Quarterly Market Commentary as at 31 December 2010*

Market Indices	Returns as at 31 December 2010						
	1 mth (%)	3 mth (%)	6 mth (%)	1 yr (%)	3 yr (% p.a.)	5 yr (% p.a.)	10 yr (% p.a.)
Australian Shares							
S&P/ASX 200 Accumulation Index	3.66	4.38	12.77	1.57	-5.02	4.32	8.40
International Shares							
MSCI World ex Aust Net Index (AUD)	0.32	2.88	1.77	-2.04	-9.82	-4.45	-4.02
Australian Fixed Interest							
UBSA All Maturities Composite Bond Index 0+ Yr	0.03	-0.19	1.08	6.04	7.43	5.76	5.88
International Fixed Interest							
Citigroup World Govt Bond 100% Hdg (AUD)	0.01	-1.09	2.17	7.95	8.34	7.18	7.65
Property							
S&P/ASX 200 A-REIT	1.21	-1.31	2.49	-0.41	-20.92	-9.50	2.31
Cash							
UBSA Bank Bill Index	0.42	1.24	2.46	4.66	5.23	5.69	5.47
Currency							
Australian Dollar ($A/$US)	6.88	5.87	21.36	13.98	5.30	6.92	6.31

Australian Shares

The Australian share market performed relatively well in the final quarter of 2010. The S&P/ASX 200 Accumulation Index climbed 4.4% during the period, which lifted returns into positive territory for 2010 as a whole.

In October, global equity markets were buoyed by hopes that the US would complete another phase of Quantitative Easing in an attempt to boost economic activity. Generally favourable Australian economic data also supported the domestic share market. Indeed, the recent performance of the Australian economy has been strong enough to prompt the Reserve Bank of Australia (RBA) to continue with its interest rate tightening cycle; the official cost of borrowing was increased by 0.25% to 4.75% in November. All of the major banks raised their lending rates by a greater margin than the official rate hike by the RBA. These moves were unpopular with borrowers but improved margins in the banking sector.

The performance of the Australian dollar also remained a key focus for investors during the period. The Australian dollar traded at a 1:1 parity with the US dollar for the first time since 1982 in October and remained close to that level for the remainder of the quarter. This trend is unhelpful for Australian listed companies which derive a portion of their earnings overseas, as the value of their offshore earnings is diminished when they are repatriated into Australian dollars.

QR National completed its much-publicised IPO in November, and a series of other corporate deals were announced. Westfield Group demerged its Australasian and international businesses, for example, while a number of companies announced takeover approaches or acquisitions. Further corporate activity is anticipated in 2011.

International Shares

The MSCI All Countries World Index rose 8.7% in USD and 2.7% when measured in AUD. Over 12 months, the index returned 12.7% in USD terms and -1.2% in AUD. Over both the quarter, gains in the Australian dollar detracted from local returns for local investors with the dollar appreciating 5.9% to $US 1.0251.

International sharemarkets rallied in the quarter on further policy action in the US, mergers and acquisition activities and improving economic conditions. This did lead to improved risk appetite and signs that investors could begin to reallocate funds into the equity market in 2011.

US equity markets were driven higher by improving US economic data, the announcement of a second quantitative easing and sound company fundamentals. Corporate profitability remains at solid levels with cash balances at record highs, the next step for US companies will be to deploy capital, either through capital investment or labour hiring, helping to stimulate the US economic recovery further. US equity markets surpassed Global Financial Crisis (GFC) levels, with the S&P 500 returning to levels last seen before the collapse of Lehman Brothers. Over the quarter the S&P500 (+10.2%), the Dow (+7.3%) and the NASDAQ (+12.0%) all finished higher. Over the 2010 calendar year, the S&P 500 returned 12.8%.

Markets in Europe were mixed with performance largely correlated with each countries' macroeconomic and debt position. Germany was a standout performer, with the DAX rising 11.0%. The German export and manufacturing sectors have been performing well, driven largely by the weaker euro and many years of efficiency gains. In contrast Spain (-6.2%) and Greece (-3.3%) both fell, while the Irish stock market finished the quarter up 8% on the bailout announcement. The UK FTSE 100 rose 6.3%. Results over 2010 were similar, Spain finished down 17.4%, while the DAX returned 16.1%.

Asian markets were generally stronger, although there were some differences in individual performance. The Nikkei rose 9.2% after falling in the September quarter. Gains were largely driven by the weakening Yen, which is good news for major exporters. The Bank of Japan did cut rates early in the quarter to a target of 0% - 0.1%. In other Asian markets, Singapore (+3.0%) and Hong Kong (+3.0%) rose but underperformed the likes of South Korea (+9.5%), Thailand (+5.9%) and Taiwan (+8.9%).

On a sector basis, the Materials (+17.7%) and Energy (+16.3%) performed well driven by sharp acceleration in commodity prices. The oil price rose 14.3% over the quarter to $US 91.4 a barrel driven by improvements in the global economy and stronger demand. The Materials sector was driven by similar factors with commodity prices rising sharply, particularly copper (+19.8%), lead (+11.9%) and zinc (+11.8%). The gold price rose 8.5% in the quarter given continued sovereign debt issues in Europe, finishing at $US 1418.8 an ounce.

Australian Fixed Interest

In Australia, domestic economic data released during the December quarter was mixed. Ten-year bond yields rose by 54 basis points to finish the quarter at 5.51%, boosted by strong employment data and improving global economic data releases. The UBS All Maturities Composite Bond Index returned -0.19% in the quarter and 6.04% over 12 months. The negative returns over the quarter were driven by the sharp rally in yields. In the shorter end of the market, the UBS Australia Bank Bill Index returned 1.24% in the quarter and 4.66% over 12 months. The returns from this index reflect interest earnings on short term money market securities with annual returns rising given lifts to the official cash rate over 2010. Ninety day bank bills finished the quarter relatively flat, although traded with considerable volatility. Over the quarter yields reached as low as 4.74% in mid October before reaching 5.12% in mid December and finished the quarter at 5.04%.

The RBA lifted interest rates by 25 basis points in the quarter to 4.75%. The move in November was prompted as the balance of risks, particularly for inflation shifted to the upside. The RBA assessed that an early tightening was necessary. Inflation concerns are also top priority for the RBA, with expectations that the current rate of inflation is the low point and will drift higher given the very low capacity in the economy. The focus by the RBA continues to be on the medium-term growth outlook for the Australian economy due to historically high terms of trade. Interest rate was then left on hold in December. Further interest rate rises are likely in 2011 as mining investment and the terms of trade stimulate the Australia economy, however the timing of moves and the extent will largely be determined by the unfolding economic outlook and the sovereign debt situation in Europe.

International Fixed Interest

The fourth quarter of 2010 proved to be a difficult one for global bond markets, particularly in the developed world. A significant upturn in global bond yields occurred, with US ten-year treasury yields increasing sharply by 73 basis points to finish the year at 3.25%. This was the largest quarterly rise since June 2009, despite the US Federal Reserve announcing a second round of quantitative easing on November 3.

Improving US economic data releases contributed to stronger investor risk appetite over the December quarter, which undermined US bonds, as did concerns over the extension of the “Bush era tax cuts”, which are likely to add to the burgeoning US fiscal deficit. Despite the announcement of a second round of quantitative easing, in which the US Federal Reserve was expected to undertake approximately US$75 billion of bond purchases per month, buying activity subsided towards the end of the quarter. The US ten-year yield spiked by 73 basis points to finish the quarter at 3.25%. The Federal Open Market Committee retained its funds target range at 0.00%-0.25%. The Committee stated that the economic recovery is continuing though “at a rate that has been insufficient to bring down unemployment”.

In Europe, investors remained focused on continued sovereign debt concerns, particularly among the peripheral eurozone countries. Bond yields amongst the southern European economies rose on debt concerns while Bonds moved with the global pattern of higher rates, finishing the quarter at 2.96%, from 2.28% at the end of September 2010.

Australian Property (including Listed and Direct)

The Australian listed property market underperformed the broader equity market in the December quarter. The S&P ASX 200 Property Accumulation Index fell 1.3% for the quarter and finished the calendar year down 0.4%.

The calendar year was marked by a number of capital raisings and mergers and acquisitions activities. In terms of mergers and acquisitions activities, the three major transactions in 2010 were Mirvac Group’s acquisition of Westpac Office Trust, Goodman Group’s acquisition of ING Industrial Fund and Stockland Group’s acquisition of Aevum.

The major news in the A-REIT sector late in the quarter was the restructure of Westfield Group. The shopping centre operator demerged its Australasian assets from the remainder of its interests. Two separate entities are now listed on the Australian share market.

While the sector remained well capitalised during the quarter, new issuance is beginning to take place. As credit markets improved throughout the quarter, REITs took the opportunity to extend and diversify their funding sources through bond issuance, predominantly in Australia.

From a global perspective over the quarter, returns were very mixed. The UBS Global Property Investors Index (local currency) increased 6.8%, with Japan the top performing region, with the UK, Germany and US also recording positive gains. Over the calendar year, the global listed property market returned 22.5%, driven predominantly by Germany, US, Canada, Japan and Hong Kong.

Cash

Inflation data released for the September quarter indicated headline inflation rose by a less-than expected 0.7%/qtr (0.8% expected), with the annual pace retreating to 2.8%, from 3.1%. The pace of underlying inflation also moderated, to 0.55%/qtr and 2.4%/yr, lower than expected and also below the RBA expectation of 2.75%. Much of this was driven by the strength in the Australian dollar and weakness in food prices. Despite the weaker than expected report, the RBA did still lift interest rates over the quarter, believing the current inflation rate is at the bottom of the cycle and will rise from here.

As we look into 2011, yields will be impacted by offshore factors, largely the pace of expansion in the US economy, the impact from the second round of quantitative easing and the US government debt outlook. Domestically the drivers are likely to include the pace of capital expenditure and mining investment and any interest rate moves by the RBA.

Currency

The Australian dollar rose against most major currencies in the December quarter. The Australian dollar is being supported by a sound domestic economy, further interest rate rises by the RBA and commodity price gains. Risk appetite also improved over the quarter and this saw the Australian dollar move through parity to finish the period at $US1.0251, up 5.9% over the quarter. Over 2011 the AUD could come under some pressure given improvements in the US economy and delays to Australia’s move to above-trend economic growth.

In terms of moves against other major currencies, the AUD rose 6.9% against the sterling, 3.1% against the yen, and 7.9% against the euro. The AUD fell 0.2% against the NZ dollar. At the end of December 2010, the AUD was buying 1.3128 New Zealand dollars, 83.06 yen, 0.6562 UK pence and 0.7652 Euros.

Over 2010, policy makers raised concerns about volatile currency moves with interventions by various central banks later in the year. Much of this was to support export sectors or reduce volatile capital flows. Japan, Brazil and South Korea have intervened to lower the value of the currency while debate continues to surround the future of the Chinese Renminbi.

***Source:** This commentary has been prepared by Colonial First State Investments Limited ABN 98 002 348 352 AFSL 232468 and is general information only.