Zenith Monthly Economic Report May 2011

ECONOMIC STATISTICS SUMMARY

	Cash Rate		Inflation Rate (%)		Unemployment Rate (%)		GDP Annual Growth (%)	
Country	**Latest**	**Last Change**	**Latest**	**Change**	**Latest**	**Change**	**Past Year**	**Change**
Australia	4.75	+0.25 (Nov-10)	3.30	↑ 0.60	4.90	↔	2.70	
USA	0.25	-0.75 (Nov-08)	2.70	↑ 0.60	9.00	↑ 0.20	2.30	↓ 0.50
Japan	0.10	-0.20 (Nov-08)	0.00	↔	4.60	↔	2.20	
UK	0.50	-0.50 (Feb-09)	5.30	↓ 0.20	7.80	↓ 0.2	1.80	↑ 0.30
China	6.31	+0.25 (April-11)	5.40	↑ 0.5	NA		9.70	↓ 0.10

AUSTRALIAN ECONOMIC COMMENTARY

On May 3, the RBA Board left interest rates on hold at 4.75% despite rising inflation figures. The Board stated last month that they anticipated a rise in the consumer price index during the March quarter after food prices were pushed higher by the floods. This proved to be correct, with the CPI rising to 3.30% for the year. However their statement highlighted that the current figures are primarily influenced by short term trends. The Board expects many of these temporary price shocks to dissipate, resulting in the CPI falling to within the target range by the end of the year. Furthermore the Board highlighted that credit growth and lending particularly in the household sector, remains subdued, alongside softening housing prices and restrained spending.

Over the last few months, the relative strength of the Australian dollar has been a key consideration in RBA rate decisions. The strength of our dollar against the US dollar cushions the inflationary impacts of rising oil prices. This helps hold down prices of consumer products. A high dollar also reduces the cost of imported goods, giving Australian businesses greater purchasing power. However at current record levels, the exchange rate creates a double edged sword which has the potential to widen the 'two speed' economy. For industries that are driven by exports, such as manufacturing, the dollar's rise has the potential to cut margins and profits even further. Some foreign exchange analysts are tipping the 'Aussie' could go as high as $US1.30 over the coming year, meaning affected industries will need to readjust to longer term expectations of a high exchange rate. Given many commodities such as oil and gold are US dollar denominated, this will actually reduce commodity prices for those who buy them in alternate currencies and may lessen impact of inflation.

So what does this mean for investors? We would expect consumer exposed sectors, namely retail and manufacturing, to be further hurt by the double whammy of restrained consumption and weaker export competitiveness. We also expect that international tourism will be adversely affected. Offshore investors may decide to lock in profits and sell their Australian investments which could potentially result in continued underperformance of Australian equities relative to the rest of the world.

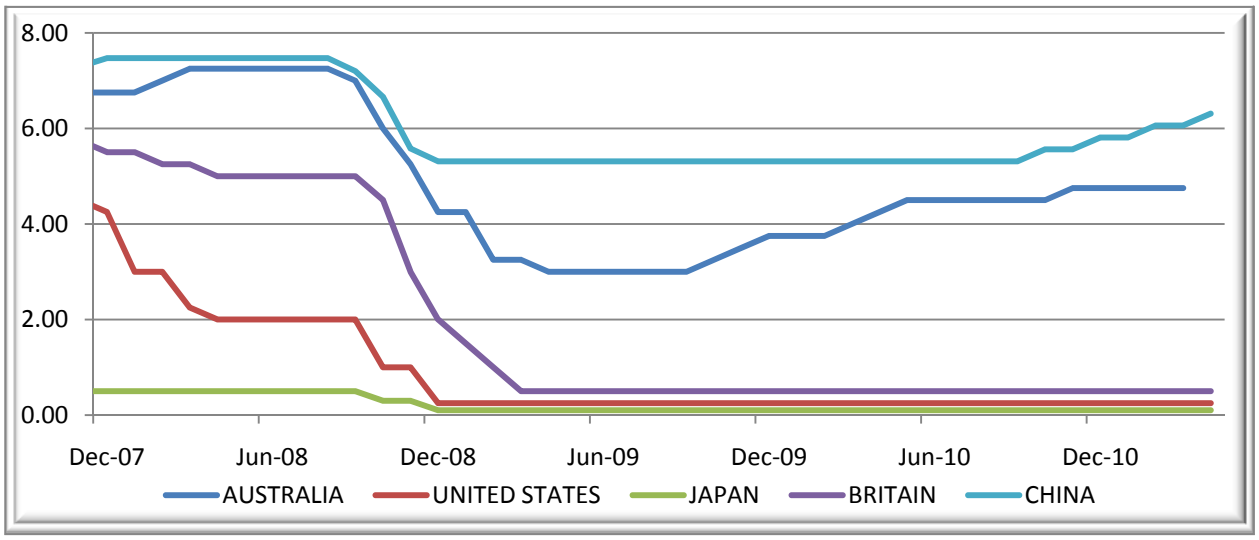
GLOBAL ECONOMIC COMMENTARY

Last month **China** pre-empted the release of official inflation data, raising rates prior to the announcement. This proved to be a portentous move as the release showed inflation rising 0.5% whilst annual GDP growth fell back slightly to 9.7%. The mild fall in GDP indicates that measures to cool the economy are not having their full effects. Continuing high commodity and oil prices, as well as food prices continue to take their toll. New data shows that poverty levels are actually increasing in China and other developing nations as urbanisation continues - an unintended consequence of development caused by inflation and cost of living pressures.

Surprisingly, the **UK** showed signs of improvement with all the key metrics moving in the right direction. Inflation fell slightly as did unemployment, although both remain high in absolute terms. Annual GDP rose slightly from a low base. Whilst this is all positive news, but only it is only weakly positive. Can it be sustained? The unemployment data was certainly better than expected given the public sector job cutbacks. But on the downside, British manufacturing activity grew less than expected in April falling to its slowest pace in seven months. A sharp slowdown in new orders cast a cloud over what has been a rare bright spot in the UK economy.

Fears of impending weakness in the **US** economy are beginning to mount. Annual GDP fell unexpectedly after the growth rate almost halved in the first quarter of 2011 on the back of rising oil and gasoline prices. The US is the world's largest consumer of oil, and the rapid price rises are taking their toll, particularly on consumers. As mentioned above, most commodities are denominated in US dollars. This means that rising commodity prices have a greater impact on the US than they do in nations with a stronger currency. As a result of these cost pressures, the US services sector grew at its slowest pace since August 2010 whilst the ISM pulled back slightly from its record highs. Whilst the US non-farm payroll data showed around 244,000 new jobs were added, this was not enough to offset unemployment rising back to 9.0%. Whilst inflation is widely tipped to rise over the year, cash rates are expected to remain on hold for the foreseeable future in order to encourage growth.

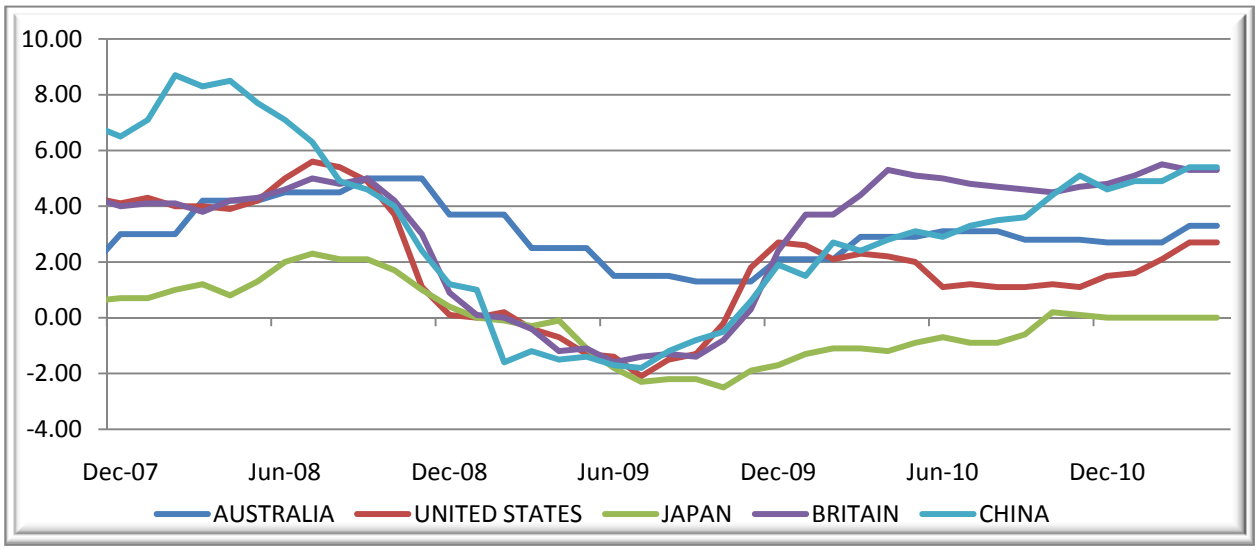
CASH RATES



In April the People's Bank of China raised rates another 25 basis points, pre-empting the inevitable inflation rise.

Elsewhere, rates remain flat despite inflation rises in Australia and the US. Australia's central bank put the inflation down to short term and unpredictable events, declining to raise rates and adopting a more longer term approach. In the US, a concerning and unexpected fall in GDP provided a strong reason to leave rates on hold.

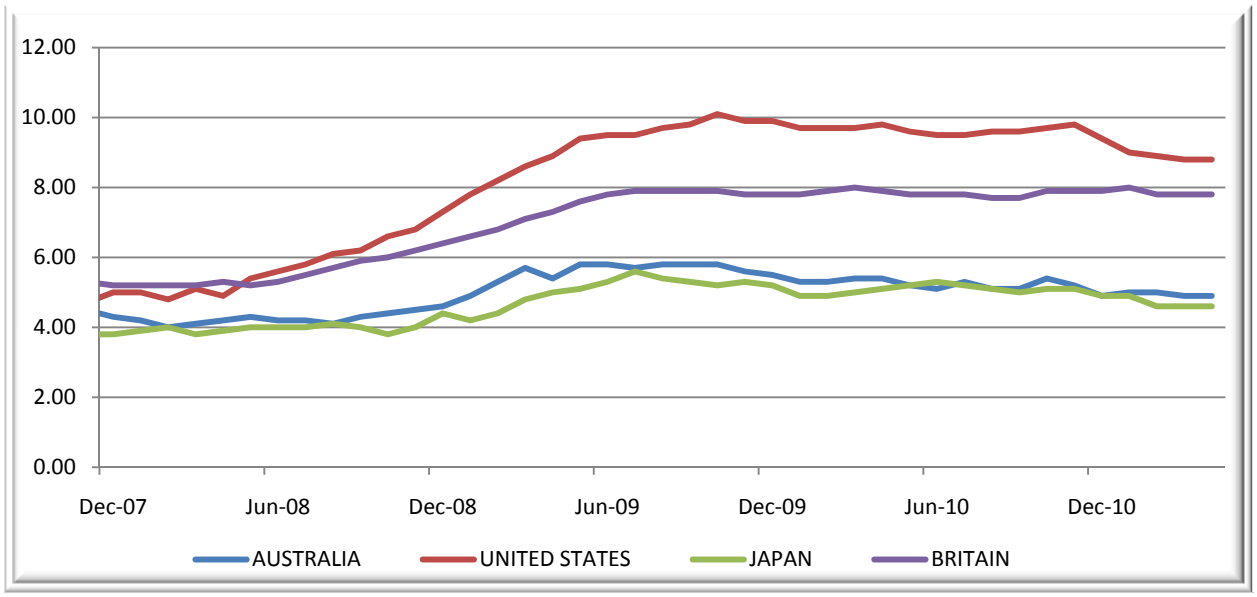
INFLATION RATES (ANNUALISED)



Inflation rates remained flat in Japan, and fell slightly in the UK although they remain very high on both a relative and an absolute basis.

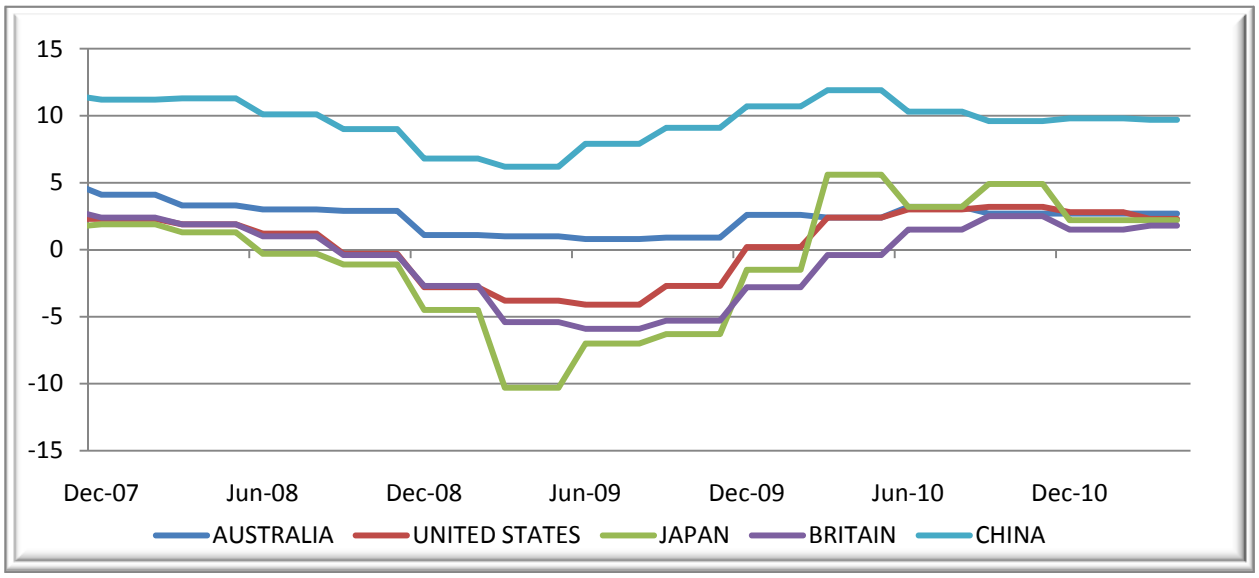
In Australia, China and the US inflation rose in line with general expectations. Whilst inflation is rising in Australia and China as a by-product of strong economic growth, sadly this is not the case in the US. Inflationary pressures are instead being exerted by rising oil prices, which are in turn starting to impede growth.

UNEMPLOYMENT RATES



US unemployment data rose back to 9.0% despite the addition of 244,000 new jobs. Rising inflation and cost pressures on employers are being blamed for the data. The services sector also grew at its slowest rate since August. This sector is one of the largest employers in the US, and this alone may be enough to account for the rise in jobless figures. Elsewhere, unemployment remained in a steady state in Japan and Australia. UK unemployment figures dipped below 8%, although the graph above suggests that this has a historically tended to return to the medium term average.

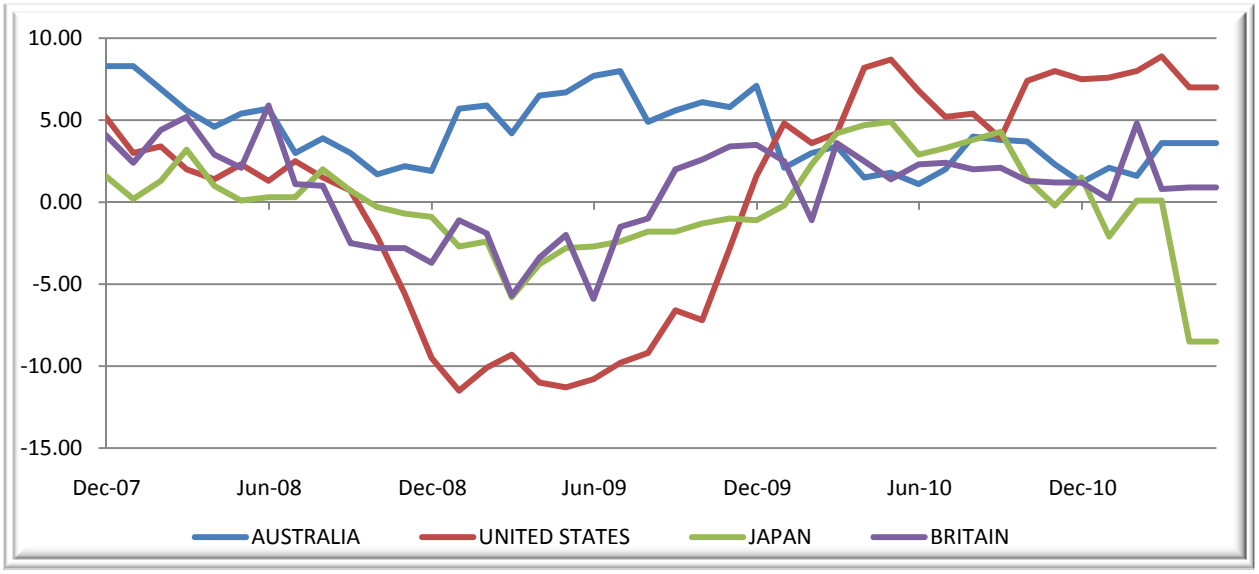
GDP GROWTH (ANNUAL)



Annual GDP figures for the US fell unexpectedly. This has been attributed to weaker than expected growth in the first quarter of 2011. The economy slowed when a spike in oil and petrol prices combined with higher inflation and continued weakness in the housing market. GDP rose at an annual rate of 1.8% for the quarter, a significant slowdown from the 3.1% growth rate in the final quarter of 2010 spurred on a dominant Christmas retail market. Economists still expect US growth to reach 3.1% this year, although the risk is on the downside given the US is the world's largest consumer of oil and its derivative products.

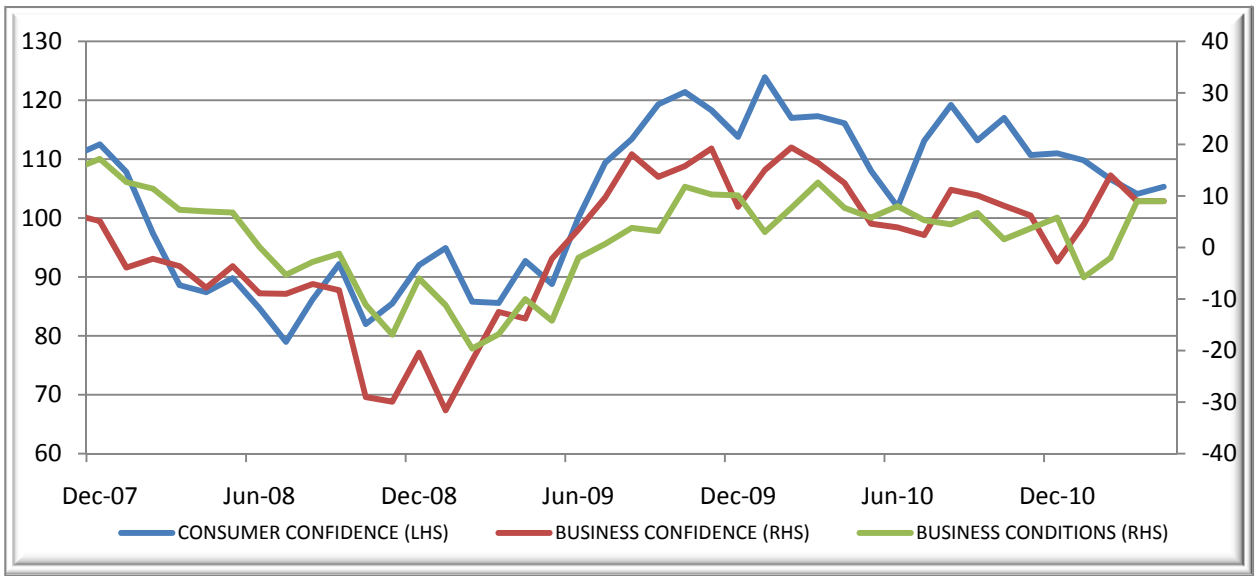
China released its first seasonally-adjusted quarter-on-quarter GDP data. At 9.7%, this showed only the slightest softening and China is still expected to grow at a rate of 9.6% in 2011 as the nation continues to invest in fixed assets. Growth improved slightly in the UK, rising 0.3% from a low base whilst the Australian GDP is forecast to fall to 2.5% this year.

CHANGE IN RETAIL SALES – ROLLING 12 MONTH CHANGE



Japan recorded the largest fall in year-on-year retail sales in 13 years. The data is the first indicator of the tsunami's effect on Japan's consumption levels. Australian retail sales were much weaker than expected in the first quarter. Retail sales fell 0.5% in March, against consensus expectations for a rise of 0.5%. Whilst consumer confidence improved slightly, the stronger dollar is further fuelling the trend towards internet shopping. In the UK, retail sales volumes rose but not as much retailers expected. Rising commodities prices have been blamed for taking a larger portion of the household budget. A similar story of consumer constraint exists in the US, where retail sales have been hampered by rising commodity prices, the automotive industry worst hit.

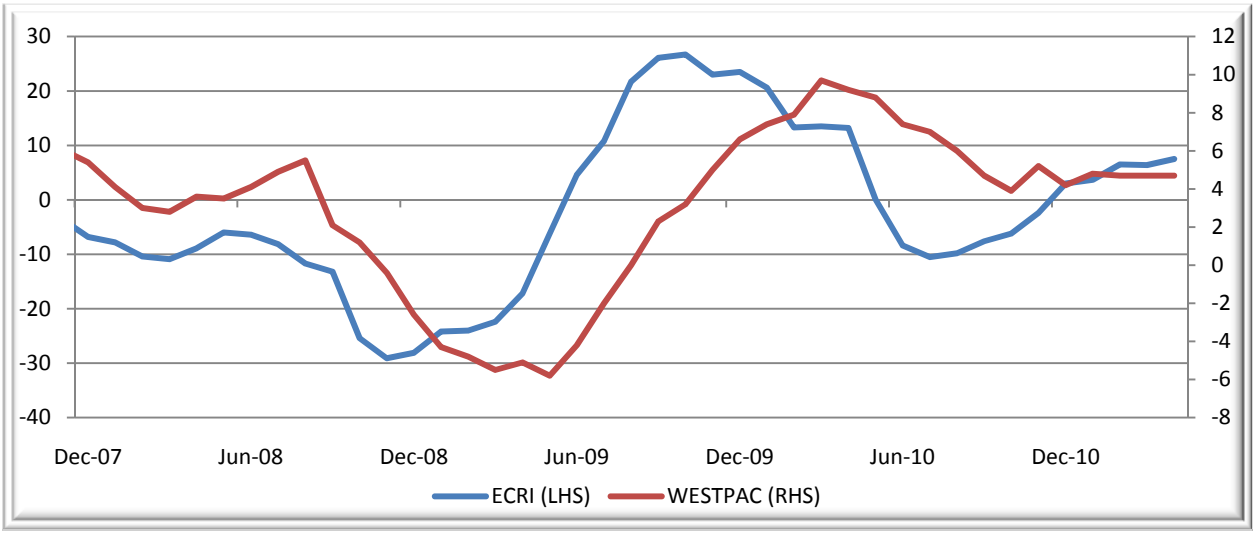
CONSUMER & BUSINESS CONFIDENCE / CONDITIONS



Consumer confidence rose by 1.2% in April after a fall of 2.4% in March. Households have recently been exposed to both positive and negative sentiment, resulting in only a mild rise. Positive influences on the consumer include the steady cash rate, the high Australian dollar and the low unemployment rate. This has however been tempered by exogenous economic shocks including ongoing turmoil in the Middle East and North Africa.

After the floods subsided, the NAB business conditions survey recorded a marked improvement in business conditions, with the overall level rising to its highest point since March 2010. Unfortunately business confidence declined in March although it remains positive and above trend. Interestingly, the two are currently closely aligned.

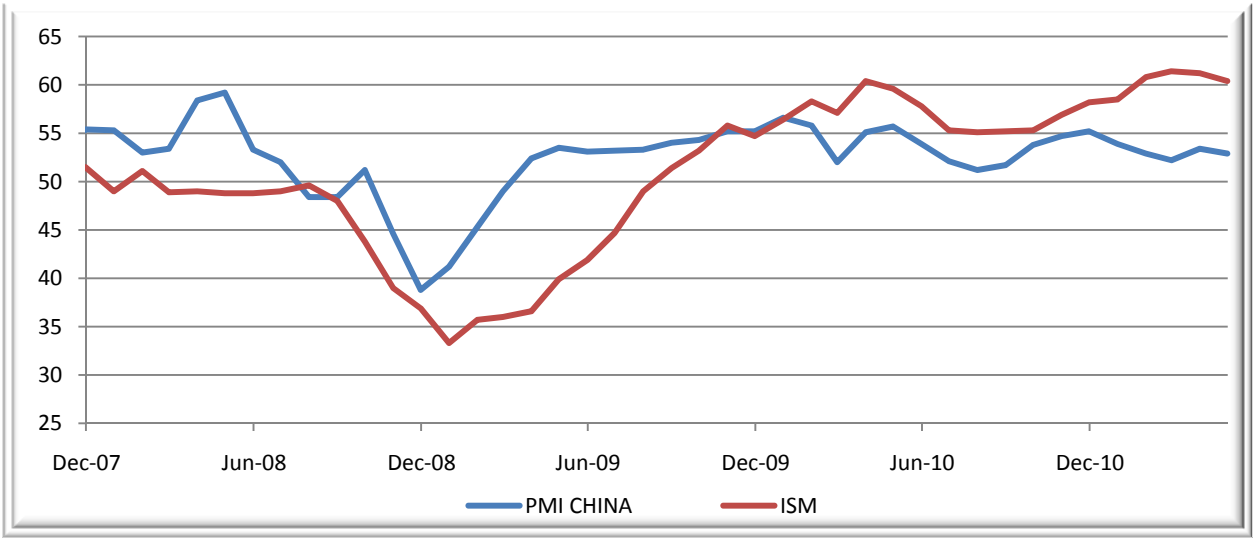
LEADING INDICATORS - WESTPAC LEADING INDICATOR (AUST) & ECRI WEEKLY LEADING GROWTH RATE (US)



The Westpac Leading Index indicates the likely pace of economic growth 3 to 9 months into the future. The index has risen to 4.70 from 3.50, indicating that sentiment is positive for above trend growth over the coming year.

The ECRI Weekly Leading Growth Rate is a predictor of economic growth in the US. It is the earliest economic figure released each week and is therefore closely monitored. The latest data shows an upturn to 7.50, which does not correlate with current negative data trends and may indicate that a more positive picture is expected in the future.

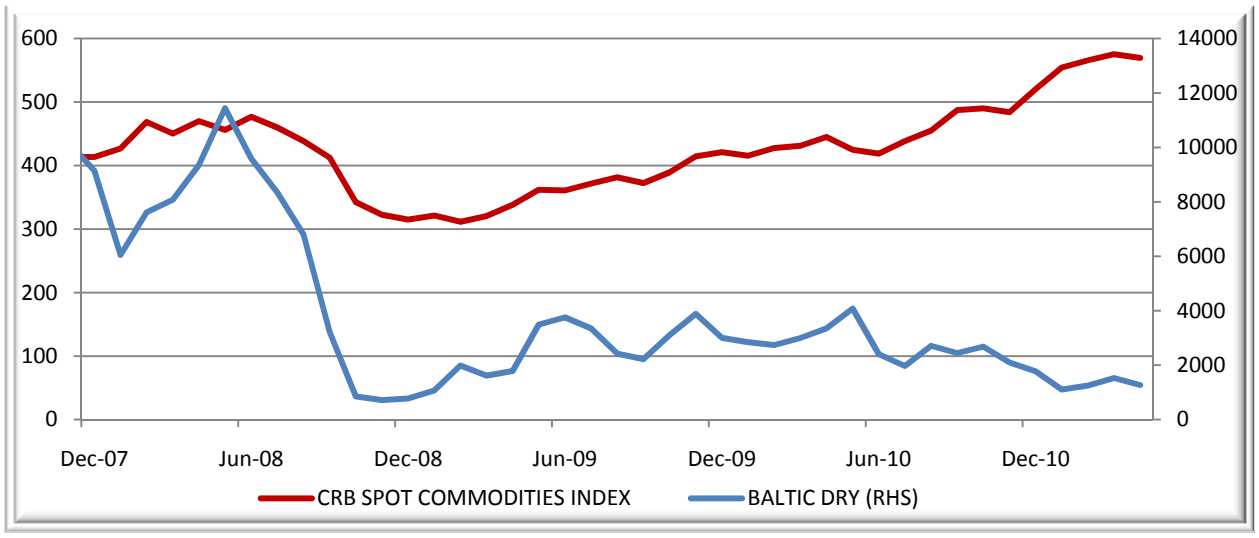
LEADING INDICATORS – MANUFACTURING DATA: ISM (US) AND PMI (CHINA)



The ISM Manufacturing Survey asks its member companies to contribute data that rates US manufacturing activity levels. The manufacturing sector contributes close to 11% of total GDP. After the ISM peaked in the first quarter at an 18 year high, it has pulled back slightly. At 60 it remains in strongly positive and expansionary territory, remaining the key to the US economic recovery.

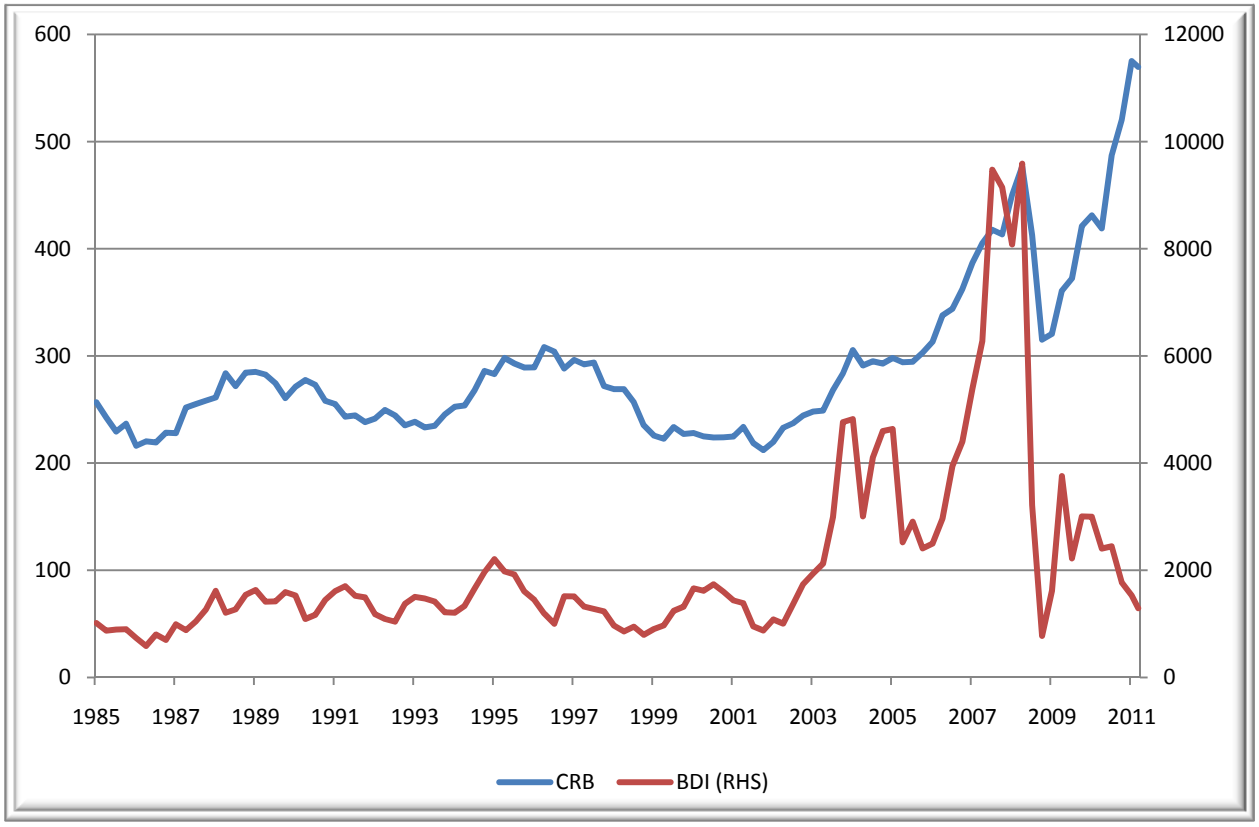
The Purchasing Managers Index (PMI) is China's manufacturing index. This leading indicator is often regarded as the bellwether for industrial activity in the People's Republic. Like the ISM, values over 50 indicate economic expansion; values below 50 indicate economic contraction. The PMI continues to fall although it remains in expansionary territory. No clear short term trend has yet been established.

LEADING INDICATORS – BALTIC DRY INDEX & CRB SPOT COMMODITIES INDEX



The Baltic Dry Index (BDI) tracks international shipping prices for various dry bulk cargoes. As the supply of ships is relatively inelastic, the BDI indirectly measures global supply and demand for shipped bulk commodities such as coal, iron ore and building materials. Since it measures demand for raw materials, it is regarded as a leading economic indicator of future growth.

To use the downward trending BDI in isolation as a proxy for global growth would be an inaccurate (and frightening) proposition. Looking at it alongside the CRB Index presents an interesting pattern. The CRB Spot Commodities Index measures spot price movements for 22 basic commodities which are highly sensitive to changes in the economic cycle. As such, it serves as an early indicator of impending changes in business activity. Whilst the CRB Index continues to reflect extremely strong demand for commodities, the main graph highlights the increasing divergence of the BDI and the CRB. Historically, these two indices are highly correlated over the long term as shown in the graph below:



Why the divergence? Shipping can easily be affected by price rises, lowering the demand for raw materials. As a result the BDI tends to lead the CRB by a few months. However, the divergence suggests a decoupling of price and demand. Some commentators have suggested that there has been a structural shift to higher commodities prices, particularly given that minerals and oil are a finite resource and that current high consumption levels are unsustainable over the long term. Have commodities prices simply realigned to a new normal? Certainly as the developing nations continue to progress, the demand for finite resources and food will present a number of challenges to the world, both politically and economically.

Author:

Angela Burmeister
Investment Analyst

Zenith Investment Partners

(03) 9642 3320
angela.burmeister@zenithpartners.com.au

DATA SOURCE: BLOOMBERG

BLOOMBERG DATA SERIES

CHART	BLOOMBERG DATA SERIES
CASH RATES	Australia RBA Cash Rate Target
	Federal Funds Target Rate US
	Bank Of Japan Target Rate of Unsecured Overnight Call Rate Expected
	UK Bank of England Official Bank Rate
	China 1 Year Best Lending Rates
	ECB Main Refinancing Rate
CPI	Australia CPI All Groups Goods Component YoY
	US CPI Urban Consumers YoY NSA
	Japan CPI Nationwide YoY
	China CPI YoY
	UK RPI YoY NSA
GDP	Australia GDP SA YoY
	GDP US Chained 2005 Dollars YoY SA
	Japan GDP Real Chained NSA YoY%
	UK GDP Chained GDP at Market Prices YoY
	China GDP Constant Price YoY
UNEMPLOYMENT	US Unemployment Rate Total in Labor Force Seasonally Adjusted
	Australia Labor Force Unemployment Rate SA
	Japan Unemployment Rate SA
	UK Unemployment ILO Unemployment Rate SA
RETAIL SALES	Australia Retail Sales YoY SA
	US Adjusted Retail & Food Services Sales Total Yearly % Change SA
	Japan Retail Trade YoY NSA
	UK Retail Sales All Retailing Sales Per Week Chained Volume YoY SA
HOUSE/LAND PRICES	Australia House Price Index Established Homes YoY 2003-2004=100
	S&P/Case-Shiller Composite-20 City Home Price Index YoY (US)
	Japan Land Prices Nationwide All YoY%
	UK Nationwide House Prices All Houses YoY NSA
	China Land Transaction Price YoY
HOUSING APPROVALS	Australia Building Approvals Dwellings YoY
	US New Privately Owned Housing Units Started by Structure Total SAAR YOY
	Japan Housing Starts YoY NSA
HOUSEHOLD CONSUMPTION	Australia GDP Final Consumption Expenditure Households QoQ SA
	Eurostat GDP Constant 2000 Prices Eurozone Household Consumption Expenditure QoQ
	Japan GDP Chained Real Private Consumption QoQ% SA
	UK GDP Final Consumption Expenditure Chained Prices Household Expenditure QoQ
	GDP US Personal Consumption Chained 2005 Dollars % Change SAAR
COMPANY PROFITS & BUSINESS OUTLOOK	Australia Comp Gross Operating Profit QoQ Chg Seasonally Adjusted
	National Quarterly Business Survey Business Confidence Outlook SA
CONSUMER & BUSINESS CONFIDENCE	Westpac-Melbourne Institute Consumer Confidence Consumer Sentiment
	National Australia Bank Business Indicators Business Confidence SA
LEADING INDICATORS	Baltic Dry Index
	CRB Spot Commodities Index
	ISM Manufacturing PMI SA
	Manufacturing PMI China
	Australia Westpac Leading Index Annualised Growth YoY%
	ECRI Weekly Leading Index Growth Rate

DISCLAIMER: *This report is prepared exclusively for clients of Zenith Investment Partners (Zenith). The information contained in the report is believed to be reliable, but its completeness and accuracy is not guaranteed. Opinions expressed may change without notice. Zenith accepts no liability, whether direct or indirect arising from the use of information contained in this report. No part of this report is to be construed as a solicitation to buy or sell any investment. The material contained in this report is subject to copyright and may not be reproduced without the consent of the copyright owner.*