

The Markets

International Equities

Stocks weaker but recover some of their losses

Equity markets began the month weaker with investors worried about further Banking sector losses and the financial health of US government sponsored mortgage financiers (Freddie Mac & Fannie Mae). Adding to investor's concern, oil reached new all time highs above US\$145 a barrel.

By mid-month the outlook began to improve as the US government approved measures to bolster the major US mortgage financiers, some US bank earnings came in better-than-feared and the price of oil began receding from its highs. Equities managed to claw back some of their losses as the Financial sector rebounded sharply, turning a 14% decline to a 7% gain by month end.

Of the major global markets, the UK was the worst performer down 3.7%. Europe ended down 1.1%, while the US and Japan were down 0.8% and 1.2%. Global equities fell 1.2% (hedged).

Outlook: Equity valuations are currently undemanding however slower global growth and the possibility of disturbances in the Financial sector may cause further weakness.

Australian Equities

Australian Equities Lower

The local market was driven lower by both Financials and Resources. Banks (-2.6%) were lower as the NAB announced \$800 million in writedowns related to credit investments and ANZ warned of lower profit on increased bad debt provisions. Resource stocks (-11.5%) fell over the month as commodity prices moderated and the global outlook deteriorated. Australian equities fell 4.6% over the month.

Outlook: Valuations on the Australian market appear fair however the domestic economy is slowing. We expect Australian equities to underperform global equity markets going forward. Interest rate cuts in late 2008 or early 2009 may provide a boost to the market.

Global Fixed Interest

Bond yields lower

Global bond yields fell over the month as risk aversion increased over concerns about the global outlook and further financial writedowns. Long end yields in the US were largely unchanged over the month though two year yields fell as the market began removing some of the increases it had priced in for the US over the next year. The hedged global bond benchmark gained 1.2%.

Australian yields were markedly lower over the month as investors grappled with a less hawkish Reserve Bank of Australia (RBA) and a weaker domestic economy. The Australian benchmark gained 1.8% over the month.

Outlook: After its recent rally Australian bonds continue to look cheap albeit less so than before. Other markets look to be around fair value however an easing in inflation may see bonds rally further.

Currencies

US Dollar rallies

The **US Dollar** rallied as weaker economic data weighed on the **Euro** and **Japanese Yen**. The **Australian** and **New Zealand Dollars** ended the month weaker with the Reserve Bank of New Zealand cutting rates and the interest rate markets in Australia increasingly pricing in cuts in the domestic rate. Returns from foreign currency exposure were 0.9% on 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*			
	Jul-08	1 month	3 months	Fin Year	1 year
Sharemarkets					
Australia (S&P/ASX 200)	4977	-4.56	-10.33	-4.56	-15.60
World (MSCI World ex Aust)	957	-1.71	-8.38	-1.71	-14.50
US (S&P 500)	1267	-0.84	-8.02	-0.84	-11.09
UK (FTSE 100)	5412	-3.69	-10.37	-3.69	-11.56
Europe (MSCI Europe ex UK)	1046	-1.06	-10.70	-1.06	-20.99
Japan (Topix)	1304	-1.24	-3.99	-1.24	-22.32
Currencies					
Australian Dollar/US Dollar	0.941	-1.99	-0.19	-1.99	9.77
Australian Dollar/Euros	0.603	-1.03	-0.41	-1.03	-3.69
Australian Dollar/Yen	101.66	-0.07	3.22	-0.07	-0.35

* Sharemarket returns inclusive of dividends, in local terms.

Economist's View

International Economies

Global growth outlook deteriorates

Key Points

- Policy trade-off between growth and price stability creates dilemma for central banks
- US Treasury and Fed react to Fannie Mae and Freddie Mac risk
- Outlook for Euro zone, UK and Japan deteriorates
- US growth supported by tax rebates and strong net exports
- China growth slowing but still provides support to global growth

Bernanke highlights twin risks of flagging growth and rising inflation

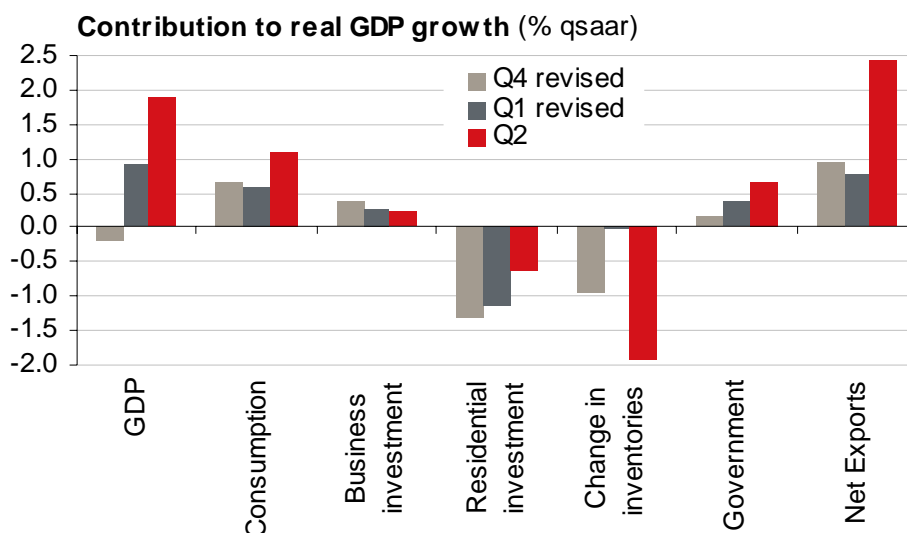
Tension over the trade-off between growth and inflation has dominated the outlook for global economic and financial markets over recent months. The situation is exemplified in the Chairman of the US Federal Reserve (Fed) Dr Ben Bernanke's semi-annual testimony to Congress, where he commented that "...the possibility of higher energy prices, tighter credit conditions, and a still-deeper contraction in housing markets all represent significant downside risks to the outlook for growth." Bernanke also stated that, "...at the same time, upside risks to the inflation outlook have intensified lately, as the rising prices of energy and some other commodities have led to a sharp pickup in inflation and some measures of inflation expectations have moved higher."

Fannie Mae and Freddie Mac

July also witnessed ongoing uncertainty over the stability of the financial system. In the first two weeks of the month, concerns over Fannie Mae and Freddie Mac, in addition to the failure of IndyMac, saw a sharp re-rating of risk in financial markets. The US Treasury and the Fed responded by providing guarantees on the solvency of the two Government-Sponsored Enterprises (GSEs). The actions of the Treasury and Fed signalled to markets that support of the financial system is a policy priority. While such a priority limits the severe downside risks associated with the credit crisis, to the extent that public funds are used in managing the crisis, the costs of underpinning financial institutions will weigh on future economic recovery as US policy makers are forced to manage deteriorating public finances.

Global growth outlook deteriorates

While the reactions of the US Treasury and Fed to the banking crisis and the retreat of oil prices had a calming effect on markets and improved the economic outlook, weaker than expected global economic data tempered the outlook. Deterioration in the outlook for growth and increases in rates of inflation typified data of the major advanced economies during July, particularly in the Euro area economies and Japan. In the US economy, headline inflation picked up to 5.0% year ended (the fastest year-ended rate since early 1991). As in the other major advanced economies, the sharp pick-up in inflation was driven by the rise in oil prices. National accounts data revealed that the US economy grew at 1.9% quarter on quarter annualised in the second quarter of 2008. Consumer spending contributed to growth (boosted by tax rebates), housing investment continued to fall (albeit at a slowing pace) and a fall in inventories generated the largest negative contribution to growth. Overall the components of domestic demand detracted from Gross Domestic Product (GDP) growth. Offsetting the weakness in domestic demand was a strong positive contribution from net exports.



China still supporting the global economy

With weak internal dynamics in the advanced economies, it is imperative that growth in developing economies remains robust if the advanced economies are to avoid a deep recession. In this regard, the Chinese June quarter national accounts were promising for the global economic outlook. Although activity in the Chinese economy continues to gradually moderate, real GDP growth remained solid at 10.1% (year-ended). Importantly, there is evidence of a transition in the driver of Chinese growth away from the external sector, in favour of domestic demand. While investment in fixed assets was strong and retail sales remained robust over the first half of the year, the external sector's contribution to growth is moderating. As China transitions to greater reliance on domestic demand, Chinese import growth will remain high and support the external sectors of its trading partners. Ongoing import demand from the non-Japan Asian economies facilitates the US economy's transition from reliance on domestic demand as its source of growth to a greater contribution from net exports, thereby cushioning the impact of slowing growth in US consumer spending and housing investment.

However, ongoing strength (albeit at a slowing pace) in the developing economies is not without cost. By maintaining the global economy at close to trend pace, the developing economies add to global inflationary pressure. Even though growth in advanced economies is below trend, inflation in these economies is above trend as the developing economies export inflation to the rest of the world via the prices of their exports and via pressure on commodity prices. As a consequence, the advanced economies are inhibited from enacting expansionary macroeconomic policy (particularly monetary policy) as swiftly as they would in the absence of inflationary pressures. Not only do the resulting higher interest rates pressure domestic spending in the advanced economies, but they also retard recovery in the prices of assets such as equities and housing and thereby retard the reconstruction of wealth. Tighter monetary policy also retards the rate at which banks rebuild profit margins, restore balance sheets and reduce credit spreads. Consequently, while robust growth in developing economies helps the advanced economies avoid a much deeper slowdown in activity than they otherwise would have experienced, it probably also means that the recovery to trend growth in advanced economies will be a lengthy process.

Interest Rates (%)

	Level	QIC forecast		
	Aug-08	3 months	6 months	1 year
Australia	7.25	7.00	6.75	6.25
US	2.00	2.00	2.00	2.50
Canada	3.00	3.00	3.00	3.25
Europe	4.25	4.25	4.00	4.00
UK	5.00	5.00	4.75	4.00
Japan	0.50	0.50	0.50	0.50

Australian Economy

RBA shifts to easing bias

Domestic conditions in the Australian economy continue to deteriorate with evidence of further weakening in consumer spending and the housing market. Real retail sales fell for a second consecutive quarter in 2008 posting their weakest back-to-back result since the introduction of the GST in 2000. In addition, credit growth continued to slow in June, weighed down by high interest rates and deteriorating consumer confidence. Furthermore, falling house prices, declining dwelling approvals and a slowdown in the rate of housing credit growth are reflective of a stagnant housing market. Tightening financial conditions and high fuel prices have weighed heavily on domestic spending in Australia, although the mid-year tax rebates may provide some relief in coming months.

In contrast to domestic conditions, external conditions remained strong with Australia's June trade balance in surplus for the second time in three months. The trade balance has been boosted by exports of non-rural exports, especially coal. Given the approximate doubling in coal and iron ore contract prices, we expect ongoing improvement in the trade balance and the current account.

Consumer prices rose in the June quarter, lifting the year-ended inflation rate to 4.5%; the highest annual rate since the introduction of the GST in 2000. Although recent price data indicates that inflation is rising, the Reserve Bank of Australia (RBA) appears comfortable that domestic demand is moderating sufficiently to reduce inflation over the medium term. In response to the change in policy emphasis of the RBA and recent data showing slowing domestic demand, the market has reversed its outlook for monetary policy and is now expecting a rate cut before the end of the year, as opposed to expecting rate hikes. Our view, since the last rate hike in March, has been that the RBA was at the end of its tightening cycle and we expected the first rate cut in the first quarter of 2009. Rhetoric from the RBA suggests they will begin easing; possibly as soon as the September meeting. In response we have brought forward our easing cycle.