



Market Watch

July 2010

Key points

- Sharemarkets gained ground as investors regained some confidence.
- This was helped by some positive results of analysis into the financial health of European banks.
- The global economic backdrop remains very cautious and uncertain.

Economic overview

It was a positive start to the new financial year, with sharemarkets gaining ground as confidence returned, albeit cautiously. These gains occurred against a back drop of global economic uncertainty, with disappointing data out of the US, and further signs of a Chinese economic slowdown, while some economic data out of Europe surprised on the upside.

Over the past several months, the global economic outlook has become more uncertain, with lingering concerns over government debt levels and the need for major developed countries to significantly wind back budget deficit and debt positions. Forecasts have been cut for global growth, mainly driven by a somewhat more lackluster US economy.

These concerns have been reflected in financial markets, with losses from April to early July in equity markets and lower government bond yields. Given the rally in July, the pertinent question is whether the weaker economic expectations have been reflected in financial market prices, or will the opaque outlook lead to further volatility.

While it is hard to predict, it is apparent the second-half of 2010 will be weaker for the global economy than the first-half, driven by tighter policy in emerging economies, the roll off of government stimulus in the US, and continued tight fiscal consolidation plans in Europe.

Economic data out of the US has weakened in recent months. The performance of the US economy in the first-half of 2010 surprised market participants on the upside, however with a large fiscal drag as stimulus is removed, a still depressed housing market and weaker than expected employment growth, the outlook is looking softer than anticipated. Despite very low labour costs and improving productivity, businesses have been reluctant to hire, with confidence low in final demand and general economic conditions.

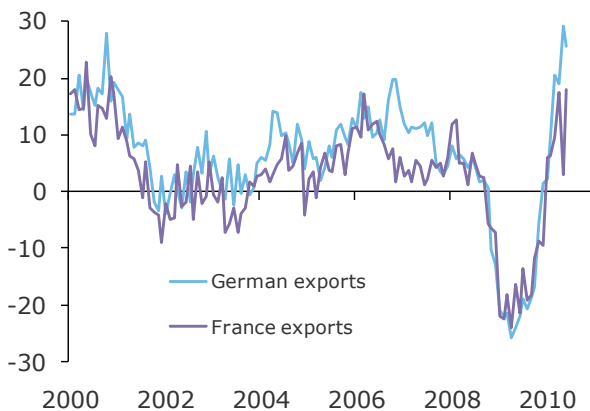
Headwinds for the US economy continue to be a very depressed housing market, with rising foreclosures, a falling home ownership rate and low sales. A recovery has been pushed out into 2011, where housing starts are expected to recover slowly as demand for housing improves and inventories are gradually reduced. In the meantime this is holding down house prices, impacting consumer confidence and spending, and leading to a rising savings rate.

The other key issues in the US are the weak fiscal position of state and local governments and deteriorating financial conditions with banks still reluctant to extend credit. The Federal Reserve is prepared to act as needed if growth deteriorates too much. Other possible policy measures could include pushing out the expiration of the Bush tax cuts (due to expire in November). Both these measures could ensure the durability of the economic recovery and lift confidence. The positives for the US economy remain very low interest rates, strong company profits and rising capital expenditure.

In Europe, economic data out of Germany has surprised on the upside. Germany exports have risen 29.2% over the past 12 months (chart below), unemployment has fallen for 13 consecutive months and industrial production has risen 12.4% on an annual basis. A weaker

euro continues support the region. The other key event that helped calm markets over July was the release of tests to judge the financial health of European banks, called stress tests. While there were question marks over the credibility of the results, it did provide further information to financial markets to assess European bank balance sheets. Only seven of the 91 EU banks failed the stress test, with one German, one Greek and five Spanish banks.

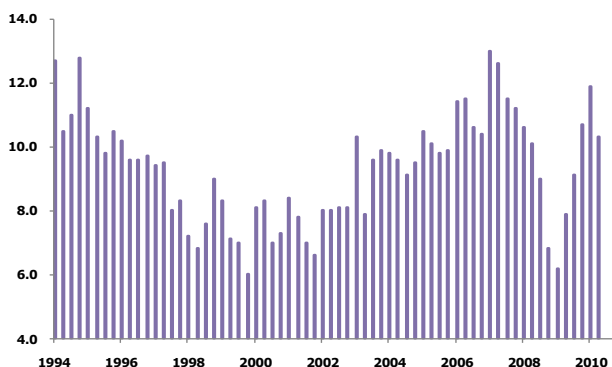
Annual export growth (%)



Source: Colonial First State Global Asset Management

China released 2Q 2010 GDP data, showing a slowdown in annual economic growth to 10.3% from 11.9% (chart opposite, above). This slowdown has been driven by policy tightening in the property sector and restrictions on the amount of bank loans. Markets had been expecting a slowdown in growth, but concerns are focused on a swifter than expected slowdown in the manufacturing sector. The focus has now switched to a possible wind back in policy tightening to manage economic growth closer to the 8% target.

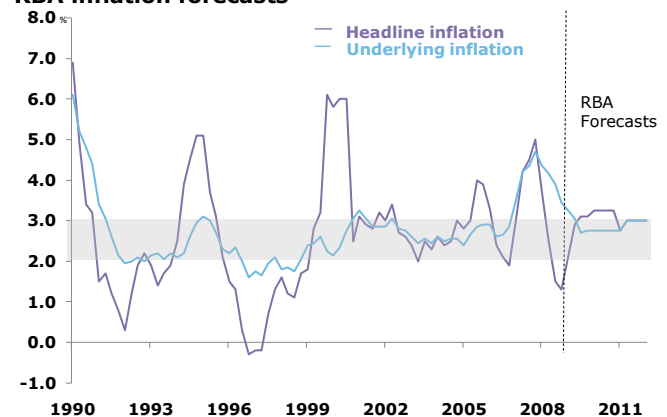
China – annual economic growth (%)



Source: Colonial First State Global Asset Management

In Australia the key piece of economic data released was 2Q CPI. Headline inflation rose by 0.6%/qtr which was less than expected. The annual pace of inflation rose to 3.1%. The pace of underlying inflation (which strips out volatile price changes) also moderated, 0.5%/qtr and 2.7%/yr, lower than expectations, but in line with RBA forecasts (chart below). Given this the RBA left the official cash rate on hold at 4.5% in early August for the third consecutive month and issued a very neutral statement signalling rates could be on hold over coming months. The softer inflation numbers were primarily driven by price falls in fruit, vegetables, domestic travel and audio visual. The deep discounting cycle from retailers to boost soft consumer demand have impacted on the inflation data. Key price rises were in tobacco prices due to a lift in the excise tax and higher health costs.

RBA inflation forecasts



Source: Reserve Bank of Australia, July 2010

Other important data highlighted continued strength in the labour market. Since June 2009, 350,000 jobs have been added to the economy, with a further 45,900 added in June. The unemployment rate now stands at 5.1%, down from its recent peak of 5.8%. This strength in the labour market is expected to begin to impact on wages over coming months and will be one factor that could see further tightening by the RBA.

Following the dramatic events of June when Julia Gillard took over from Kevin Rudd as Prime Minister, July was yet another eventful month in Australian politics. The Federal election was called for 21 August, and campaigning started with full steam.

There seem to be no significant differences between the two major parties in terms of the broad fiscal strategies or the implications for monetary policy, but there are major areas of policy differences relating to resource taxes, carbon pricing, the national broadband network and superannuation. While in the long term there are likely to be no significant impacts on financial markets, some short term volatility could be experienced.

Australian shares

After falling to a 10-month low in early July, Australian shares performed relatively well in the remainder of the month. The S&P/ASX 200 Accumulation Index added 4.5% in the month as a whole.

Investor sentiment improved sharply early in the month after Prime Minister Gillard and major resources companies agreed on revised terms of the proposed Resources Super Profits Tax, now the Mineral Resources Rent Tax. This development removed some of the uncertainty which had been affecting the Materials and Energy sectors for the past couple of months.

The best performing sector of the market in July, however, was Industrials (+7.2%) as investors favoured stocks with some leverage to economic activity. Employment data confirmed that the Australian economy continues to add workers, suggesting the domestic economic recovery remains on track. More defensive areas of the market, such as Telecoms (-0.5%), Health Care (+0.9%) and Consumer Staples (+1.8%) underperformed the broader share market.

Investor attention is now firmly on the fiscal full year earnings reporting season. Most companies with a June year end will release their annual results to the market in the next four weeks.

Global shares

Global equity markets rallied in July on improving risk appetite and after several months of falls. Clarity from the European bank stress tests helped equity markets moved forwards as did a positive earnings season in the US.

The MSCI World Net Index rose 0.9% in AUD and 5.9% in AUD (hedged). The strong AUD held back returns for local investors, appreciating 7.2% against the USD over July to US 90.53 cents.

US equity markets performed well, assisted by a supportive profit season although concerns moved to focus on economic growth over the remainder of 2010. The Dow rose 7.1% and the S&P 500 and NASDAQ were both up 6.9% and NASDAQ. Over the past 12 months the Dow returned 14.1%.

European markets were also largely positive, although performance did differ between countries. The German DAX index rose 3.1%, France was up 5.8% while Spain (+13.4%) and Greece (+17.3%) both rallied strongly. The stress test results did help to restore confidence in a number of financial companies and the broader market over the month.

In Asia, equity markets were more subdued. The Japanese markets moved higher with the Nikkei rising 1.7% to be down 8.1% over 12 months. While strong Asian economic growth has helped the Japanese economy through its trade links, traction needs to be seen in domestic economic activity.

Elsewhere, Asian markets were higher. Hong Kong (+4.5%), Singapore (+5.4%) and Thailand (+7.3%) all rose.

Global emerging markets

Emerging markets performed in line with developed markets in July. There are signs that the emerging economies are beginning to enter a policy induced slowdown. Some signs of a slowdown are evident in China and to a lesser extent in Brazil and India.

Despite this both India and Brazil lifted official interest rates in July, although by not as much as markets were expecting and indicated a slower pace of tightening going forward. Pakistan, Korea, Thailand, Chile and Peru also lifted official interest rates in the month.



The MSCI Emerging Markets Index rose 8.0% in USD and 1.2% in AUD. China was a key outperformer in July, rising 13.7% despite the softer GDP report. Markets have become more comfortable that a positive policy response will occur if the economy slows too much. These gains also come after a fall of 22% from a recent peak in April 2010 to the end of June.

Brazil (+10.8%), Sri Lanka (+11.9%), Russia (+12.3%) and Argentina (+10.3%) performed well, assisted by gains in risk appetite and improvements in commodity prices. Eastern Europe posted moderate gains, with Poland (+7.8%), Czech Republic (+6.4%) and Hungary (+5.7%) rising.

Fixed interest

Global financial markets remained concerned about lingering sovereign risk uncertainties, the 'soft patch' in US economic data, and the slowing Chinese economy. The need to proactively reduce deficits in deeply indebted nations has also remained at the forefront of fixed interest investors' mind.

In the US, government bonds continued to fall during the month, primarily driven by negative sentiment on the back of slowing growth, concerns about the high government deficits in the developed world, weaker Chinese data, and uncertainty about the European banks stress test. 10-year Treasury yields fell to end July at 2.88%.

In Europe, German Bond yields also fell as risk appetite increased during the month, with 10-year yield fell by ending July at 2.67%.

In the UK, Q2 GDP data was stronger than expected and markets at this point are backing the new government to implement the tough fiscal austerity measures. With downside risks to growth, high unemployment, a wobbly housing market and falling aggregate demand from Europe the market continues to expect no rate hikes until mid 2011. Government bonds traded sideways in July, with 10-year yields ending July lower at 3.3%.

In Australia, the key release was updated Budget forecasts provided by the Federal Government through an economic statement. There were downgrades to real GDP growth

forecasts to 3% in 2010/11 and 3.75% in 2011/12. However there were upward revisions to inflation, commodity prices and the terms of trade, driving a stronger nominal GDP forecast. The Economic Statement has also detailed the impact on the budget from the changes to the taxation of resources. While the switch from the previously proposed Resources Super Profit Tax (RSPT) to the Minerals Resource Rent Tax (MRRT) will cost A\$7.5bn in revenue over the four years to 2013/14, parameter changes (ie. higher commodity price forecasts) will add back A\$6bn in revenue, implying a net cost of just A\$1.5bn. The better budget outlook will also help Australia's net debt peak at just 6% of GDP at June 2012, well down on the collective net debt of the advanced economies of 94.2% of GDP in 2015.

With the release of the economic statement in July the bond market is unlikely to be concerned by the higher inflation forecast and the improvement in the budget bottom-line is not significant enough to alter the bond selling program. The critical point is that the better budget outlook will also help Australia's net debt peak at just 6% of GDP at June 2012, well down on the collective net debt of the advanced economies of 94.2% of GDP in 2015.

Commonwealth Government bond yields rose with the 10-year benchmark Commonwealth Government bond yield rising over the month and ended July at 5.19%.

The UBS All Maturities Composite Bond Index returned 0.27% in the month and 7.81% over 12 months.

Listed property

The Australian listed property sector failed to keep pace with the broader Australian share market in July as investors favoured stocks in other areas of the market. The S&P/ASX 200 Property Accumulation Index did, however, appreciate 1.0%, its first monthly gain since April 2010. In spite of this gain, A-REITs remain at a modest discount to Net Tangible Assets, suggesting the sector remains reasonably valued.

The Retail sub-sector (+0.1%) struggled following the release of subdued retail sales data, while the Office sub-sector (+0.9%) also underperformed despite the release of favourable employment data. The best performing sub-sector of the market in July was Diversified, which managed a 2.3% gain.

Company news flow was limited during the month as most companies were in 'blackout' phase ahead of the release of their full year earnings in August. It was also a quiet month in terms of commercial property sales, with the sale of the Birkenhead Point Shopping Centre and Marina for \$174 million the only major transaction of note.

Most overseas listed property markets performed very well in July. Singapore was the standout performer, although the US, UK and several Continental European markets added between 8% and 10%. As a whole, the UBS Global Investors Index added 7.7%.

Index performance

Index returns – July 2010	Level	1 month (%)	12 month (%)
S&P/ASX200 Index	4,494	4.5	5.9
S&P/ASX 200 Accumulation Index	31,977	4.5	10.1
MSCI World Net Index (AUD)		0.9	0.9
MSCI World Net Index AUD Hedged		5.9	12.3
Dow Jones Index	10,466	7.1	14.1
UK FTSE 100	5,258	6.9	14.1
German DAX Index	6,148	3.1	15.3
France CAC Index	3,643	5.8	6.3
Japan - Nikkei	9,537	1.6	-7.9
Hong Kong – Hang Seng	21,030	4.5	2.2
MSCI Emerging Markets Net Index (AUD)		1.1	10.1
US 10 year bond yield	2.91%	-3bps	-57bps
Australia 10 year bond yield	5.20%	11bps	-41bps
UBS All Maturities Composite Bond Index	6,162	0.3	7.8
90 Day Bank Bill Index	4.78%	-15bps	157bps
UBS Australian Bank Bill Index	6,947	0.4	4.0
S&P/ASX 200 - A-REIT Accumulation Index	19,076	1.0	18.8
UBS Global Real Estate Investors Index (Net TR) AUD Hedged	1,062	7.7	37.6
AUD/USD (end of month)	0.9042	7.5	8.2
Oil price	\$US78.95/ barrel	4.4	13.7
Gold price	\$US1181/ ounce	-4.9	23.8

Source: Colonial First State. Data to 31 July 2010. **Past performance is no indication of future performance.** These index returns do not reflect the performance of any Colonial First State fund or investment option. For returns for any Colonial First State Fund or investment option please refer to the performance section of the Colonial First State website available at colonialfirststate.com.au.

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