

Genesys Market Commentary

For the Month ending 30 June 2011

Market Outlook

Looking back on the month of June, one gets a sense of déjà vu. A few exceptions aside, global investment markets have traded sideways, with the same key economic themes persisting. The difference now: the outlook for recovery is more pessimistic.

The European debt crisis has not been resolved. Despite agreement in the Greek parliament at the end of June on a range of austerity measures, the risk of contagion among the periphery has increased, with spreads on the sovereign debt of Spain, Portugal, Ireland, and now Italy, reaching new highs.

In the US, the optimism with which 2011 began has been all but wiped away. Economic growth slowed to an annualised 1.9% in the first quarter, and is unlikely to show any significant improvement in the near-term.

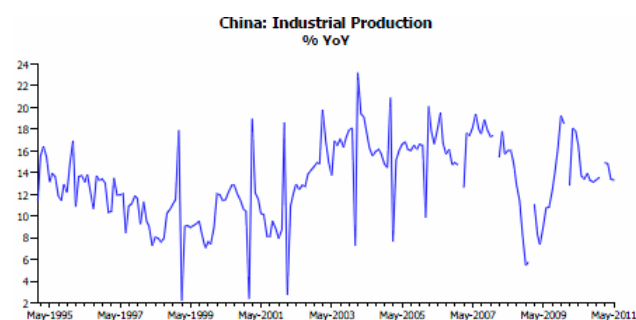
The key underlying fundamental dragging the outlook for the US economy is jobs. Contrary to leading indicators which suggested continued improvement in employment, June figures showed that hiring by US firms had fallen to its lowest point since May 2010. Adding to the bleak US employment figures, average hourly earnings declined and the aggregate unemployment rate held above 9%.

The increasing sense of pessimism in the developed world is taking its toll on consumers, with retail sales volumes virtually unchanged over the past 12 months and significantly below their pre-GFC level.

This, combined with currency appreciation, has hit export-driven Asian markets hard. Industrial production in China, India, Singapore and Taiwan has fallen considerably over the latest quarter.

Weakness in these markets has direct and indirect flow on effects for the Australian market. In a direct sense, lower IP among our trade partners reduces their demand for Australian primary imports.

Charts: Asian Industrial Production



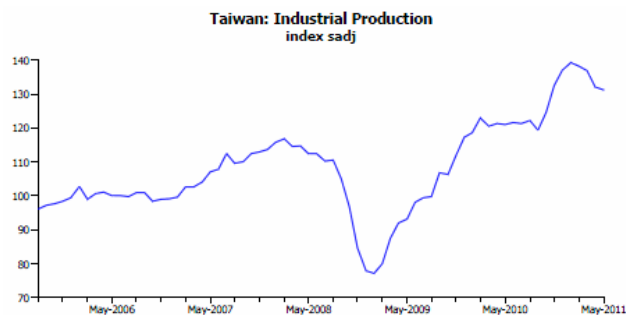
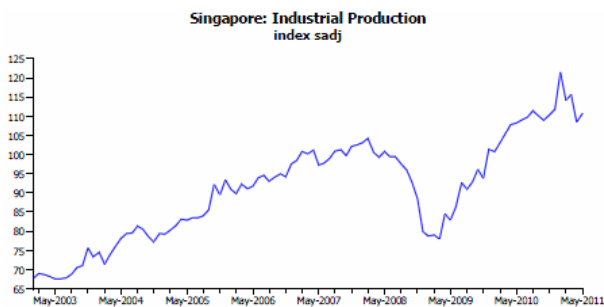
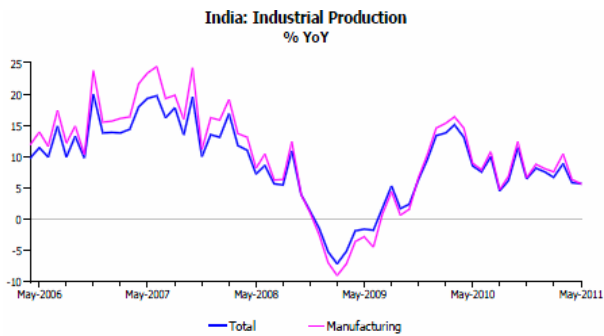
Source: Andrew Hunt Economics

Asset Class Performance Summary to 30 June 2011

Asset Class	Index	1 Mth (%)	3 Mths (%)	6 Mths (%)	1 Yr (%)	2 Yrs (% p.a.)	3 Yrs (% p.a.)	5 Yrs (% p.a.)	7 Yrs (% p.a.)	10 Yrs (% p.a.)
Australian Cash	UBSA Bank Bill Index	0.40	1.23	2.47	4.98	4.43	4.78	5.62	5.64	5.44
Australian Fixed Interest	UBSA Composite Bond Index	0.55	2.33	4.42	5.55	6.70	8.05	6.50	6.23	6.18
Global Fixed Interest	BarCap Global Aggregate Index (Hedged) in AUD	0.22	2.87	3.85	6.93	9.20	9.45	8.38	7.51	7.76
Australian Listed Property	S&P/ASX 300 A-REIT Index	-0.77	-0.49	3.23	5.87	12.87	-9.65	-10.32	-2.95	2.07
Global Listed Property	UBS Global Investors Index (Hedged) in AUD	-2.02	4.00	9.56	32.50	35.74	1.43	-0.82	-	-
Australian Shares	S&P/ASX 300 Accumulation Index	-1.98	-4.26	-1.27	11.90	12.47	0.26	2.37	8.38	7.22
International Shares (Unhedged)	MSCI World ex Australia Index in AUD	-2.07	-2.91	0.87	2.66	3.93	-3.28	-5.15	-1.17	-3.71
Global Smaller Companies	MSCI World Small Cap Index in AUD	-2.80	-4.43	0.31	7.57	10.86	1.56	-4.45	0.26	0.07
Global Emerging Companies	MSCI Emerging Markets Index in AUD	-2.00	-4.51	-3.42	0.83	9.02	0.49	3.57	10.68	7.86

Source: van Eyk, Morningstar, Bloomberg





Source: Andrew Hunt Economics

Weaker global economic data also negatively impacts growth-gearred economies, such as Australia. The local equity market and currency have both been hit in the last month, as investors rotate into more defensive options.

The outlook for the local economy has also been reigned in, with a previously hawkish RBA now appearing more likely to cut than raise interest rates in the next 12 months (at least on futures pricing).

There is little positive news for markets. Little surprise then that a recent FTSE survey of UK finance directors found that over 30% believe the British economy will fall into recession. Business and consumer sentiment statistics for Australia and New Zealand, while not as dramatic as the Poms', reflect a similar outlook, falling to their lowest levels in two years.

Add to this increasing consumer and investor uncertainty over government tax policy (the recently announced \$23/tonne carbon tax, for example), ongoing oil and commodity price volatility (MENA countries from Libya to Syria and Yemen remain in turmoil), and increasing signs that monetary policy in China is not curtailing inflation.

The way these factors play out over the next month is well worth-watching. The potential is there for a perfect-storm to upset the global recovery.

Market Commentary

Equities

Global equity markets fell in June. In the US, the Dow Jones Industrial Index and S&P500 ended the month down -2.1% and -2.5%, respectively. Stock indices ended the month lower in Europe, with falls in the UK (-1.6%) and France (-0.7%). Germany managed a slight gain of +0.2% over the month, up from May's loss of -2.9%. Asian markets were also very weak, with significant falls recorded in Hong Kong (-5.4%), China (-5.2%) and Taiwan (-3.7%).

The Airline and Retail industries were some of the hardest hit in June. Despite recent softening, the oil price remains high and volatile. Combined with natural disasters leading to travel disruptions and carbon tax uncertainty it is expected to leave the Airline industry with a profit less than 25% of last year's for FY2011. US retailers are also struggling to regain losses from April amidst poor weather conditions and a slowing housing market. 80% of retailers reported sales under target for the June month.

Despite poor monthly results, both developed and emerging markets finished up over FY2011. The greatest gains were recorded in the US (Nasdaq +30.5%, S&P500 +27.2%, Dow Jones +25.9%), despite ongoing concerns of a double-dip recession and stagnant housing market and employment figures. Strong growth was also reported in manufacturing-export markets of Germany (+22.5%) and Korea (+23.7%).

Domestically, the Australian market was weighed down in June by a continued strong AUD and sustained fears of a slowdown in China, European contagion and the end of the Fed's quantitative easing program. The ASX200 fell by -2.13% over the month.

Defensive positions performed strongest in June. Consumer staples (+0.5%) and utilities (+0.8%) were the only sectors to gain over the month. Energy stocks were the worst performers, down -8.4% followed by IT (-5.3%), Telco's (-4.1%) and Industrials (-3.3%). A sell off in these sectors was a consequence of the fall in oil price.



The oil price fell again in June, down -7.4% to \$95.12 per barrel. The price drop stemmed from the market's bleak outlook for growth given the worsening European sovereign debt crisis and continuing poor economic figures in the US as well as supply increases created by the release of strategic petroleum reserve by the Internal Energy Agency.

Fixed Interest

US interest rates are expected to stay range-bound in Q3 and the yield curve to remain steeper. US Treasuries had a strong second quarter in 2011, helped by an economic soft patch, concerns about European sovereign risk, and (in recent weeks) a downturn in world stock markets. Some of these factors should fade in Q3. The end of the second round of quantitative easing removes the Fed as a buyer of Treasuries. Despite this, rates should hold on to their gains, before rising toward the end of the year.

Theoretically, the end of quantitative easing should pose a challenge for Treasuries; however, a look at the demand-supply dynamics suggests that this need not be the case. When exits are well anticipated, the market prices the exit well in advance. If rates rise in the second half of the year, it should be due to an improved growth outlook, rather than driven by the end of QE II.

In Europe, the deterioration in the European periphery dominated Q211, despite the ECB actually hiking rates in early April and doing so again in early July. The outlook for peripheral spreads is one of relative stabilisation. The base case scenario is that the spreads for Spain and Italy will continue to trade in the same range as they have done since the beginning of the crisis (c175-275bp for 10y Spain versus Germany, c110-180bp for 10yr BTP/Bunds).

With spreads currently at the wider end of the range, there should be a bias for tightening from here. The outlook for Ireland and Portugal remains more uncertain as their markets are illiquid and contagion risks will likely remain a key factor regardless of the idiosyncratic developments in these markets. However, the economic data flow on a global basis is likely to start recovering after its Q2-11 soft patch. This should push the market to focus again on fundamentals, which justify a continuation of the rate tightening cycle by the ECB.

While credit spreads have widened globally on the back of European sovereign volatility, total returns for the year remain positive, driven in part by the large move in rates. After a solid Q1, credit spreads were generically wider across markets and regions in Q2. In spread terms, high yield and emerging market credit widened the most, followed by investment grade. The recent back-up in spreads has created buying opportunities in various markets.

In investment grade, the largest upside remains in financials. The recent sell off in high yield also makes it increasingly attractive. Issuance is likely to be a key driver of credit spreads in different markets. We continue to remain positive on credit with expectations that carry and coupons will drive returns moving forward rather than further spread compression.

Property & Infrastructure

Despite a weak June, ending the month down -2.1%, Global REITs have had a positive quarter (+4.6%) and a strong financial year (+36.6%). The asset class has performed well over the past two years, with its strongest recent gains occurring in the second half of 2010.

This month, the US has been the weakest (-3.2%), while prices in the UK demonstrated relative strength (1.2%). Europe ex UK (-1.8%) and Asia ex-Japan (-0.9%) also underperformed.

Global infrastructure produced a return of 0.1% in June, outperforming the global equity market. Infrastructure has returned +2.2% over the quarter, outperforming global equities. This year, however, infrastructure has underperformed equities. The more economically sensitive sub-sectors, including toll roads and logistics underperformed during June while water utilities performed well. M&A activity in the sector has continued and debt financing has been favourable.

Domestic REITs (-0.8%) end the month softer, although outperformed the local equity market and the global REIT market. For the quarter, domestic REITs returned -0.49%, strongly outperforming the domestic equity market. Domestic REITs continue to underperform the global REIT market despite evidence of more attractive valuations and increasing offshore interest.



Alternatives

Hedge funds experienced a difficult month with all major strategies reporting negative returns in June. Macro strategies (-1.8%) led the decline, with performance of trend-following strategies heavily impacted by sharp market reversals across equities, bonds and currency markets. Equity Long/Short strategies (-1.2%) and Event Driven strategies (-1.1%) also posted negative returns while Relative Value delivered a comparatively modest fall in what has been a volatile month.

Commodities were broadly negative with Agriculture (-10.0%) and Energy (-5.5%) falling the most. Crude oil prices suffered heavy falls during the month amid signs of softening global economic outlook and supply increases created by the release of strategic petroleum reserve by the Internal Energy Agency.

Base metals were a mixed story over the month with Aluminium (-5.3%) and Nickel (-2.2%) down, while spot prices for Copper (+1.1%) and Zinc (+2.3%) advanced. These results stem from a steel industry forecast that Chinese steel demand will continue despite persistent fears of monetary tightening.

Gold declined -2.2% in June, but substantially outperformed other commodities and precious metals such as silver (-9.1%). The continuing uncertainties over the resolution of the Greece debt problem and the contagion risk to other European nations are adding to the demand for the commodity, particularly as core government bond yields remain near historical lows. The relative performance of gold reflects a continuing reduction in speculative risk appetite.

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