

The Markets

International Equities

Rebound short-lived on fears of stagflation

Equity markets rebounded strongly in April following the weak performance of the previous quarter. Investors were reassured following the US Federal Reserve's (Fed) bailout of Bear Stearns that a complete financial meltdown may be avoided. Earnings came in above expectations and write-downs from sub-prime losses were not as bad as feared. US economic data showed moderate improvements and growth appeared to be holding up reasonably well although there were some concerns that this was being temporarily bolstered by tax rebates.

This optimism faltered in May and June as inflation fears emerged on the back of new record highs in oil and food prices. Central banks responded by becoming increasingly hawkish, and markets started pricing the possibility of hikes by the Fed in 2008. These fears gained momentum as markets focussed on the risk of stagflation. Some concerns over the credit crisis were reignited, as warnings about further losses were issued by investment banks. Financial stocks reached new lows, and a number of global markets also fell below their March lows.

US shares ended the quarter 2.7% lower, UK 0.4% lower. Europe (ex UK) underperformed losing 4.1%, while Japan reversed the underperformance of the previous quarters gaining 8.9% over the quarter. Global equities fell 0.2% in hedged terms.

Outlook: Equity valuations are currently undemanding on current earnings but near-term risk is presented by both slower global growth and higher inflation.

Australian Equities

Resources surge, other sectors sag

Australian shares followed the global trend higher and then back lower this quarter. The market was supported by the ongoing strength in commodity prices, as Rio secured a record 86% increase in iron ore contract prices. Gains outside the Resource sector (+18.7%) were scarce however, with Financials (-10.0%), Media (-20.1%), Listed Property (-15.5%) and Consumer Discretionary (-21.7%) all down sharply over the quarter. Australian equities fell 1.8% over the quarter.

Outlook: Valuations on the Australian market appear fair. While domestic growth is expected to remain robust, there are risks to consumption from a weaker housing market and high interest rates. We expect Australian equities to underperform global equity markets going forward.

Global Fixed Interest

Bonds sell off

Bonds sold off sharply over the quarter as the market's focus on the risk of a deep and prolonged recession shifted to a focus on growing inflationary pressures. The Fed cut rates in April to 2.0%, though markets shifted to price in hikes by the end of this year as economic data improved and inflation risks increased. The yield on the US ten year bond

rose close to 1.0% from the March low, before moderating slightly to end the quarter at 3.97% (+0.56% over the quarter).

Other central banks also moved to focus less on the weaker growth outlook and more on the high inflation evident throughout most of the global economies. The European Central Bank (ECB) signalled that they intended to hike rates in July, and the market priced out further cuts from the Bank of England (BOE). The benchmark return for global bonds (hedged) was down 0.6% for the quarter.

Domestically the Reserve Bank of Australia (RBA) left rates on hold over the quarter amid signs that previous tightenings are beginning to be felt. Another higher than expected inflation reading increased expectations that rates are likely to be high for an extended period. The Australian ten year bond yield rose from 6.05% to 6.45%, with the benchmark gaining 0.4%.

Outlook: Global bonds appear to be fairly-valued as markets have responded to higher inflation fears. US bonds still appear relatively expensive though Australian bonds offer good-value, with a rally likely when the market gains confidence that the peak in rates has been seen.

Currencies

Reprieve for the US Dollar

After falling sharply in the March quarter, the **US Dollar** stabilised against the other majors in the three months to June. This reflected the improvement in credit and financial market sentiment, the reduced probability of recession and the associated end of the Fed's aggressive easing cycle. The **Euro** reached a new all-time high during the quarter but finished relatively unchanged against the US Dollar, with higher interest rates providing support.

The **Japanese Yen** weakened gradually against the majors as risk aversion fell. The **Australian Dollar** outperformed over the quarter, supported by the continued strong rise in coal and iron ore prices and interest rate differentials, touching a high of US\$0.966 on the last day of the quarter. Returns from foreign currency exposure were -6.4% 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. However near term further weakness remains a risk as markets reassess their expectations of Fed rate hikes. 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*			
	Jun-08	1 month	3 months	Fin Year	1 year
Sharemarkets					
Australia (S&P/ASX 200)	5215	-7.46	-1.79	-13.40	-13.40
World (MSCI World ex Aust)	975	-8.28	-1.03	-15.69	-15.69
US (S&P 500)	1280	-8.43	-2.73	-13.12	-13.12
UK (FTSE 100)	5626	-6.77	-0.37	-11.58	-11.58
Europe (MSCI Europe ex UK)	1059	-11.06	-4.11	-22.80	-22.80
Japan (Topix)	1320	-6.20	8.90	-24.39	-24.39
Currencies					
Australian Dollar/US Dollar	0.960	0.65	5.13	13.11	13.11
Australian Dollar/Euros	0.609	-0.72	5.73	-3.04	-3.04
Australian Dollar/Yen	101.73	1.07	11.96	-2.91	-2.91

* Sharemarket returns inclusive of dividends, in local terms.

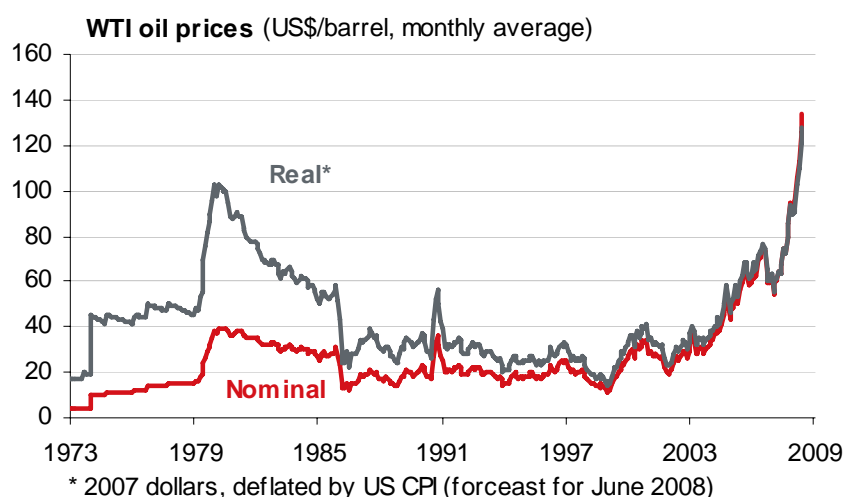
Economist's View

International Economies

Rising oil prices boost inflation concerns

The global economy has continued to be restrained by a number of shocks over the past quarter. In particular, the continued financial market turmoil, a general downturn in housing cycles and the squeeze in real incomes from higher food and energy prices continue to weigh on activity. While the downside risks to global growth due to dislocations in financial markets have eased somewhat since mid March, conditions remain fragile. Further strains could emerge due to the continued fall in US house prices, the emergence of further losses at major financial institutions or a sharper-than-expected downturn in the US economy. Overall, we continue to expect the global economy to slow significantly in 2008 and remain weak in 2009, led by sluggish growth in the advanced economies and slowing, but still solid, growth in major emerging markets.

Global inflation has picked-up in recent months, given the rapid increase in food and energy prices. Indeed, oil prices have doubled over the past year, recently rising above US\$140 per barrel, while prices of a number of food commodities have also picked-up sharply. Nonetheless, in constant dollar terms, the prices of many commodities remain well below their late 1970s and early 1980s peak, with the major exception of crude oil. Headline inflation is expected to remain high throughout 2008 and has recently prompted many central banks, including those in Brazil, Mexico, Peru, Chile, Taiwan, India, Philippines, Russia, Poland, Norway and South Africa to tighten monetary policy over recent weeks.



US

Growth in the US economy is expected to remain weak in coming quarters, weighed down by the continued housing downturn. Conditions in the housing market remain weak, with housing starts and permits down around 57% since their 2005/06 peak. The stock of unsold homes remains elevated, which is continuing to place downward pressure on house prices. Prices have now fallen 18% since their peak in mid 2006 according to the Case-Shiller 20-city index. Household consumption has slowed significantly in recent quarters, weighed down by tighter credit conditions, falling housing wealth and deteriorating labour market conditions. However, the tax rebates associated with the Economic

Stimulus Act of 2008 have begun to provide support to the household sector, with real personal consumption expenditure firming in recent months. Nevertheless, the support is likely to prove temporary, with consumer spending expected to weaken once the impact of the tax rebates fades in late 2008. Furthermore, labour market conditions have softened further in recent months, with the unemployment rate jumping 0.5 percentage points in May to 5.5%, the largest monthly gain since 1980.

Elevated inflation remains a concern for the US Federal Reserve (Fed), with headline consumer prices up 4.2% over the year to May, while consumer inflation expectations have also picked-up sharply. Headline inflation is expected to rise further in coming months, due to the recent increase in energy prices, before moderating later this year and next year. Core inflation has remained more moderate, up 2.1% over the year to May. While we continue to expect the federal funds rate to remain unchanged until the economy begins to recover in 2009, there is a risk the Fed may need to raise rates sooner if the upside risks to inflation continue to build.

Eurozone

After surprisingly resilient growth in the March quarter, the euro area economy is expected to moderate significantly in coming quarters. Forward-looking business surveys continue to suggest more moderate, below-trend growth over the remainder of 2008. Inflation continues to pick-up in the region, with headline inflation up 4% over the year to June according to the preliminary release, double the European Central Bank's (ECB) upper target. In response to the worsening inflation outlook, the ECB raised the repo rate by 0.25% to 4.25% in July. We expect the ECB will leave policy unchanged for the remainder of 2008.

Japan

The Japanese economy also remained resilient in early 2008, with real Gross Domestic Product (GDP) growth rising 1% over the March quarter. However, partial indicators suggest a significant moderation in coming quarters, led by a slowdown in the external sector. Business and consumer sentiment has declined further in recent months, while labour market conditions have softened somewhat. While consumer price inflation picked-up to 1.3% over the year to May, this continues to be entirely due to a pick-up in food and energy prices and excluding these items core inflation remains close to zero. We continue to expect the Bank of Japan to leave rates unchanged until 2009.

China

Activity in the Chinese economy remains strong, although momentum has eased in recent quarters with year-ended growth in real GDP moderating to 10.6% in the March quarter. While export growth has eased modestly due to slowing global activity, domestic conditions remain solid. Inflation remains elevated, at 7.7% over the year to May, but continues to be largely driven by sharp gains in food prices. While the Chinese authorities have recently announced an increase in domestic fuel prices by 17-18% and nationwide electricity prices by 4.7%, we expect moderating food price inflation to largely offset the increase in energy prices in the near-term. Furthermore, we expect growth to remain strong in China in 2008, but slow to an annual pace slightly below 10%.

Interest Rates (%)

	Level	QIC forecast		
	Jul-08	3 months	6 months	1 year
Australia	7.25	7.25	7.25	6.75
US	2.00	2.00	2.00	2.50
Canada	3.00	3.00	3.00	3.00
Europe	4.25	4.25	4.25	4.25
UK	5.00	5.00	5.00	4.25
Japan	0.50	0.50	0.50	0.75

7-Jul-08

Australian Economy

Moderation in the economy continues, although elevated inflation remains a concern

Recent data continues to suggest that growth in the Australian economy is moderating in response to the substantial tightening in financial conditions since mid 2007 and the recent increase in fuel prices. The slowdown has been particularly felt by the household sector, with subdued retail sales and falling motor vehicle sales over recent months. Consumer and business sentiment has also fallen sharply, while credit growth to both households and business has slowed significantly. Furthermore, there is tentative evidence that labour market conditions are beginning to ease, with employment falling in May for the first time since October 2006. However, national income continues to receive a boost from the rising terms of trade, while additional mid-year tax cuts will provide some support to the household sector.

Inflationary pressures remain a concern, with headline inflation up 4.2% over the year to the March quarter, with similar gains recorded for underlying inflation. Inflation is expected to remain elevated throughout 2008, boosted by the recent increase in global oil prices. However, provided demand growth remains moderate, inflation is expected to ease over the course of 2009. The Reserve Bank of Australia (RBA) continues to note that the current stance of monetary policy is appropriate and we expect the RBA to leave rates unchanged for the remainder of the year.