

January 2009

## The Markets

### International Equities

#### Market gloom continues into the New Year

Having begun the year with an optimistic tone, sentiment in equity markets quickly turned sour as a continuation of poor economic data and company profit downgrades faded any hopes of a quick recovery in early 2009. Market participants were reminded of the precarious position financials are in, with the UK government increasing its stake in the Royal Bank of Scotland, while the Bank of America required additional funding from the US government following losses from its acquisition of Merrill Lynch. Major governments including the US, UK and Germany also announced additional fiscal stimulus packages. In the US, a program to purchase impaired assets from banks and the establishment of a 'bad bank' is currently under negotiation.

All major markets finished January weaker, although most remained above their mid-November lows. The US market underperformed, losing -8.4% over the month, while the UK and Japan fell by -6.4% and -7.6% respectively. Europe (ex-UK) lost -5.9%. Global financials were the clear losers over the month, as investors continue to favour defensives. Hedged international shares retreated -6.8% over the month.

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 month down -4.9%. Cyclical sectors continue to underperform defensives, as fears of a local recession continue to build. Financials were under pressure, dropping -8.8%, in line with the general underperformance of global financials. Resources were surprisingly resilient, losing only -1.7% despite profit downgrades by major miners BHP and Rio Tinto and poor Chinese economic data. Markets reacted favourably to their plans to cut spending as well as plans by Rio Tinto to divest assets.

Outlook: There are a number of factors that should support Australian shares, including reasonable valuations, high dividend yields and lower cash rates. Australian banks are also relatively well capitalised compared to global peers. The lower Australian dollar will 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

Global bonds were weaker over the month despite the poor global economic outlook and lower interest rates, as investors instead focused on the expected increase in bond supply arising from expansive fiscal policies. US 10 year bond yields ended the month higher at 2.8%, up from 2.3%, a reaction to the US Federal Reserve's (Fed) failure to announce concrete plans to start purchasing government bonds as a policy tool. European and UK bond yields were also higher over the month. Australian ten year bond yields followed the global trend to finish the month higher at 4.1%, up from 4%. Return on the Barclay's Capital Global Aggregate Index was -0.6%.

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 Reserve Bank of Australia (RBA) is likely to keep rates lower for longer, while in the US the prospect of quantitative easing will keep bond yields low.

## Currencies

### US dollar and Yen strength continues

Risk aversion remained the dominant theme within currency markets. The US dollar gained ground against other major currencies except for the Japanese yen, which remains a key beneficiary of risk aversion. The British pound was only slightly weaker against the US dollar, and the currency now appears significantly undervalued after sustaining heavy falls in recent months. The euro was weaker following market speculation of a potential exodus from the currency as a number of member countries were downgraded by credit rating agencies. The Australian dollar fell to US\$0.636 from US\$0.697, as a combination of weak Chinese growth, risk aversion and expectations of further RBA rate cuts all weighted on the currency. Returns on foreign currency exposure were 7.6%.

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 slowing growth drives expectations for eventually lower interest rates.

## Financial Markets (%)

| Sharemarkets                | Level at<br>31-Jan-09 | 1 month<br>return | 3 month<br>return | FYTD return | 1 year<br>return |
|-----------------------------|-----------------------|-------------------|-------------------|-------------|------------------|
| Australia (S&P/ASX 200)     | 3541                  | -0.05             | -0.11             | -0.30       | -0.34            |
| World (MSCI World ex Aust.) | 628                   | -0.07             | -0.12             | -0.35       | -0.38            |
| US (S&P 500)                | 826                   | -0.08             | -0.14             | -0.35       | -0.39            |
| UK (FTSE 100)               | 4150                  | -0.06             | -0.04             | -0.25       | -0.26            |
| Europe (MSCI Europe ex UK)  | 697                   | -0.06             | -0.12             | -0.34       | -0.38            |
| Japan (Topix)               | 794                   | -0.08             | -0.08             | -0.39       | -0.40            |
| Currencies                  |                       |                   |                   |             |                  |
| Australian Dollar/US Dollar | 0.6359                | -0.09             | -0.04             | -0.34       | -0.29            |
| Australian Dollar/Euro      | 0.4962                | -0.01             | -0.05             | -0.19       | -0.18            |
| Australian Dollar/Yen       | 57.1102               | -0.10             | -0.12             | -0.44       | -0.40            |

\* Sharemarket returns inclusive of dividends, in local terms.

## Economist's View

### Key Points

- Global economy collapses in 4<sup>th</sup> quarter 2008, with Asia particularly weak
- Cash rates at or approaching zero in the G7
- Policy focus turns to fiscal stimulus, but too late to avoid severe recession
- Global growth to fall to 0.9% and advanced economies to contract in 2009; weakest outcome since WWII

### International Economies

#### Global economy collapses in 4<sup>th</sup> quarter 2008, with Asia particularly weak

The freeze in global credit markets following the failure of Lehman Brothers has condemned the global economy to a very sharp slowdown in the last quarter of 2008 and in the first half of 2009. The fall in US equity prices and house prices has wiped out around \$13 trillion from US household wealth since mid-2007 and, not surprisingly, has led to a fall in domestic spending. Rising credit spreads and falling equity prices have also increased the cost of capital, which is now impacting on investment spending.

As the scenario of wealth destruction and frozen credit markets plays out across the global economy, global trade has collapsed and emerging market economies have stalled. In particular, the previously robust economies of the Asia region dramatically reversed direction in the last quarter of 2008. The Chinese economy slowed to 6.8% in the December quarter of 2008, down from 9% in the September quarter, while many other Asian economies are reporting strong negative growth rates for the last quarter of 2008.

#### Cash rates at or approaching zero in the G7

In response to the downturn, policy makers have stepped up their efforts to counter the slide of the economic and financial system into an even deeper and protracted decline. The US and Japanese central banks have already effectively taken cash rates to zero, and although the central banks of Europe and the UK appear more reluctant, we expect that they too will be forced to lower their cash rates to zero by the second half of the year.

#### Official interest rates (%)

|           | Level at | QIC forecast |        |        |
|-----------|----------|--------------|--------|--------|
|           | 5-Feb-09 | May-09       | Aug-09 | Feb-10 |
| Australia | 3.25     | 2.50         | 2.50   | 2.75   |
| US        | 0-0.25   | 0-0.25       | 0-0.25 | 0-0.25 |
| Canada    | 1.00     | 0.50         | 0.50   | 0.50   |
| Europe    | 2.00     | 1.00         | 0.50   | 0.00   |
| UK        | 1.50     | 0.50         | 0.00   | 0.00   |
| Japan     | 0.10     | 0.00         | 0.00   | 0.00   |

## Policy focus turns to fiscal stimulus, but too late to avoid severe recession

With the scope for further support from monetary policy fading, governments around the world have been formulating fiscal stimulus packages to boost economic growth. In the US, it looks likely that President Obama will implement a package of around \$US825bn (5.8% of GDP) over the coming two years. A number of other major advanced economies have also announced fiscal packages averaging around 1% of GDP. While these packages will be a positive development for the global economy, our research indicates that they will not prevent a severe global recession.

## Global growth to fall to 0.9% and advanced economies to contract in 2009; weakest outcome since WWII

Our forecasts for average annual GDP growth across the main global economies are reported in Table I. At less than 1% growth in 2009, the global economy will endure an outcome at least as weak as any in the post-war period. Collectively, all major advanced economies will contract in 2009; the first negative annual growth since WWII. Despite the Obama fiscal package, growth will be firmly negative in the US in 2009. Emerging market economies will grow at less than 4% in 2009, with growth rates below 4% associated with recession in emerging market economies. The slowdown in China is pronounced and we expect GDP growth to slip below 7% in 2009.

Beyond 2009, we expect growth to gradually recover, but to remain below trend despite the impact of expansionary fiscal policy. In our forecasts, fiscal stimulus has the effect of pulling growth forward into 2009 and 2010. At the completion of the fiscal packages, the requirement that governments must restore public finances will inevitably involve a combination of higher taxes and lower government spending, which will weigh on future growth.

However, the short-term prospects are extremely dire if policy makers fail to pass the proposed fiscal packages. Our results indicate that the US package should halve the rate of contraction in the economy in 2009 and improve growth by over 1% in 2010. This should limit the rise in the US unemployment rate to just over 8% by the end of 2010, compared to a rate of over 10% in the absence of the package, and would represent the saving of around 2.5 million US jobs. In our opinion, it is highly likely that policy makers in other advanced economies will be forced to increase the size of their fiscal packages in 2009 to be more in line with that of the US.

**Table I. Global growth forecasts**

| Real GDP growth forecasts<br>% annual average | QIC  |      |      |      |
|---|------|------|------|------|
|   | 2009 | 2010 | 2011 | 2012 |
| <b>World</b>                                  | 0.9  | 3.1  | 4.1  | 4.5  |
| <b>Advanced</b>                               | -1.3 | 1.6  | 2.0  | 2.6  |
| US  | -1.2 | 2.3  | 2.1  | 2.6  |
| Japan   | -3.1 | -0.5 | 0.0  | 1.4  |
| Euro area                                     | -1.8 | 1.0  | 1.4  | 2.2  |
| Germany                                       | -2.2 | 1.3  | 1.3  | 1.9  |
| France  | -1.4 | 1.2  | 1.0  | 1.8  |
| Italy   | -2.0 | 0.2  | 1.2  | 1.8  |
| Spain   | -1.9 | 2.0  | 1.5  | 3.0  |
| UK  | -2.5 | 0.5  | 2.1  | 2.6  |
| <b>Emerging &amp; developing</b>              | 3.5  | 4.8  | 6.3  | 6.6  |
| <i>Developing Asia</i>                        | 5.6  | 7.3  | 7.6  | 7.6  |
| China   | 6.5  | 8.1  | 8.5  | 8.3  |
| <i>Western Hemisphere</i>                     | 1.8  | 2.5  | 4.7  | 4.9  |
| <i>Central &amp; Eastern Europe</i>           | 1.6  | 1.3  | 3.2  | 4.7  |

## Australian Economy

### Fiscal and monetary policy to the rescue

The outlook for Australia has also deteriorated markedly following a sharp slowdown in growth in China and the rest of the Asia region. The collapse in commodity prices and the terms of trade is undermining the outlook for investment and exports, particularly in the mining sector. However, significant monetary and fiscal stimulus is in the pipeline, with the government announcing a \$A42bn fiscal package worth around 3.8% of GDP to be spent over the next four years and the Reserve Bank lowering cash rates to 3.25%. Our preliminary analysis indicates that the fiscal package will boost growth by around 0.8% in 2009 and 0.2% in 2010. Our results are similar to estimates made by Treasury, which estimated that the package would boost growth by 0.5% in the fiscal year 2008-2009 and by 0.75%-1.0% in the fiscal year 2009-2010. Our analysis for fiscal years 2008-2009 and 2009-2010 are 0.2% and 1%, respectively (refer Table 2). Nevertheless, given the current weakness in the global economy, the fiscal stimulus is unlikely to prevent the Australian unemployment rate from rising to around 7% by the end of 2010.

**Table 2. Australian growth forecasts**

| GDP forecasts<br>% annual average | QIC       |             |                    | Treasury    |                    |
|-----------------------------------|-----------|-------------|--------------------|-------------|--------------------|
|                                   | No fiscal | With fiscal | Impact of stimulus | With fiscal | Impact of stimulus |
| Calendar Year                     |           |             |                    |             |                    |
| 2009                              | -0.2      | 0.6         | 0.8                | -           | -                  |
| 2010                              | 1.4       | 1.6         | 0.2                | -           | -                  |
| Fiscal Year                       |           |             |                    |             |                    |
| 2008/09                           | 0.9       | 1.1         | 0.2                | 1.0         | 0.5                |
| 2009/10                           | 0.3       | 1.2         | 1.0                | 0.75        | 0.75-1             |