

## The Markets

### International Equities

#### Market weakness extends into first quarter

The weakness in global shares extended into the March quarter, with key equity markets finishing the quarter lower despite a sharp rally since early March. Equity markets remained under pressure for much of the quarter, weighed down by deteriorating economic data and disappointing earnings, although this was offset more recently by further support from policy makers as well as hopes by some that economic growth will resume later this year.

Policy makers continued to extend their efforts to support markets and the economy; the US and Australian governments both announced additional fiscal spending packages while plans to restructure major US car-makers are currently under negotiation. Central banks in the US and UK began quantitative easing in order to further ease monetary policy. This essentially entails central banks creating money to buy financial assets. A number of US and European banks received further government funding, with the nationalisation of some major global banks a very real possibility. US Treasury Secretary Geithner announced the \$140 billion Public-Private Investment Fund (PPIF) as the next step to remove distressed assets from US bank balance sheets.

The US and UK shares were down for the quarter (11% and 10.3% respectively). Europe ex-UK equities underperformed on a relative basis, while Japanese equities outperformed other major markets (-12% and -8.9% respectively). Hedged international shares lost 11.9% in the March quarter.

**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 shares relatively resilient despite weak global conditions

The Australian market lost 2% over the March quarter, outperforming other major equity markets. Aggressive easing of interest rates by the Reserve Bank of Australia (RBA), a sharply weaker currency and the announcement of a \$42 billion 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 (RIO), Fortescue Metals Group (FMG) and OZ Minerals (OZL). Insurance firms underperformed, losing 18.4% amid investment losses, disaster-related writedowns and capital raisings. In contrast, banks performed relatively well, finishing the quarter up 8.9%, as recent earnings results proved surprisingly resilient.

**Outlook:** There are a number of factors that ought to support Australian shares: reasonable valuations, high dividend yields, lower cash rates and the banks are relatively well capitalised compared to global peers. The lower Australian dollar (AUD) 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 enters a severe downturn.

## 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 over the quarter as investors focused on greater bond issuance stemming from higher government spending. The US ten year bond yield ended the quarter higher at 2.8%, despite the Federal Reserve (Fed) officially beginning quantitative easing in March. The Australian ten year bond yield also finished the quarter higher at 4.4%, up from 4%, as the RBA hinted at a slower pace of interest rate cuts and some recent improvement in equity market sentiment. The return on the Barclays 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. The RBA is likely to keep rates lower for longer. Quantitative easing by the US and UK central banks, and the prospect of the European Central Bank (ECB) doing the same, should keep bond yields low.

## Currencies

### US dollar stronger, Japanese yen weaker

Over the quarter the US dollar gained against other major currencies, benefiting from its reserve currency status. The Euro lost ground, weighed down by investor concerns about the structural integrity of the European Monetary Union (EMU) and bank exposure to Eastern Europe. The Japanese yen (JPY) was the worst performer amongst the major currencies for the quarter, losing its safe haven allure as investors became increasingly concerned about deteriorating domestic economic conditions. The AUD was roughly steady against the US dollar (USD), ending the quarter at US\$0.697. A number of factors helped support the AUD, including a paring back of market expectations for interest rate cuts and increasing investor optimism for a more resilient Chinese economy. Returns on foreign currency exposure were -1.6%.

Outlook: We see the AUD as somewhat undervalued, but it remains exposed to further concerns about the global growth environment. The outlook for the USD 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 (%)

	Level	% Return*			
	Mar-08	1 month	3 months	Fin Year	1 year
Sharemarkets					
Australia (S&P/ASX 200)	3582	7.98	-1.98	-28.24	-29.52
World (MSCI World ex Aust)	595	4.70	-11.64	-38.00	-38.64
US (S&P 500)	798	8.76	-11.01	-36.35	-38.09
UK (FTSE 100)	3926	2.99	-10.29	-27.90	-28.17
Europe (MSCI Europe ex UK)	650	3.98	-11.95	-37.77	-40.33
Japan (Topix)	774	3.45	-8.85	-40.11	-34.78
Currencies					
Australian Dollar/US Dollar	0.695	8.76	-0.34	-27.60	-23.89
Australian Dollar/Euros	0.523	4.04	4.34	-14.08	-9.16
Australian Dollar/Yen	68.63	9.79	8.58	-32.54	-24.47

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

## Economist's View

### Key Points

- **Slump in global economic growth continues in the first quarter of 2009**
- **Policy announcements and positive economic data lift investor confidence**
- **Economic outlook will improve over the remainder of 2009, but negative growth rates to persist**
- **Australia to outperform other advanced economies, but RBA will still need to lower rates to 2.5%**

## International economies

### Slump in global growth continues in first quarter of 2009

The first quarter of 2009 has seen a continuation of the slump in global economic growth. Around the global economy, industrial production, business investment and exports have registered falls in the first quarter of 2009 around the same orders of magnitude as those recorded in the last quarter of 2008. The fall in industrial activity and capital expenditure over recent months in major advanced economies has severely damaged the growth prospects of developing economies through international trade linkages. The global economy now faces the threat of a negative feedback loop between advanced and developed economies being established through a downward trade spiral.

### Policy announcements and positive economic data lift investor confidence

Over March, a raft of policy initiatives, which culminated in a communiqué from the G20 summit, was announced by various governments and policy makers. The Bank of England (BoE) and the Fed announced plans to buy sovereign and corporate bonds, in official moves to quantitative easing. US Treasury Secretary Timothy Geithner unveiled the PPIF, whereby the Treasury in partnership with private-sector financial institutions, will purchase toxic assets from banks. Finally, the G20 announced \$1.1 trillion increase in International Monetary Fund (IMF) funding, destined for the alleviation of economic and financial conditions in Emerging Markets, and a centralised approach to the regulation of the global financial system.

Recent economic data also showed signs of a reduction in the pace of economic contraction. Within the US, the pace of correction in capital expenditure and inventories appears to have slowed, housing market data generally improved, and real consumer spending is likely to register positive growth in the March quarter. Within Asia, fiscal stimulus continues to support Chinese domestic demand and is providing a partial offset to the decline in foreign demand, while the pace of decline in Korean industrial activity continues to slow.

In response to policy announcements and improving data, risk aversion in financial markets moderated with global equity markets rallying by around 20% from their March 9 lows, the oil price rising by around 12%, commodity prices generally rising by around 10% and the safe-haven currencies of the USD and JPY falling against the other major currencies.

### Growth outlook is improving, but negative quarterly growth domestic product (GDP) growth rates will persist

We expect current policy initiatives will improve financial conditions resulting in a decline in credit spreads and ongoing recovery in equity prices. Lower spreads and higher equity prices will lower the cost of capital to businesses and households and improve the outlook for business and housing investment.

Improving financial conditions will also slow the rate of decline in household net wealth, which will be a positive for consumer spending. However, the pace of economic growth will not be sufficient to stem the decline in employment over 2009, and we expect the unemployment rate will continue to rise in most advanced economies over the remainder of the year. Rising rates of unemployment will place downward pressure on wage growth, which, combined with falling employment levels, will lower the rate of growth in household disposable income. In the absence of more substantial tax cuts and other government benefits to the household sector, weak growth in disposable income and the threat of job losses will result in subdued consumer spending in most advanced economies in 2009.

The fall in global growth over the last six months has been extremely swift. The pace of economic contraction has been hastened by sharp reductions in inventory levels and capital expenditure. Recent data show that the reductions in inventories have abated as businesses have corrected inventories to more sustainable levels. Consequently, the drag to growth from de-stocking will diminish over the remainder of 2009.

Overall, global growth will remain weak during 2009, with negative quarterly growth rates likely in the US, Japan, Euro area and UK in the first and second quarters of 2009. Fiscal stimulus, expansionary monetary policy and credit-market initiatives will lead the US out of a cycle of contracting economic activity in the second half of the year. The absence of significant fiscal stimulus and, in the case of the Euro area, the ongoing resistance by the ECB to lower the effective cash rate to zero and engage in quantitative easing, reduces the chances of positive growth in the UK and Euro area economies in the second half of 2009. Japanese economic growth will improve sharply from the second quarter of the year as export demand recovers from the collapse experienced over the last six months. However, the damage to domestic demand generated by the fall in export income will mean positive growth in the Japanese economy will be difficult to establish in 2009.

### Interest Rates (%)

	Level		QIC forecast	
	Mar-09	3 months	6 months	1 year
Australia	3.00	2.50	2.50	2.50
US	0.00 - 0.25	0.00 - 0.25	0.00 - 0.25	0.00 - 0.25
Canada	0.50	0.50	0.50	0.50
Europe	1.25	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

### Australian growth to fall by 0.2% in 2009 – worst outcome in 20 years

The Australian economy contracted for the first time in eight years in the December quarter, with real GDP falling 0.5%. With activity set to contract again in the March quarter, the Australian economy is experiencing its first recession since 1990/91. The severity of the recession will partly depend on how households respond to the \$12 billion in tax rebates, issued in March and April. Our forecast assumes that approximately one-fifth of the handouts will be spent in the first three months, consistent with our interpretation of spending patterns following the \$8.7 billion of stimulus payments received in early December. Despite the impact from the stimulus in 2009 and 2010, the economy is not expected to commence a self-sustaining recovery until 2011, with real GDP growth expected to fall by 0.2% in 2009 before recovering modestly to 1.1% in 2010 and 1.4% in 2011.

However, the downturn would have been even more severe without the recent 30% depreciation of the AUD, which provides a significant competitive boost to our economy. The fall in the AUD should help limit the fall in export volumes to a modest 3.5% in 2009, while improved competitiveness and falling domestic demand will result in a fall in import growth of around 1.5%.

Nonetheless, with GDP to fall in 2009 and the unemployment rate set to rise to around 7% by the end of the year, the RBA will need to lower the official cash rate in the coming months. We expect the RBA to lower the official cash rate to 2.5% by the end of the financial year.