

February 2009

The Markets

International Equities

Market weakness led by financials

Global equity markets have continued their downwards trend since mid-January. Market sentiment remains subdued, weighed down by deteriorating economic data, disappointing earnings and cuts in dividends. Financials remain under pressure, with a number of major institutions, including Citigroup, receiving further assistance from their respective governments. In Europe, markets were focused on systemic risks due to losses on bank exposures to Eastern European economies. Further fiscal stimulus measures were announced by a number of governments. The US Congress passed a previously announced economic stimulus package of around US\$787bn.

The US and Europe ex-UK markets both underperformed on the month (-10.6% and -10.0% respectively), with the S&P 500 falling below 1997 levels. Japanese and UK equities outperformed on a relative basis, falling by 6.4% and 7.0% respectively. Hedged international shares were down 8.5% in February.

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

Australian market relatively resilient despite weak global conditions

The Australian market lost 4.6% in February, outperforming its global peers. The aggressive easing of interest rates by the Reserve Bank of Australia (RBA) to-date, a sharply weaker currency, as well as the announcement of a A\$42bn fiscal stimulus package by the Rudd government helped to cushion the local market from the otherwise difficult global environment. Resources were supported by further news of Chinese investors taking interest in a number of local miners including Rio Tinto, Fortescue and OZ Minerals. Insurance firms were the big underperformers on the month, losing 18.3% amid investment losses, disaster-related writedowns and capital raisings. In contrast banks performed relatively well, finishing the month up 4.2%, as recent earnings results proved surprisingly resilient.

Outlook: There are a number of factors that should support Australian shares: reasonable valuations, high dividend yields and lower cash rates. Australian banks are relatively well capitalised compared to global peers, and 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 as the global economy and/or China slows significantly.

Global Fixed Interest

Bonds weaker on supply and fiscal concerns

Despite the poor economic outlook globally and lower interest rates, global bond yields were higher as investors focused on increasing higher bond supply from fiscal expansion. The US 10 year bond yield ended the month higher at 3%, up from 2.8%. European and UK bond yields were lower, as interest rate expectations continue to fall and the Bank of England (BoE) moved closer to quantitative easing. Australian 10 year bond yields finished the month higher at 4.4% from 4.1%, as the RBA hinted at a slower pace of interest rate cuts. The return on the Barclay's Capital Global Aggregate Index was 0.2%.

Outlook: Bonds are reasonably valued once the outlook for a prolonged period of lower interest rates is factored in. 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 is expected to keep bond yields low.

Currencies

US dollar and Australian dollar stronger

The US dollar recorded broad gains against other major currencies, as continued risk aversion and the deteriorating global economic outlook both favoured the global reserve currency. The euro was weaker, weighed down by pressures relating to Eastern Europe bank exposures. Despite continued falls in equity markets and continued risk aversion, the Japanese yen was the worst performer amongst the G-10 currencies, as investors instead focused on weakness in the Japanese economy. The Australian dollar was steady against the US dollar, finishing the month at US\$0.639. The announcement of a fiscal spending package by the Rudd government, as well a paring back of expectations for interest rate cuts, both contributed to the currency strength. Returns on foreign currency exposure were 2.1%.

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 investor's perceptions of US assets. We expect the euro to weaken as weaker growth drives expectations for eventually lower interest rates.

Financial Markets (%)

Sharemarkets	Level at 28-Feb-09	1 month return	3 month return	FYTD return	1 year return
Australia (S&P/ASX 200)	3345	-4.60	-9.50	-33.50	-36.90
World (MSCI World ex Aust.)	570	-9.10	-14.70	-40.80	-42.60
US (S&P 500)	735	-10.60	-17.30	-41.50	-43.30
UK (FTSE 100)	3830	-7.00	-9.80	-30.00	-31.80
Europe (MSCI Europe ex UK)	626	-10.00	-15.80	-40.20	-44.20
Japan (Topix)	757	-6.40	-10.90	-43.20	-42.80
Currencies					
Australian Dollar/US Dollar	0.6389	0.50	-1.90	-33.40	-31.70
Australian Dollar/Euro	0.5030	1.40	-2.00	-17.40	-18.40
Australian Dollar/Yen	62.5083	9.50	0.80	-38.60	-35.80

* Sharemarket returns inclusive of dividends, in local terms.

Economist's View

Key Points

- **Equity markets retrace gains since November – money market conditions supported by policy intervention**
- **Central banks continue to lower rates – UK to implement quantitative easing**
- **Obama administration launches policy initiatives – won't prevent US growth contracting by 2% in 2009**
- **Australian GDP falls for the first time in eight years – another contraction to follow in first quarter 2009**
- **Nation Building and Jobs Plan will provide significant support to consumer spending – despite leakage to savings**
- **Reserve Bank on hold – but more rate cuts to come**

International Economies

Equity markets retrace gains since November – money market conditions supported by policy intervention

Recent economic data releases have confirmed the broad-based ongoing weakness within the global economy. Labour demand is falling rapidly with unemployment rates picking up sharply. Deteriorating labour market conditions have weighed heavily on household consumption, consumer sentiment and the housing market sector, which is yet to exhibit any signs of stabilisation. Global PMI indicators are languishing as industrial production plunges, and export demand remains weak. Financial institutions remain under pressure, with AIG requiring a further capital injection and S&P financial stocks losing 33% since the end of January.

As a consequence, global equity markets have retraced their December 2008 gains and, in most advanced-economy markets, have fallen below their November lows. Despite weakness in equity markets, money market conditions have improved since the worst of the credit freeze in October last year, which is largely due to sustained central bank intervention. Interbank spreads remain stable at levels substantially below their 2008 fourth quarter peaks, and Baa corporate bond spreads remain nearly 1% below their 2008 highs.

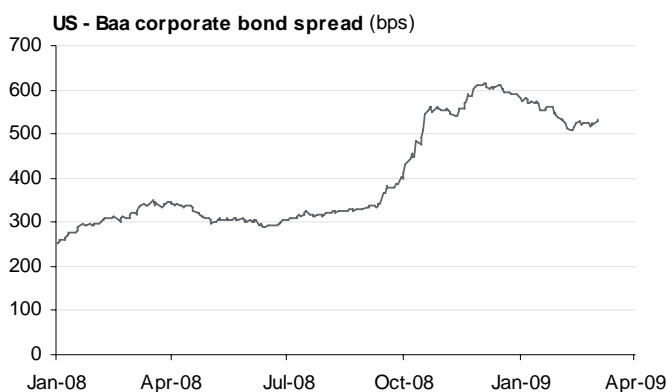
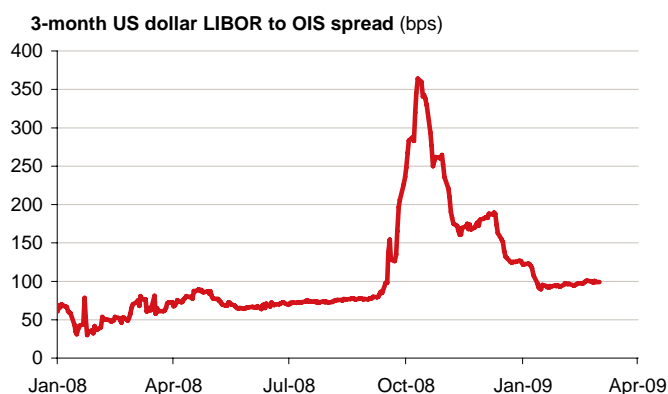
Central banks continue to lower rates – UK to implement quantitative easing

Central banks continue to lower official cash rates, with the European Central Bank (ECB) and BoE reducing rates to 1.5% and 0.5% respectively. The BoE has announced plans to buy £150 billion of government and corporate bonds, and despite its rhetoric, we expect the ECB will be forced to follow the central banks of the US, Japan and the UK in adopting an effective 0% interest rate policy (i.e. quantitative easing) by the second half of the year.

Obama administration launches policy initiatives – won't prevent US growth contracting by 2% in 2009

The US Senate passed the American Recovery and Reinvestment Act containing US\$789.2bn of tax rebates, government infrastructure spending and State government assistance. The package will be implemented over a ten year period; however, around three quarters of the total will be spent within the next 18 months. The Obama administration also announced the \$US75bn Homeowner Affordability and Stability Plan to help between seven and nine million homeowners avoid foreclosure.

US GDP for the last quarter of 2008 was revised down substantially from -3.8% to -6.2% (annualised). US GDP growth will be strongly negative in the March quarter and our current forecast is for a 4% contraction, with downside risks. The Obama fiscal package should forestall further sharp contractions in activity beyond the first quarter (QIC expects flat growth in both the second and third quarters of 2009), and growth should turn positive towards the end of the year, but remain below trend. This is a very weak outlook for the world's largest economy and the US Federal Reserve (Fed) will be forced to maintain the effective cash rate at zero throughout the year in the face of deflation and an unemployment rate that will reach 9.5% by year end.



Interest Rates (%)

	Level at		QIC forecast	
	6-Mar-09	Jun-09	Sept 09	Mar-10
Australia	3.25	2.50	2.50	2.50
US	0-0.25	0-0.25	0-0.25	0-0.25
Canada	0.50	0.50	0.50	0.50
Europe	1.50	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

GDP contracts for the first time in eight years – another contraction to follow in first quarter 2009

Fourth quarter GDP figures showed the Australian economy contracted by 0.5%. A substantial fall in inventories offset positive contributions from net exports and business investment. Household consumption was weaker than expected, with consumers preferring to save rather than spend additional income generated from monetary and fiscal easing. Although retail data suggests that government payments made in December 2008 are continuing to support consumption in January, the economy will not avoid negative growth in the first quarter of 2009 and is therefore in a technical recession.

Nation Building and Jobs Plan will provide significant support to consumer spending – despite leakage to savings

Similar to the US, the Nation Building and Jobs Plan will support growth beyond the first quarter, but, despite the boost, the Australian economy will struggle to register positive annual growth in 2009. The impact of the package will depend on the response of households to cash handouts, which will total A\$11 billion over March and April of this year. The national accounts data showed that consumption spending rose by only 0.1% in the last quarter of the year, despite A\$8.7 billion in bonus payments to low income earners and pensioners.

Of course, we do not know how much consumption would have fallen in the absence of the package. In comparable economies, where households were not supported by government handouts, consumer spending was far weaker than in Australia. For instance, consumer spending fell by 1.1% in the US, 0.9% in the Euro area and 0.7% in the UK. Our analysis suggests that consumer spending would have fallen by 0.3 to 0.4% without the package, implying that only between 8-10% of the bonuses were spent during December. However, we expect bonus-driven expenditure to continue over the coming months. Our analysis also suggests that around 20% of the A\$11 billion Nation Building and Jobs Plan tax break will be spent over the first three months, with around 50% spent by the end of 2010. Including flow-on effects, our simulations of the package indicate that growth consumer spending will receive a boost of 0.8 % in 2009 and 0.6% in 2010.

Reserve Bank on hold – but more rate cuts to come

Prior to the GDP release, the RBA surprised the market by leaving interest rates unchanged at 3.25% at its March meeting. The Bank cited the strength of the Australian banking system, the success of the monetary policy transmission mechanism to deliver large reductions in interest rates and the significant fiscal initiatives as reasons behind the pause. Australia has not seen the severe contraction in growth experienced in other developed nations; however, weak conditions are likely to continue for the first half of 2009. While the Board considers the current stance on monetary policy appropriate, we continue to expect that the cash rate will be lowered to 2.5%.