Market Update

March 2011

- Earthquake in Japan threatens global economy
- US consumers contribute to economic growth
- China continues tightening of monetary policy

What's inside?

The pulse

↑ **AUD/USD**
2 US cents to 1.02 USD

↓ **US Unemployment**
to 8.9%

February market performance

Equity Markets – Price Indices	Index	At Close 28/02/2011	% Change 1 Month	% Change 12 Months
Australia	All Ordinaries	4923.63	1.52%	5.86%
Japan	Nikkei	10624.09	3.77%	4.92%
Hong Kong	Hang Seng	23338.02	-0.47%	13.24%
UK	FTSE 100	5994.01	2.24%	11.94%
Germany	DAX	7272.32	2.75%	29.90%
US	Dow Jones	12226.34	2.81%	18.41%
EMU*	Euro 100	2431.08	2.21%	13.25%
World**	MSCI - Ex Aus (Gross)	941.98	2.79%	15.68%

Property – Price Index	Index	At Close 28/02/2011	% Change 1 Month	% Change 12 Months
Listed Trusts	S&P/ASX 300 A-REIT	868.15	2.37%	1.04%

Interest Rates	At Close 28/02/2011	At Close 31/01/2011	At Close 28/02/2010
Aust 90 day Bank Bills	4.97%	4.92%	4.13%
Australian 10 year Bonds	5.50%	5.51%	5.49%
US 90 day T Bill	0.14%	0.16%	0.12%
US 10 year Bonds	3.42%	3.37%	3.62%

Currency[3]		At Close 28/02/2011	% Change 1 Month	% Change 12 Months
US dollar	A$/US$	1.02	2.17%	13.73%
British pound	A$/STG	0.63	0.66%	6.66%
Euro	A$/euro	0.74	1.33%	12.26%
Japanese yen	A$/yen	83.32	1.85%	4.55%
Trade-weighted Index		75.50	2.44%	8.63%

1 Top 100 European stocks trading on the FTSE
2 Price Index – Source: www.msci.com
3 All foreign exchange rates rounded to two decimal places
Source: Iress Market Technology
Past performance is not a reliable indicator of future performance.

Global economies

In February it was no surprise the main driver of market sentiment was the fear of disruptions to the world oil supply and subsequent rise in oil prices.

The potential effect on the fragile global economy of the political unrest in Egypt was seemingly eased by the peaceful resignation of President Mubarak. However, in Libya, violent clashes between the government and protesters created concern that unrest could spread to other parts of the Middle East.

The main reason why the unrest could have a negative impact on the US economy is because as a net importer of energy, the US remains vulnerable to spikes in the price of oil. Indeed, oil price spikes in the past have been associated with a US recession.

Oil aside though, recent economic reports and data pointed to further global economic growth through late 2010 and into the opening months of this year.

While some have been exceptionally strong such as global manufacturing indicators, others have been weaker such as spending and business activity. A contributing factor to this has been the severely cold weather in northern Europe and parts of the US.

In the US, it's becoming clearer that consumers are beginning to contribute to the US growth recovery. After household consumption growth accelerated to 4.1% annualised in the December quarter, there have also been signs that demand for labour is rising and employment is beginning to grow.

The unemployment rate fell from 9.8% in November to 8.9% in February. Further evidence of this improvement saw jobless claims continue to trend lower overall while non-farm payroll employment picked up.

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While acknowledging the self-sustaining nature of the US recovery, Federal Reserve (Fed) Chairman Bernanke in his testimony to Congress, kept expectations in check and expressed the view that it will be some years before the unemployment rate returns to more normal levels.

Over in Europe, leaders continue to discuss what measures they can take to support those European economies with the most extreme debt levels.

With the larger European economies, like Germany, accelerating and some signs that inflationary pressures are rising again, the European Central Bank (ECB) is now giving intense consideration to tightening monetary policy and lifting interest rates from 1%.

In the Asia-Pacific region the Chinese Government lowered their growth target by 0.5% to 7% for the next five years with an emphasis on quality growth, to ensure that the economy is on a sustainable path.

On the policy front, the People's Bank of China tightened monetary policy settings again this month, lifting one year deposit and lending rates by 0.5% and also lifting bank reserve liquidity ratios to stem inflationary pressures.

A liquidity ratio is the percentage of cash that lending institutions need to have relative to loans. A high liquidity ratio reduces the ability of banks to issue new loans and stems the flow of capital flowing into the system.

In Australia, the economy appears to be pretty soft, as the expected boom in business investment, centred on minerals and energy, is still at an early stage.

Big movers this month

Going up

↑ Materials 3.7%

Going down

↓ Health Care 3.2%

The weakness in recent Australian business activity has been evident in the monthly NAB Business Surveys. Business conditions fell into negative territory in January, following the floods, and only marginally improved in February. Retail, wholesale, manufacturing and construction are all doing it tough, while conditions have recovered strongly in mining.

Equity markets

Sharemarkets were up in the first half of February but then retreated as tensions in the Middle East and North Africa escalated.

Reinforcing this drop in sentiment, the VIX volatility index, which measures risk aversion, increased over the month. While the index remains well off the highs seen in May last year during the Greek Sovereign Debt crisis, there's no doubt the current mood among investors is nervous and flighty.

As to the outlook for sharemarkets, much will depend on developments in the Middle East and North Africa. At present, the rise in the price of oil will have a small negative effect on global growth prospects.

The key to any substantial impact will be Saudi Arabia, which is the second largest supplier for world oil markets. If the current moderate political tensions in the Kingdom escalate, the oil price could go much higher and if Saudi supplies start to dry up, global stocks would be affected.

Australian equities

	Index/Benchmark	1 Yr	3 Yrs	5 Yrs	7 Yrs
Australian	S&P/ASX 300 Acc.	9.02%	-0.26%	4.04%	9.96%
	S&P/ASX 50 Acc.	7.31%	0.94%	4.30%	9.99%
	S&P/ASX Small Ordinaries Acc.	21.57%	-2.43%	4.12%	9.83%

The local ASX 300 Index lagged most global sharemarkets in February. Initially the market traded higher but peaked on 17 February. After that, the Middle East and North Africa concerns weighed on the market as the price of oil rose and the ASX 300 fell back.

The reporting season in the Australian equity market after the half year to December 2010 has been very close to expectations. But earnings expectations for the year ahead have risen in net terms by around 2%, with positives such as the mining sector leading the upward revisions.

Sector	1 Mth	3 Mths	1 Yr
Energy	3.6%	6.9%	15.4%
Materials	3.7%	7.2%	22.9%
Industrial	1.2%	3.6%	3.5%
Consumer Discretionary	1.7%	2.9%	-0.5%
Consumer Staples	0.7%	3.9%	8.0%
Health Care	-3.2%	0.6%	4.2%
Financials	2.3%	8.4%	2.3%
Info Tech	-3.0%	-1.8%	-11.7%
Telcos	2.4%	2.7%	1.9%
Utilities	-2.4%	-2.3%	3.3%
Property	3.3%	7.1%	6.8%

Australian dollar (AUD)

There continues to be significant demand to buy the AUD on dips. This reflects still bullish sentiment on the part of longer-term investors, likely reflecting confidence that China's industrialisation/urbanisation driven climb in commodity demand will be sustained. This is also despite some concerns around rising inflation in Asia.

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Global equities

	Index/Benchmark	1 Yr	3 Yrs	5 Yrs	7 Yrs
Global	MSCI World Ex Aus Acc. ($A)	7.00%	-3.16%	-3.77%	1.13%
	MSCI World Index Hedged ($A)	18.04%	-1.67%	0.01%	4.06%
	MSCI World Small Cap ($A)	16.62%	3.16%	-2.18%	4.29%
Emerging	MSCI Emerging Mkts Free	6.33%	-2.29%	2.93%	10.96%
	MSCI AC Far East Free (ex Japan)	7.48%	-1.40%	3.36%	7.73%

Global equities trended higher over February, with the MSCI World (ex-Australia) Accumulation Index up by 1.29%. US stocks performed pretty well, with the S&P 500 up by 3.2% in the month. This good news follows a period of solid rises in the latter half of 2010, as investors anticipated the positive effects of the Fed's second round of quantitative easing of monetary policy (QE2) on the economy.

The US reporting season for the December quarter is now virtually over. At the time of writing, 495 of the S&P 500 had reported – and annual earnings-per-share growth for the S&P 500 companies has been 33.1% to the end of the December quarter, 13% above pre-reporting season expectations.

Revenue growth of US companies has also outperformed, rising 7.4% year on year, 1.6% ahead of expectations with 290 companies reporting positive surprises, far outweighing the 129 delivering negative surprises.

Property

	Index/Benchmark	1 Yr	3 Yrs	5 Yrs	7 Yrs
Australian	S&P/ASX 300 A-REIT Acc	6.78%	-14.00%	-9.18%	-1.30%
Global	UBS Global Investors Index	16.32%	-4.03%	-5.54%	N/A

The S&P/ASX 300 A-REIT Accumulation Index rose 3.4%, outperforming the broader domestic equity market for another month. Overall, the S&P/ASX 300 A-REIT Accumulation Index has risen 6.8% in the 12 months to February, underperforming the broader market.

The UBS Global Investors Index rose 1.8%, marginally underperforming the domestic index over February. Over the 12 months to February, however, the UBS Global Investors Index was up more than double that of the local benchmark, at 16.32%.

Fixed interest

	Index/Benchmark	1 Yr	3 Yrs	5 Yrs	7 Yrs
Australian	UBS Composite 0 + Years	5.54%	7.70%	5.89%	5.98%
	Australian 90 Day Bank Bill	4.80%	4.88%	5.52%	5.53%
Global	BarCap Global Agregate Index	-6.92%	1.56%	0.12%	2.04%
	BarCap Global Ag,. Index Hedged	7.66%	8.21%	7.55%	7.05%

The Australian bond market was slightly stronger in February, with concerns over the impact of recent natural disasters continuing to boost returns. The UBS Composite Bond Index rose 0.4% over February, while the Australian 90 Day Bank Bill Index rose 0.4%. Over the 12 months to February, these indices returned 5.5% and 4.8% respectively.

The Barclays Capital (BarCap) Global Aggregate Index Hedged $A rose 0.5% in February and has returned 7.7% for the last 12 months.

The earthquake in Japan

Japan's devastating earthquake on 11 March resulted in much tragic loss of life after a massive 8.9 magnitude quake hit the island country.

For the economy, Japan's Government will have a major reconstruction and repair task ahead of it and will need to borrow to support those tasks. To help sentiment, the Bank of Japan has already embarked on more quantitative easing.

As a result of the quake the Japanese Yen immediately spiked higher against the USD, on expectations of a strong capital inflow to support the relief effort but, as NAB's London strategist, Gavin Friend points out, the last thing Japan needs at the moment is a strong Yen. If the USD falls to 80 Yen or below (reflecting a strengthening Yen), NAB expects intervention to prevent a further Yen appreciation.

For Australia, there are a number of potential impacts. Exports could suffer initially, as Japan is our second largest export market behind China, taking about 18% of our exports. Japan's output will fall although the rebuilding phase may add to commodity demand. The AUD rallied strongly on the night of the quake but has since settled back.

At the time of writing, Japan is facing a new threat following the initial devastation of the earthquake, with the risk of a meltdown at one of its nuclear reactors approximately 250kms north of the capital. Since news broke of the story there have been global market declines and increased uncertainty about the full impact on the global recovery. We are following developments with this and will update you with any changes to the global economic outlook when the impacts become clearer.

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