Markets and Economies Update

February 2009

Global Economy

The global economy continued to contract in February, evidenced by further deterioration in economic data and financial conditions. US unemployment rose to a 16-year high of 7.6%, payrolls declined and consumer sentiment worsened, reflecting a bleak outlook. This was compounded by the sharpest quarterly GDP decline since 1982, with real GDP coming in at -1.6% in the December quarter on weaker investment and consumer activity. The US manufacturing sector remained depressed, however readings did improve slightly from the 28-year low set in December last year. Nominal retail sales improved in January, although they remain 9.7% lower than January 2008 levels. The slowdown in the US housing market continued with January's housing starts falling to an historic low and house prices and sales declining further. In response, the Obama Administration announced a US$275 billion 'Housing Plan' involving a capital injection into Fannie Mae and Freddie Mac to encourage lending and foreclosure relief for homeowners. The US Government's proposed US$787 billion fiscal stimulus package received congressional approval during the month and the US Treasury announced a 'Financial Stability Plan' to support the US financial system. Despite aims to improve 'accountability and transparency', the market viewed the 'Financial Stability Plan' with scepticism given the lack of detail and vague commitments to lending initiatives. The Japanese economic slump worsened in February as the December quarter real GDP result revealed a 3.3% contraction in economic growth, the sharpest since 1974 (-4.6% for the year to December 2008). Significant declines in net exports and capital spending were the key negative contributors. Japan's industrial production and exports declined further, with production retreating to 1984 levels. Leading indicators for Japan's labour market continued to deteriorate and the jobs to applicants ratio hit a five-year low. In China, tentative signs of recovery in economic activities emerged in February. Lending growth increased 21.3% yoy, the highest since 2003, reflecting fiscal stimulus measures and the associated surge in infrastructure spending. The pace of contraction in China's business conditions appeared to slow with manufacturing surveys improving, particularly in terms of new orders and production. Nevertheless, a sharp fall in China's exports (down 17.5% for the year to January) continued to reflect the impact of the severe downturn in global economic activity. China's inflation rate moderated to 1% yoy in January. The European economy again struggled in February with downturns in activity across the region, particularly in terms of exports and business investment. Europe's real GDP recorded a 1.5% fall in the December quarter as manufacturing orders receded and industrial confidence suffered another sharp fall. Consumers in the region remained pessimistic, with surveys revealing decade-low consumer confidence readings. This mirrored the economic climate in the UK, where the Bank of England cut interest rates by 0.5% to 1.0% in February, citing a 'deep recession' and a 'collapse in confidence'. Falling house prices and surging unemployment remained at the heart of the problem.

Australian Economy

Despite clear signs of a slowing economy, there were some bright spots on the Australian economic landscape in February. These were encouraged by the RBA's 'further sizeable reduction' in interest rates, taking the benchmark cash rate to 3.25%, which, coupled with massive fiscal stimulus, is intended to provide 'substantial stimulus to demand and activity'. Retail sales were boosted by these measures, rising 3.8% in December, although in annual terms retail spending only increased 0.6% for the year to December, the slowest pace in eight years. The labour market continued to soften with employment growth slowing, job advertisements falling and unemployment rising to 4.8% in January. This was reflected in weak business sentiment and subdued consumer confidence readings. Positively, housing finance ticked up strongly and credit growth bounced (albeit from a low base), while capital investment remained robust, with new private capital investment rising 6.0% in the December quarter.

International Shares

International shares remained volatile in February with most of the major indices closing the month lower. The persistent stream of negative economic data continued to undermine investor confidence, despite the range of fiscal and monetary stimulus measures announced by governments and central banks globally. Renewed selling pressure in the US equity market remained a driving factor of global share market downside as uncertainty about the US financial rescue plan intensified. The leading measure of global shares performance, the MSCI World (ex-Australia) Accumulation Index, returned -9.1% in local currencies (or -10.8% in unhedged Australian dollar terms). The US S&P 500 Accumulation Index returned -10.6%. In the European region, the Eurostoxx Accumulation Index returned -11.0%, while the UK FTSE 100 Accumulation Index returned -7.0%. Shares in Japan were also lower, with the Topix Accumulation Index returning -4.7%. However, Chinese shares again defied the global trend, with the S&P/CITIC 300 Total Return Index returning 5.4% for February.

Australian Shares

The Australian share market retreated further in February with the S&P/ASX 200 Accumulation Index returning -4.6% for the month. The steady stream of capital raisings was a major driver of this underperformance; total equity issuance (as a percentage of market capitalisation) reached its highest level since October 2000. Despite attractive valuations and some encouraging data results locally, further deterioration in the global economic outlook and ongoing financial market volatility heightened risk aversion and put further downward pressure on shares. This was compounded by a weak profit reporting season, during which disappointing results, negative surprises and dividend cuts were central themes. The only sector to produce a positive return in February was Energy (1.9%). Other sectors to perform relatively well included Consumer Staples (-1.1%) and Information Technology (-2.3%). Gloucester Coal, Riversdale Mining and Arrow Energy were the largest positive contributors to the Energy sector; while Wesfarmers, Lion Nathan and Foster's Group were the strongest Consumer Staples performers. The poorest performing sectors were Industrials (-21.3%), Property (-17.9%) and Utilities (-10.7%). Asciano Group, Alesco and Boart Longyear dragged down the Industrials sector; while Goodman Group, Tishman Speyer Office Fund and Macquarie Countrywide Trust detracted particularly from the Property sector.

Direct Property

As in previous months, the slowing domestic economy continued to weigh on the commercial property market in February. Capital market fragility and weak business sentiment maintained downward pressure on demand for space in all property sectors. Development activity slowed and there is growing pressure on rents and land values in many markets. However, leasing markets have become more competitive with higher incentives required to attract tenants in many markets. Positively, office tenancy renewals increased, reflecting a preference for lease renewal rather than the outlay costs of moving. Similarly, demand for industrial space weakened as business sentiment continued to deteriorate and transaction activity slowed.

Listed Property Securities

The S&P/ASX Property 200 Accumulation Index declined further in February, returning -16.2%. The major theme for the month was the profit reporting season, which revealed that capitalisation rates are increasing and asset values are falling as the operational environment continues to deteriorate. Westfield Group raised A$2.9 billion via an institutional placement in order to enhance balance sheet flexibility and pursue acquisition opportunities. The funding requirements of this issue put pressure on the entire A-REIT sector. Outperformers for the month were defensive stocks with limited exposure to offshore property markets and relatively low gearing. Also of note during the month was the disparity of returns between the top performing and the lowest performing stocks (a spread of 63.8%). Retail (-8.0%) was the strongest performing sub-sector, followed by commercial (-16.8%). Diversified (-25.3%) and industrial (-62.2%) underperformed considerably.

Australian Bonds

Australian bond yields rose in February as indications emerged that the RBA intends to slow the pace of monetary easing, which was supported by some stronger-then-expected domestic data releases during the month. The yield on Australian ten-year bonds ended February 33 bps higher, rising from 4.10% to 4.43% over the month; while the three-year bond yield opened at 2.90% and gained 45 bps to close at 3.35%. The government's fiscal stimulus package and economic revisions resulted in forecasts for a budget deficit, funding for which will require large volumes of bond issuance. Resultant concerns about an increase in the supply of bonds to fund this stimulus pushed yields higher. The spread between Australian and US ten-year bond yields widened in February.

Inflation-Linked Bonds

The real yield on the Commonwealth ten-year interpolated Capital Indexed Bond rose 6 bps in February to close at 2.23%. Inflation-linked bonds outperformed similar maturity nominal bonds over the month. The ten-year break-even inflation level rose 24 bps to 2.12% after inflation expectations edged higher following December's extreme lows. The RBA's aggressive 1% rate cut early in the month lowered the market's expectations of further substantial easing in March, which saw nominal bond yields rise. The sell-off in the US bond market also served to push local yields higher in February.

Cash

Bank bill yields again fell in February as data released during the month indicated that the downside risks to growth remain. Accordingly, another interest rate cut by the RBA put significant downward pressure on short-dated yields during the month. The three-month bank bill rate opened at 3.41% and closed 25 bps lower at 3.16%. The decline in the six-month bank bill yield was less significant, with the rate opening at 3.11% and falling only 2 bps to close at 3.09%. Credit margins remained wide reflecting ongoing liquidity and economic uncertainty.

International Bonds

International bond yields were somewhat mixed in February. The US ten-year bond yield rose 17 bps to 3.01% on concerns about an increase in the supply of bonds to fund the expanding fiscal deficit. Japan's ten-year bond yield was relatively flat, falling just 2 bps to 1.28% for the month. In the European region, Germany's ten-year bond yield dropped 19 bps to 3.11%, while the UK ten-year bond yield fell 8 bps to close at 3.62%

Australian Dollar

The Australian dollar (A$) gained in February, rising against the US dollar (US$), the Japanese yen (JPY) and the currencies of Australia's major trading partners (as per the Trade Weighted Index [TWI]). The A$ closed the month at 63.73 US cents (up 0.4% from 63.49 US cents) and JPY62.26 (up 8.9% from JPY57.18). The TWI closed the month at 54.8 (up 3.0% from 53.2). While the A$ was little changed against the US$, it rose solidly against the yen as the Japanese currency continued to unwind, reflecting the severely weakened state of the Japanese economy. The release of some better-than-expected data locally was also supportive of the A$.