



Quarterly Market Outlook – March 2011

The Global Economy



- [Introduction](#)
- [Australia](#)
- [United States](#)
- [Europe](#)
- [Japan](#)
- [Asia \(ex-Japan\)](#)

Investment Sectors

- [Australian Shares](#)
- [International Shares](#)
- [Property Securities](#)
- [Fixed Interest & Cash](#)
- [Stock Market Indices](#)

Introduction

2010 concluded with a notable improvement in sentiment towards the outlook for the global economy. Global economic recovery continues around the world, albeit at various speeds. The focus on the sovereign debt issues plaguing Europe has gradually shifted to signs of improvement in the US economy and consensus forecasts expect global economic growth to accelerate to 4.1% over 2011.

The Australian economy maintained steady momentum over 2010, with September quarter GDP rising at a 2.7% annual rate. Australia's unemployment rate continues to fall and demand for resources continues to see money flow into the economy via strong terms of trade. The recent flooding tragedy across Australia creates significant headwinds for the Australian economy. Despite being extremely difficult to quantify, costs of up to 1.0% of GDP are being forecast due to lost productivity and damage to infrastructure. The floods are also expected to contribute around 0.2% to inflation.

Signs that US economic recovery is gaining traction took the global spotlight towards the end of the year,

March 2011 Quarterly Market Outlook as at 31 December 2010

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and were welcomed by investment markets. The key positives were increased retail sales, improvements in the troubled job market, the tax breaks announced by the Obama administration as well as September quarter GDP increasing to a 2.6% annual rate.

Euro-zone September quarter GDP grew at annual growth rate of 1.9%. The austerity measures required to repair over-extended balance sheets continues to weigh on domestic demand in the region. The positive news was that recent bond issues from some of the smaller heavily-indebted nations were successful, alleviating some concerns regarding the possibility of a full blown sovereign debt crisis.

Japan's economy grew at an annualised rate of 4.5% over the September quarter, although it is expected that this momentum was not maintained into final quarter of the year. Japan also needs to deal with its own issues of excessive public debt, with the added problem of persistent deflationary pressures.

Chinese inflation is another issue raising concerns on at the global level. Chinese inflation hit a 28-month high of 5.1% in November, prompting Chinese officials to raise interest rates and place further restrictions on bank lending. There are growing concerns that if China moves too aggressively to curb inflation and cool the economy, there is a danger of triggering an economic hard-landing. All concerns aside, the World Bank forecasts 8.7% GDP growth in China over 2011 and many economists believe this is far too conservative.

Australia

The Australian economy enjoyed a strong 2010 given the difficulties facing our developed market peers. 2011 is expected to mark the 20th consecutive year of positive economic growth in Australia. Despite this strength, an avalanche of recent economic data releases has provided mixed signals regarding the strength and momentum of Australia's economy moving into 2011. The latest national accounts figures came in lower-than-expected, with September quarter GDP rising 0.2% for the quarter and 2.7% annually. The Australian economy appears to be hesitating as the driver of growth rotates from public spending to private demand, against a backdrop of rising interest rates and a much stronger currency.



Despite questions being raised about Australia's economic momentum, the outlook remains positive. Australia's terms of trade rose 24% in the year to September, with the Reserve Bank of Australia (RBA) noting that "terms of trade are at their highest level since the early 1950s, and national income is growing strongly as a result". This rising national income is boosting both profits and wages. Recent surveys point to more confident consumers and businesses, particularly within the mining sector. This is expected to result in a surge in business investment, with the November released ABS CAPEX survey indicating that firms plan to lift investment in 2010/11 by 20%. The timing could not be better - with fiscal stimulus continuing to taper off.

Australia's unemployment rate has fallen again, dipping to 5.0% in December. While this fall extends a 10-month run of job creation, only 2,300 jobs were created over December. The increase included 1,700 full-time and 600 part-time jobs and was well below consensus forecast of 25,000 jobs being created. The falling unemployment rate was more a result of fewer people looking for work and the result viewed as disappointing.

The savings preference of Australian households reflects ongoing risk aversion, with consumers opting for saving and retiring debt over spending. Consumer spending fell 1.4% over October and retail sales fell 1.1%. However this is at odds with the Westpac MI Consumer Survey, which rose over October, and in particular, the 'time to buy major household items' sub-index surged 9.9% to the highest level since early 2005. Clearly there must be something else at play. With October being a school holiday month, the high Australian dollar may have sparked a rise in overseas travel, or perhaps the poor billionaire retailers really have been losing significant sales to online international competition.

The Australian dollar rallied 5.8% over the December quarter and 14.0% over 2010, to finish the year at \$1.02 US dollars. The weak US dollar is likely to persist while the US Fed's aggressive anti-deflation stance remains intact, but the outlook for Chinese economic growth is becoming increasingly important in determining investor attitude towards the Australian dollar. Volatility in currency markets is expected to continue into 2011.

The latest domestic risk to the economy is the tragic widespread flooding occurring across Australia, particularly in commodity rich Queensland. Quantifying the exact effect on the economy is an extremely difficult task, although such predictions are currently popular in the media with lofty figures being provided. RBA board member Warwick McKibbin said the disaster could shave up to 1.0%, or \$13 billion, from Australia's \$1.3 trillion economy. The flooding will

impede mining production and dampen other economic activity, with the prices of many fruits and vegetables set to rise. However, the water will eventually recede and growth will resume. Additionally, massive stimulus will be added through the rebuilding process and may result in the RBA postponing any further interest rate rises in the near term.

United States

US economic data released the final quarter of 2010 point to continued improvement in economic activity. While starting from a very low base, after recently emerging from recession, broad base improvements were seen across most parts of the economy including employment, business investment, housing, confidence and manufacturing.

The final revision of US third quarter economic growth came in slightly higher than the previous estimate. GDP grew at an annual rate of 2.6% in September 2010 quarter compared to the previous estimate of 2.5%. This was still lower than the consensus forecast of 2.7% and was driven by an increase in business investment rather than domestic demand. The upward revision was the result of a US \$121.4 billion increase in business investment in inventories, which added 1.6% to GDP growth.

The upward revision in growth was dampened by a downward revision in consumer spending, which only rose 2.4% during the quarter, down from the 2.8% pace previously reported. This increase in consumer spending was still the strongest rise since the first quarter of 2007. Accounting for two-thirds of the US economy, a sustained revival in consumer spending is crucial for the US economy transitions from recovery to growth. However, retail sales rose 1.2% over November after healthy Thanksgiving sales, suggesting improvement in confidence in US consumers. As in Australia, December figures will provide a better barometer for consumer confidence.

The US employment market also showed signs of improvement toward the end of the year but remains extremely weak. In December, The US jobless rate fell noticeably, declining from 9.8% to 9.4%. In aggregate, 103,000 jobs were created, including a 113,000 rise in private sector employment. Within the data, there was also an upward revision for jobs growth in October and November and job growth levels are expected to improve over the coming months.

The major US news in November was the Fed's announcement of a second round of quantitative easing (QE). The measures will see the purchase of US\$600 billion worth of treasuries between now and June 2011, to provide further stimulus to the economy, although economists are divided as to the true level of



support this will provide. The second major announcement was President Obama's large tax-break package, which is expected to add 0.5% to GDP growth in 2011. The announcement followed several weeks of heated debate between political parties in the US. The package has removed a large amount of fiscal uncertainty and seen upgrades to US economic growth forecasts for 2011.

Housing remains the laggard of the US economy, failing to show any meaningful, lasting signs of improvement in the latter half of 2010. December housing data did show moderate signs of improvement, with housing starts (+3.9%), existing home sales (+5.6%) and new home sales (+5.5%) all rising over the month. Fortunately, the housing market does not appear to be dragging down the rest of the economy.

Overall economic conditions in the US reflect gradually declining levels of uncertainty amid a global economic transition from recovery to expansion. Expansion is expected to continue in the US, increasingly driven by business investment and consumer spending. A movement away from reliance on government stimulus and inventory rebuilding, which drove economic recovery over 2010, should provide the foundations for sustainable economic recovery and support the US job market. Consensus GDP growth forecasts for the US in 2011 now stand at 2.6%.

Europe

European nations continue to struggle under the weight of the austerity measures required to deleverage overexposed country balance sheets. Recent revisions to September quarter GDP saw Europe's economy expand less than initially estimated. This was the result of companies trimming spending to weather the region's debt crisis, which appears to be stabilising for now.

Euro-zone GDP rose 0.3% over the September quarter for an annual growth rate of 1.9%. Europe's economy has been increasingly reliant on exports as the austerity measures have been dampening consumer demand and forcing companies to pare costs. Over the third quarter of 2010, consumer spending increased 0.1%, government spending rose 0.4%, exports increased 1.9% and imports rose 1.5%. The Euro-zone jobless rate held at 10.1% in November and remains at the highest in more than 12 years.

The German economy remains the single beacon of strength in Euro-zone. Over the September quarter, Germany recorded GDP growth of 0.7% from the second quarter, where it grew 2.3%. While slowing markedly from quarter to quarter, a healthy 3.9% annual GDP growth rate was recorded. This strong rate of growth is in contrast to the sharp contraction

experienced in 2009, when economic output fell by 4.7%, Germany's worst showing since World War II. The German unemployment rate fell to 7.7% in 2010 amid this recovery.

The UK economy was dealt a blow after September quarter GDP figures were unexpectedly downgraded. GDP grew 0.7%, down from the 0.8% previously estimated. Annually, growth was trimmed down to 2.7% from the previously reported 2.8%.

The French and Italian economies both expanded 0.3%. Ireland, which had the Euro-zone's highest budget shortfall in 2010, had a GDP increase of 0.5%. Spain's economy stalled and Greece's economy contracted 1.3%. Although Euro-zone members are making every attempt to deal with their debts and the European Union agreeing on a permanent rather than temporary bailout fund, there is the potential for further unfavourable developments in the evolution of the Eurozone debt crisis. Investors are likely to remain on high alert.

Most recently, Ireland was causing the greatest concerns, after admitting it would need to raise funds to support its battered banking industry, resulting in Irish bond yields rising to crisis levels. European governments sought to quell the market turmoil and handed Ireland an €85 billion aid package, which was effectively a bailout package. They also diluted previous proposals to force bondholders to bear some cost of future bailouts. Market confidence was partially restored but Moody's has just downgraded Ireland to Baa1 from Aa2 (BBB+ from AA in Standard & Poor's terminology).

Portugal and Spain were believed to be next in line for sovereign debt difficulties and also witnessed sharp yield rises in their respective bond markets. Recent activity in European bond markets has cooled concerns surround further troubles with these nations, following successful bond issues by both Spain and Portugal. Spain attracted lower rates for its long-term debt than had been previously demanded by investors, demonstrating it could access market financing at affordable rates.

Portugal was also able to raise debt capital, albeit at expensive rates. This has temporarily ended speculation that Portugal would be the next domino to fall in the crisis and that Germany and France had been pressuring Portugal to accept a bailout to prevent further contagion.

Headwinds from deleveraging and fiscal austerity measures will continue to weigh on activity in the European periphery, while core countries are likely to recover to pre-crisis GDP levels over 2011. As a whole, the Euro-zone is expected to grow by a mere 1.4% next year, while falls in GDP are expected to fall in



Greece, Ireland, Portugal and possibly Spain.

Japan

The stuttering Japanese recorded positive GDP growth over the September quarter, despite the persistent threat of deflation and the need to reign in the nation's massive public debt. Japan's economy grew 1.1% over the quarter, which translates into annualised growth of 4.5%. Despite beating previous estimates, the result offered little comfort to policymakers wary of slowing growth in the current quarter. The upward revision was the result of an increase capital spending and inventories, aided by a rush to beat expiring government incentives.

Japan's export growth accelerated for the first time in nine months in November, but came in short of expectations amid fears of a looming economic slowdown. Exports in November rose 9.1%, the 12th straight monthly increase, fuelled by strong overseas demand, particularly for Japanese steel and metal working machinery. The figure still fell short of consensus expectations for a 10.8%. Commentators have indicated that the Japanese economy is on path for shrinking exports, due to a stronger yen making Japanese products more expensive in overseas markets and expectations for weakening overseas demand.

Japanese policymakers are faced with the difficult task of striking a balance between supporting a flagging economy and reining in public debt, which accounts for nearly 200% of GDP. In November, the Japanese government passed an extra budget worth \$58 billion to cover a new stimulus package, designed to contain the threat of a "double-dip" recession. This is the second stimulus package release by newly appointed Japanese Prime Minister Naoto Kan and aims to ease concerns over deflation and a stronger yen. The package includes job programmes and welfare spending as well as assistance for small businesses.

Official interest rates remain at 0.1%, forcing the Bank of Japan (BOJ) to employ other measures to provide stimulus to the struggling economy. The BOJ last month rolled out a plan to inject \$60 billion into the economy by buying assets ranging from government bonds to corporate debt.

Consensus economic forecasts now point to a 0.1% contraction in the December 2010 quarter, as exports slow and car manufacturing output slumps after the expiry of government incentives for purchases of low-emission cars. Economic recovery is expected to resume next year, driven by growth in demand from emerging Asia, but the outlook for Japan is far from certain.

Asia (ex-Japan)

At lot of attention was drawn to the outlook for Chinese economic growth over the December quarter. Chinese officials are faced with the dilemma of trying to maintain balanced and stable economic growth while containing growing inflationary pressures.

Chinese inflation reached a 28-month high of 5.1% in November, raising concerns about the rising price of food. Food prices account for one-third of the calculation of China's CPI, and an 11.7% rise in food prices contributed to 74% of November's CPI growth. Chinese policy makers responded promptly in December by raising the benchmark one-year lending rate by 0.25% to 5.81%, as well requiring banks to set aside 18.5% of their deposits in an effort to curb rampant lending activity.

Investors have become increasingly wary that an overreaction by Chinese officials to stem rising inflation could result in an economic hard-landing. While this will remain an ongoing concern from some investors, it is certainly not consensus. In November, the World Bank raised its forecast for China's total 2010 GDP growth to 10%. China's September quarter GDP growth came in at an annual rate of 9.6%, slowing down from second quarter growth rate of 10.3%. The World Bank have forecast that China's growth will slow to 8.7% in 2011, however many economists view this figure as far too conservative.

India's domestically-powered economy continued to surge over the September quarter, growing faster than expected. Annual GDP grew 8.9% in the September quarter matching the growth recorded in the previous quarter. In the other key emerging Asian economies, the World Bank's latest forecast shows Thailand will grow 3.2% in 2011 after expanding 7.5% in 2010. Thailand's 2011 GDP growth will be the lowest among emerging markets in Asia, compared to 4.8% for Malaysia; 5% for the Philippines; 6.2% for Indonesia; 6.5% for Vietnam; and 8.7% for China.

For the industrialised Asian economies, South Korea's GDP growth slowed in the third quarter to 0.7% from 1.4% in the previous quarter, as exports fell drastically in the wake of cooling global growth. On a year-on-year basis, GDP grew 4.5%. Taiwan's economy grew faster than expected 2.9% over the September 2010 quarter, with GDP expanding 9.8% annually.

Asia (ex-Japan) will continue to grow at a rapid pace over 2011. 2011 will also see an increasing willingness of policy makers to tighten policy settings, to moderate growth to more sustainable levels and reduce inflationary pressures. Concerns will remain as to the



ability of policy makers to engineer an economic soft landing, but so far their efforts have been promising.

INVESTMENT SECTORS

Australian Shares

The final quarter of 2010 saw a resource dominated market rally push the Australian market into positive territory for the year. The All Ordinaries Accumulation Index (including dividends) rose 5.3% over the December quarter for a 3.3% annual return. Despite the Australian economy growing steadily and Australian companies enjoying healthy balance sheets, the sharemarket was not able to gain any significant momentum over 2010. This was largely the result of economic and financial issues abroad, as well as local headwinds from rising interest rates as well as the political and policy uncertainty resulting from the change of leadership in the Labour government, the subsequent election and the new look minority government.

A comparison of industrial and resource performance points clearly at a two-speed economy. The S&P/ASX 300 Resources Accumulation Index rose 13.3% for the quarter and 12.3% annually, compared to a 0.8% quarterly rise in the S&P/ASX 300 Industrials Accumulation Index which fell 2.6% over 2010. In recent months investors focussed on the ongoing strength in demand for bulk commodities like iron ore and coal. Recent Chinese import and export data supports the view that demand should remain high for some time to come.

This trend was also apparent at the sector level. The Materials sector (+13.7% QoQ, +11.7% YoY) was the only sector to record material gains over 2010. The only other sectors to rise over the year were Healthcare (+8.8% QoQ, +2.2% YoY) and Utilities (-1.6% QoQ, +0.1% YoY). The worst performing sector of 2010 was Telcos, falling 18.5% for the year, despite rising 6.1% over the December quarter. This was driven by a particularly volatile year for Telstra (+6.5% QoQ, -18.7% YoY). Telstra's share price went into free fall earlier in the year after providing guidance of flat sales and a sharp fall in earnings for 2010. More recently, Telstra's price has recovered somewhat, after the announcement of a potential \$13.8 billion deal between Telstra and the NBN.

Another key domestic theme impacting the Australian equity market has been the household saving rate increasing as high as at any point through the past 20 years. The move towards saving and retiring debt has impacted the Financials (-1.1% QoQ, -9.2% YoY) and Consumer Discretionary (-2.5% QoQ, -8.9% YoY) sectors, rounding out the worst performing sectors in

2010. The major retails are now publicly lamenting the consumer's new thrift, aggressively campaigning against tax rules allowing GST free purchases from international online vendors.

Unsurprisingly, in the environment, almost all of the top performing individual stocks were resource stocks. The only exception was Tower Australia (+65.4% QoQ, +38.5% YoY) after an attractive takeover offer from Japanese insurer, Dai-ichi Life. The majority of the top 20 were resource stocks, led by Sundance Resources (+130.0% QoQ, 271.0% YoY) and Cudoco (+125.2% QoQ, -9.7% YoY). Riversdale Mining (+62.7% QoQ, 138.4% YoY) also rose strongly after Rio Tinto (11.3% QoQ, 14.1% YoY) announced a takeover offer.

This Riversdale transaction was view as being a little on the expensive side for Rio Tinto, given Riversdale's price more than double over 2010, and the company successfully raised \$300 million in new capital in July, at a significantly lower price. It appears the larger resource companies in Australia are finding it increasingly difficult to deal with the excess cash their businesses are generating, with BHP Billiton's (+16.3% QoQ, +4.9% YoY) Potash bid falling through in the latter half of the year.

The Australian equity market finished the year somewhat dazed and confused. The same period two years ago was characterised by outright pessimism and the same period last year by unbridled optimism. 2010 has finished with markets unsure as to where to go next. On one hand we have markets in developed economies struggling with massive levels of government debt accompanied by rescue packages, austerity measures and monetary programs. On the other hand we have global economic growth fuelled by demand from developing economies, massive amounts of money following into the Australian economy via a resource boom and share prices trading at much lower prices than company profits would suggest. The same risks faced in 2010 will concern investors moving into 2011, but the market appears thirsty for more good news and is likely to rally once this is received.

International Shares

Global equity markets rallied strongly over December resulting in strong performance in both the December quarter and for 2010 in total. The MSCI World Index (ex-Australia) USD finished the quarter up 8.9% and returned 11.7% over 2010. The rapidly appreciating Australian dollar reduced these returns to 3.0% over the quarter and -2.0% over 2010. Over the year, the Australian dollar has risen 14.0%, from \$0.90 to \$1.02 USD. Despite the Euro-zone sovereign debt woes and concerns that Chinese may apply the economic brakes too hard to contain inflation, 2010 concluded on a distinctly positive note.



As was the case throughout 2010, market movements in the December quarter were driven predominately by macroeconomic events and economic data releases. US equity markets were buoyed by an upswing in retail sales growth and President Obama's extension of Bush era income tax cuts, which are both good signs for the US's highly important consumers. All the major US indices posted strong gains over the December quarter. The tech focussed NASDAQ index continues to outperform, rising 12.0% for the quarter and 16.9% annually. The S&P 500 was not far behind, returning 10.2% for the quarter and 12.8% over 2010, while the Dow Jones returned 7.3% for the quarter and 11.0% annually.

European equity markets continued to lag the broader global market, but with a wide dispersion of returns across countries. Continued strength in the German economy saw the German DAX index rally 11.0% over the quarter, returning 16.1% over 2010. Germany stands without the need for deep fiscal cuts and significant balance sheet adjustment and its exports industries are benefitting from a weaker Euro. The same cannot be said for the next largest European economy, with the French CAC40 Index rising just 2.4% for the quarter and fell 3.3% for the year. At the other end of the spectrum, where significant austerity measures are required, Greece and Spain's equity markets recorded respective quarterly falls of 6.6% and 7.1%.

Asian equity markets enjoyed another strong quarter, benefiting from improvements in the performance of the US economy as well as continued growth in China. South Korea (+9.5% QoQ, 21.9% YoY) and Taiwan (8.9% QoQ, 9.6% YoY) were the strongest performing regional markets over the December quarter. The weakest performing market was India (+2.2% QoQ, 17.4% YoY) where rising interest rates held the market back. China's Shanghai B index (+5.7% QoQ, -14.3% YoY) was also held back by concerns over rising inflationary pressures and policy measures being introduced to combat them. If China is forced to take more drastic action to ease growth and contain inflation, this will have a negative impact on all the regional markets.

Japanese equity markets rallied over the December quarter, after an indiscriminate sell-off over the September quarter. The Nikkei index rose 9.2% over the quarter, falling 3.0% on an annual basis. The Japanese equity market was a beneficiary of a rotation out of emerging Asian markets following China's inflationary surprise and the subsequent monetary policy tightening.

2010 was a volatile year for international equity markets, which finished on a positive yet cautious note. Volatility is likely to continue into 2011, with a number

of the issues facing markets over 2010 requiring more time to play out. The key risks for the global economy and equity markets are ongoing sovereign debt issues, emerging markets inflation and the resulting policy responses. Notwithstanding these risks, the outlook for international equities remains positive. Developed world inflation should remain low throughout 2011, consensus forecasts predict global economic growth accelerating to 4.1% in 2011 and corporate earnings should remain strong.

Property Securities

Australian Real Estate Investment Trusts (A-REITs) failed to gain any traction over the December quarter. The ASX A-REITs Accumulation Index fell 1.2% for the quarter 0.7% over the last 12 months. The quarter was marked by an increase in corporate activity.

The Industrial sector (+4.5% QoQ, +9.7% YoY) was the only A-REIT sector to rise over the December quarter. Within the sector, ING Industrial Fund rose 7.1% over the quarter, following a revised takeover bid from a consortium led by Goodman Group (0.8% QoQ, 2.4% YoY).

This was followed by the Commercial sector, which fell 0.2% over the quarter and 6.5% over 2010, driven by the performance of the Commonwealth Property Office Fund (-9.5% QoQ, -14.2% YoY) and the ING Office Trust (-7.5% QoQ, -13.3% YoY).

Australia's Retail sector was down 1.4% over the quarter, for a modest 2.5% annual return. The major event in the retail sector was Westfield's (0.1% QoQ, -2.2% YoY) unspectacular launch of their new retail trust, WRT. Since the launch, WRT has consistently traded below the offer price of \$2.75. One possible cause of the share prices weakness could be speculation and anecdotal reports of poor Christmas shopping sales this year. Centro Retail Group (+45.5% QoQ, +45.5% YoY), which previously announced the commencement of a market tender process to purchase some or all of its assets, is currently working through the proposals received and a short list is expected by late January 2011.

The Diversified sector fell 2.8% for the quarter and 5.2% over 2010. Stockland Trust Group (-6.3% QoQ, -8.9% YoY) and GPT Group (0.0% QoQ, -2.8% YoY) were the key contributors. GPT made news by selling part of its interest in two of its unlisted funds to raise money to retire debt.

The major announcement on the corporate activity front came from Lend Lease. Subject to regulatory approval, Lend Lease intends to acquire Valemus Australia for \$960 million from Bilfinger Berger SE. Earlier in the year, Bilfinger attempted to raise \$1 billion



via floating Valemus on the market, but the IPO failed.

The Australian listed property sector continues to struggle to gain traction despite a supportive economic environment. The Australian economy continues to expand and the sectors difficult task of balance sheet repair and re-capitalisation, required post-GFC, has largely been complete. The current difficulty faced by the sector is that while an appetite for riskier assets is slowly returning, investors largely remain risk averse. The recapitalised A-REITs sector is now viewed as relatively low-risk, but the average sector yield of 6.5% can easily be obtained in fixed interest markets. It seems investors are requiring a little more to return to the sector. A general equity market rally and increased appetite for risk over 2011 should provide some momentum for the A-REITs sector.

Fixed Interest & Cash

In November, the RBA raised the cash rate by 0.25% to 4.75%, marking the first rise in 6 months. The RBA Board cited concerns about potential rising inflationary pressures in the medium term given the high level of income flowing into the economy, combined with a lack of spare capacity in the economy. Including the additional interest rate increases added by Australian banks, above the rise in the benchmark rate, interest rates to Australian borrowers are slightly above their long-term average. In their latest December meeting, the RBA reaffirmed that they are comfortable with this position.

Futures markets appear to be expecting another 0.25% rise in the near future, with 90-day bank bills rose modestly from 4.89% to 4.96% over the quarter. While most commentators anticipate a number of further official increases in cash rates over the next 12 to 18 months, the rate should remain on hold in the near term, particularly given the uncertainty regarding the economic impact of the floods. The UBS Australian Bank Bill index returned 1.2% over the quarter and 4.7% over the last 12 months.

Once again, there was no change to official interest rates in the major developed economies. While consensus expectations for the US economy have become more optimistic, the Fed is wary of the risks of raising interest rates too soon. Meaningful movements towards desired levels of unemployment and inflation would be required before rate rises are on the table. Markets are not pricing near term rate rises by the Fed, the Bank of England, the European Central Bank or the Bank of Japan.

Global sovereign bond yields continued their sharp appreciation over the December quarter. This was driven by the Fed's announcement of a second round of Quantitative Easing, which has lifted inflation

expectations and reduced risk aversion amongst investors. Over the December quarter, yields on 10-year US Treasuries rose from 2.60% to 3.29%, 10-year German Bund yields climbed from 2.27% to 2.96%, UK 10-year Gilts rose from 2.94% to 3.39% while Japanese 10-year government bonds pushed back above 1%, rising from 0.94% to 1.13%. The Citigroup World ex-Australia GBI (hedged in \$A) fell 1.1% over the December quarter, returning 7.9% annually.

A similar trend was apparent in Australian, with 10-year bond yields increasing from 4.96% to 5.55%. The UBS All Maturities Composite Bond Index fell 0.2% over the quarter, returning 6.0% over 2010.

European sovereign concerns eased during December as investors shifted their focus to US economic improvements. The outlook for fixed interest yields in the short-term will continue to be driven by investor's attitudes to risk and the performance of the global economy. However, bond yields are at highly depressed levels globally and over the medium to longer term, yields ultimately drift higher, to more normal levels.

STOCK MARKET INDICES AS AT 31 DECEMBER 2010



<i>Stock Market Indices</i>	<i>1 yr % pa</i>	<i>3 yrs % pa</i>	<i>5 yrs % pa</i>	<i>7 yrs % pa</i>
ASX All Ordinaries Accumulation Index	3.31	-4.92	4.85	10.07
S&P/ASX 300 Industrials Accumulation Index	-2.56	-7.76	1.28	6.89
S&P/ASX 300 Resources Accumulation Index	12.31	1.89	13.46	19.95
S&P/ASX 300 Listed Property Accumulation Index	-0.68	-21.36	-9.79	-1.65
Dow Jones Industrial Index - US	11.02	-4.43	1.56	1.47
Standard & Poors 500 Index - US	12.78	-5.03	0.15	1.77
Nikkei Dow Index - Japan	-3.01	-12.57	-8.69	-0.69
Dax Index – Germany	16.06	-5.01	5.04	8.27
FT-SE 100 Index – UK	9.00	-2.96	0.98	4.02
Shanghai B Index - China	-14.31	-18.89	19.32	9.40
MSCI World Acc Index net divs in \$A	-2.08	-9.86	-4.39	0.34

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