

OCTOBER 2010 – DECEMBER 2010

Cash & fixed interest are generally considered relatively low risk investments when compared to shares and property. Consequently the expected returns are lower, and modest returns are generally made over long time periods. One thing to bear in mind is inflation. For example, if the interest rate earned on a cash investment is 5% p.a. and the annual inflation rate is 3% p.a., the real return is 2% p.a.

## Quarter Review

Earlier in the quarter the RBA surprised markets by holding the cash rate at 4.50% instead of increasing to 4.75% as expected. The release of weaker than expected consumer price data in late October caused the market to underestimate the chance of a rate hike in November. However the RBA did raise the rate to 4.75% in November. Concern over sovereign finances in peripheral Europe continued in the December quarter, prompted Ireland to accept an EUR85 billion support package and raised concerns over contagion to sovereign bond markets in other larger countries. In the meantime, a large rise in headline inflation in China, driven by food prices, raised fears of tightening in policy which could cause a sharp slowdown in growth.

The main development for financial markets in the quarter was the decision by the US Federal Reserve in November to provide additional monetary stimulus in the form of the purchase of US\$600 billion of treasury securities, dubbed 'QEII' by markets.

The US Federal Reserve's decision reflected their dissatisfaction with the pace of the recovery which has thus far been quite weak by historical standards. As the quarter progressed, a run of stronger than expected economic data saw optimism increase about global growth.

Domestically, despite underlying inflation slowing to the middle of the Reserve Bank's target band, the RBA raised rates by 25bps to 4.75% in the quarter. The bank described the move as a pre-emptive modest tightening of policy against rising inflationary pressures caused by the large expansionary shock to the economy from very elevated terms of trade. Subsequently, growth in the Australian economy was reported to have slowed in the September quarter to a soft pace despite a continued surge in mining investment while data shows a marked weakness in retail spending.

## Outlook

Some fund managers believe that a large part of the recently reported weakness in activity reflects poor weather over the Australian east coast rather than a significant softening in underlying momentum. As a result these fund managers expect that the RBA will push rates higher in 2011 as they seek to rebalance the economy in the face of a substantial rise in Australia's terms of trade, and the associated surge in mining investment and employment. However, recent commentary from the RBA, alongside continued poor weather, has seen a push back on expectations for the next move in rates to the middle of 2011.

## A note from our legal team

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