

The Markets

International Equities

Global shares marginally higher despite renewed focus on credit

Most share markets managed gains over the month, with the reduction in inflationary concerns from falling oil prices offsetting weaker global economic data and renewed concerns over the prospects for financials.

The oil price continued to fall, finishing the month around US \$115 per barrel. This, combined with weaker growth, saw interest rate expectations scaled back outside of the US. However speculations regarding the possible government bail-out of Freddie Mac and Fannie Mae refocused attention on the lingering impact of the credit crisis on financial stocks and growth.

Of the major markets, the UK outperformed (+4.9%), helped by a sharply weaker Sterling, while the Japanese market declined 3.7%. The US market rose 1.4% while Europe ex-UK shares gained 1.3%, assisted in part by weakness in the Euro. The expected boost to consumer spending from the fall in energy prices drove the consumer discretionary sector to outperform in most markets. Financials were slightly weaker in the US and Europe, though sharply weaker in Japan on disappointing profit results. International shares gained 1.5% (hedged).

Outlook: Equity valuations are currently undemanding on a number of measures, however slower global growth and the possibility of disturbances in the financial sector may cause further weakness to earnings.

Australian Equities

Australian Shares outperform

The Australian share market (+4.1%) performed better than most offshore markets. Resources (+2.0%) managed a small gain as investors remained wary of lower commodity prices amid concerns about global growth. Financials were generally stronger (+5.2%), buoyed by prospects for an interest rate cut, though Macquarie and Suncorp both fell around 14% after posting disappointing earnings results. The earnings reporting season created increased dispersion within sectors. Listed Property performed well, gaining 10.3% in the month as results beat sharply lowered expectations.

Outlook: Valuations on the Australian market appear reasonable, though international markets look cheaper still. We expect Australian shares to recover over the medium-term, though underperform global share markets. Interest rate cuts in late 2008 or early 2009 may provide a boost to the market.

Global Fixed Interest

Bond yields lower

Slowing economic growth, renewed risk aversion and a reduction in inflationary concerns resulted in lower global bond yields in August. US ten year bond yields fell from 3.95% to 3.8%, while two year bond yields also moved marginally lower. UK bond yields fell sharply growth indicators continued to deteriorate and markets priced in rate cuts for later in the year. Weaker European data also saw lower bond yields. The return on the Lehman Aggregate Index was 1.5% (hedged).

Australian bond yields declined sharply, with ten year bond yields falling from 6.20% to 5.75% over the month. Continued evidence of a loss in economic momentum, along with a clear signal from Reserve Bank of Australia (RBA) that interest rates could be cut before inflation returns to their target band, saw monetary easing priced in with expectations for the first cut in September.

Outlook: The recent rally in Australian bonds has moved the market from cheap to around fair value, the market may be vulnerable to expectations about the size and speed of interest rate cuts. Global bonds appear fair value considering the downside risks to growth.

Currencies

US Dollar rallies

The US Dollar rallied sharply as relative growth momentum and interest rate expectations moved to favour the US. The Euro weakened from 1.56 to 1.46 on further signs that growth is slowing in Europe, while the British Pound declined as housing market weakness weighed on UK growth sentiment. The Japanese Yen held steady against the US Dollar, helped by renewed risk aversion. The Australian Dollar fell sharply from US\$0.94 to around US\$0.86 on speculation of an impending interest rate cut and falling commodity prices. Returns on foreign currency exposure were -6.3% for the International equity benchmark.

Outlook: The trough in the US Dollar increases our confidence that medium term valuations will provide the currency with some support. The Euro continues to be the most overvalued of the major currencies, while valuations also suggest a lower profile for the Australian Dollar over the next 6 to 12 months.

Financial markets (%)

	Level	% Return*			
	Aug-08	1 month	3 months	Fin Year	1 year
Sharemarkets					
Australia (S&P/ASX 200)	5136	4.09	-8.07	-0.66	-14.24
World (MSCI World ex Aust)	966	1.06	-8.89	-0.67	-13.47
US (S&P 500)	1283	1.45	-7.89	0.59	-11.14
UK (FTSE 100)	5637	4.86	-5.85	0.99	-7.07
Europe (MSCI Europe ex UK)	1059	1.29	-10.87	0.21	-19.39
Japan (Topix)	1255	-3.73	-10.82	-4.93	-20.68
Currencies					
Australian Dollar/US Dollar	0.861	-8.44	-9.68	-10.26	5.86
Australian Dollar/Euros	0.585	-2.96	-4.66	-3.96	-1.98
Australian Dollar/Yen	93.46	-8.06	-7.14	-8.13	-0.89

* Sharemarket returns inclusive of dividends, in local terms.

Economist's View

Key Points

- **Euro area, UK and Japanese economies in retreat**
 - **Commodity prices continue to fall, financial markets stabilise**
 - **US GDP growth revised up, outlook relative to G7 economies improves and USD rallies**
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International Economies

Euro area, UK and Japanese economies weaken

Second quarter national accounts data confirmed the deterioration in the economies of the Euro area, UK and Japan. Although weaker growth in the second quarter was expected, given surprisingly strong first quarter growth, recent data for July and August and forward indicators suggest that weak growth will continue in the second half of the year.

It was inevitable that the combined effects of oil prices at \$US140+ per barrel, USD/€ exchange rate close to 1.60 and European Central Bank (ECB) tightening would prove too much for Euro area economy to withstand. The consequence of these shocks has been sharp increases in the cost of living and real exchange rate, which together have undermined real disposable incomes of the household sector and the international competitiveness of the traded goods sector. Even though the balance sheet of the Euro area household sector is robust, with high savings rates and high levels of debt servicing capacity, the impact of a sharp fall in real disposable income in an environment of softening labour markets has led to a fall Euro area consumer spending. The Japanese economy has also experienced a slowdown in domestic spending as a consequence of a sharp increase in inflation in an environment of softening labour markets.

In contrast to the Euro area, the UK household sector is highly leveraged. Consequently, the vulnerability of consumer spending and residential investment to falling asset prices has been exposed and UK growth has suffered from weak consumer spending and a sharp decline in housing investment. In addition, the size of the Government budget deficit limits the ability of expansionary fiscal policy to relieve the slowdown in private sector spending. Offsetting the fall in domestic spending has been a positive contribution from net exports. With weak domestic fundamentals, the British Pound has been among the weakest of the major currencies, allowing for an improvement in international competitiveness of the UK economy.

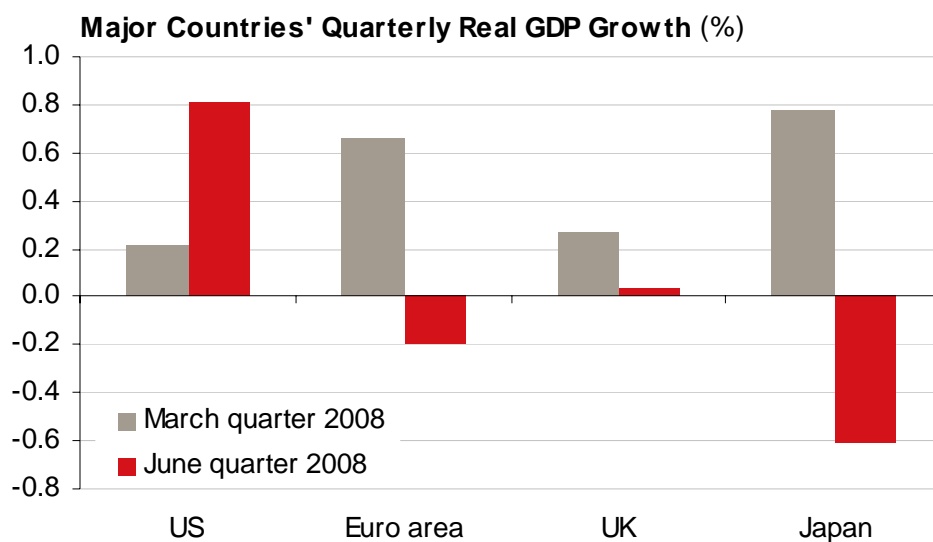
Commodity prices continue to fall, financial markets stabilise

The slowdown in these three advanced economies has contributed to the overall deterioration in global growth and subsequent fall in commodity prices. With slowing growth and lower commodity prices, the inflation outlook has moderated and global bond yields have fallen. Uncertainty in financial markets has also moderated, with most indicators of risk having either fallen, e.g. Volatility Index (VIX) and Ted Spread, or stabilised e.g. Oil States International (OIS)/Libor spreads.

Within the Euro area, the exchange rate has devalued by around 7.0% against the US Dollar over August, restoring competitiveness to the traded goods sector, while German 10 year bond yields have fallen by around 0.30%. In the UK, the British Pound has continued to devalue against the US Dollar, by around 9.0% over August, and the yield on 10 year Gilts has fallen by around 0.4%. Competitive exchange rates, lower interest rates and falling inflation will improve the outlook for the European and UK economies.

US GDP growth revised up, outlook relative to G7 economies improves and USD rallies

While the advance estimates of the second quarter US national accounts had been released in July, the preliminary estimates released in August showed a sharp upward revision. Although the second quarter results were positively skewed by the influence of tax rebates, the contribution to growth from net exports was nonetheless impressive. However, while the sharp devaluation of the US Dollar in the first half of 2008 has contributed to the strong net export performance it has also contributed to the weak performance of net exports in the Euro area. Hence, the recent rally in the US Dollar against the Euro, which we argued above, will improve the outlook for the Euro area economy, and will detract from the outlook for the US economy. The countervailing nature of currency movements (and monetary policy) will limit a swift reversal of the current weakness in the advanced economies. That is, expansionary monetary policy and a devaluation of the currency in the US assists recovery of the US economy at the expense of its trading partners.



Interest Rates (%)

	Level	QIC forecast			
	Sep-08	3 months	6 months	1 year	
Australia	7.00	6.75	6.50	6.25	
US	2.00	2.00	2.00	2.75	
Canada	3.00	3.00	3.00	3.25	
Europe	4.25	4.00	3.75	3.50	
UK	5.00	4.75	4.25	4.00	
Japan	0.50	0.50	0.50	0.50	

Australian Economy

RBA cuts rate by 0.25%, terms of trade and government infrastructure spending support strong investment growth

As anticipated, the RBA lowered the interest rate from 7.25% to 7.00% at its September 2nd Board meeting. However, recent strength in data relating to investment spending and the ongoing rise in Australia's terms of trade has tempered the market's assessment of the pace of the easing cycle.

Our view has been that although tight credit conditions and rising living costs were destined to slow the rate of growth in private consumption expenditure and stall housing investment, mining related investment spending combined with government related infrastructure spending (both of which are related to Australia's booming terms of trade) would underpin economic activity in the second half of 2008 and into 2009 allowing for a soft landing of the economy. Consequently, we continue to expect a gradual easing of monetary by the RBA with rates around 6.25% at this time next year. The release of national accounts data for the second quarter of 2008, which showed strong growth in private and public sector investment, combined with strong private capital expenditure expectations for 2008/09 confirm our underlying view on the Australian economy.