

Economic Commentary

Another budget surplus, more tax cuts, rising wages and unemployment at a 32 year low. Apart from drought and the cost of housing, things look pretty good in the Australian economy.

With a strong economy, inflows of taxation helped secure a projected budget surplus of \$10.6 billion for 2007-08. Tax cuts worth \$5.3 billion were given and \$5 billion will be set aside in a permanent higher education fund. Numerous small spending programs will help keep the economy growing at a steady pace.

Unemployment came in at 4.4% in April and almost another 50,000 jobs were created. On top of this, average weekly earnings are up 3.5% on a year earlier. With inflation up only 2.4%, real wages are rising.

The Australian dollar (AUD) fell 0.7% against the US dollar (USD) during May. It started the month at US 83.20 cents and ended it at US 82.66 cents. A year ago the AUD stood at US 76.02 cents. The AUD bought 0.4176 UK pounds at the end of May 2007 and 1.12 NZ dollars.

Australian shares

It was yet another strong month on the Australian sharemarket. The S&P/ASX 300 Accumulation index rose 2.6% in May to be up 32.0% over 12 months. The All Ordinaries share price index set a new record of 6372 points, finishing the month at 6341.

Share prices were volatile during May. The market rose and fell on news from around the world including movements in commodity prices, tax changes in China and gyrations in the US sharemarket. Also driving share prices were takeover activity, takeover speculation, earnings outcomes and the state of the economy.

In takeover news, the directors of Rinker and Symbion Health have recommended acceptance of bids for their respective companies. Bids for Qantas and APN News & Media were rejected by shareholders while Coles remains in the sights of Wesfarmers.

The market was boosted in May when speculation emerged regarding a possible takeover of Rio Tinto. Rio Tinto's share price rose almost 20% in the first week of May ending the month up 15.2%. No bid has emerged but speculation continues.

The news on earnings during the month was mostly positive. Macquarie Bank reported earnings growth of 69%, while NAB lifted earnings 7.0% over the same period last year. In the media sector, West Australian newspapers announced that its 3rd quarter earnings were up 33% on a year earlier.

Not all the news was good. In recent weeks ResMed, CSR and Centennial Coal all announced profit downgrades.

In the five months to end-May the pace of the sharemarket has matched that of the previous three years. Quite apart from 'takeover-assisted' activity there have been strong gains by a range of well known companies. Telstra is up 20.8%, Woolworths has risen 16.6% and QBE is up 10.1%. Blood products company CSL is up 37.2%, ASX has risen 29.3% while BHP is up 25.6%.

Moving in the opposite direction have been Fosters (-6.5%), IAG (-3.9%) and Aristocrat Leisure (-1.6%).

During May the top 100 companies (+2.3%) were outperformed by the smaller companies' index (+5.4%) with smaller companies up 46.0% over 12 months compared to 30.3% for those in the top 100. Small resource companies posted a 9.8% rise to be up 64.7% over 12 months.

After the recent surge in share prices, is the market expensive? Not really. Prices have growth broadly in line with earnings and the market's price to earnings ratio remains close to its ten year average. What we've seen is not a replay of the US tech-boom. Simply stated, Australian companies are making very good profits and investors expect this to continue.

Are these expectations realistic? China continues to sustain demand for resources; the US is growing at a modest pace and Europeans are growing in confidence. Japan is struggling back to health; interest rates are not excessive and real wages in Australia are growing. This is not the backdrop of hard times and if well managed it provides a good foundation for further sharemarket expansion.

Global shares

It was also a positive month for global shares. The MSCI World Index was up 2.5% in USD and up 3.2% in AUD terms. Driving offshore markets were takeover activity, mostly stable interest rates and good economic news.

Over the past 12 months, the MSCI World index is up 11.3% in AUD terms.

US markets hit new records during May. The S&P 500 index has finally surpassed the level it reached back in 1999 – the height of the technology boom. The Dow also set new records reaching 13,633. The Dow stood at 7286 in October 2002.

The US market saw Walt Disney lift earnings 27%, the Nasdaq Stock Market Inc bid for Sweden's exchange and Alltel, America's fifth largest wireless operator agree to a US\$27.5 billion private equity takeover bid. On top of this, economic news out of the US was positive with modest inflation and a pick up in business sentiment.

Germany was among the strongest European markets this month rising 6.4%. The German market has become attractive for its firming economy, its lower valuations and takeover activity. This month, DaimlerChrysler AG sold its loss making Chrysler arm to a private equity firm.

Elsewhere in Europe the UK's FTSE 100 rose 2.7% despite a rate hike from the Bank of England; Italy fell 0.8% while the market in France was up 2.4%.

Markets in Asia were positive with South Korea's Kospi index scaling new heights. It rose 10.3% in the month to be up 29.1% over the past year. Korean ship builders and auto makers are expecting strong earnings growth over the next two years partly on the back of strong growth in orders from China. In Japan the Nikkei rose 2.7% to be up 15.6% over 12 months.

Events in China unsettled some global markets in May just as they did back in February. In late May, the Chinese authorities lifted the stamp duty on share trades from 0.1% to 0.3%. The increase was an attempt to curb speculative share trading. Global investors however soon came to realize that a slump in the Chinese sharemarket is not the same as a slump in its real economy and markets picked up.

Among other emerging markets, Argentina rose 9.5%, Mexico was up 8.3% but Russia fell a further 11.3%. The MSCI Emerging Markets index, measured in AUD, rose 5.3% in the month to be up 23.0% over 12 months.

In sector terms the strongest sectors during May included materials (+6.2%), telecommunications (+5.7%) and energy (+5.7%). Commodity prices remain firm, oil prices have moved up from US\$51 per barrel in January to US\$64 in May and telcos are benefiting from rising demand for services.

Looking ahead global growth remains firm and concerns over the US slowdown are easing. Europe is also expecting growth but faces the prospect of slightly higher interest rates. Provided global growth remains firm, global sharemarkets should find support.

Fixed interest

With inflation below 3% and forecast to remain that way until at least 2009, the Reserve Bank of Australia (RBA) left its cash rate unchanged at 6.25% following its meeting in early May.

According to an RBA statement in May, inflation is expected to rise a little over the longer term. The forecast gradual pick-up in inflation reflects the expectation of firm growth in demand and output and that spare capacity in the economy will remain low.

Ninety day bank bill yields were stable during the month moving from 6.38% to 6.36%. The stability reflects the markets view that the RBA will not official interest rates in the near term. The UBSA Bank Bill index returned 0.54% in May and 6.38% over the past 12 months.

Prospects of stronger economic growth in the US saw their 10 year bond government yields move up from 4.62% to 4.89%. Local bond yields rose in sympathy moving from 5.89% to 6.01%. As the RBA noted, there are upward risks to inflation and the bond market sought to be rewarded for the increased risk. The UBSA Composite Bond index returned

0.05% for the month and 4.64% over 12 months as bond yields have edged up.

Listed property

The Listed Property sector rose 4.2% in May again assisted by takeover activity and a strong equity market. Over the past twelve months the S&P/ASX 200 Listed Property Accumulation index is up 40.8%.

The listed property trust Investa Property Group rose 16.1% in the month after it agreed to be purchased by Morgan Stanley of the US. Also performing well were Commonwealth Property Office Fund (+16.0%) and Centro Retail Property Group (+12.5%).

At the end of May, the yield on listed property sector was 5.70% compared with a 10 year government bond yield of 6.01%.

Global property markets performed reasonably well in May with the S&P/Citigroup World Property index gaining 1.2% to be up 35.5% over 12 months. The best property markets over 12 months have been Singapore (+88.1%), France (+62.1%) and Italy (+49.8%).

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