarter saw the Australian economy post solid growth in the fourth quarter of 2010. Australian Bureau of Statistics (ABS) revealed GDP grew by 0.7% in the December 2010 quarter, for an annual growth rate of 2.7%. Economic growth over 2010 was largely driven by net exports, business investment and government spending. Household spending and housing activity remains soft as households continue retire debt and save money. It is for this reason that Australia is described as a two-speed economy, with commodity oriented industries in one lane and weak service sectors in the other.

While GDP data is not yet available for the first quarter of 2011, most economists are expecting a dip in GDP due to Australia's own natural disasters. The January floods, which devastated Queensland and impacted regions of NSW and Victoria, produced a substantial disruption to economic activity. This may well see the Australian economy contract in the March quarter. The extent of the contraction will ultimately depend upon how quickly normal operations resume and upon any further adverse supply shocks in terms of commodity exports. 2011 GDP growth forecasts are being revised down, although rebuilding activities will provide economic stimulus later in the year.

The Australian household remains highly cautious, with consumers facing the combined pressures of rising fuel and food bills as well as a series of interest rate rises over 2010. Consumer confidence bounced slightly in the latest April reading, with the Westpac – Melbourne Institute Index of Consumer Sentiment rising 1.2% in April. In aggregate, Australian consumers are still more optimistic than pessimistic. However, this rise was driven by a 12.2% confidence surge among non-metropolitan residents, while confidence for city-dwellers' actually fell 4.6%. Another interesting feature of the consumer landscape at present is an increasing divergence between consumer attitudes and their actual consumer spending. While being persistently cautious in relation to spending, factors such as a high Australian dollar and ongoing discounting by retailers of items such as electronics and clothing mean consumers actually believe it is a good time to buy.

The Australian dollar rose an additional 0.9% over the March quarter following a 14.0% rise over 2010. As at 31 March 2011, an Australian dollar was purchasing US $1.03, but has pushed above US $1.05 more recently. Ongoing weakness in the US dollar is likely to persist while the US maintains near zero interest rates and continues to print money. On the flip side, the Chinese economic growth outlook is becoming an increasingly important determinant in investor attitude towards the Australian dollar. Currency markets volatility is expected to continue throughout 2011.

Moving further into 2011, Australia's economy will continue to benefit from strong commodity exports. Government spending on flood rebuilding will provide an additional growth driver. Business investment is expected to gain momentum, with large capital expenditure plans for mining and energy projects over the medium term. Australian household spending and housing activity remain the key areas of uncertainty.

Despite the expected short-term dip in growth for the March 2011 quarter, both Australia's economic outlook and current fundamentals remains positive. New impediments to global growth are emerging in terms of Japanese growth, oil price fears and the difficulties faced by smaller European economies, but Australia is afforded the luxury of being able to reduced interest rates, one not enjoyed by the majority of our developed market peers. Additionally, Australia's economy remains highly leveraged to the rapid growth in emerging Asia, which presents both opportunity and risk. Economic forecasts for Australian GDP are quite divergent given the difficultly in assessing the extent of the disruptions from the cyclone and flooding. Count's primary Research House, Lonsec, expects Australia's annual growth rate to dip to 2.0 - 2.5% pa in the first half of 2011 and then recover to around 3.0% by year end.

United States

US economic data flow in the March quarter was largely positive, suggesting a structural recovery in economic activity. US employment, consumption, business investment and net exports all showed signs of improvement but housing activity continues to be a drag on the economy. US GDP for the final quarter of 2010 came in at an annual rate of 3.1%.

The standout positive trend over the first 3 months of 2011 has been a sustained, albeit gradual, improvement in the US labour market. The US labour market added around 200,000 new jobs per month, pushing the jobless rate down to 8.8% - its lowest level in almost two years. Stronger jobs growth is still required to meaningfully reduce the jobless rate to pre-GFC levels.

The US housing sector remains extremely weak with prices continuing to fall and starts and sales tumbling to new lows. The most recent data showed heavy monthly falls in housing start (-22.5%), new home sales (-16.9%) and existing homes sales (-9.6%). These figures obviously point to the risk of another downward spiral in the US housing market threatening confidence, spending and the US banking system. The news was not all negative though. Other developments in the labour market included mortgage delinquency rates and foreclosures appearing to have peaked, falling vacancy rates, unsold new homes at record lows and a surge in consumer plans to purchase new homes.

There are still a number other issues policy makers in the US need to work through. There is no doubt that the current phase in the US recovery has been significantly aided by supportive monetary and fiscal policy. Interest rates remain at near zero and money is still being printed to fund the debt acquisition program (quantitative easing). Both measures will eventually need to be unwound. Additionally, the US currently runs a massive budget deficit of around 9% of GDP and has not moved to stem this like in the UK and in Europe. The issue almost shut down the US government in early April, with Republicans pushing for larger cuts to the budget than Democrats were willing to concede. It is unlikely that any major headway will be made on the issue until after the election in 2012.

Over the March 2011 quarter, the US economy presented an image of improving economic growth. The US economy has now recorded seven consecutive quarters of recovery, with the sources of growth now coming from a wider base. In particular, improvement in the labour market is setting the stage for a transition to self-sustaining recovery, where accommodative monetary and fiscal policy can eventually be unwound. The IMF forecasts 2.8% growth in the US economy over 2011, while consensus forecasts have recently been revised up to 3.2%.

Europe

Economic growth continues across Europe as a whole, but the results were dispersed across the region. Germany and the other core countries are holding up well, offsetting conditions in the peripheral nations which continued to quietly deteriorate on a range of fronts. The Eurozone recorded GDP growth of 2.0% over the final quarter or 2010.

In Germany, the economic upswing continued through the final quarter of 2010, but the pace of growth moderated from the preceding quarters. German GDP rose 0.4% for the quarter, up 4.0% when compared with a year earlier. Germany's strong export performance has been a big boost to overall European data, and March 2011 figures should also include a weather related bounce in construction. In other areas of the Eurozone's largest economy, domestic spending growth has only been modest despite falling unemployment, while retail sales figures remain flat over the last 12 months. This means that German export growth is unlikely to have any spill over benefits to its surrounding nations.

French GDP was also up, but not to the same extent as in Germany. French GDP increased by 0.3% in the December 2010 quarter for an annual growth rate of 1.5%. Across the strait, British GDP contracted 0.5% in the final three months of 2010 for a 1.5% annual expansion. This was largely the result of heavy snow disruption to economic activity although forecasts for March 2011 GDP have been revised down, and expectations for an interest rate rise pushed back.

Europe's sovereign debt crisis is old news but the problem has been stubbornly persistent. Fortunately it is only the smaller countries of Greece, Ireland and Portugal which have been affected so far and have had to implement the deepest fiscal austerity measures. These countries are being supported by the ECB and a European Financial Stability Facility (EFSF), of which changes were made to over the quarter. The package will be upgraded to from €250 billion to €440 billion, but the exact details of how this will be achieved remain to be finalised. A permanent bailout fund has also been planned for the future. Portugal is now widely expected to be next in line for a bailout, with its Prime Minister resigning in March following the rejection of fiscal austerity measure by parliament.

Provided these issues are contained within these smaller nations, they should not be of major concern. Where it could become a major issues is if market concerns shift to Spain and then on to Italy. If rising bond prices caused these larger states to default on their debt, the scale could trigger another round of widespread losses within the European banking system. Fortunately this is not the case and bond yields have remained relatively unchanged in Spain and Italy, suggesting the issue is presently contained. Additionally, recent bank balance sheet stress testing in Ireland indicated less recapitalisation funding than expected is required, although the two banks that previously avoided nationalisation are likely to come under state control. Over 2011, the IMF forecast economic expansion of 1.6% in Europe and 2.0% in the UK.

Japan

The tragic events of the Japanese earthquake and Tsunami resulted in untold human suffering, which was followed closely with concern from all corners of the globe. From an economic perspective, the timing was also most unfortunate. Despite Japan's economy shrinking an annualised 1.1% in the fourth quarter of 2010, the first contraction in five quarters, market commentators were starting to note signs of recovery. Export growth had accelerated for a second month in a row in December and was up sharply from a year earlier. The devastation has obviously pushed this recovery off course in the short-term. Japan's economy has now been stifled by damage to industrial production, supply chains, infrastructure and power supply as well as a serious deterioration in confidence.

It is extremely difficult to accurately forecast the extent of the economic impact in GDP growth terms, but March 2011 quarter figures will surely be negative, officially pushing Japan back into recession. The Bank of Japan (BoJ) was quick to respond, announcing its quantitative easing program would be doubled and liquidity pumped into the Japanese banking system. Fiscal stimulus will also be on the agenda and the rebuilding efforts will provide a boost to growth throughout the second half of the year. Estimates from the Japanese government place reconstruction spending over the next three years somewhere between ¥16 and ¥25 trillion. The peak rate of expenditure expected to occur in 2012 adding 1.5% to of annualised real GDP at the peak of the reconstruction process. The IMF forecasts Japan to grow by 1.4% in 2011.

Asia (ex-Japan)

With the exception of Japan, the major Asian economies are maintaining a strong growth trajectory. Inflationary pressures are now mounting and in Asia's two rising giants, with the latest inflation numbers released late in the quarter showing annual inflation of 4.9% in China and 8.3% in India. This has led to monetary policy tightening in China, India and emerging Asia more broadly.

Economic growth in China unexpectedly accelerated in the fourth quarter of 2010, expanding at an annual rate of 9.8%. This was in spite of a series of tightening measures and highlights the difficulties Chinese officials face in cooling an overheating economy while avoiding a potential hard-landing. In China's latest Five-Year Plan, the government has lowered its medium term growth target to 7-8%, with the intention of creating self-sustaining growth based on domestic consumption and to reduce reliance on exports and investment. Markets have concerns that further policy moves to combat inflation are on the horizon and indeed benchmark one-year lending and deposit rates were increased by 0.25% on April 5 to 6.31% and 3.25% respectively. This was the fourth interest rate hike in the current cycle.

India's GDP is not far behind that of China, with 8.2%

expansion recorded in the fourth quarter of 2010. India's monetary policy tightening cycle has been more protracted with the Bank of India lifting interest rates 8 times since March 2010.

Inflationary pressures pose a particularly difficult situation for emerging Asian economies, given the potential for civil unrest if not adequately controlled. Global inflation in recent times has been more pronounced in food and fuel prices, which representing a significant component of personal expenditure within these populations. At either side of the spectrum, failing to contain these pressures or creating sharp downturn in growth pose the risk of political unrest. Due to its size, markets have been predominantly focused on China, which has proved adept at handling this balancing act so far. The IMF forecasts the Chinese economy to grow by 9.6%, India to grow by 8.2% and Japan to grow by 1.4% in 2011.

INVESTMENT SECTORS

Australian Shares

The Australian equity market followed global equity market higher in the first three months of 2011. The All Ordinaries Accumulation Index (including dividends) rose 2.9% over the March quarter for a 4.8% annual return. It was a volatile ride, with a number of domestic and global issues creating difficulties for investors. January left investors in the Australia market digesting the impact of flooding on the Australian economy. February subsequently saw further domestic disaster in the form of cyclone Yasi, uprising in several Arab nations and a resulting spike in the price of oil. To complicate matters even more, March bore witness to the devastation in Japan and the potential for nuclear catastrophe.

Industrials outperformed Resources over the March quarter, but Resources remain firmly ahead over the past 12 months. The S&P/ASX 300 Industrials Accumulation Index rose 3.5% for the quarter and fell 0.5% annually, compared to a 2.3% quarterly rise in the S&P/ASX 300 Resources Accumulation Index which rose 13.7% over the last 12 months.

At the sector level, Energy (+4.6% QoQ, +6.5% YoY) was the standout performer and actually benefited from the Japanese nuclear disaster and rising oil prices. This was largely within the LNG sector, whereas uranium stocks were sold off heavily in response to the nuclear crisis. Financials (+3.6% QoQ, -7.2% YoY) and AREITs (+2.5% QoQ, -1.0% YoY) were the other sectors recording notable gains for the quarter. Information Technology (-9.3% QoQ, -20.0% YoY) and Utilities (-3.8% QoQ, -4.1% YoY) were the worst performing sectors.

Several large Australian companies conducted capital management initiatives over the quarter. BHP Billiton (+2.9%) completed a $6 billion off-market share buy-back. In March, JB Hi-Fi (+12.5%) followed suit while Origin Energy (+0.2%) announced a $2.3 billion rights issue. By far the biggest shock was Leighton Holdings (-4.2%) announcement of a $757 million capital raising at a 22% discount to its share price, following the announcement of a record loss of $4,277 billion. In other news, Treasurer Wayne Swan has rejected the proposed takeover of ASX (-8.7%) in its current form.

Despite Australia's healthy economic performance, Australian equities continued to underperform global equity markets on both a quarterly and annual basis. There are a number of potential reasons for this. Firstly, there are several question marks around the possibility, timing and extent of number of proposed government taxes, most notably a carbon tax and the Mineral Resource Rent Tax. Other factors include a strong Australian dollar as well as disruptions to export activity as a result of the extreme weather conditions experience in January.

These issues aside, the Australian economy remains healthy, with an extremely strong boost to national income being supplied from rising export commodity prices. 2011 will also see further support in the form of substantial investment in new mining and natural gas projects as well as the rebuilding process following the floods. Most Australian companies are operating healthy balance sheets and market valuations are below the historical average. Continued improvement in the global economy should see further rises in the Australian market throughout 2011.

International Shares

Over the first three months of the year, equity markets were consumed with a plethora of global issues that are yet to fully play out. The key drivers of recent market volatility have been escalating tensions in Northern Africa and the Middle East, the Japanese natural disasters as well as the ongoing European sovereign debt saga. These issues however, were set against the backdrop of an otherwise improving global economy, which saw the MSCI World Index (ex-Australia) USD finish the quarter up 4.8%, for a 13.4% rise over the past 12 months. The Australia dollar finished the quarter up 0.9% at US $1.03, but this movement masks deeper volatility within currency markets, with the Australia dollar up 12.6% over the past 12 months. In Australian dollars, the index returned 3.8% for the quarter and 0.8% over the past 12 months.

US equity markets were amongst the strongest performers over the first three months of the year, reflecting improved sentiment towards the prospect of systematic improvements in the US economy. The Dow Jones enjoyed the strongest quarterly returns, up 6.4% for a 13.5% annual return. The S&P 500 was close behind, rising 5.4% for the quarter and 13.4% over the last 12 months, while the NASDAQ rose 4.8% for a 16.0% annual return. The coming June quarter will see the commencement of the US earnings reporting season. Improvements in both the size and quality of US company earnings will provide a good barometer for the health and sustainability of US economic recovery.

In Europe, sovereign debt concerns remained the principal focus, although there was no evidence that the key fear of contagion to Spain is on the immediate horizon. The largest European equity markets continue to rise, with the German DAX index up 1.8% over the March quarter and 14.4% over the past 12 months. In France, the French CAC40 Index rose 4.8% for the quarter, up 0.4% on an annual basis. The UK FTSE finished the quarter where it started, up 4.0% for the year.

Quarterly results in emerging Asia were mixed. Their proximity and closers trade ties to Japan saw a greater impact of the natural disaster on their equity markets. China's Shanghai B index rose 4.3% for the quarter but is still down 5.8% on an annual basis. India's SENSEX index was down 5.2% for the quarter, despite a 9.1% rally over March, and is up 10.9% on an annual basis. Elsewhere in Asia South Korea (+2.7% QoQ, 24.5% YoY), Malaysia (+1.7% QoQ, 17.0% YoY) and Hong Kong (+2.1% QoQ, +10.8% YoY) rose while Taiwan (-3.2% QoQ, 9.6% YoY) and Singapore (-2.6% QoQ, +7.6% YoY) both fell. China remains the key driver of activity in the region and the extent and success of Chinese efforts to control inflation will be the focus of equity markets over 2011.

Considering the catastrophic events that besieged Japan over the quarter, the Japanese Nikkei index held up remarkable well. After taking a battering immediately after the earthquake and tsunami, the Nikkei recovered some of this ground to finish the quarter down 4.6%, recording a 12.0% annual loss. The difficulties created by these events still have some way to play out, with the threat of a potential nuclear meltdown still palpable and ongoing power disruptions placing additional pressures on an economy that was already struggling.

International equity markets survived a tumultuous start to the year with surprising resilience. Issues that have been with us for some time like rising Chinese inflation and European sovereign debt issues were trumped by natural disaster, social unrest and rising oil prices. Despite increased uncertainty in the short term, the global economy remains on a steady growth trajectory. The IMF forecasts global economic growth of a respectable 4.4% in 2011. Over 2011, aggregate GDP growth of 2.5% is forecast for developed economies, led by the US while 6.5% is forecast for growth in the developing economies over 2011, driven by China.

Property Securities

The S&P/ASX 300 A-REIT Accumulation Index produced very similar results to the broader Australian equity market over the first quarter of 2010 and over the last 12 months. The index rose 3.7% for the quarter and 4.7% annually.

Many of the difficulties facing the Australian REITs sector have subsided. Access to debt or refinancing funding is becoming increasingly available, balance sheets have been deleveraged, valuations have stabilised, capital growth in underlying asset has resumed and transactional activity is on the increase.

Corporate activity over the March quarter was limited, with the key event being Investa's (+11.7% QoQ, +6.0% YoY) management takeover of the former ING Office Fund.

Australian REITs will continue to benefit from a favourable domestic economic outlook, particularly in terms of a low and falling unemployment rate. With stronger balance sheets and more conservative and sustainable payout ratios the sector is increasingly viewed as a lower risk asset class. However, current A-REIT yields relative to bonds and cash have restricted any major fund flows into the sector thus far.

In global REITs, the UBS Global Real Estate Investors Index (hedged into $A) returned 5.8% over the March 2011 quarter and 24.8% over the last 12 months. The US and Canadian listed property markets have been the best performing markets, while Japan and Singapore recorded the greatest falls over the first three months of the year. The global REIT market has worked through largely the same issues as the domestic REITs since the GFC, with balance sheets now largely repaired.

The outlook for the global REIT market is more difficult to summarise, with a wide variety of forces in play in different markets. In the US, the media remains focused on ongoing weakness in the housing market.

The outlook for European property markets are also widely dispersed, with strong growth expected in the major cities within Germany and the UK while weakness is expected to continue in the peripheral nations. Asian property markets will continue to be supported by rapid economic growth, but Chinese officials are highly focused on preventing a speculative bubble within its property markets.

Fixed Interest & Cash

There were no changes to the RBA cash rate over the March 2011 quarter, which has been held at 4.75% since November 2010. In the minutes of the most recent April board meeting, the RBA stated that in line with their previous decisions and current financial market developments, "interest rates on both housing and business loans were a little above average level." While also referencing increase uncertainty surrounding the Japanese disaster, they believe this setting is appropriate based on their medium term economic and inflation outlook. This has been taken by markets to mean no interest rate rises are planned for the remainder of 2011.

Central banks in the major developed economies have kept short-term interest rates very low over the first three months of 2011, although the European Central Bank (ECB) has been the first to make a gradual upward move in interest rates. For the first time since 2008, the ECB raised its target rate by 0.25% to 1.25% in early April. The Bank of England is yet to follow suit.

In the US, the cash rate remains near zero and additional support is being provided in the form of quantitative easing. This support cannot go on indefinitely and continued improvement in the US economy will firstly see the quantitative easing program withdrawn, followed by a gradual tightening of monetary policy. Futures markets are currently pricing a 1.0% fed fund rate by the end of 2011.

10-year Australian Government Bond yields finished the quarter unchanged at 5.5% despite falling sharply by 0.15% to 5.35% following the Japanese disaster. The UBS Composite Bond Index returned 2.0% in the March quarter and 6.86% over the past 12 months.

In was a more volatile ride in international bond markets although upward momentum in yields was maintained. The upward trend in US 10-year Treasury hit a speed bump on 16 March, falling from 3.42% to 3.17%, only to finish the quarter up 0.17% at 3.47%. Bond yields in the major European markets rose, with German 10-year Bund yields rising by 0.37% points to 3.34% over the quarter and UK 10-year Gilt yields up 0.20% to 3.59%. Japanese, 10-year Government Bond yields added 0.14% to 1.26% over the quarter. In aggregate, the Citigroup World ex Australia GBI (hedged) in $A returned 0.4% for the quarter and 6.2% annually.

Globally, bond yields have been progressively rising, which is consistent with a recovering global economy. The March quarter saw a brief rush back to the safety of bonds due to geopolitical tensions and Japanese disasters, but the overall trend of rising yields continued. Bond yields remain only slightly above inflation, while major developed economies have been aggressively issuing bonds to fund their fiscal deficits. These factors combined with an improving global economic outlook should see global bond yields continue to rise, particularly as uncertainties surrounding the Libyan conflict and the Japanese nuclear facilities subside.

STOCK MARKET INDICES AS AT 31 MARCH 2011

Stock Market Indices	1 yr % pa	3 yrs % pa	5 yrs % pa	7 yrs % pa
ASX All Ordinaries Accumulation Index	4.80	1.22	3.58	9.83
S&P/ASX 300 Industrials Accumulation Index	-0.5	-0.5	0.67	6.57
S&P/ASX 300 Resources Accumulation Index	13.69	5.05	10.24	20.39
S&P/ASX 300 Listed Prop. Accumulation Index	4.74	-14.55	-9.46	-2.05
Dow Jones Industrial Index - US	13.48	0.15	2.09	2.51
Standard & Poors 500 Index - US	13.37	0.08	0.47	2.36
Nikkei Dow Index - Japan	-12.04	-7.99	-10.58	-2.58
Dax Index – Germany	14.43	2.52	3.36	8.98
FT-SE 100 Index – UK	4.03	1.19	-0.19	4.35
Shanghai B Index - China	-5.76	-5.51	17.68	7.71
MSCI World Acc Index net divs in $A	0.74	-4.47	-5.37	0.78