

Market update – February 2012

Summary

- Retail sales increased in the US and UK showing signs of a tentative rebound
- Default in Greece avoided, leading to a rise in Global and Domestic Bond yields
- The Australian dollar increased mainly due to higher commodity prices and the RBA holding the cash rate at 4.25%

Economic overview

United States

Favourable labour market data has contributed significantly to the recent lift in US economic sentiment. Specifically, non-farm payrolls, a key measure of job creation, posted a strong gain in January (+243,000), significantly exceeding both market expectations and the December (+203,000) result. Significantly, a pattern of consistent gains in each of the 3-, and 6-month moving averages remains intact, while the longer-term 12-month moving average continues to make solid, albeit modest, progress. In aggregate, these data series underscore the growing trend in US employment, highlighted by the unemployment rate falling from 9.0% in September to its present level of 8.3%.

Consistent with an increased level of employment, the headline measure of retail sales posted a rise of 0.4% in January following a flat result in December. Interestingly, a breakdown of the major sales categories revealed a marked reversal in respective gains and losses over the two-month period. In January, weakness was notably evident in the motor vehicles & parts (-1.1%) sector, which had jumped sharply in December (+2.5%).

Elsewhere, general merchandise (+2.0%) and sporting goods (+1.1%) sales rebounded strongly, following surprisingly weak respective results (-0.7% and -0.6%) for the key Christmas shopping period. Interestingly, non-store (-1.1%) sales, which are mostly made online, posted a second successive monthly decline. This represents a sharp

contrast with the situation here in Australia, where consumers have evidently embraced the advent of online shopping. Another interesting aspect of the category breakdown was the consistent pattern of gains in food & drink services (+0.6%) sales. These have advanced in every month since September last year, a record unmatched in any other sector. This is perhaps an indication that US consumers are choosing to shift their discretionary spending towards buying an experience rather than buying goods.

Elsewhere within the US household sector, the respective January measures of both new and existing home sales were significantly influenced by revisions the prior month's result. In the case of new homes, sales slipped by 0.9% to 321,000 units, after the December result was revised up from an initial estimate of 307,000 to 324,000 units. In the case of existing homes, a downward revision of 0.5% to the initial December estimate paved the way for a 4.3% increase in January sales volumes. Encouragingly, both series continued to show signs of a reduction in the glut of unsold homes overhanging the market. Specifically, the respective measures of months' supply of homes available for sale contracted for both new (5.6 from 5.7) and existing (6.1 from 6.4) homes. Furthermore, the improving trend in both measures evidently remains intact, with both having contracted by more than a full month since September last year.

Australia

After falling in each of December (-29,300) and November (-6,300), total employment numbers increased by 46,300 in January. This lowered the unemployment rate from 5.2% to 5.1%. Although positive at first glance, the detail of the result was somewhat less convincing. The lower unemployment rate appears to have been partly driven by job seekers withdrawing from the market. The participation rate in January was 65.3%, down from an average of 65.6% over the course of 2011. Moreover, job creation in the month was largely concentrated in the part-time (+34,000) sector, with comparatively few full-time (+12,300) positions added. Significantly, the measure of part-time hours worked declined by 2.9%, which does not bode well for these positions becoming permanent.

Following a somewhat anaemic performance over the closing months of 2011, retail sales rose by 0.3% in January. A sectoral breakdown revealed strength was concentrated in the hospitality (+4.3%) sector, which encompasses cafes, restaurants and takeaway food outlets. It appears that, in common with their US counterparts, Australian consumers are spending their money on the experience of eating out, as opposed to purchasing physical goods. Further evidence of this apparent tendency was the continuation of the recent weakness in department store (-0.2%) sales. Unsurprisingly, sales at the state level illustrated the ongoing impact of the mining boom. Queensland (+1.7%) and Western Australia (+1.0%) both reported strong growth, in contrast to ongoing consumer caution in New South Wales (-0.5%) and Victoria (-0.4%).

China

Monetary easing highlighted recent economic news flow from China, where the People's Bank of China (PBOC) lowered its required reserve ratio (RRR) for banks by 0.5%. Deutsche Bank suggest this will increase the banks' pool of funds available for lending by approximately RMB420 billion. The PBOC may have hinted at its intention in an earlier statement in which it indicated an objective of ensuring that the banking system "meets the demand for mortgage loans from first home

buyers". The PBOC appears to have looked through an increase in consumer price inflation as the year-on-year rate of growth in China's Consumer Price Index (CPI) accelerated to 4.5% in January from 4.1% previously. It was evident that seasonal factors were at play as the result was largely driven by a spike in food (+10.5%) prices. These typically have a particular upside bias during the winter months, and in this instance demand was probably further boosted by the timing of the Chinese New Year holiday. Elsewhere, non-food (+1.8%) prices rose modestly.

Europe

In Europe, the regional measure of industrial production slipped by 0.6% in December, following a steady result in November. A fall in energy (-1.2%) output was largely to blame, as output of capital (-0.1%) and intermediate (0.2%) goods declined only marginally, while production of durable consumer goods (+0.4%) rose. Compared with the corresponding period a year earlier, overall output declined by 0.9%. Meanwhile, weakness in the Euro, associated with regional financial stress, appears to be having a trade benefit. Goods exports from the broader European Union (EU) to China grew by 21% to €92 billion over the first ten months of 2011, compared to the corresponding period a year earlier. Moreover, export growth has been strong for an extended period, having risen from €26 billion in 2000 to €113 in 2010, the last full year for which results are available. A sectoral breakdown of the latest result revealed that manufactured goods, mainly machinery and vehicles, comprised the vast majority of these exports, with primary products such as food and basic materials accounting for the balance. A national breakdown revealed that almost half came from Germany (48%), which comfortably outpaced the collective contributions of France (11%), Italy (7%) and the UK (7%), who were the next three largest exporters.

United Kingdom

In common with the US, retail sales in the UK are showing signs of a tentative rebound. In volume terms, sales grew for a fourth consecutive month in January, rising by 0.9%. This lifted the year-on-year rate of increase to 2.0%. A notable aspect of the result was that it was highlighted by a 2.1% gain in non-food sales, which implies an increased level of discretionary expenditure. The apparent increase in discretionary expenditure was interesting from the point of view that, somewhat counter intuitively, it occurred against the backdrop of weakening in the labour market. Data for the three months to December showed that UK unemployment rose by 0.1% to 8.4%, its highest level since the three-month period to November 1995.

Japan

Nascent strength in household expenditure was also evident in Japan, where retail sales rose by 4.1% in January. This lifted the year-on-year rate of growth to 1.9%, well ahead of expectations for a decline of 0.1%. Japanese consumers appear to have been further encouraged by the renewal of a government subsidy for the purchase of environmentally friendly cars, as sales rose by 24% over the year. In order to meet this demand, car manufacturers similarly accelerated their output, lifting their year-on-year rate of output to 18.6%.

Asset Sector Review

Global shares

After rising strongly in January, the major international sharemarkets extended their gains in February. In the US, each of the technology-oriented NASDAQ Composite Index (+5.5%), broadly based S&P 500 Index (+4.2%) and Dow Jones Industrial Average (+2.6%) of leading stocks posted gains in excess of 2%. Against a backdrop of improved economic sentiment, stocks were further boosted by generally favourable quarterly earnings reports. With almost all the companies within the S&P 500 Index having reported their results, an analysis by JP Morgan indicates that slightly more than 60% exceeded market expectations.

Beyond the US, markets similarly gained ground over the month. The UK (+3.3%) posted a strong

return, almost matching the Euro Stoxx 50 Index (+3.9%) of leading European stocks, which was buoyed by the multi-party agreement to prevent Greece defaulting on its debt. The gains in the US and European markets nevertheless paled in comparison to the stellar jump in Japan's Nikkei 225 Index (+10.5%), which surged in response to hopes that monetary easing in China would bolster the performance prospects of Japanese exporters.

Australian shares

In contrast to its overseas counterparts, the Australian sharemarket, as measured by the S&P/ASX 200 Accumulation Index (+1.9%) posted a comparatively modest gain. Aside from macroeconomic and sovereign credit developments, news flow over the month was highlighted by results from the quarterly profit-reporting season. Of the companies that have reported to date, those that exceeded expectations (37%) slightly outnumbered those that underperformed (36%) the estimates of JP Morgan. Interestingly, these results represented a reversal of form from the previous period, when those that outperformed were in the minority (36% v 39%).

Commodities and Currencies

The tone of US economic data underpinned a broadly based rise in commodity prices over the month. Crude oil (+12.1%) led the advance, as signs of increased US usage were accompanied by fears of a potential disruption to supplies amid heightened geopolitical tensions associated with Iran's nuclear programme. Base metals (+2.3%) prices rose in response to hopes that the easing in Chinese monetary policy would boost productive activity and lead to an increased demand for commodity resources. The iron ore price underperformed relative to the exchange-traded base metals, as seasonal ordering patterns were impacted by the earlier than usual Chinese New Year holiday.

Higher commodity prices provided the platform for a further advance in the Australian dollar, which rose by 1.0% against its US counterpart. The Reserve Bank of Australia (RBA) contributed to the currency's upward momentum by holding the official cash rate steady at 4.25%, surprising some

currency traders who had factored in an easing of monetary policy.

Fixed Interest

For most of February, attention within the credit and broader financial markets remained firmly fixed on whether Greece would receive the necessary funding to meet a scheduled debt rollover on 20 March and so avoid an uncontrolled default. Greek parliamentary approval of an austerity package collectively negotiated by the country's political leaders, the European Commission, the European Central Bank and the International Monetary Fund paved the way for European finance ministers to determine the finer details of the funding package. The key points were a 0.5% reduction, applied retrospectively, to the interest rate charged by European nations on their bailout loans to Greece, and a pledge to refund any profits made on existing loans. Critically though, private holders of Greece's debt will be required to agree to a 53.5% reduction

in the capital value of their holdings. The ultimate willingness of these investors to accept such losses, and the ability of Greece to fully implement the agreed austerity package, remain potential stumbling blocks.

Against the backdrop of market relief that an imminent default in Greece had been avoided, global and domestic bond yields moved higher over the month. The Commonwealth 10-year bond yield rose from 3.72% to 3.97%, taking its lead from the US 10-year Treasury bond which rose by 10 basis points (bp) to 1.94%. Credit investors were similarly heartened, resulting in the European iTraxx 5-year credit index tightening by 15bp over the month. By comparison, the comparable indices in the US and Australia tightened by 7bp and 17bp respectively.

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