QIC Outlook
Market & Economic
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30 April 2009

The Markets

International Equities

Market optimism grows

Global share markets extended the rally that began in March to produce another month of strong gains in April. Investors took heart from strong first quarter profits for some US banks (Wells Fargo and Goldman Sachs) and economic data that pointed to an improving global economy, the so-called 'green shoots'.

Policy makers remain committed to supporting the financial system and the economy. The US Federal Reserve (Fed) and the Bank of England (BoE) continued their quantitative easing efforts. The European Central Bank (ECB) is considering such policy. In the US, further progress towards restructuring the key auto-makers was made, with plans for a merger between Chrysler and Italian auto-maker Fiat being finalised. Investors have also been focused on the upcoming results of the US Treasury's stress-tests for bank capital adequacy.

The major developed share markets ended the month sharply higher. The US and UK markets gained 9.67% and 8.49% respectively, while Japanese equities were up 8.29% for the month. Europe ex-UK shares outperformed other markets, ending the month up 14.91%. Hedged international shares gained 10.64% in April.

Outlook: Equity valuations currently appear quite attractive on a number of measures, though sentiment has significantly improved. However, investor caution may return given the likelihood of sharply lower earnings. Evidence that policy measures are beginning to take effect and an exhaustion of selling pressures could allow the rally to continue.

Australian Equities

Australian market up on global optimism

The Australian market gained 5.57% in April as risk appetite amongst investors improved on better-than-expected economic data. Compared to the strong performance put in by other major markets, the local market underperformed in comparison; a stronger Australian dollar (AUD) and the realisation that the Reserve Bank of Australia (RBA) may be nearing the end of its easing cycle provided some headwind. Industrials generally outperformed, while banks underperformed, weighed down by increasing provisions for bad debt as the prospect for consumer credit worsens.

Outlook: There are a number of factors that should support Australian shares: reasonable valuations, high dividend yields, lower cash rates and the fact that banks are relatively well capitalised compared to global peers. However, valuations are not as attractive as in other markets, and there are risks to resource earnings as the global economy remains weak.

Global Fixed Interest

Bonds weaker on supply and fiscal concerns, better economic outlook

Despite the promise of low interest rates by a number of key central banks, global bond yields were higher over the month on the flow of improved economic data, increased supply and concerns over fiscal deficits in a number of countries. The US 10 year bond yield ended the month higher at 3.13%. Australian 10 year bond yields were also higher, ending the month at 4.57% on reduced expectations of further rate cuts by the RBA. The return on the Barclays Capital Global Aggregate Index was 0.64% (hedged) in April.

Outlook: Bonds are reasonably valued once the outlook for a prolonged period of lower interest rates is factored in. The RBA is likely to keep rates lower for longer. Quantitative easing by the US and UK central banks, and the prospect of the ECB doing so too, should keep bond yields low.

Currencies

Australian dollar stronger on improved risk appetite

The flow of better-than-expected economic data and the sharp rally in global share markets also saw risky currencies rally strongly, as investor risk appetites improved over the course of the month. The US dollar (USD), previously lauded as a safe haven currency, weakened against a number of major currencies. The euro also lost ground, weighed down by investor concerns over the structural integrity of the European Monetary Union. The Japanese yen (JPY) was also weaker on the month, as the Japanese economy continues to deteriorate. The AUD rallied strongly against other major currencies, ending the month at US$0.74. A number of factors helped support the AUD, including a paring back of market expectations for interest rate cuts, as well as increasing investor optimism for a more resilient Chinese economy. Returns on foreign currency exposure were -5.03%.

Outlook: We see the AUD as close to its fair value, but it remains exposed to further concerns about the global growth environment. The outlook for the USD is now more mixed, valuations are less attractive and the proposed bailout plan has contradictory implications for foreign investors' perceptions of US assets. We expect the euro to weaken as weaker growth drives expectations for eventually lower interest rates.

Financial markets (%)

Sharemarkets	Level as at 30-Apr-09	1 month return	3 month return	Financial YTD return	1 year return
Australia (S&P/ASX 200)	3780	5.57	8.78	-24.24	-28.82
World (MSCI World ex Aust.)	665	10.50	6.77	-30.45	-35.17
US (S&P 500)	872	9.67	6.57	-30.20	-35.26
UK (FTSE 100)	4243	8.49	3.93	-21.78	-27.21
Europe (MSCI Europe ex UK)	738	14.91	7.56	-28.50	-35.46
Japan (Topix)	837	8.29	6.81	-35.14	-36.94
Currencies					
Australian Dollar/US Dollar	0.73	5.74	15.54	-23.44	-22.04
Australian Dollar/Euro	0.55	5.95	11.73	-8.97	-8.40
Australian Dollar/Yen	72.28	5.33	26.57	-28.94	-26.60

Sharemarket returns are inclusive of dividends, in local terms.

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Economist's View

Key Points

- Global growth outlook stabilises at a low level
- Risk aversion continues to recede, but remains elevated
- Australia to outperform other advanced economies

International Economies

Global growth outlook stabilises at a low level

Recent economic data indicates that a turning point in the global economy has been reached. While the data continues to suggest a contraction in activity in coming quarters, the pace of decline is slowing from the rate experienced in late 2008 and early 2009. Tentative evidence has emerged of a stabilisation in household demand in the US, with consumer spending rising in the March quarter and a modest improvement in confidence in recent months. The fiscal package should also help support real disposable incomes in coming months, although spending is expected to remain subdued given the weak labour market and expected continued rise in the unemployment rate. Nonetheless, there are emerging signs that the pace of job layoffs will soon begin to slow. Furthermore, the downturn in the housing market appears to be bottoming, with sales and starts relatively stable since the beginning of the year.

The pace of contraction in other advanced economies also appears to be abating, while the strongest sign of an improvement in economic conditions is emerging from Asia. Estimates of quarterly growth in China picked up in the March quarter, with further recovery expected in the June quarter. Policy stimulus continues to support Chinese domestic demand, with urban fixed-asset investment accelerating in March due to continued growth in government-influenced investment and a rebound in property investment. Industrial production rebounded significantly in March and business confidence, as indicated by the Purchasing Managers' Index (PMI) survey, has improved sharply since November. Elsewhere in Asia, the South Korean economy was flat in the March quarter after a sharp contraction in late 2008.

Risk aversion continues to recede, but remains elevated

Financial markets have recorded substantial improvements in recent weeks, with major equity markets rallying by around 35% since their low-point on 9 March and market volatility, as measured by the volatility index (VIX), reaching its lowest point since late September 2008. Debt markets have also seen an improvement, with interbank spreads and corporate bond spreads continuing to narrow from their peaks. The reduction in risk aversion has also contributed to the rally in the AUD to above US$0.75.

The reduction in risk aversion has been associated with a concerted effort by policy-makers to reduce the risk of a systemic failure in the global financial system. This has culminated with regulators declaring that nearly all of the 19 largest US bank holding companies "*have sufficient Tier 1 capital to absorb the unusually high losses*" associated with an adverse economic environment. However, regulators require ten of the firms to raise additional common equity (or restructure their existing capital structure) over the next six months, with a total $75 billion of common equity required.

In our view, recent data and market movements are consistent with our outlook that global growth reached its low point in the first quarter of 2009 and will improve over the remainder of the year and into 2010. However, the recovery in growth will not be swift. For example, we expect negative quarter-on-quarter gross domestic product (GDP) growth in the US economy in the first half of 2009, and modest positive growth rates in the second half of the year.

Interest Rate Forecast (%)

	Level at 08 May 2009	Jun-09	QIC forecast Sep-09	Mar-10
Australia	3.00	3.00	2.50	2.50
US	0.00 - 0.25	0.00 - 0.25	0.00 - 0.25	0.00 - 0.25
Canada	0.50	0.50	0.50	0.50
Europe	1.00	0.50	0.50	0.50
UK	0.50	0.50	0.50	0.50
Japan	0.10	0.10	0.10	0.10

Australian Economy

Australia to outperform other advanced economies

The Australian economy contracted for the first time in eight years in the December quarter, with real GDP falling 0.5%. With activity set to contract again in the March quarter, the Australian economy is experiencing its first recession since 1990/91. While the economy is feeling the fallout from the global financial crisis, activity has been cushioned by the sharp improvement in our trade balance over recent quarters following the large depreciation of the AUD. Indeed, partial trade data suggest net exports will continue to make a significant contribution to GDP growth in the March quarter, with the decline in imports outstripping the fall in exports.

Consumer spending has remained more resilient in Australia than in other advanced economies, supported by significant and timely policy stimulus. After falling in the first half of 2008 due to high interest rates, retail sales have rebounded in the past three quarters, with sales up an impressive 1% in the March quarter. Consumer spending is expected to remain resilient in coming months as the Government's $900 handouts flow through to the economy, although spending is likely to be relatively subdued over 2009/10 due to falling real disposable income as a result of declining employment and moderating wage growth.

Conditions in the labour market unexpectedly improved in April, with employment rising by 27,300 jobs and the unemployment rate falling from 5.7% to 5.4%. Nonetheless, conditions are expected to deteriorate further, with the unemployment rate forecast to rise to around 7% by the end of 2009 and above 8% in 2010. This sharp build in excess capacity is expected to lead to a significant softening in wage growth.

The consumer price index (CPI) data for the March quarter provided a mixed message on inflationary pressures within the Australian economy. Headline inflation rose a modest 0.1% over the quarter, with the year-ended rate slowing to 2.5% from 5% in the September quarter 2008. Falling petrol prices and a sharp fall in prices for deposit and loan facilities were largely responsible for the weak result, with these two components detracting around one percentage point from quarterly growth. Underlying inflationary pressures remained evident, with the average of the weighted median and trimmed mean measures up 1.1% over the quarter and 4.2% over the year. Underlying inflationary pressures are expected to moderate in coming quarters due to softening wage growth as labour market slack builds.

The RBA left interest rates unchanged at 3% in May and, combined with recent positive data, the market has significantly pared back expectations of further cuts. We continue to expect that the weakening inflation outlook will force the RBA to cut rates to 2.5%, although the next move is now expected in the second half of the year.

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