

May 2011

‘We believe the investment climate remains sound, but we are closely watching the debt situation in Europe as this could affect economic growth.’

Craig Turnbull
Chief Investment Officer



Share markets react to high debt levels in Europe

Share markets fell in May, partly in response to rising concern among investors over the European debt crisis and the risk that it could slow down global growth.

The Australian share market fell by 2.38%, with the weakest sectors being Financials and Consumer Discretionary. Overseas, share markets also declined with some of the European markets suffering the most.

The cause of the European debt situation

Governments and banks often raise funds by issuing debt investments such as bonds. This form of borrowing from investors is referred to as debt financing.

In the financial crisis of 2008 and amidst concern over rising government deficits and debt levels, many large banks struggled to repay borrowings and had to be rescued with public funds to avoid a collapse of the financial system, causing the debt problems faced in Europe today.

In the European Union, Greece, Ireland and Portugal currently have very high levels of debt and there is widespread investor concern over whether they will be able to service their borrowings.

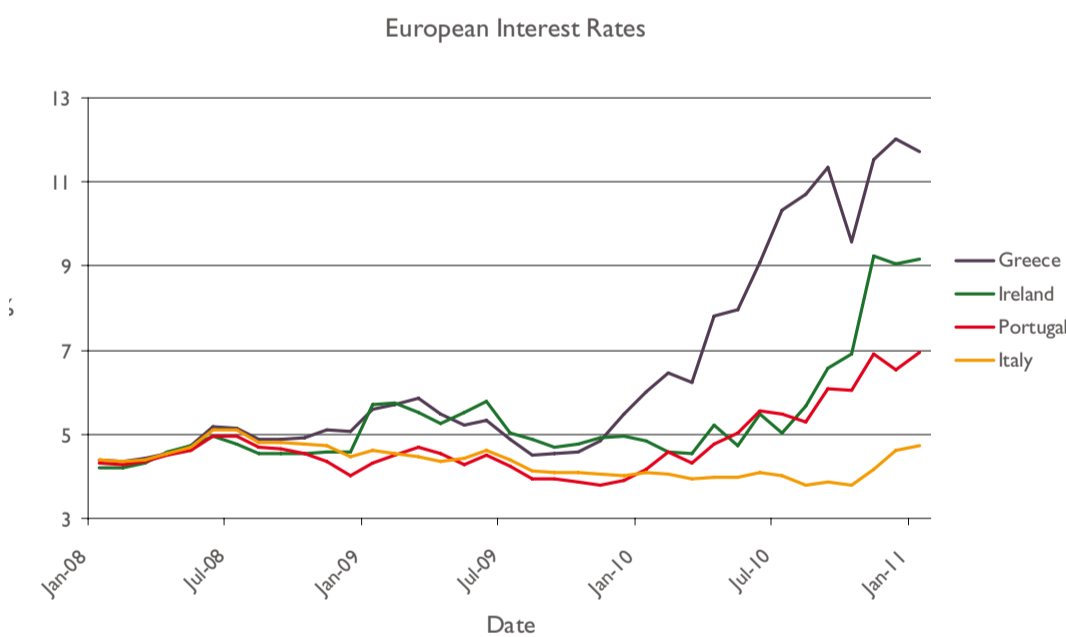
As part of the European Union, these countries get the benefit of sharing the euro currency, but for this privilege they are supposed to limit their budget deficits.

Why are investors concerned?

These problems raised concerns with investors that several European governments may not be able to honour their debt commitments.

The fear is that interest payment or maturities may be delayed or reduced, a concept sometimes referred to as sovereign debt risk. As a result, potential investors have started to demand a higher interest payment to buy new government bonds from these countries.

The chart below shows how the cost of debt has risen for some of the affected European Union nations:



Source: OECD

Notice how interest rates among these countries were all very similar until the start of 2009 when investors started to be concerned with sovereign debt risk.

When investors demand higher interest rates on new debt, this only compounds the budget problems these economies are already facing and can result in a disastrous debt spiral.

As a result, the European Union and the International Monetary Fund were forced to bail out Greece and then subsequently rescue Ireland and Portugal as well.

As part of the rescue terms, these countries have had to commit to a reduction in government spending, a measure which is further hurting these economies.

The longer term outlook

Fortunately, the larger economic regions in North America and the developing nations, such as China and India, remain on a gradual recovery path.

While we believe the investment climate remains sound, we are closely watching the situation in Europe to make sure the problems do not spread too widely and have an impact on economic growth in other regions.

Markets at a glance

for the month ending 31 May 2011

- ↓ Australian shares¹ down by **2.38%**
- ↓ Australian Government Bonds² down to **5.21%**
- ↓ Australian dollar down to **US\$1.0709**
- Cash rate³ steady at **4.75%**
- ↓ International shares⁴ down by **2.32%**

1 ASX 200
2 Yield on 10 year Australian Government bonds
3 RBA cash rate
4 MSCI – World ex Australia