

The Markets

International Equities

Tumultuous quarter for global shares as financial crisis deepens

Most equity markets recorded double-digit losses over the quarter, prompted by a sharp worsening in the financial crisis and slowing global economic growth. Equity market volatility and risk aversion rose to extreme levels during the quarter, with the VIX index (a measure of equity market volatility) reaching record high levels. Emerging markets were also hit hard, with a number of countries including Iceland, Hungary and Ukraine, requiring International Monetary Fund (IMF) loans. Commodity prices slumped given the dim prospects for global growth and trade, with the price of crude oil sliding to around US\$45 a barrel, despite OPEC production cuts.

Policy-makers around the world took forceful action to contain the crisis, with key central banks all reducing interest rates substantially and the US and Japan effectively lowering interest rates to zero. The US Federal Reserve (Fed) also introduced various alternative policy measures, including buying agency and asset-backed debt and commercial paper, and potentially buying Treasury debt to lower long-term bond yields. Major governments also loosened fiscal policy aggressively, with measures including guaranteeing bank deposits and injecting capital into banks. The US government introduced the Troubled Asset Relief Program (TARP) to recapitalise the banking sector, and offered bailout loans to the auto-sector.

All major markets suffered heavy losses over the quarter. The US market lost 21.9%, while Europe ex-UK and Japan fell 20.5% and 20.9% respectively. The UK market outperformed relative to other major markets, retreating only 8.7%. Emerging markets also suffered, losing 22.0% over the quarter. Traditional defensives outperformed as investors concerned about the financial crisis and weakening global growth abandoned financials and cyclical sectors. Hedged international shares fell 23.1%.

Outlook: Equity valuations currently appear quite attractive on a number of measures. However, investors are naturally cautious given the likelihood of sharply lower earnings as the global economy faces an increasingly bleak outlook. Evidence that policy measures are beginning to take effect and an exhaustion of selling pressures could result in a short-term rebound

Australian Equities

Market weaker on global concerns

Global developments remain the principal driver of the local market, which ended the quarter down 18.3%. The losses were broad based, and all ten Global Industry Classification Standard (GICS) sectors recorded falls. Defensives outperformed the broad market, while financials and cyclical sectors continued their retreat. Resources fell 18.6%, amid the slump in commodity prices and the collapse of the takeover bid of Rio Tinto from BHP. Financials lost 20.4%, as concerns over the financial crisis outweighed the aggressive Reserve Bank of Australia (RBA) easing and the government bank deposit guarantee. Listed property was hit particularly hard, losing 32.9%, as investors fled stocks perceived as risky, highly leveraged or complex.

Outlook: There are a number of factors that should support Australian shares, including reasonable valuations, high-dividend yields, lower cash rates and the fact that banks are relatively well capitalised compared to global peers. The lower Australian dollar will also boost the value of offshore earnings. However, valuations are not as attractive as in other markets and there are risks to resource earnings if the global economy and/or China slows significantly.

Global Fixed Interest

Bonds rally on slowing global growth and risk aversion

Global bonds rallied strongly over the quarter on a weak global economic outlook, risk aversion and deflation fears. In the US, quantitative easing and the prospect of the Fed buying Treasuries helped drive the US 10 year bond yield down sharply from 3.8% to 2.2%. In Australia, the 10 year bond yield fell from 5.4% to 4.0% due to the aggressive easing of interest rates by the RBA. Credit and money market spreads widened sharply in early October, and remain at wide levels despite efforts by central banks to improve market liquidity. The return on the Barclays Capital Global Aggregate Index, formerly known as the Lehman Global Aggregate Index, was 4.8%.

Outlook: Bonds are generally expensive in most markets, though the pronounced cyclical risks make this pricing somewhat justified. Lower headline inflation and weaker growth should allow the UK and European central banks to lower rates further. The RBA is likely to keep rates lower for longer, while in the US the prospect of quantitative easing will keep bond yields low.

Currencies

Risk currencies weaker on volatility and risk aversion

Currency markets were exceptionally volatile over the quarter, and the weak outlook for global growth and heightened risk aversion saw risky currencies sell off sharply. The US dollar recorded broad gains against other major currencies, benefiting as investors sought to unwind their offshore investments amid the financial crisis. The Euro, British pound and Canadian dollar all weakened against the US dollar. The Japanese yen and the Swiss franc were the only major currencies to outperform the US dollar, benefiting from their safe haven status. The Australian dollar fell steeply from US\$0.789 to a low of around US\$0.607, before rebounding to around US\$0.697. The weakness in the currency was exacerbated by aggressive RBA easing, concerns over Chinese growth and commodity prices, as well as a general aversion to risky assets. Returns from foreign currency exposure were 11.5% on the international equity benchmark.

Outlook: We see the Australian dollar as somewhat undervalued, but it remains exposed to further concerns about the global growth environment. The outlook for the US dollar 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 decline as weaker growth drives expectations for eventually lower interest rates.

Financial markets (%)

	Level	% Return*			
	Dec-08	1 month	3 months	Fin Year	1 year
Sharemarkets					
Australia (S&P/ASX 200)	3722	-0.28	-18.25	-26.79	-38.44
World (MSCI World ex Aust)	677	1.07	-20.79	-29.83	-38.75
US (S&P 500)	903	1.06	-21.94	-28.48	-37.00
UK (FTSE 100)	4434	3.52	-8.68	-19.64	-28.33
Europe (MSCI Europe ex UK)	743	-0.60	-20.54	-29.33	-42.72
Japan (Topix)	859	3.03	-20.89	-34.30	-40.62
Currencies					
Australian Dollar/US Dollar	0.697	7.06	-11.61	-27.35	-20.60
Australian Dollar/Euros	0.502	-2.27	-10.68	-17.65	-16.48
Australian Dollar/Yen	63.201	1.90	-24.53	-37.87	-35.57

* Sharemarket returns inclusive of dividends, in local terms.

Economist's View

Key Points

- **Data confirms sharp slowdown in the global economy in 2008q4 and a bleak outlook for the first half of 2009**
- **Financial markets stabilise, despite weak economic data, as policy initiatives support investor confidence**
- **Central banks lower official cash rates - US and Japan move to zero interest rates – increasing focus on fiscal policy**
- **Australian economy on the brink of recession – forestalled by fiscal stimulus**
- **Australian private-sector spending to weaken but currency devaluation to support trade balance**

International economies

Data confirms sharp slowdown in the global economy in 2008q4 and a bleak outlook for the first half of 2009

Data released in December continued to show a global economy in sharp decline. Measures of industrial activity fell sharply, while most business surveys were either at their lowest recorded levels or at multi-decade lows. Expenditure measures also weakened during the month, with anecdotal evidence of particularly weak US consumer spending in December. The fall in economic activity is leading to a rapid unwind in inflation pressures, with consumer prices falling on a month-on-month basis in November. Furthermore, extremely weak international trade data from China reflects the extent to which slowing activity in advanced economies is now affecting the growth prospects of emerging market economies.

Financial markets stabilise, despite weak economic data, as policy initiatives support investor confidence

Figure 1 reports various financial market risk measures. The left hand panel reports the spread between interbank lending rates and expectations of the official cash rate and is an indicator of risk within the banking sector. The right hand panel reports the VIX, which is a measure of equity market volatility. The spikes in these measures show the extreme levels of risk that occurred in the wake of the Lehman Brothers failure. The resulting freeze in credit combined with the collapse in equity prices that occurred over this period led to sharp increases in the cost of capital and sharp declines in household wealth. This in turn led to falls in private sector spending throughout the global economy during the last quarter of 2008. Both panels of Figure 1 show the reduction in risk that occurred during December in response to policy initiatives, particularly those of the US Fed and US Treasury. For the global economy to stabilise and eventually recover, the thawing of credit markets and the fall in equity market risk will need to continue.

Central banks lower official cash rates - US and Japan move to zero interest rates – increasing focus on fiscal policy

Given the sharp decline in global economic activity and inflation, it is not surprising that central banks have responded with aggressive easing of monetary policy. The US, European, UK, Canadian and Australian central banks reduced their official cash rates by between 75bps and 100bps in December. The US Fed has effectively implemented a zero interest rate policy by reducing the Fed Funds rate to a range of 0.0 to 0.25 per cent, consistent with our forecast. The Fed has been joined by the Bank of Japan, which has taken their target rate to 0.10 per cent.

With the scope for further reductions in cash rates diminishing, the focus of policy is turning towards fiscal stimulus. In last month's report, we discussed results from our simulations that showed a fiscal stimulus of between 4 to 5 per cent of GDP (around \$US700bn) is required to stabilise US growth in the second half of 2009 and to boost growth in 2010. In December, President-elect Obama revealed his administration's intent to implement such a package over 2009-10, beginning with \$US300bn of tax cuts and the largest government investment program in the post-war period.

To date, it appears that other major economies, such as Europe, UK and Japan, intend to implement much smaller fiscal packages than that of the US (on average less than half of the size of the US package as a percent of GDP). Unless further sizeable fiscal packages are announced, or financial market conditions improve more rapidly than we are currently forecasting, cash rates in Europe and the UK will approach zero in the second half of 2009.

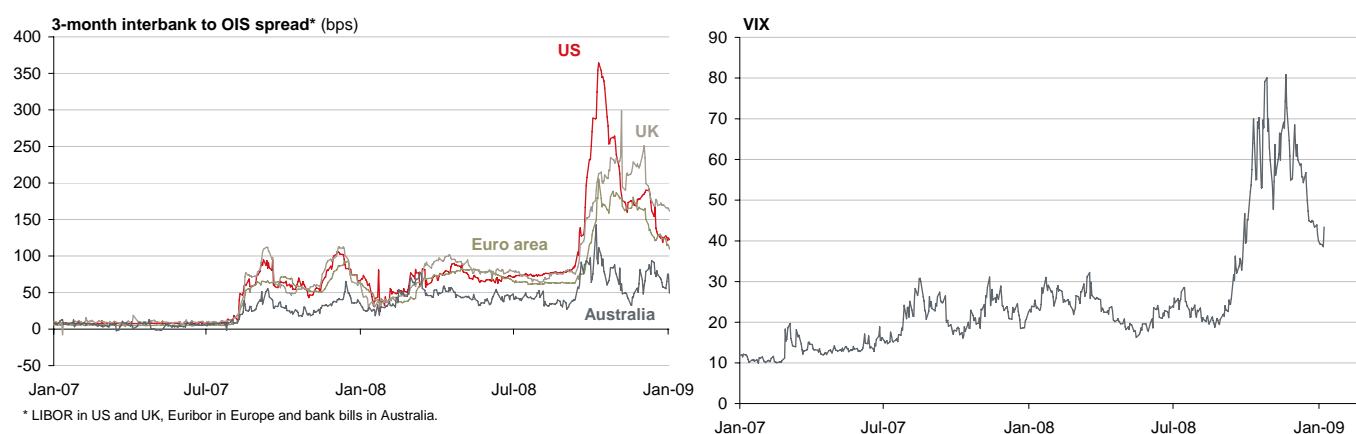


Figure 1. Two measures of financial market stability

Official Interest Rates (%)

	Level	QIC forecast		
	Jan-09	3 months	6 months	1 year
Australia	4.25	3.00	3.00	3.00
US	0.25	0.00	0.00	0.00
Canada	1.50	1.00	1.00	1.00
Europe	2.50	1.00	0.50	0.00
UK	1.50	0.50	0.00	0.00
Japan	0.10	0.00	0.00	0.00

Australian Economy

Australian economy on the brink of recession – forestalled by fiscal stimulus

Australian data released over December continues to show deteriorating economic conditions. The decline in economic activity over 2008 is having an impact on the labour market, with the unemployment rate rising to 4.4% in November. The housing market continues to weaken, with housing starts falling sharply in the September quarter and building approvals continuing to decline rapidly in October and November. In addition, surveys of business conditions and private sector credit growth fell to levels last seen during the 1991 recession. A bright spot in recent data releases has been consumer spending, where retail sales rose in October and November. A significant increase in consumer spending is anticipated in December, boosted by the Federal government's \$8.4bn fiscal stimulus package. Given the monthly retail sales data for October and November, and the likely result for December, strength in consumer expenditure should generate positive GDP growth for the December quarter.

Australian private-sector spending to weaken but currency devaluation to support trade balance

Australia is not immune from global events, and the sharp fall in the terms of trade that is occurring as global growth slows is depriving the Australian economy of an important income source that supported strong growth in domestic demand in recent years. Even though policy shocks are currently supporting household income, our opinion is that much of the stimulus will be saved as households and businesses improve their balance sheets to better cope with the deteriorating economic conditions. But while being a small open economy leaves us hostage to external shocks, we are also armed with one strong advantage – a very flexible exchange rate. Since the peak in the exchange rate in July, the AUD has fallen by around 25% against the USD, providing a significant boost to the international competitiveness of the traded goods sector. This will be particularly important for the import-competing sector, and we expect imports to fall by around 4.0% in 2009. A more competitive exchange rate will also benefit exporters, and our forecasts indicate the devaluation should limit the fall in exports in 2009 to 1.5%. As imports fall more rapidly than exports, the net contribution of international trade to GDP growth will be positive in 2009 and will provide an important offset to soft growth in domestic demand, which we are forecasting at 0.3% during 2009.