HCAP Market Commentary

25 May 2012

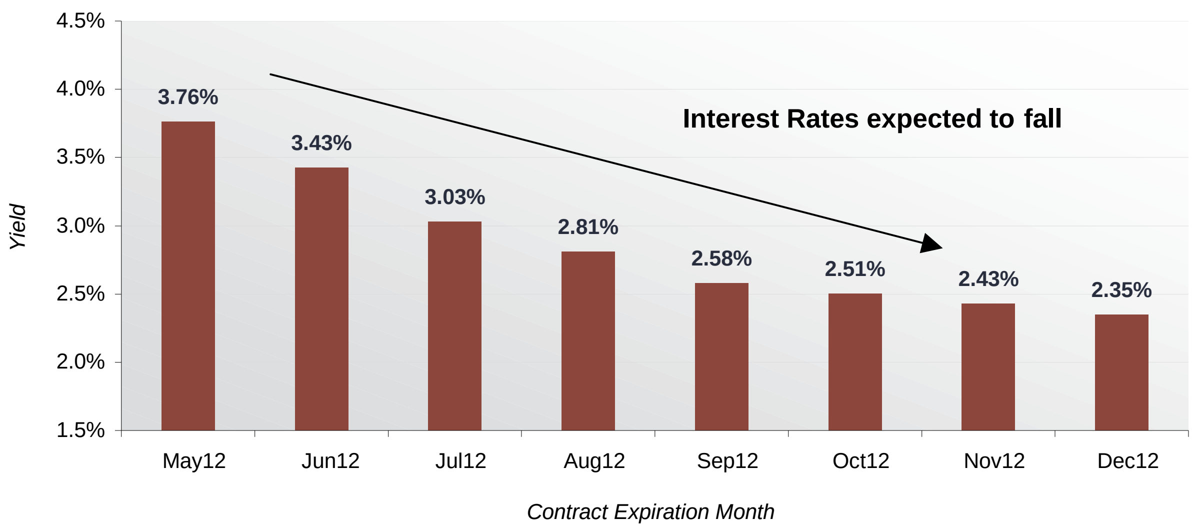
The chilling head winds of Europe's economic debt crisis continue to set the scene, causing ongoing volatility and uncertainty in global investment markets. At the time of writing, the AUD was trading down at 0.9750 (down from 1.0430 at the end of April) and equities have lost a massive 7.50% in the month of May so far.

Investors fear that Europe's leaders are not addressing the real issues at play, rather they are simply "kicking the can down the road". This is not helping investor sentiment.

Despite Australia's better relative economic fundamentals, Australian markets are intrinsically linked to the global economy. A bright light for investors though has been the safe haven performance of government bonds. Bonds have rallied strongly in the face of such uncertainty, but in our view are now looking fully priced. Three-year government bonds now offer investors a shabby 2.36%, whereas 10-year bonds offer a yield of 3.13%. Investors seeking yield need to look further afield.

Looking at what the Futures Market tells us about interest rates looking forward, the following chart highlights a very interesting picture. Despite the recent 50 basis point rate cut by the Reserve Bank some weeks ago to 3.75%, from 4.25%, the futures market is signalling further aggressive cuts to come. By December this year, the market is saying that cash rates will be cut set to 2.35%. If rates were cut to 2.35% as implied in the futures market, this would equate to the lowest rate on record for 60 years.

30 Day Interbank Cash Rate Futures



Steve Howell – CEO, HCAP Asset Management, www.hcap.com.au

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