QIC Outlook
Market & Economic
Dynamic Investment Solutions

WEEKLY ECONOMIC BRIEF – 21 April 2011

Key Points

- ***Standard and Poor's places the US sovereign debt rating on negative watch***
- ***Rising food and energy prices push global inflation higher***
- ***Australian dollar surges to US$1.07***

Chief Economist's View

Following a downgrade of Ireland's sovereign debt rating by Moody's, rating agency Standard & Poor's decision to place US sovereign debt AAA rating on negative watch ensured that global fiscal policy remained centre stage during the week. The reason for the negative watch was concern that policymakers would struggle to form an agreement on the appropriate path of fiscal tightening and that during a period of delay, the US government's fiscal position would fail to consolidate. However, despite ongoing concerns with the fiscal positions of the developed economies, equity and bond markets managed to rally over the week as a combination of weaker than expected US inflation, ongoing recovery in US and European manufacturing sectors and robust US company earnings' reports boosted investor confidence.

The release of March CPI data showed that headline inflation in the US rose to a yearly rate of 2.7 per cent, which was slightly lower than market expectations. In addition, core inflation (which exempts food and energy prices) rose modestly to a yearly rate of 1.2 per cent, indicating that the sharp increases in food and energy prices are taking time to work their way through the price system. As energy and food prices level off (and potentially fall) the strong impetus to headline inflation will swiftly moderate. Federal Reserve (Fed) Chairman Bernanke's current stance on monetary policy assumes that the rise in core inflation will be modest and that the current level of headline inflation is transitory and will moderate once commodity and food prices stabilise. The March inflation report is consistent with the Fed's view, allaying market fears that the Fed will tighten policy more quickly than anticipated.

European inflation data also showed the euro area headline CPI rising at a yearly rate of 2.7 per cent in March and core CPI rising by 1.3 per cent. However, in contrast to the Fed, the response of the European Central Bank (ECB) has been to focus on the elevated level of the headline rate leading it to tighten monetary policy. The difference in approach to policy between the ECB and the Fed can be partially attributed to differences in the potential for pass-through of temporary spikes in food and energy prices to core inflation via the labour market. In Europe, the presence of wage indexation agreements in countries such as Spain and Italy, mean that increases in headline CPI feed through to the economy's price system through wage increases. To head off this transmission from headline to core, the ECB raised its refinancing rate in early April and further hikes are anticipated this year.

While higher food and energy prices are driving headline inflation higher in the developed economies, the impact is even more pronounced in emerging markets, where food and energy form a much larger share of the consumer basket. CPI data for China showed that headline inflation once again pushed above 5.0 per cent, rising by a yearly rate of 5.4 per cent in March. Rising inflation prompted the People's Bank of China to raise banks' reserve requirement ratios by 0.5 percentage points to a level of 20.5 per cent for large banks and 18.5 per cent for small banks.

Despite rising headline inflation, recovery in US and euro area manufacturing sectors continues. US industrial production maintained its fast pace of growth in March, while business surveys continue to point to ongoing expansion in the sector. Similarly, German and French manufacturing PMI surveys picked-up in April, close to their all-time highs. Consistent with manufacturing data, US company earnings' reports have been strong with 75 per cent of companies beating analyst expectations. In China, 2011Q1 GDP growth also exceeded market expectations, rising at a yearly rate of 9.7 per cent. While Chinese growth is slowing to more sustainable levels, the pace of decline is moderate as policymakers maintain a gradual approach to tighter monetary and fiscal policy.

Over the week the Australian dollar appreciated to a new high of US$1.075, despite the release of dovish minutes from the Reserve Bank of Australia's April Board meeting. The Australian dollar has been pushed higher by a combination of rising commodity prices and weakness in the US dollar. Our view is that the Australian dollar will struggle to maintain current levels as pressure on commodity prices emanating from temporary factors, including the political problems in the Middle East and the floods in Queensland, abate.

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Financial Market Update

- Global equity markets rebounded 0.7 per cent over the past 6 days, largely reversing the fall experienced last week. In the US, the S&P 500 fell 1.1 per cent on Monday after Standard and Poor's placed the US AAA long-term credit rating on negative outlook, noting that *"there is a material risk that U.S. policymakers might not reach an agreement on how to address medium- and long-term budgetary challenges by 2013."* Markets rebounded on Tuesday and Wednesday, supported by positive earnings results, with the S&P 500 finishing up 1.2 per cent over the past 6 days. Of the 76 companies in the S&P 500 that have reported earnings to date, 75 per cent have had positive earnings surprises. Earnings reports from the technology sector have been particularly favourable, with Intel up 9.3 per cent since last Thursday after releasing positive results and Apple releasing a strong earnings report after the close on Wednesday. Although Australian and Japanese equity markets underperformed, falling 0.5 per cent, this largely reflected time-zone differences.

- Major government bond yields fell further over the past 6 days, with 10-year yields in the US declining 9 basis points. Yields fell 9 basis points last Friday after a softer-than-expected increase in the core CPI and while there was a brief spike higher in yields after the S&P announcement, the move wasn't sustained. 10-year yields in Germany and the UK fell by around 11-12 basis points, weighed down by a flight to quality as concerns intensified around peripheral European countries following talk of a Greek debt restructure. Over the past 6 days, 10-year yields jumped 150 basis points in Greece to 14.75 per cent, 73 basis points in Ireland to 10.07 per cent and 40 basis points in Portugal to 9.28 per cent.

- In currency markets, the Australian dollar continues to advance, rising above US$1.07, supported by higher commodity prices and weakness in the US dollar. The Australian dollar has now appreciated by 7½ per cent over the past month. In commodity markets, West Texas Intermediate oil prices rose 2.5 per cent to almost US$111 per barrel as US oil inventories unexpectedly fell, with prices now back close to the peaks seen in early April.

Table 1. Financial market movements, 14 - 20 April 2011

Equity markets	**Level**	**Change**
MSCI World Index (local currency)	926.5	0.7%
US - S&P 500	1,330.4	1.2%
Japan - Nikkei	9,606.8	-0.5%
UK - FTSE 100	6,022.3	1.0%
Germany - DAX	7,249.2	1.4%
France - CAC	4,004.6	0.9%
Australia - S&P/ASX 200	4,859.0	-0.5%
Fixed interest (10 yr sovereign yields)	**Yield**	**Change**
US	3.41%	-9.0 bps
Japan	1.24%	-6.3 bps
UK	3.58%	-11.3 bps
Germany	3.31%	-12.3 bps
Australia	5.52%	-8.6 bps
Foreign exchange	**Rate**	**Change**
USD-JPY	82.560	-1.1%
EUR-USD	1.452	0.2%
GBP-USD	1.641	0.3%
AUD-USD	1.071	1.6%
Commodity markets	**Level**	**Change**
WTI oil price (US$/barrel)	110.85	2.5%
CRB index	365.54	1.4%
Other	**Level**	**Change**
VIX	15.07	-7.4%

Source: Bloomberg

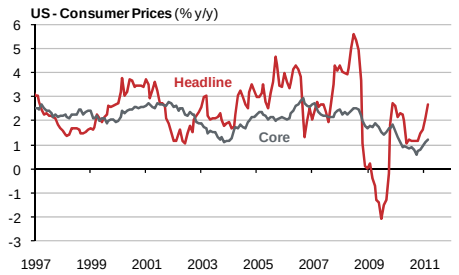
Economic Update

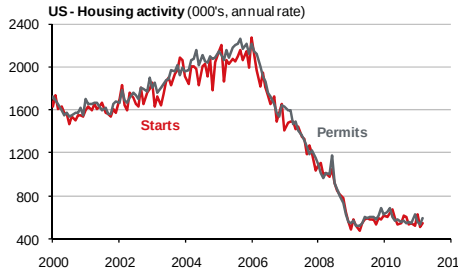
US

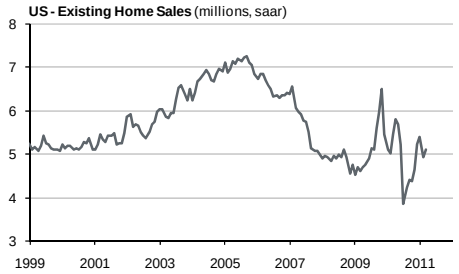
- Rising energy prices boost headline inflation but core prices remain subdued
  - Headline consumer prices rose in March by 0.5% for the second consecutive month. Energy prices increased by 3.5%, driven by a 5.6% rise in gasoline prices. Compared to one year ago, headline inflation is at 2.7%, up from 1.6% inflation recorded in January.
  - The increase in core prices was more moderate, rising 0.1% to be 1.2% higher than one year ago.
- Housing market data stronger but levels remain weak
  - After weak prints in January and February, housing starts and permits rose strongly in March, up 7.2% and 11.2%, respectively. The gains were broad-based in terms of the region and building-type. Despite the solid gain, annualised housing starts remain at around a third of their historical average. Not surprisingly, sentiment among homebuilders remains weak, with the NAHB sentiment index falling back to 16 in April, after briefly rising in March.
  - Existing home sales rose by more than expected in March, up 3.7% over the month. Incoming data points to a further increase in home sales, with purchase mortgage applications rising strongly in the week ending 15 April.
- Industrial production higher in March, with surveys pointing to strong outlook
  - Industrial production rose 0.8% in March, following upward revisions to January and February. Manufacturing output increased 0.7%, led by a recovery in motor vehicle production. Incoming surveys point to further gains in April after a solid increase in the Empire State manufacturing survey (21.7 from 17.5) and its underlying components.
- Consumer sentiment improves after sharp fall in March
  - The University of Michigan consumer sentiment index ticked up in April after a sharp decline in March (69.6 from 67.5). Elevated prices continue to weigh sentiment, with one-year ahead inflation expectations unchanged at 4.6% for the second consecutive month.

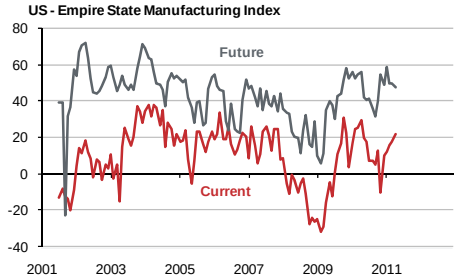
Euro area

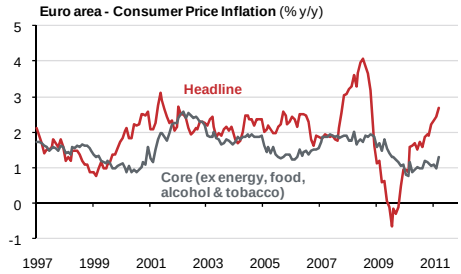
- Inflation surprises to the upside in March
  - Headline inflation in March was stronger than the preliminary estimate, rising 2.7% over the year. Core prices also jumped, rising from 1.0% y/y in February to 1.3% y/y in March.
- Trade deficit narrows in February
  - The ex-euro area trade deficit narrowed €0.7bn to €2.4bn in February. Export values continue to rise strongly, up 1.6% over the month while import values increased 1.0%.
- Business sentiment above trend in April
  - PMI sentiment indicators remain at above trend levels, with the euro area composite indicator ticking up from 57.6 in March to 57.8 in April. Manufacturing PMI edged higher while the services PMI dipped slightly but remains substantially above the critical 50 point threshold that indicates expansion. At the country-level, growth continues to be driven by Germany and France, with Markit noting in the press release that indicators for the peripheral economies moderated.

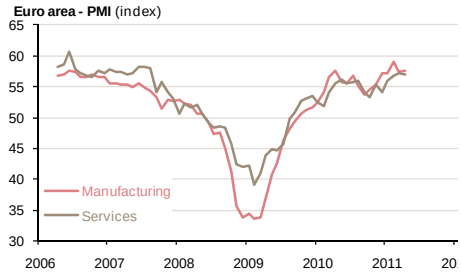






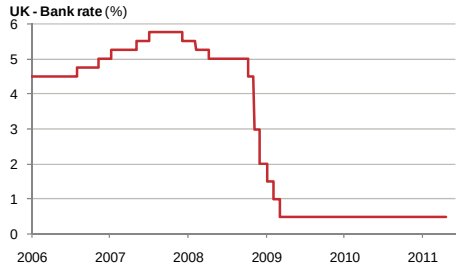






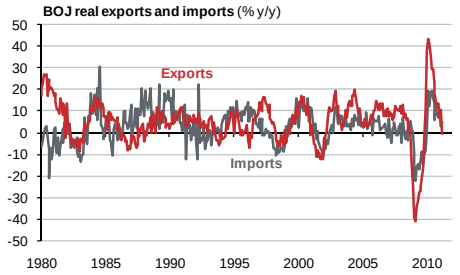
United Kingdom

- MPC minutes point to downside risk to near-term growth
  - The minutes from the April MPC meeting reveal that members see the risks to inflation as broadly balanced but near-term growth may surprise to the downside given the recent falls in energy and construction output.
  - The voting dynamics remained unchanged, with five members electing to leave the Bank Rate at 0.5% and the asset purchase program at £200bn. Andrew Sentence voted to increase the Bank Rate by 50bps and Spencer Dale and Martin Weale preferred a 25bps hike. Adam Posen continues to argue the case for further £50bn in quantitative easing.



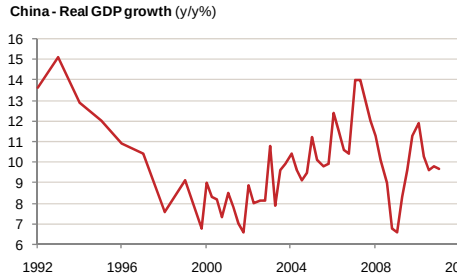
Japan

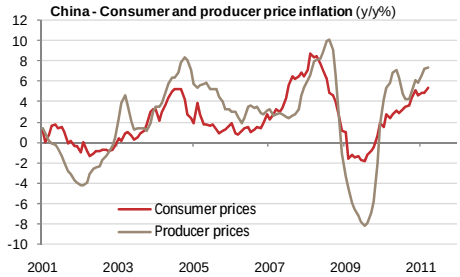
- Exports substantially weaker in March following the earthquake and tsunami
  - The trade surplus narrowed sharply in March, falling ¥381bn to ¥96.3bn. Unsurprisingly, exports fell sharply over the month after the earthquake and tsunami halted production and disrupted transportation channels. Exports fell 7.7%, led by a 30% plunge in motor vehicle exports. Exports of auto parts, which have significant implications for global automobile supply chains, fell 13.9%. On a real basis, exports fell 8.0% while real imports slipped 1.4%.



China

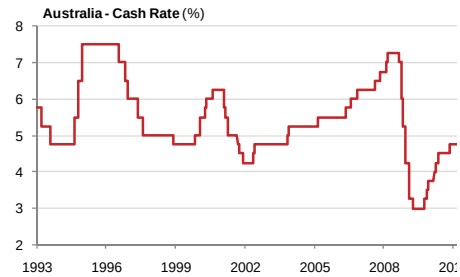
- Activity stronger than expected in Q1, despite tighter monetary policy
  - Real GDP expanded by 2.1% in Q1, to be 9.7% higher than one year ago. This was above the market estimate for 9.4% year-ended growth. Domestic demand was solid over the quarter, with nominal retail sales 16.3% higher than one year ago, industrial production up 14.4% y/y and urban fixed asset investment increasing 25% y/y. The ongoing rise in activity continues to place upward pressure on prices, with CPI rising from 4.9% to 5.4% in March. Upstream pricing pressures also continue to build, with producer prices rising 7.3% in year-ended terms.
  - The persistence in activity prompted the PBOC to raise the reserve requirement ratio by 50bps for the fourth time this year, lifting the RRR for large banks to 20.5% and 18.5% for small banks.

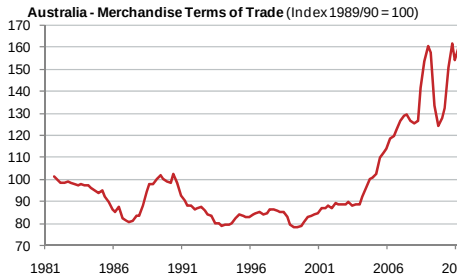




Australia

- RBA balancing near-term uncertainty against strong medium-term outlook
  - The minutes from the April RBA meeting reveal that members see increased uncertainty in the short-term following the Japanese earthquake, slower than expected recovery in Queensland mines and the sovereign debt crisis. Against this however, the terms of trade is expected to remain elevated and the mining investment boom is on-track to continue which will provide a significant boost to Australian growth and inflation prospects. Based on this, the Board judged it appropriate to leave the cash rate on hold at 4.75% to ensure that *"the medium-term inflation outlook remained consistent with the target."*
- Merchandise terms of trade rise sharply in Q1
  - The merchandise terms of trade index rose 3.8% in Q1 as the 5.2% increase in export prices outpaced the 1.4% rise in import prices. Commodity prices continued to rise following strong global demand and supply constraints in the wake of the recent floods, with coal prices up 3.7% and metal ore prices rising 7.4% over the quarter. The strong Australian dollar kept import prices in check, although petroleum prices increased 14.2% over the quarter.





Source: FactSet

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