Colonial First State

Monthly Market View

August 2012

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

- August was a relatively quiet month, partly due to summer holidays in the northern hemisphere.
- Market participants were also waiting for a number of key events in September to reassess the economic and market outlook. Amid relatively thin trading volumes, most major equity markets rallied, while bond markets were volatile.

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Economic overview:

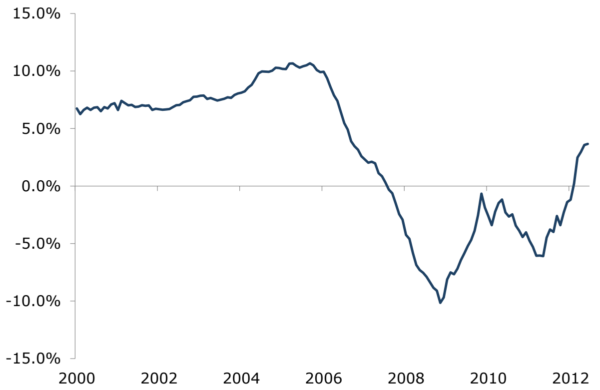
On 31 August, markets keenly awaited remarks from US Federal Reserve (the Fed) Chairman, Ben Bernanke at the annual Jackson Hole Economic Symposium. Financial markets were hoping for clarity on the timing and extent of further stimulus from the Fed, particularly further bond buying given the ongoing malaise in the US economy.

However, the speech did little to placate market demands. Rather, Bernanke focused on the costs and benefits of further unconventional monetary policy. In a clear indication that the Fed would be willing to provide further accommodation if required, Bernanke noted "…taking due account of the uncertainties and limits of its policy tools, the Federal Reserve will provide additional policy accommodation as needed to promote a stronger economic recovery and sustained improvement in labour market conditions in a context of price stability."

In the US, data continued to show a subdued economic environment. Employment rose by 163,000 in July but the unemployment rate drifted higher to 8.3%. Housing market data continued to show improvement across a number of different indicators. The NAHB Housing Market Index, a measure of homebuilders' sentiment, rose to 37, the highest since February 2007. Building permits rose 6.8%/month, existing home sales were

2.3% higher and new home sales were up 3.8%. The FHFA home price index rose 0.7%/month to be up 3.7% for the year. See chart below for details.

US FHFA House Price Index - annual growth (%)



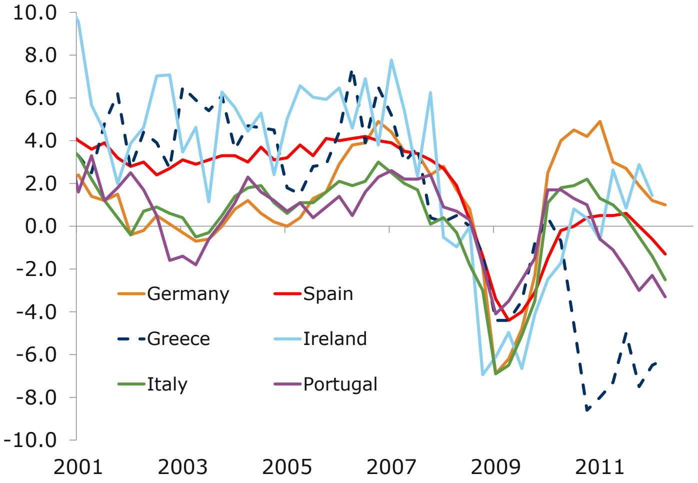
Source: Bloomberg. Data to 30 June 2012

In Europe, the focus was on probable action by the European Central Bank (ECB). Early in August, ECB President Mario Draghi affirmed expectations for a conditional bond buying program to be introduced at some point in the future. The exact scale, timing and method of these operations remains uncertain, although there is hope the details will be clarified at the 6 September board meeting.

At the same time, markets are keenly awaiting the outcome of the German Constitutional Court ruling on the legality of the European Stability Mechanism (ESM). This would allow the ESM to become operational and provide a further mechanism in Europe to assist the financing of countries in distress. The expectation within financial markets is that Spain (and perhaps Italy) will need to seek a formal bailout, then accept the conditions imposed to receive assistance from the ECB in lowering borrowing costs.

In European economic news, Q2 GDP data was released. Overall, the Eurozone economy contracted by 0.2% and -0.4% for the year. By country, Portugal (-1.2%), Finland (-1.0%), Cyprus (-0.8%), Italy (-0.7%) and Spain (-0.4%) were the weakest over the quarter. Germany and France both recorded flat growth, with annual growth now just 1.0% and 0.3% respectively. See chart below for details.

Annual GDP growth (%)



Source: Bloomberg. Data to 30 June 2012. Ireland to 31 March 2012

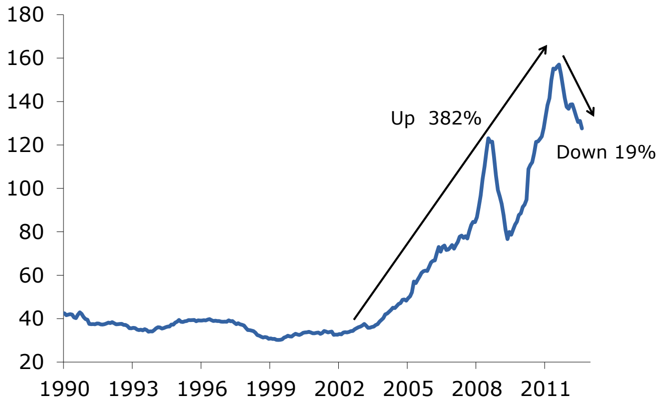
In other news, German Chancellor Angela Merkel and Greek Prime Minister Antonis Samaras held meetings. Merkel confirmed she wants Greece to stay in the euro and for Greece to remain committed to the bailout conditions. Any approval for further time for Greece to meet conditions will be considered post the troika (ECB/EU/IMF) visit to Greece in September.

Concerns regarding the near-term outlook for the Chinese economy intensified in August. This was clearly evident in the performance of the iron ore price; which fell 26% from US$117/metric tonne to US$89.4. In other data, the HSBC Flash Manufacturing PMI Index fell to 47.8 from 49.3.

A change in political leadership is expected in China in October and November. The hope is that this will lead to a round of new policies to improve the growth outlook in China. What is clear, however, is that the prospects of an economic rebound in Q3 2012 are premature. A rebound is now not anticipated until Q4 2012 or Q1 2013.

In Australia, the fall in the iron ore price flowed through to the RBA Commodity Price index, which was down 2.6% in August. See chart below for details.

RBA Commodity Price Index



Source: RBA. Data to 31 August 2012

The unemployment rate was 5.2%, with 14,000 jobs created in July. Other data was mixed, with retail sales falling 0.8% following two strong months of gains (benefiting from government assistance payments). Consumer confidence fell 2.5%, while business confidence also retreated.

Construction work done in Q2 2012 fell 0.2% due to weak residential construction activity. Private capital expenditure data rose 3.4%. The pipeline of work was also revised higher for 2012/13 to A$181.5bn, an increase of 4.7% from the previous estimate. Of this, A$119bn is within the mining sector.

A number of high profile mining projects were delayed in August, given the uncertain outlook. This will impact the pipeline of investment projects after 2014. Australian Q2 GDP data will be released in early September.

Australian shares

The announcement of company results for the 2011/12 financial year was the main focus for investors in the Australian sharemarket during August. The subdued tone of outlook statements was among the clearest observations from the reporting season as a whole.

Forward earnings expectations were reduced for approximately half of all companies reporting; earnings upgrades for 2013 and beyond were more infrequent. Downgrades were particularly common in the materials sector, mainly due to declining commodity prices.

The Reserve Bank of Australia (RBA) also forecasted a peak in mining investment in 2013/14, which did little to support investor sentiment towards materials stocks in general. The increasingly uncertain outlook for mining companies was also highlighted by BHP Billiton's decision to defer expansion plans at its Olympic Dam copper mine in South Australia.

In spite of these influences, the S&P/ASX 200 Accumulation Index rose during the month, recording a gain of 2.1%. Investors' recent obsession with yield stocks appeared to fade in August. A number of stocks with a high yield, which had performed well in recent months, struggled as investors banked profits from the rally. This resulted in the underperformance of sectors such as Telecoms and A-REITs.

Listed property

The S&P/ASX 200 Property Accumulation Index returned -0.1% in August, underperforming the broader sharemarket. After four months of outperformance, culminating in a generally solid set of results for A-REITs over the reporting season, investors took profits in the sector.

At a stock specific level, Goodman Group (+6.1%) and Centro Retail Australia (+4.4%) were among the top performers. Goodman Group's 2011/12 Financial Year results beat analyst expectations, whilst Centro announced a debt-restructuring arrangement which should support earnings growth. Stockland (-5.1%) fell after its 2011/12 Financial Year results were met with disappointment.

The yield-producing nature of A-REITs should provide support to the sector in the medium term, in the face of an increasingly cautious macroeconomic outlook.

Offshore property markets also produced relatively muted returns. The UBS Global Property Investors Index (local currency) returned 0.3% in August. Regionally, Singapore (+3.4%) and Japan (+3.2%) performed most strongly, while Continental Europe (-0.9%) and Australia underperformed.

Global shares

In spite of relatively thin trading volumes, global equity markets posted gains in August, reflecting expectations of further stimulus by the ECB and the Fed.

The MSCI World Index rose 2.3% in USD terms and rose 4.1% in AUD terms, although this masked considerable divergence between countries and industry sectors. The AUD fell 1.7% against the USD on renewed concerns over the pace of growth in China and falls in the price of iron ore.

US equity markets rose, led by the NASDAQ which was up 4.3%. The S&P 500 (+2.0%) and the Dow Jones (+0.6%) also posted reasonable gains.

European equity markets all rose, although performance was diverse. Spain (+10.1%) and Italy (+8.7%) rose sharply on hopes the ECB will intervene in government bond markets to lower borrowing costs. Elsewhere, the German DAX rose 2.9% and the French CAC was up 3.7%. In the UK, the FTSE 100 added 1.4%.

In Asia, markets were mixed, although the Shanghai Composite Index continued to fall. The Index declined 2.6% during the month and has now lost 15% since April, on economic growth concerns.

Elsewhere in Asia, Hong Kong (-1.6%) and Singapore (-0.4%) both fell. The slower pace of growth in China has been negatively impacting the pace of growth in the rest of Asia through trade links. In Japan, the Nikkei retreated 7.2%.

Among the sectors, IT (+4.2%) and consumer discretionary (+3.6%) were the best performers, while utilities (-0.4%) underperformed.

Global emerging markets

Emerging market equities fell 0.3% in USD terms, however rose 1.5% in AUD terms as the AUD weakened. There have been growing concerns over the pace of growth in emerging economies, particularly Asia ex-China and Latin America.

During August, Hungary, Colombia and Brazil all eased monetary policy. Brazil has now cut the official SELIC target rate from a peak of 12.5% in July 2011 to 7.5%.

The better performing markets in August included Czech Republic (+6.8%), Argentina (+5.3%) and Sri Lanka (+4.8%). Mexico (-3.2%) and Russia (-3.4%) were among the weakest.

Global fixed interest

High grade global bond yields rose sharply in early August, continuing their upward trend from late July, after ECB President Mario Draghi committed the ECB to doing 'whatever it takes' to save the euro.

The defensive 10-year German Bund yield rose sharply, by 34 bps to 1.61% mid-month. Yields in the euro-periphery plummeted in response to improved risk sentiment, as market participants continued to factor in the prospect of more active support from the ECB.

The yield on the 10-year Spanish Government Benchmark bond fell by 124 bps to 6.12% on 22 August 2012, having reached an intra-month high of 7.36% on 3 August 2012.

However, the yield eventually finished the month at 6.83%, up by 12 bps from the previous month, as fiscal concerns over Spain's second largest region, Catalonia, increased. The regional government requested €5 billion from the special €18 billion Spanish Government rescue fund.

Towards month-end some market participants began to re-price in the likelihood of a Spanish sovereign bailout, with the yield heading back towards 7%.

US bond yields came under pressure from improving US economic data releases, including payrolls, retail sales and ISM services reports. This began to push out market expectations of further stimulus by the Fed in the near term.

The 10-year US Treasury yield rose by 36 bps over the first three weeks of August, touching a three-month high of 1.83% on 22 August 2012. Overall, the yield increased by 4 bps to 1.51% by August month-end, having finished July at 1.47%.

In terms of central bank action, the ECB left its refinancing rate unchanged at 0.75% at its August meeting. President Draghi acknowledged that the Governing Council discussed lowering interest rates, but did not believe that the eurozone economy and inflation outlook warranted further stimulus yet.

In the UK, the Monetary Policy Committee (MPC) voted unanimously to hold the Bank Rate at 0.5% and maintain the stock of asset purchases at £375 billion.

The Australian 10-year government bond yield increased sharply in the first half of August. Yields followed the lead of global bond markets, rising 43 bps from a July month-end yield of 3.01% to an intra-month high of 3.44% on 16 August 2012. In the month as a whole, the 10-year CGS yield finished August unchanged at 3.01%.

Bond market participants responded to the deteriorating Australian economic outlook by reinstating around 50 bps of implied RBA rate cuts by year-end.

The RBA left the cash rate unchanged at 3.5% for a third consecutive month.