

30 April 2010

The Markets

International Equities

World equity markets were mixed in April

Global equity markets experienced mixed performance in April. The MSCI All Countries World Index (ex Australia) gained 0.34% in local currency terms, while in unhedged Australian dollar (AUD) terms the return was -1.2%. Most markets started the month strongly; however this was reversed in the latter part (especially in Europe) as the Greek sovereign debt crisis and fear of contagion weighed on sentiment.

The Greek crisis outweighed the impact of good global economic data released throughout the month, including encouraging releases from Europe and the US.

Cyclical sectors outperformed in April, with consumer discretionary (+3.6%), industrials (+2.4%) and energy (+2.2%) strong. Healthcare again lagged, down 3.3%, and materials were also down 1.8%. Regulatory issues caused a sell-off in US investment banks, leading financials down 0.5%.

Not unexpectedly, the European countries at the centre of sovereign debt concerns experienced sharp falls through April. Greece was down 9.9%, Portugal down 7.2% and Spain down 3.1%. Denmark (+7.6%), Singapore (+3.7%) and the US (+1.6%) posted better performances. There were large moves in Ireland (+10%) and Finland (-7.4%); however in each case this was driven by a single stock that dominates the country index. Emerging market countries were slightly weaker than developed. Egypt (+10%) and Morocco (+6.1%) were the noteworthy performers while Israel (-6.7%) and Brazil (-3.9%) sold off.

Outlook: April also saw continuing improvement in economic fundamentals in the US and Europe, supporting earnings expectations and valuations. Inflation expectations continue to be low, which also supports valuations.

Overall, our confidence in valuations increased over the course of the month. Fundamental earnings improved and increased the probability that the markets' high expectations will be met. In addition, the favourable interest and inflation-rate environment remained intact. However, in this low-inflation, low-interest-rate and high-earnings-growth environment, equity valuations are very sensitive to changes in investors' risk aversion. A drop in confidence can lead to significant market corrections, as we experienced at the end of April and beginning of May. The probability of this type of event will remain higher than normal in coming months.

At the time of writing, world equity markets had reversed the sharp falls seen at the beginning of May, following agreement on a sizeable "stability package" for the Euro area. Our view is that the current sovereign debt crisis will not spark a second global financial crisis (GFC). The size of the stability package means that the peripheral European governments will not have to access debt markets for sovereign financing for more than a year. Consequently, the immediate liquidity issue, which would have been the catalyst for contagion to the European banking system, appears to have been dealt with. However, the austerity measures in various countries, necessary to reduce the budget deficit and ensure long-term debt sustainability, are likely to lead to even weaker European growth than would have been the case otherwise. European growth is currently recovering from the deep 2008-09 recession and should remain low over the medium term.

Australian Equities

Domestic equities declined

For the second month of 2010, the ASX200 declined, falling 1.3% in the March quarter. The ASX200 was down 1.4% for April as the resources sector, while starting the month on a strong note, ended April 4.1% weaker. Investors were concerned about the risk of China moving to tighter monetary policies, the possible global growth impact of fiscal strain in Europe and the possibility of a windfall tax on mining profits. These external negative factors outweighed good domestic macroeconomic news. While retail sales fell, employment rose by a further 19,600, keeping the unemployment rate at a relatively low 5.3%. The NAB survey of business conditions pointed to a strong business sector.

Outlook: Over the next couple of months, the Australian equity market is likely to remain focused on monetary policy in the Asia-Pacific region, the fallout from the Greek rescue package and the outcome from the Henry Tax Review. Australian economic data continued to beat consensus expectations. Further rates rises are expected from the Reserve Bank of Australia (RBA), as the Board believes that growth is likely to be around trend and inflation close to target over the coming year. This will place pressure on households' disposable income which, along with the removal of the stimulus package, will adversely impact the retail sector. We expect this to lead to buying opportunities as the medium-term outlook is not so negative.

The resources sector is also expected to weaken as it contends with the prospect of a cooling Chinese economy and digesting the impact of the Henry Review, where a 'super profit' tax of 40% will be imposed by the Federal Government. While there was weakness in resource stocks in April, it will take the market some time to fully digest the true impact of the proposed new tax.

While the Australian economy is less dependent on the performance of the European economy, general market weakness from that zone is likely to continue to flow through to market sentiment in Australia. This will add to any market volatility in the near term.

Global Fixed Interest

Global long bond rallied in April

Global long bonds rallied through April as equity markets produced mixed performance. After last month's sell-off, the yield on 10-year US treasuries came in 17 basis points (bps) to 3.65% while Australian 10-year bonds moved 7 bps lower to 5.71%. The ongoing Greek sovereign debt crisis continues to support German bunds, with a flight to quality keeping yields low at 3.02% (from 3.09% at the end of March). Breakeven inflation (traded via ZCS markets) moved higher in the US; however it was flat in Australia and drifted lower in Europe.

In line with equity market moves, US credit spreads moved tighter throughout the month. The high-yield spread is 5.48%, a fresh two-year low, while investment-grade credit is 1.43% above similar duration US treasuries. Emerging market credit spreads widened somewhat over the course of the month.

The RBA Board raised interest rates by 25 bps to 4.25% in early April, continuing the tightening cycle that began in October with rates at 3%. With strength in the domestic economy, global growth expected to be at trend and inflation consistent with targets, the Board decided to move rates closer to their long-term average. Cash returned 0.35% for the month.

Outlook: Despite the impressive acceleration in US growth and growing confidence regarding the enduring nature of the upswing, we believe that core inflationary pressures will continue to surprise to the downside in coming months. The extraordinary amount of excess slack in the economy that opened up during the recession will take some time to work off, even with a strong growth recovery.

Recent economic indicators in Europe have been positive; however, the Eurozone recovery is likely to lag that of most major economies. Recent sovereign debt problems and the potential for even greater fiscal austerity programmes in

peripheral countries reinforce our view that the European Central Bank (ECB) will raise rates later than most other G10 central banks.

The trend of declining default activity was supported in April with only two defaults. Year-to-date there have been 18 companies that have defaulted, which compares to 60 over the same period last year. The declining trend in defaults, strong earnings, accelerating gross domestic product (GDP) growth and robust capital market conditions all support the outlook for credit. Away from the European peripheral sovereigns, underlying economic fundamentals, company profits and balance sheets are supportive. Investors worldwide remain hungry for yield. Furthermore, credit spreads are not expensive relative to the underlying default and downgrade risks. We therefore remain positive about the medium-term outlook for credit.

In Australia, we continue to anticipate further official increases in the cash rate over coming quarters, with the cash rate rising to 5% by the end of the year and around 5.5% by 2011.

Currencies

Currencies were little changed in April

During April, the global economy continued to improve and companies reported strong profit growth, leading to a modest rally in both bond and equity markets. Currencies were little changed, with a fall of less than 2 per cent in the Euro against the USD and a rally of less than one per cent in the STG and AUD against the USD. However, events in Europe in the first week of May have overshadowed this relatively supportive environment for asset prices. The Euro fell by a further 4 per cent against the USD, bond yields in peripheral European countries rose sharply and equity prices collapsed as sovereign default risk spiked as ratings agencies downgraded debt in several European countries.

Rising sovereign default risk in Europe has been a constant weight on the Euro over the last six months, resulting in a 16 per cent fall in the currency since its peak in early December 2009. The fall in the Euro is only slightly less than that experienced during the post-Lehmann rise in risk aversion which saw the USD and Yen strengthen sharply in late 2008. In fact, the level of the USD/Euro exchange rate reached on 7th May of 1.26 was only marginally above the trough in the Euro reached during the post-Lehmann fallout (1.25). Our estimates of long term valuations suggest this level is around the midpoint of the fair value range for the Euro, but our cyclical forecasts suggest it is likely to be near the trough in the short term. It also seems to be a level that has sparked European policymakers into taking significant action.

Data continue to show Asian economies are leading the global upswing. With little spare capacity in the region, the increase in demand has been met with upward pressure on commodity prices, leading authorities to begin the process of removing stimulus in several countries, including China and India. In Australia, the RBA raised rates by 25 basis points for the third consecutive month in May, taking the cash rate to 4.50 per cent. This should continue to support the AUD in the near term, despite the currency being overvalued relative to its longer-term fundamentals. Other commodity-exporting countries are also benefiting from the strength in commodity prices. Increases in official interest rates are imminent in Canada and New Zealand, while we have now seen three 25 basis point increases from the Norges Bank since the end of last year, the latest being in early May.

Outlook: The AUD remains above long-run estimates of fair-value, such as those based on purchasing power parity (PPP). Despite this, it is likely to remain around USD\$0.90 over coming months as increasing interest rate differentials, stronger relative growth prospects and an improvement in commodity prices continue to support the currency.

Following its fall over the last six months, the Euro has moved from being overvalued to being within its fair value range against the USD. Our PPP estimates suggest that the Yen, STG and CAD also remain within their fair value ranges against the USD.

Financial markets (%)

Sharemarkets	Level as at 30-Apr-10	1 month return	3 month return	Financial YTD return	1 year return
Australia (S&P/ASX 200)	4807	-1.38	6.54	25.58	32.38
Developed World (MSCI World ex Aust.)	867	0.34	8.97	25.94	32.95
World (MSCI AC World ex Aust.)	330	0.31	8.60	26.07	33.87
US (S&P 500)	1186	1.58	11.05	31.23	38.84
UK (FTSE 100)	5553	-2.02	8.27	34.38	35.85
Europe (MSCI Europe ex UK)	917	-1.56	4.75	24.28	28.68
Japan (Topix)	987	0.84	10.51	7.89	19.63
Currencies					
Australian Dollar/US Dollar	0.93	1.42	4.73	15.14	26.70
Australian Dollar/Euro	0.70	3.20	9.47	21.46	26.26
Australian Dollar/Yen	87.51	2.04	8.60	12.19	21.06

Sharemarket returns are inclusive of dividends, in local terms.

Economist's View

Key Points

- The return of risk aversion – will the EU debt crisis spark GFCII?
 - Solid global economic data – US private-sector spending takes the lead
 - Australian policy-makers take centre stage – RBA raises rates, Henry Tax Review released
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International Economies

The return of risk aversion – will the EU debt crisis spark GFCII?

Recent movements in global financial markets have been dominated by renewed concerns about sovereign default risk among peripheral European governments. The slide in sentiment began with a revision to the Greek budget deficit and a downgrade of Greece's credit rating by Moody's. The crisis built as rating agency Standard & Poor's downgraded Greece's credit rating to junk and also cut the credit ratings of Portugal and Spain from A+ to A- and from AA to A-, respectively. At the same time, Germany balked at approving the European Union (EU) and International Monetary Fund (IMF) rescue package in the face of voter opposition and the proximity of State elections. In the first week of May, protests over the Greek government's fiscal austerity package, combined with the EU's perceived lack of urgency to deal with the crisis, sparked a sharp spike in risk aversion across global financial markets. In response, EU members and the IMF were forced to arrange a €750 billion loan package to support fiscal consolidation of member nations in an attempt to restore financial market confidence in the region.

Events in Europe have led many commentators to draw parallels between the current sovereign debt crisis and the global financial crisis (GFC) of 2008-09:

- A large entity on the brink of insolvency (Lehman Brothers/Greek government)
- Failure by policy-makers to show decisive action to avoid debt default (US Federal Reserve (Fed) and Treasury/Greek government and EU)
- Potential for contagion to other institutions (banking system/other peripheral European governments)
- Potential for systemic risk to the banking system in developed economies (predominately US, UK and Europe during the GFC, predominately Euro area in the Greek sovereign default crisis)
- Increases in financial market risk premia spreading the impact across all global economies

Our view is that the current sovereign debt crisis will not spark a second GFC. First, although the formulation of policy in the EU is cumbersome, the threat of contagion to the European economic and financial system has been sufficiently strong that the size of the stability package means that the peripheral European governments will not have to access debt markets for sovereign financing for more than a year. Consequently, the immediate liquidity issue, which would have been the catalyst for contagion to the European banking system, appears to have been dealt with. However, even with risk premia subsiding, the shock to financial markets over the first half of this year is likely to have taken a toll on Euro area economic growth prospects, and potentially global economic growth prospects. Simulations conducted with our global macroeconomic model indicates that if the recent spike in financial market risk premiums were sustained for another quarter, real gross domestic product (GDP) growth in 2010 and 2011 would be lowered by 0.5 per cent in the Euro area and around 0.2 per cent globally.

Solid global economic data – US private-sector spending takes the lead

Turmoil in global financial markets has overshadowed a generally positive flow of global economic data over the month. Overall, the data was consistent with ongoing strength in the Asian and US economies, but continued underperformance in the European region.

National accounts data for the first quarter of 2010 showed a US economy growing at an above-trend rate of 3.2 per cent (quarterly seasonally adjusted annualised rate (qsaar)). Importantly, strong contributions to growth came from consumer spending (3.6 per cent qsaar) and investment in equipment and software (13.4 per cent qsaar). The shift in the contribution to growth away from public sector spending to private sector spending in the US bodes well for the sustainability of the recovery once fiscal stimulus is unwound.

National accounts data for the Chinese economy was also released over the month and showed real GDP to be 11.9 per cent higher in the first quarter of 2010 than in the same period last year. Growth was driven by strong domestic spending, including strong contributions from urban fixed investment and retail sales. The ongoing strength in domestic demand has prompted the People's Bank of China to increase the reserve requirement ratio of Chinese banks and has forced officials to introduce further restrictions to cool the housing market. Elsewhere in the region, March quarter GDP in South Korea and Singapore exceeded expectations, while data from Japan showed signs of robust consumer spending and an ongoing recovery in industrial production.

In contrast, data from the Euro area was mixed. Industrial production was generally stronger than expected and business sentiment surveys indicated an ongoing recovery in activity. However, the consumer sector remains weak, hampered by a 10 per cent unemployment rate.

Interest Rate Forecast (%)

	Level at 10 May 2010	Jun-10	QIC forecast Sep-10	Mar-11
Australia	4.50	4.50	4.75	5.00
US	0.00 - 0.25	0.00 - 0.25	0.50	1.00
Canada	0.25	0.25	0.50	1.50
Europe	1.00	1.00	1.00	1.25
UK	0.50	0.50	0.50	1.00
Japan	0.10	0.10	0.10	0.10

Australian Economy

Policy-makers take centre stage – RBA raises rates, Henry Tax Review released

Policy-makers took centre stage in recent weeks, with the Reserve Bank of Australia (RBA) lifting the cash rate and the Federal government releasing the Henry Tax Review. At their May meeting, the RBA raised the cash rate by 25 basis points (bps) to 4.5 per cent, citing recent increases in coal and iron ore prices as the catalyst behind the move. Further rate hikes are expected, although with the cash rate now at the RBA's declared average level, future hikes are expected to be more gradual.

Despite the RBA raising interest rates quite aggressively in the past eight months, conditions within the Australian housing market have remained more resilient than expected, with dwelling approvals rebounding in March and house prices up nearly 5 per cent for the quarter. In contrast, rate hikes have already impacted consumer spending, with retail volumes nearly flat in the March quarter.

In addition, the Federal government released the Henry Tax Review and its response to the Review's recommendations. So far, the government plans a limited response to the Review's 138 recommendations. The key policy initiatives announced by the government in response to the Review include the introduction of a 40 per cent tax on the abnormal

profits of mining companies (called the Resource Super Profits Tax (RSPT)), the reduction in the corporate tax rate from 30 per cent to 28 per cent and an increase in the compulsory employer superannuation contribution from 9 per cent to 12 per cent. Markets reacted negatively to the RSPT, with the share prices of Australia's two largest miners, BHP Billiton and Rio Tinto, falling 8 and 9 per cent, respectively.

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