Market Update & Outlook

April 2011

- Japan disaster to cost up to 25 trillion Yen
- Rising commodity and food prices in Europe cause concern
- Aussie dollar climbs to 29 year high against USD

What's inside?

The pulse

↑ **AUD/USD**
1.9% to 1.0338 US cents

↑ **WTI Oil 3 Month Futures**
10.1% to $106.7 per barrel

While the ground is shaky the Australian outlook remains on firm footing

Rob Henderson – Chief Economist, NAB Global Markets

The impact of recent natural disasters is starting to show in local economic data. The NAB Business Survey recorded softer economic activity throughout Australia from December to February, and a particular fall in Queensland activity.

Despite this, confidence has surged lately, both in Queensland and nationwide and the outlook is now pretty good. Medium term prospects for the Australian economy are positive with businesses expected to spend a massive amount on investment in the coming year, led of course by the mining sector.

1. Mining and resources

There will be some short-term weakness in commodity demand due to the floods and the Japanese earthquake, however, beyond the March quarter, the resource boom should combine with the reconstruction efforts to create a surge in business investment.

A number of speeches given by RBA officials in the past month focused on the mining boom. The boom will see strong investment and growth that will require careful management from the RBA.

2. Retail and housing

Offsetting the upside risks from strong mining growth are relatively soft retail and housing sectors. Retail sales grew by 0.5% in February back to the long run average but the past year has seen just 3.6% growth. It is too early yet to tell whether retailing is on the mend but at least this was a better result.

The housing market also remains weak, with house prices essentially going sideways since mid-2010. The Melbourne and Sydney markets are relatively stronger than most, but only had 2-3% of growth in the past quarter.

Other housing indicators are also slowing. Building approvals fell 7% in February after the 12% fall in January. Housing finance approvals declined in the first couple of months in 2011 and housing credit growth is also slowing.

With households cautious, the savings rate has climbed to a two-decade high, which is helping contain inflationary pressures. But it may only be a matter of time before a stronger labour market results in increased wages and a stronger consumer sector.

3. Employment

Employment rose by a strong 38,000 in March and the unemployment rate fell to 4.9%. Leading indicators such as the DEEWR Internet Index are pointing to ongoing growth in labour demand ahead.

4. Interest rates

While softness in the economy means the RBA is under no pressure to raise interest rates in the near-term, the RBA remains on inflation alert. As the economy continues to expand, with the labour market and industrial capacity already tight, inflation risks will rise. We expect the RBA will need to raise the cash rate again by August, with a further rise in November taking the cash rate to 5.25% by the end of the year.

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Global economies

It's hardly surprising that aside from the events unfolding in North Africa and the Middle East, Japan's earthquake, tsunami and subsequent nuclear accident has been top of mind for many people throughout March.

It also now appears that Australia, in part, will play its part in the rebuilding and reconstruction phase by providing the increase in commodity demand from Japan.

The cost of this effort is understandably being closely scrutinised with Japan's Cabinet Office estimating the bill for reconstruction to be between 16 and 25 trillion Yen, equal to between 3 and 5% of Gross Domestic Product (GDP).

More recently, the Bank of Japan has released a special Tankan business survey to give an early indication of what Japanese business thinks will happen to trading conditions because of the natural disasters.

Not surprisingly, Japanese business thinks the quake and tsunami will have an adverse impact on conditions but the scale of the anticipated effect on large enterprises is surprisingly small.

In China, while economic indicators released throughout the month have been somewhat mixed, the expectation is that China will grow by 9% in 2011.

And, although it's too early to fully determine what impact Japan's recent earthquake and nuclear crisis will have on China, a contraction in Japanese GDP is likely to have at least some impact on Chinese growth in the near term.

To give this impact some perspective, trade linkages alone are significant, with Japan accounting for around 7.5% of China's total export values (likely to be even larger once inter-regional trade is accounted for).

Inflation concerns continue to drive monetary policy with The Peoples' Bank of China tightening their stance. While this seems to be an appropriate response for the time being, the low level of real interest rates suggests further policy tightening will be needed.

Rising inflation is not just an issue for China and broader Asia. In Europe, rising commodity and food prices have been worrying the European Central Bank (ECB).

The March CPI 'flash' estimate showed Eurozone inflation running at an annual 2.6%, up from 2.4% compared to the previous month. This prompted the ECB President to indicate that a rate rise was imminent which is widely expected to happen at the meeting in April, and if not, May.

However, a move to monetary tightening won't be welcomed in some of the debt-stressed Eurozone countries such as Greece, Portugal, Ireland and Spain. The economies of these countries are either declining or experiencing only weak growth—not normally an ideal time to tighten monetary policy.

Big movers this month

Going up – Energy +3.3%

Going down – Property -1.9%

March market performance

Equity Markets – Price Indices	Index	At Close 31/03/11	% Change 1 Month	% Change 12 Months
Australia	All Ordinaries	4928.61	0.10%	0.73%
Japan	Nikkei	9755.10	-8.18%	-12.04%
Hong Kong	Hang Seng	23527.52	0.81%	10.77%
UK	FTSE 100	5908.76	-1.42%	4.03%
Germany	DAX	7041.31	-3.18%	14.43%
US	Dow Jones	12319.73	0.76%	13.48%
EMU*	Euro 100	2331.24	-4.11%	1.90%
World**	MSCI - Ex Aus (Gross)	926.99	-1.59%	7.09%
Property – Price Index	**Index**	**At Close 31/03/11**	**% Change 1 Month**	**% Change 12 Months**
Listed Trusts	S&P/ASX 300 A-REITS	849.05	-2.20%	-0.98%
Interest Rates		**% At Close 31/03/11**	**% At Close 28/02/11**	**% At Close 31/03/10**
Aust 90 day Bank Bills		4.93%	4.97%	5.50%
Australian 10 year Bonds		5.50%	5.49%	5.77%
US 90 day T Bill		0.09%	0.14%	0.15%
US 10 year Bonds		3.47%	3.42%	3.83%
Currency* **		**At Close 31/03/11**	**% Change 1 Month**	**% Change 12 Months**
US dollar	A$/US$	1.03	1.38%	12.56%
British pound	A$/STG	0.64	2.81%	6.60%
Euro	A$/euro	0.73	-1.15%	7.41%
Japanese yen	A$/yen	85.87	3.06%	0.15%
Trade-weighted Index		76.30	1.06%	6.42%

* Top 100 European stocks trading on the FTSE ** Price Index – Source: www.msci.com

*** All foreign exchange rates rounded to two decimal places
Source: Iress Market Technology
Past performance is not a reliable indicator of future performance.

Over in the US, the debate about when the Federal Reserve will start to tighten policy has hotted up. Several voting members of the Fed's monetary policy committee have argued publicly against completing the full installment of the second round of quantitative easing (QE2).

The third national accounts estimate showed the US economy expanded by 0.8% in the December quarter and by 2.8% over the year. However, reports remain mixed with some business surveys at high levels and showing the labour market is continuing to strengthen, while other indicators have shown some weakness and point to a relatively subdued start to the year.

Inflationary pressures in the US are also rising due to increases in global commodity prices such as oil and food, price pressures in other countries and a depreciating US dollar.

This has resulted in headline inflation picking up strongly in recent months, however this isn't overly concerning as most measures of inflationary expectations remain within historical bandwidths and there still seems to be a significant amount of underutilised capacity.

Equity markets

Currencies were particularly volatile during March. The Yen rallied following the March 11 disaster but it was restricted by the intervention of the G7 nations.

The Australian Dollar continued its strong run against the US Dollar in to early April to reach post-float highs. This has substantially affected returns of unhedged products with the MSCI World Index made up by over 55% of US companies.

Australian equities

	Index/Benchmark (% pa)	1 Yr	3 Yrs	5 Yrs	7 Yrs
Australian	S&P/ASX 300 Acc.	3.79%	1.13%	3.21%	9.70%
	S&P/ASX 50 Acc.	2.40%	2.13%	3.62%	9.76%
	S&P/ASX Small Ordinaries Acc.	13.49%	-0.92%	2.80%	9.59%

On 16 March as a result of the disasters in Japan, the Australian Market ASX 300 Accumulation Index was 5.9% below its February close. But by the end of the month the entire down move had been clawed back with the Index finishing slightly higher, up 0.7% for the month.

The main catalyst which caused the mid-month plunge in Australian equities was the news of a second explosion and fire at one of Fukushima's nuclear power plants and fear that radiation was sent to dangerous levels in the areas surrounding the reactors.

Fortunately, once the situation began to stabilise and analysts could more appropriately factor in the impacts, the market recovered.

Nevertheless, the radiation threat affecting the Fukushima region has sparked debate into the future of nuclear power as an alternative power source to coal. Companies mining uranium, such as Paladin Energy and Energy Resources of Australia, saw their stock free fall, with only marginal recovery from the recent lows to date.

Sector	1 Mth %	3 Mths %	1 Yr %
Energy	3.3%	5.6%	8.7%
Materials	1.3%	1.7%	14.6%
Industrial	0.5%	1.7%	-0.7%
Consumer Discretionary	0.3%	2.6%	-5.1%
Consumer Staples	-0.8%	2.3%	4.2%
Health Care	2.9%	0.2%	0.9%
Financials	0.2%	5.0%	-2.9%
Info Tech	-1.1%	-7.8%	-17.4%
Telcos	1.4%	4.8%	3.0%
Utilities	2.2%	-2.1%	2.7%
Property	-1.9%	3.7%	4.7%

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Global equities

	Index/Benchmark (% pa)	1 Yr	3 Yrs	5 Yrs	7 Yrs
Global	MSCI World Ex Aus Acc. ($A)	0.64%	-4.53%	-5.48%	0.70%
	MSCI World Index Hedged ($A)	9.70%	-1.32%	-0.70%	4.01%
	MSCI World Small Cap ($A)	10.55%	2.54%	-3.92%	3.67%
Emerging	MSCI Emerging Mkts Free	5.14%	0.07%	2.76%	11.26%
	MSCI AC Far East Free (ex Japan)	7.21%	0.93%	3.13%	8.50%

Global markets continued to be hindered by the instability in North Africa and the Middle East with a no-fly zone now existing in Libya. These ongoing issues and Japan's natural disaster put a further strain on the market resulting in a rapid slide.

As a result, the MSCI World ex-Australia Accumulation Index declined 2.6%. It was not all bad news for the regions that make up the index however, with India returning 9.4% and regaining some of its losses from previous months.

Emerging Markets and Asia (ex-Japan) overall, both saw strong gains in the face of disaster. The MSCI Emerging Markets Index and the MSCI Far East Free (ex-Japan) were up 4.3% and 4.1% respectively.

Property

	Index/Benchmark (% pa)	1Yr	3 Yrs	5 Yrs	7 Yrs
Australian	S&P/ASX 300 A-REIT Acc	4.74%	-14.55%	-9.46%	-2.05%
Global	UBS Global Investors Index	8.93%	-6.35%	-7.40%	N/A

The S&P/ASX 300 A-REIT Accumulation Index pared its gains from previous months, declining 2.0% during March but outperforming the global property sector which, represented by the UBS Global Investors Index, fell 2.2%.

Regionally, Japan had the worst returns as a result of the disasters and underperformed by over 18% compared to the Index.

Unsurprisingly, infrastructure holdings on the eastern coastline of Japan were badly damaged during the Japanese natural disasters with rail and power stations being the hardest hit.

Fixed interest

	Index/Benchmark (% pa)	1 Yr	3 Yrs	5 Yrs	7 Yrs
Australian	UBS Composite 0 + Years	6.86%	7.37%	6.01%	5.94%
	Australian 90 Day Bank Bill	4.85%	4.80%	5.51%	5.52%
Global	BarCap Global Agregate Index	-4.90%	-0.29%	-0.71%	1.57%
	BarCap Global Ag,. Index Hedged	7.43%	8.22%	7.80%	6.97%

Australian Bonds rose in March with the UBS Composite Bond Index gaining 0.7%. In terms of yield, Australian 10 year government bonds remained relatively unchanged in March, from February, and are close to levels seen the same time last year at 5.5%.

Globally, international bond prices were volatile throughout the month, eventually closing lower. The Barclays Capital (BarCap) Global Aggregate Index finished the month 1.1% lower. Helped by a stronger Australian dollar, the hedged equivalent finished marginally higher, up 0.3%.

Australian dollar (AUD)

Currency volatility climbed in response to the events that unfolded in Japan with the AUD/JPY down by a staggering 11% from high to low. Meanwhile, the G7 intervened to weaken the Yen on March 18, which helped stabilise the Nikkei.

The AUD/USD also fell to its lowest level in 3 months, down to 97.12 US cents on 17 March. Since then however the AUD climbed to a 29-year high against the US Dollar and had gone beyond the 1.05 US Dollar Mark.