



# Quarterly Market Outlook – September 2010

## The Global Economy



- [Introduction](#)
- [Australia](#)
- [United States](#)
- [Europe](#)
- [Japan](#)
- [Emerging Markets](#)

## Investment Sectors

- [Australian Shares](#)
- [International Shares](#)
- [Property Securities](#)
- [Fixed Interest & Cash](#)
- [Stock Market Indices](#)

## The Global Economy

### Introduction

The final quarter of the 2009/10 financial year was marked by increasing uncertainty regarding the pace of global recovery. In particular, concerns were focused on ongoing sovereign debt issues in Europe and its effect on economic growth, conflicting economic signals regarding the pace of US recovery and whether or not the Chinese government can cool economic growth whilst avoiding a hard landing. In this environment, most major equity markets fell. Despite these issues, the International Monetary Fund (IMF) projects global growth of 4.5% in 2010 and 4.25% in 2011. This represents an upward revision of about 0.5% in 2010, stemming from stronger activity during the first half of the year.

Economic conditions in Australia remain notably strong. March quarter GDP growth held steady at an annual rate of 2.7%. The Australian economy continues to benefit from close proximity to fast growing Asian nations, where demand for Australia's

resources is fuelling strong terms of trade.

Recovery in the US was a little shakier. The final revision of March quarter GDP was released in late June, showing that the US economy grew at a lower-than-expected 2.7%. Detracting from economic growth were consumer spending, retail sales and consumer confidence. The US housing market remains particularly weak and a 9.5% unemployment rate is not helping the situation.

Japan saw real annual GDP growth of 4.9% over the March quarter, up 4.6% on the previous year. This figure was supported by both strong growth in exports and strong private domestic demand. Deflationary pressures and a poor fiscal position present major headwinds for the Japanese economy, which will continue to rely on external growth drivers.

Europe's financial woes have been the focus of much attention over the June quarter. Concerns over sovereign debt defaults have spilled over to the European banking sector and the introduction of fiscal austerity measures to tackle debt problems will drag on economic recovery. It may take 5 to 10 years for weaker European nations to repair their debt positions and move back onto a strong expansionary path.

Emerging Asia, on the other hand, is likely to fuel global economic growth for many years to come. Annual Chinese GDP growth moderated to 10.3% from 11.9% in the first quarter, slightly below market forecasts of 10.5%. Chinese officials are intentionally slowing the rapid growth rate and so far there is little evidence of a pending hard landing in the economy. India recorded healthy GDP growth of 8.6% in the first quarter of 2010, and most other economies in the region are growing strongly.

Moving into the second half of 2010, many of the same global themes will be present. Europe will remain the laggard of global growth while Asia will continue to expand strongly. Japan and the US sit somewhere in the middle. A positive corporate reporting season in the US could provide a much needed boost in confidence. The Australian economy will continue to be supported by Asian resource demand.

September 2010 Quarterly Market Outlook as at 30 June 2010

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## Australia

Australia's economy continues along a moderate growth path amid an uncertain global outlook. March quarter GDP growth figures came in at 0.5%, following growth of 0.9% in the December 2009 quarter. Annually, growth held steady at 2.7% and the outlook for Australia remains strong. Domestic economic indicators remain largely positive as Australia continues to benefit from growth in Asia.

Australia's labour market continues to improve, evident in the June unemployment figures. Australia's unemployment rate was a seasonally adjusted 5.1%, compared with a downwardly revised 5.1% in May. Total seasonally adjusted employment rose by 45,900 to 11.1 million. Full-time employment rose by 18,400 to 7.8 million and part-time employment was up by 27,500 to 3.3 million. The rate is now well below its recent peak of 5.8%, reflecting marked improvement in underlying economic conditions in Australia.

These results failed to translate into improvements in business sentiment and consumer confidence over the June quarter. European sovereign debt issues, concerns of a slowdown in the US and China, uncertainty over the resources super profits tax (RSPT) and recent interest rate rises were the obvious villains. Recent figures were far more promising. Consumer confidence experienced a record rebound in July as Australians remain positive about the domestic economy. The Westpac-Melbourne Institute consumer sentiment index rose 11.1% in July. This was the strongest monthly increase since the survey's commencement in the mid-1970s. This rebound reversed all the June quarter declines. The result was aided by 2 months without an interest rate rise, an equity markets rally and the release of the above-mentioned employment data.

Removing the uncertainty surrounding the Resource Super Profit Tax (RSPT) provided a further boost to confidence levels in Australia and the demise of a once popular Prime Minister. Kevin Rudd's RSPT effectively ended his career. It is hard to understand why Kevin Rudd had such difficulty convincing the public it was a good idea. In theory, the plan was to place a heavy tax on mining companies (with significant foreign ownership), that generate massive profits by digging up Australia's greatest natural resources and then transferring these funds to other business sectors in the form of tax reductions. These tax reductions were then the basis for making employers pay more money into our super funds. But an over-complicated design, fears it would impact economic growth and employment and furious opposition from Australia's mining sector, saw Kevin Rudd knifed by his own party and Australia's first female Prime Minister, Julia Gillard, emerge.

Julia's "moving forward" catch phrase began with sorting out the mining tax. After industry consultation (notably absent from Rudd's approach), the RSPT was replaced with a revised Mineral Resource Rent Tax (MRRT). The tax rate was reduced from 40% to 30% and the rate at which the tax kicks in was increased from about 5% to around 12%. The new tax is now limited to iron ore and coal companies, whose annual profits exceed \$50 million, and the retrospective nature removed. These changes have resulted in a downgrade in estimated revenue from the tax from \$12 billion to \$10.5 billion. To compensate, the government reduced their cut to the corporate tax rate to 29% rather than 28%. Budget surplus is still expected by 2012-13 and the planned increase in super guarantee contributions, to 12% by 2019, will go ahead under a labour government.

Ongoing strength in the Asian region is expected to generate strong demand for commodities and further price increases for Australia's main commodities - iron ore and coal. Australia's terms of trade are forecast to rise by 17.0% in 2010/11, to around their highest recorded levels. The increase is expected to provide economic momentum and improvements in business investment, particularly in the resources and mining sectors. This will have obvious flow on effects to the wider economy. Overall business is expected to improve dramatically in the second half of the current financial year, employment conditions will be supported and the Australian government recently upgraded its surplus forecast from \$1 billion to \$3 billion in 2013.

Despite global pessimism surrounding sovereign debt problems in Europe, the outlook for Australia remains extremely robust. Renewed tightening in global credit markets and a slowdown in the global economy will certainly have an impact on the domestic economy, particularly a slowdown in China. Momentum in the Chinese economy is showing clear signs of fading, but is expected to remain at 10% for the remainder of the year and reduce to 9.0% in the following year. Growth in the remainder of developing Asia also remains strong. Current risks remain on the upside for Australia provided China avoids a hard landing.

## United States

The US economy continued to grow over the June quarter, although the pace of recovery is showing signs of moderation. The final revision of March quarter GDP was released in late June, showing that the US economy grew at 2.7%, lower than the average analyst forecast of 3.0%. The estimate was the second downward revision of GDP growth for the March quarter, which was initially calculated at 3.2% before an adjustment to 3.0% in late May. The growth rate was well below that of the final quarter of 2009, when GDP was estimated at 5.6% - the strongest growth in



six years.

A key factor in the downward revision was an adjustment of growth in US consumer spending from 3.5% to 3.0%. Retail spending dropped 0.5% in June, following a 1.1% fall in May. Excluding autos, total spending was down 0.1% in June. While weaker than expected, US consumer spending accounted for more than 75% of GDP growth for the quarter and was the highest level since the March 2007 quarter.

Also on the weaker side was US consumer confidence. As in Australia, European debt concerns, slowing global growth and falling equity markets were in the front of consumers' minds. US citizens are also at the mire of high unemployment rates and the ongoing environmental catastrophe occurring in the Gulf of Mexico. Sentiment plummeted in June. The Conference Board's Consumer Confidence Index dropped to 52.9 in June from 62.7 in May. A reading of 90 indicates a stable economy while a reading of 100 or above indicates strong growth. The percentage of consumers expecting more jobs in the months ahead fell from 20.2% to 16% in June while the percentage of those expecting fewer jobs increased.

June employment figures confirmed these fears. While 431,000 jobs were added, this was well below market expectations of 536,000. The result was driven by private sector employment, where 41,000 jobs were added versus an expected 180,000. The June jobless rate was 9.5% in June, down from 9.7% in May, and has been interpreted as a loss of momentum in the US job market. US businesses appear reluctant to hire and the remainder of the payrolls were due to temporary employment positions for the US Census. Future US employment data will remain the key indicator of recovery in the US.

The housing sector remains a key weakness in the US and a genuine cause for concern. In May, new home sales fell by 32.7%, sales of existing homes fell by 2.2% and housing starts fell by 10.0%. In the June quarter, a record 269,962 US homes were seized from homeowners unable to service their mortgages. Lenders are aiming to claim more than 1 million properties by the end of 2010. According to RealtyTrac Inc., home seizures have risen 38% over the last 12 months and 5% since the March quarter. Foreclosures were 8% higher, with foreclosures being filed on more than 1.65 million properties in the first half of 2010. In the near term, further weakness is expected but more affordable housing, rising demand and relatively low mortgage rates should provide support later in 2010.

Strength in the manufacturing sector was evident early in the June quarter, as companies restocked inventories and replaced old equipment. But this strength showed signs of fading over June, with the ISM composite, a key measure of manufacturing

activity, falling from 59.7 to 56.2. This figure was lower than consensus expectations but is still expansive. The manufacturing sector has provided the US economy with strong support over the past 12 months.

The US Federal Reserve kept interest rates on hold at 0%-0.25%. The expectation for a rate hike has been pushed out to at least 2011. The Fed have also indicated that they are prepared to do whatever it takes to promote financial stability which is key to a sustained economic recovery, including printing more money.

So while the US economy remains on an expansionary path there is mounting evidence that the pace of recovery is faltering. However in early July, the International Monetary Fund (IMF) raised its forecast 2010 US GDP growth forecast from 3.1% to 3.3%, and its 2011 growth forecast from 2.6% to 2.9%. Looking into the September quarter, poor sentiment towards the US and global economic outlook will continue to provide headwinds to US economic recovery. Persistent weakness in US housing and labour markets, European debt problems and slowing manufacturing growth in Asia has markets expecting slowing economic activity.

## Europe

Europe's financial woes have been the focus of much attention over the June quarter. Concerns over sovereign debt defaults have spilled over to the European banking sector and the introduction of fiscal austerity measures to tackle debt problems will drag on economic recovery.

So what is all the big fuss about? The first concern came from debtors starting to investigate the fiscal positions of various European countries and question how they can possibly meet their debt obligations. This caused considerable anxiety for financial markets. Almost all of this debt is held by European banks (often in other countries with sovereign debt issues) and there were concerns we were on the verge of another full blown global financial crisis. Funding pressure re-emerged and spread through interbank markets, also fuelled by uncertainty about policy responses.

To calm global financial markets, the European Union (EU), with a little help from the IMF, enacted a swift and sweeping rescue package in response to the poorly defined risks of loan repayment defaults. The package consists of an €860 billion fund to be made available as loans and lines of credit. It consists of several components including a €110 billion dedicated facility for Greece. This certainly helped alleviate market concerns, but the situation isn't good. Heightened uncertainty about financial sector exposure to sovereign risk could curtail the supply of bank credit and increase funding costs, particularly in Europe.



The next problem lies in the fiscal austerity measures being implemented by European nations to restore stretched fiscal positions. The situation varies from country to country but broad strategic similarities are apparent. Public sector wages, social benefits, retirement plans and tax bills are about to take a hit.

Looking at the weakest EU Member, Greece, the task is to slash its current annual deficit of 13.6% of GDP to 2.6% by 2014. 75% of Greece's government spending goes to generous public sector wages and social benefits and the austerity measures include reducing public sector employment, freezing wages, raising retirement ages and reducing pension payments. The party is well and truly over and there has already been blood on the streets.

Even the EU's strongest members have austerity plans of their own. France is aiming to cut its current deficit from 8% today to 3% by 2013, a deficit reduction of around €100 billion. The measures involve spending cuts, closing tax loopholes, income from renewed economic growth and winding down stimulus measures. Germany has an easier task of reducing its deficit to 3% by 2013, from 5% today. The UK sits atop a lazy \$1 trillion foreign debt which is predicted to double within 5 years. The UK's new Prime Minister, David Cameron, expects years or even decades of effort will be required to sort this problem out.

Colonial First State's chief economist, Stephen Halmarick, predicts these austerity measures will hold regional GDP growth at 0-1% for up to a decade.

The majority of economic indicators released in Europe over the June quarter point directly at a struggling economy. April retail sales declined 1.2%, the biggest decline in a year. May's unemployment figures were slightly below forecast, but disappointing at 10.0%. European consumer confidence readings were steady over June, while business confidence showed signs of improvement. The European purchasing managers' index, which indicates manufacturing levels, was flat, but still indicating economic expansion.

The German economy remains the standout performer in the region. GDP, adjusted for seasonal effects, rose 0.2% from the fourth quarter, when it also gained a revised 0.2%. On yearly comparison, GDP rose by 0.5% after falling in the previous 5 quarters. Consensus expectations were for stagnant growth after Germany experienced its harshest winter in 5 years, affecting construction output. But the German economy has actually benefitted from Europe's sovereign debt crisis. The Euro's 16% decline against the dollar since late November has increased the competitiveness of Germany's exports abroad. Foreign sales recorded their biggest jump in 18 years, rising 10.7% in March. This propelled Germany's export-dependent manufacturing sector higher, with industrial production

rising 2.7% in June.

France's economy grew at 0.1% in the first quarter of 2010 after a 0.5% expansion in the fourth quarter of 2009. Economic confidence indicators tracked sideways for the most part while key economic indicators were mixed.

UK first quarter GDP of 0.3% was down 0.2% on the year. In the UK, jobless claims fell more than expected in May and retail sales rebounded. Consumer confidence was weaker, house prices increased by less than expected and mortgage approvals remained unchanged in May.

Using cheap credit to fund generous wage, welfare and pension payments will haunt many European nations for many years to come. Difficult decisions regarding the required austerity measures have already seen outbreaks of civil unrest. From an economic perspective, growth in the region is expected to remain slow for an extended period of time. Credible fiscal reduction strategies and the EU's finance stability package should contain (but not eliminate) the risk of contagion to the financial sector.

## Japan

The Japanese economy continues to struggle under ongoing deflation and a compromising fiscal and monetary policy position. The situation has all the makings of Japan's "lost decade" in the 1990s where, following the bursting of an equity and property bubble, Japan suffered deflation, slow growth and three recessions.

Japan's core consumer prices fell 1.2% in the year to May, after a 1.3% drop in April, for the fifteenth month in a row. Excluding food and energy prices, the inflation index fell 1.6% in the year to May, matching the record annual decline from the previous month.

Japanese revised first quarter GDP figures on the other hand, were quite good. Japan's economy grew 1.2% in the first quarter of 2010, driven by stimulus-fuelled consumption and strong exports to Asia. Real GDP grew at an annual rate of 4.9% over the March quarter and was up 4.6% on the previous year. Domestic economic indicators were mixed with consumer spending up just 2.7% over the year, while private capital expenditure was down 3.2% from the previous year.

Private consumption, which accounts for around 60% of Japan's economy, grew 0.3%. This was in part due to a rush in demand for flat-screen televisions in April following a government incentive scheme for low-emission electronic goods. Retail sales in April were up 5.1% from the previous year. Given falling prices from



deflationary pressures, this means sales volumes were up quite significantly. Whether this can persist remains to be seen.

After the resignation of Japan's Prime Minister, Yukio Hatoyama, a new administration has commenced. Key members of the new administration appear to have a greater focus on fiscal reform than their predecessors. The new government plans to keep the current level of fiscal spending the same over the next 3 years. There is an argument that the current level is not sufficient to boost economic growth while a high level of sovereign debt to GDP means Japan cannot afford to take on more debt.

The Japanese economy continues to benefit from strong growth in Asia, with external demand contributing 0.7% to GDP. The key driver was exports, up 34.3% from the previous year. Strong export growth in Asia was pivotal in turning around Japan's recession as Japan continues to rely heavily on overseas demand for economic growth. This is not an ideal position in the current environment. The Yen's strength against the Euro means that Japanese exports in Europe are becoming far less competitive while strong import demand in the US is also likely to fade. For these reasons, concerns about the strength of economic recovery in the US and Europe will continue to cloud the outlook for the Japanese economy.

## Emerging Markets

Asia continues to shake off tension in global financial markets, recording strong growth in the first half of 2010. Economic activity in the region has been supported by both strong growth in exports and strong private domestic demand. Exports have been bolstered by global and domestic inventory cycles and demand recovery in developed countries. Despite fading stimulus support and volatility in financial markets due to European concerns, South-East Asian private domestic demand maintained its momentum from 2009.

The pace and drivers of growth remain substantially dispersed across the region. China's economy cooled in the June quarter as the government enacted its plan to ease monetary and fiscal stimulus back to more normal levels. In particular, the Chinese government moved to curb lending to home buyers and local authorities and phasing out government stimulus spending to put an end to inventory rebuilding. This followed the credit surge it previously promoted in response to the global credit crisis. Annual Chinese GDP growth moderated to 10.3% from 11.9% in the first quarter, slightly below market forecasts of 10.5%. Economists polled by Reuters predict full year growth of 10.0% for 2010 before slowing to 9.0% in 2011.

In a surprise move, the People's Bank of China (PBoC) has signalled the end of the Renminbi's 23 month peg against the US dollar. This move affords Chinese policymakers more flexibility to deal with rising inflationary pressures. Commodity prices, typically priced in US Dollars, will cost less in Renminbi-terms, curbing inflation, increasing import penetration and reducing China's trade surplus. China's CPI to May 2010 was 3.1%. The move reflects confidence in both the Chinese and global economy. It will also allow China to focus on domestic sources of economic growth rather than having to rely on its exports. The Renminbi has appreciated around 0.6% against the US dollar since these changes were implemented on 19 June 2010.

Economic indicators in China generally weakened over the June quarter, with the exception of exports. Despite a weakening Euro, China's exports surged 48.5% in the 12 months to May, recording its strongest growth since the onset of the global financial crisis. While impressive, these figures reflect a rise from a particularly weak base. Other concerning figures included sharp drops in factory growth to 13.7% in the year to June, below forecasts for 15.3% and May's 16.5% figure. It should be noted that China's slowdown is intentional and engineered. So far, it appears to be going well and a hard-landing can be avoided.

India is not far behind China in growth terms, recording healthy GDP growth of 8.6% in the first quarter of 2010. Clearly India is not yet experiencing any fallout from the troubles in Europe and moderating US economic recovery. While Europe is India's largest export market (around 20% of exports), exports are a relatively modest share of GDP. Manufacturing output grew at an annual rate of 16.3% in the quarter as consumers spent up on cars and other goods. A good winter harvest saw farming output grow at an annual rate of 0.7%. The Indian government expects the economy to grow 8.5% in the current fiscal year that commences April 1, on forecasts of stronger farm output and a more general global recovery.

Strong regional growth rates are by no means limited to the larger players. Singapore, for example, expects its economy to soar 15.0% year after a record expansion of 19.3% in the second quarter of 2010. This is the fastest growth rate on record since the government began releasing quarterly GDP figures in 1975 and has Singapore on par to take over China as the fastest growing economy for 2010.

The results were consistent across other parts of the region but to varying degrees. Hong Kong's GDP grew 8.2% annually in the first quarter of 2010. South Korea's first quarter GDP came in at an annual rate of 7.8% while Malaysian GDP grew 10.1%.

GDP growth forecasts for Asia continue to be revised



upward for 2010. The International Monetary Fund (IMF) has raised their regional growth forecast to 7.5%. The IMF predicts a gradual slowdown to around 6.75% through 2011, as the global inventory cycle runs its course and countries wind back stimulus.

While growth forecasts in emerging Asia are being revised upwards, there are obvious downside risks. Asia has limited direct financial linkages to the more debt laden European economy, but financial instability in Europe still poses problems for Asia. Despite having relatively strong (and an increasing focus on) domestic demand, most Asian nations remain highly dependent on foreign demand and export growth. In many cases export exposure to Europe is on par with export exposure to the US. A reversal in European economic recovery as a result of fiscal austerity measures or tighter credit markets could well see these growth forecasts revised down.

## Investment Sectors

### Australian Shares

Following modest returns over the first 3 months of the year, the All Ordinaries Accumulation Index (including dividends) fell 11.0% over the June quarter, almost mirroring returns in the US market. Annually, this equates to a return of 13.8%. European financial concerns, US economic uncertainty and the potential for a hard-landing in the Chinese economy were the central themes for all equity markets over a volatile quarter.

There was no significance difference between the returns of industrials and resources over the June quarter reflecting a broad market sell-off. The S&P/ASX 300 Industrials Accumulation Index fell 11.3% for the quarter, up 14.5% annually. The S&P/ASX 300 Resources Accumulation Index fell 11.1% for an annual return of 9.8%.

Sector returns were as you would typically expect amid renewed caution. Defensive sectors were on the stronger side of the ledger with telcos (6.6%), REITs (-3.0%) and consumer staples (-4.7%) taking out the top spots. Sectors leveraged to the economic cycle experienced the greatest declines. Industrials (-19.5%) were the hardest hit, followed by financials (-14.4%), information technology (-12.6%), consumer discretionary (-12.4%), energy (-11.9%) and materials (-10.6%).

While economic sensitivity was the key driver, stock specific forces were at play. Performance in the telco sector was driven by Telstra (+7.6%). In late June,

Telstra signed a non-binding Financial Heads of Agreement with NBN Co to participate in rolling out the National Broadband Network (NBN). If shareholders agree to the proposal (which they should), the transaction will deliver a post-tax net present value of approximately \$11 billion to Telstra.

Looking at individual stocks, exposure to the price of gold was the key to success. Gold miners Eldorado Gold Corp (55.9%), Lihir Gold Limited (39.0%), Avoca Resources (38.4%) and St Barbara Limited (34.6%) took out the top four positions over the quarter, with particularly healthy returns. Gold is traditionally favoured by investors during times of uncertainty. In US dollars, the price of gold has appreciated 34.3% in the 12 months to 30 June 2010 and 185.0% over the past 5 years. Unfortunately investing in inert metals stored in vaults provides about as much economic stimulus as using most of the available credit in Australia to fund the purchase of existing residential properties.

Taking out the 5th best performing space was Gunns Limited (22.0%), where unusually high trading volumes fuelled speculation of a looming takeover. In other corporate activity news, the demerging of Foster Group's wine and beer businesses attracted the attention of Chinese conglomerate, Bright Foods. Foster's beer assets are in the sights of another Chinese company, TsingTao, and takeover speculation is rife. News Corporation announced a takeover offer on British broadcaster BSkyB and negotiations are in place to formalise the offer.

The worst performing stocks fell on earnings downgrades with Sonic Healthcare (-53.3%), Virgin Blue (-59.0%), Elders Limited (-69.9%) and Isoft (-70.2%) falling heavily. 82% of stocks in the ASX 200 fell over the June quarter. Australia's relatively strong economic position and the strength of the Chinese economy should support the domestic equity market in the coming September quarter.

Despite the absence of the fiscal and economic woes of our developed world counterparts, the Australian share market will follow the lead from overseas markets. The September quarter will see an Australian Federal election, but with neither party offering too much for financial markets to mull over, this should be overshadowed by economic news from abroad. Growth in China and Asia, although moderating, should provide support for commodity prices and the Australian market. Domestically, the focus will be on the half yearly reporting season, where we will get a clearer picture of how businesses have fared.



## International Shares

With the exception of a handful of South East Asian markets, all the major global market indices fell over the June quarter. The MSCI World Index fell 12.4% in US dollars. An 8.4% fall in the Australian dollar saw the index return -4.4% in local currency. Again, conditions in Europe and mixed signals regarding US recovery were the key driving forces.

In the US over the June Quarter, the Dow Jones was the best performing index falling 10.0% for an annual return of 15.7%. This was followed by the S&P500 (-11.9% QoQ, 12.1% YoY) and the NASDAQ (-12.1% QoQ, 14.9% YoY). On top of broader economic concerns, US markets also had to deal with the ongoing saga in the Gulf of Mexico, a massive lawsuit hanging over the head of investment bank, Goldman Sachs, and the proposal for tougher banking regulation.

All of these uncertainties have hopefully been alleviated. The environmental and economic disaster appears to have been stalled for now and Goldman Sachs has settled its charges. Goldman Sachs reached a \$550 million settlement agreement on their civil fraud charges after misleading customers on mortgage-related investment sales. \$300 million will go to the government and \$250 million to compensate two European banks that lost money on their investments.

More importantly, the Obama administration has signed into law a sweeping overhaul of the regulation of the US financial services industry. The changes will affect almost every level of business for US financial giants. The changes include forcing over-the-counter derivatives to pass through channels such as clearing houses and exchanges, banks not being able to trade their own accounts to unrelated customers as well as curbing bank involvement in private equity and hedge funds. Other changes include new regulatory powers to control the liquidation process in the event of other major collapses, several new financial services regulators and consumer watchdogs (with sharp teeth) and fees charged on debit card transactions are even set for a reduction. Hopefully these changes make it a lot easier to separate ethical investment professionals from crooked salesmen.

In Europe, the German market was particularly resilient considering the weakness of its neighbours which it oversees. German exports benefitted from a weaker Euro. The German DAX index was down a modest 3.1%, for an annual return of 24.1%. France, walking a more difficult fiscal path, didn't fare so well. The French CAC40 fell 13.4%, for an annual return of 9.6%. In a broader European view, the Eurotop index fell 8.8% for

a 14.6% annual return. UK investors weren't smiling about their economic outlook, with the FTSE falling 13.4% for a 15.7% annual return.

Despite regional growth rates several gears higher than the developed world, Asian equity markets were for the most part negative. Slowing growth in China saw a heavy sell-off in Chinese equities over the June quarter. The Shanghai B index fell 22.9% for the quarter and is sharply negative (-19.0%) over the past 12 months. India's Sensex index was up a modest 1.0% for a 22.1% annual return. South Korea (0.3% QoQ, 22.2% YoY) managed to stay positive while Hong Kong (-5.2% QoQ, 9.5% YoY), Singapore (-1.8% QoQ, 21.5% YoY), Malaysia (-0.5% QoQ, 22.2% YoY) and Taiwan (-7.5% QoQ, 13.9% YoY) pulled back.

Poor old Japan. Despite benefitting from strong trade with its Asian neighbours, investors are increasingly concerned about Japan's ability to sustain economic growth and its equity market suffered as a result. The Nikkei fell 15.4% from April to June, joining China as the only major index to fall over the 2009/10 financial year, down 5.8%.

International equity markets had a volatile quarter and this is likely to continue in the medium term. After a strong rally from the gloomy post-GFC lows, more recent economic indicators have been a reality check for investors and markets. The clean-up from the debt binge over the past decade is still going to require a lot of work. A repeat of the 2007/8 credit crisis is unlikely because the risks are far better understood. Key themes for the coming quarter will be the Chinese government's ability to avoid a hard-landing economic slowdown and whether economic recovery in the US can maintain momentum.

## Property Securities

The Australian REITs sector had a relatively strong quarter, outperforming equities by around 10%. The ASX A-REITs Accumulation Index fell by 1.5% from April to June. For the 2009/10 financial year, REITs also outperformed the Australian market, returning 20.3%.

In the absence of any major corporate activity, investors in A-REITs maintained the same macro-economic focus as the equity market. The sector however, benefitted from renewed interest from both domestic and international investors. Improved valuations and balance sheets plus an improved outlook for steady income streams contributed to A-REITs relative performance.

Looking at the various property subsectors, the retail



REIT subsector was the strongest performer over the quarter, returning a modest 1.4% for an annual return of 16.2%. Annually, the industrial REIT subsector remains the standout performer, returning 88.8% over the previous 12 months despite a 3.3% fall over the quarter.

At an individual stock level, only 2 companies from the ASX300 A-REIT index recorded positive returns. Commonwealth Property Office Fund returned 1.6% for the month and 12.0% annually, appealing to investors with its conservative gearing levels and a quality portfolio. Abacus Property Group returned 1.1% for the quarter and 10.8% annually. While a little more volatile, the current yield is +8% and speculation surrounding the sale of 343 George Street, Sydney provided price support. Ardent Leisure Group (-26.6% QoQ, -30.0% YoY) and Centro Properties (-41.3 QoQ, 45.2% YoY) were the biggest losers.

While underperforming Australian REITs for the quarter, International REIT annual returns reflect significant outperformance. The UBS Global Property Index (hedged into AUD) fell 5.0% for the quarter, returning 43.9% annually.

In the US, the REIT market has enjoyed an extended rally since March 2009. The shakeup from the GFC prompted companies to repair their balance sheets and streamline their operations and they have been rewarded for their efforts.

This situation in Europe is a little more difficult. The economic environment is providing significant uncertainty but strong earnings downside seems to be already priced in. Most European REITs are trading at around 15% lower than their current net assets. The valuations do appear to be stabilising in some markets while rents are also stabilising or even rising in some cases.

You'd never guess it. Asian REITs outperformed developed market counterparts over the June quarter. Strong regional economic growth as well as healthy underlying property market fundamentals is providing support, with Singapore and Hong Kong the standout markets.

Japanese weakness has extended to its property market. Strong supply and weak demand has developed in one of the least occupied markets. The current vacancy rate in Tokyo is 9% and moderate rises are expected.

The relative outperformance of the REITs sector, in a falling market, reflects a significant turnaround in

sentiment towards the sector. REITs were one of the most punished sectors during the GFC, enduring a particularly volatile period. It appears that after recapitalisation and rationalisation in the sector, investors now view REITs as a lower risk investment and may become an increasingly sought after sector if ongoing investment market troubles continue.

### **Fixed Interest & Cash**

The Reserve Bank of Australia (RBA) affected two consecutive 0.25% rate rises in April and May before leaving the cash rate unchanged at 4.5% in its June meeting. A strong domestic economy with inflation edging toward the upper end of the 2-3% band resulted in the rate rises, while financial market concerns about sovereign debt issues in Europe, the potential impact on equity markets saw the RBA move to a wait and see approach.

The RBA cited growing concerns regarding uncertainty in the global economic outlook but for the time being expects growth to remain around trend for 2010. On the domestic economy, the RBA see the high level of terms of trade as a key strength in the Australian economy and expect inflation to stay towards the upper end of its target band.

Increased risk aversion driven by offshore events was evident in Australian bond markets, particularly over June. Increased demand for government bonds saw 3 and 10-year government bond yields rise by 0.29% and 0.28% to 4.43% and 5.09% respectively. 90-day bank bills yields increased by 0.05% to 4.92%, with financial markets expecting further rate rises ahead.

In the major Australian fixed interest and cash indices, the UBS Australian Composite Bond Index returned 3.6% over the June quarter and 7.9% annually. The UBS Australian Bank Bill index returned 1.1% over the quarter and 3.9% for the financial year.

Short term interest rates remain unchanged in the major developed markets. This is likely to remain the case until well into 2011.

The US Fed left the official rate unchanged at a range of 0-0.25%. At their June meeting, the Federal Open Market Committee downgraded their economic outlook for the US economy, stating "financial conditions have become less supportive of economic growth on balance, largely reflecting developments abroad." Financial markets have taken this tone as indicating interest rates will remain low in the US for some time to come.

Both the European Central Bank (ECB) and the Bank of England (BoE) left their respective interest rates of 1% and 0.5% on hold over the June quarter, for obvious reasons. As expected, the Bank of Japan



(BoJ) left its target policy rate unchanged at 0.1%. The BoJ maintained its view that the economic recovery is expected to continue and deflation should begin to moderate going forward.

Long-term government bond yields have fallen in most countries, with rising risk aversion around the globe. US government bond yields were lower, with 10-year yields finishing the quarter below 3%. The trend was obviously the result of sovereign debt concern and a flight to safety but with uncertainties in Europe actually moderating in late June, concerns regarding the state of the US economy became more dominant.

Yields in German government bond yields were also down. Much of this was prompted by investors selling Greek government bonds and replacing them with German government bonds after credit rating agency, Moodys, downgrade their rating of Greek bonds. UK bond yields were also down, with 10-year government yields finishing the quarter at 3.35%. This was largely due to a harsh government budget designed to tackle the UK's hefty foreign debt issues.

In aggregate, the Citigroup World ex-Australia GBI (hedged) in Australian dollars returned 3.5% for the quarter for an annual return of 9.2%.

Concerns regarding European sovereign debt issues subsided notably by the end of the June quarter. Should this trend continue the performance of government bonds are likely to decrease and yields will begin to rise from abnormally low levels. The average yield on a global government bond portfolio stands at around 2.5% and the global supply of government bonds is likely to remain on the high side. Corporate bonds would be the obvious winners if sustained global economic growth can gain traction. For short term global interest rates in developed economies, markets are not expecting any changes until well into 2011, or possibly even later.

# STOCK MARKET INDICES AS AT 30 JUNE 2010



<i>Stock Market Indices</i>	<i>1 yr % pa</i>	<i>3 yrs % pa</i>	<i>5 yrs % pa</i>
ASX All Ordinaries Accumulation Index	13.78	-8.01	4.72
S&P/ASX 300 Industrials Accumulation Index	14.47	-10.46	1.72
S&P/ASX 300 Resources Accumulation Index	9.79	-0.81	13.99
S&P/ASX 300 Listed Property Accumulation Index	20.34	-24.31	-8.34
Dow Jones Industrial Index - US	15.71	-10.00	-0.99
Standard & Poors 500 Index - US	12.12	-11.82	-2.85
Nikkei Dow Index - Japan	-5.78	-19.73	-4.13
Dax Index – Germany	24.06	-9.35	5.40
FT-SE 100 Index – UK	15.71	-9.38	-0.78
Hang Seng Index - Hong Kong	9.52	-2.58	7.23
MSCI World Acc Index net divs in \$A	9.93	-11.60	-0.13

September 2010 Quarterly Market Outlook as at 30 June 2010

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