QIC Outlook
Market & Economic
May 2008

Go Further

The Markets

International Equities

Equities balance impact of higher inflation

Investor's attention swung to inflation in May as oil prices rose to record highs ($US 135 a barrel mid-month) and as central banks dampened expectations of rate cuts in the presence of high commodity-driven inflation. Assisting sentiment was a modest improvement in US economic data and some subsidence of credit market problems.

US shares rose 1.3% as the Energy (+4.2%) and Materials (+4.0%) sector rallied while weakness was seen in Financials (-10.2%) following insurer AIG's warning that further credit markets losses could continue. Europe (ex UK) rallied 1.5%, the UK lost 0.2%. Japanese equities gained 3.6% as foreign investor interest picked up. Global equities rose 2.0% 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 rise again

The Australian sharemarket finished May up 1.5%. The Resources sector (+7.6%) was the focus of corporate activity. There were reports that Chinese materials group Chinalco was seeking a 9% stake in BHP (+2.9%), Macarthur Coal, Santos and Fortescue Metals were also the subject of overseas corporate interest.

Westpac announced a friendly all script takeover of St George Bank (+29%), which has been particularly hard hit by the credit crunch. Outside of St George, Financial sector performance was mixed as global financials weakened and as markets saw the Reserve Bank of Australia (RBA) taking a more hawkish approach to interest rates. Listed Property lost 9% in April.

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 pressured by inflation scare

Bond markets continued to be pressured by concerns about higher inflation and some evidence that the US economy may skirt outright recession despite a weak housing market.

US bond yields rose, the ten year yield increasing to 4.06% from 3.73%. The US Federal Reserve (Fed) also provided a more pessimistic outlook for growth (lower) and inflation (higher) going forward, markets are now priced for the first interest rate increases from the Fed in early 2009. Bonds in Europe were similarly weak. The European Central Bank (ECB) has remained clearly focused on fighting inflation while higher than-expected inflation and a deterioration in the inflation outlook has seen the market abandon hopes of further easings from the Bank of England (BOE). The benchmark return for global bonds (hedged) was down 0.51% for the month.

Domestically, the RBA adopted a somewhat hawkish tone in the latest Monetary Policy Statement, with increased expectations that rates may stay at 7.25% for some time. The Australian ten year bond yield rose from 6.28% to 6.53%.

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

The **US Dollar** finished the month largely unchanged against the **Euro** and **Japanese Yen** with the Fed remaining on hold and renewed concerns about rising inflationary pressures. Reflecting the inflation/commodity price themes the commodity currencies such as the **Canadian Dollar** and **Australian Dollar** outperformed with the Australian Dollar reaching a twenty-four year high of US$0.965 during the month. The return on foreign currency exposure was -1.6% for the International equity benchmark.

Outlook: With the US Dollar's attractive valuation, combined with signs that interest rate differentials have stopped moving against it, we remain positive on the US Dollar. The Euro remains our least favoured currency in terms of valuations, while the recent rise in the Australian Dollar appears overdone relative to fundamentals.

Financial markets (%)

	Level	% Return*			
	May-08	1 month	3 months	Fin Year	1 year
Sharemarkets					
Australia (S&P/ASX 200)	5655	1.53	2.61	-6.43	-6.58
World (MSCI World ex Aust)	1064	1.62	5.64	-8.08	-9.00
US (S&P 500)	1400	1.30	5.77	-5.12	-6.70
UK (FTSE 100)	6054	-0.17	4.51	-5.16	-5.10
Europe (MSCI Europe ex UK)	1192	1.49	4.89	-13.19	-14.04
Japan (Topix)	1408	3.65	7.33	-19.39	-18.48
Currencies					
Australian Dollar/US Dollar	0.953	1.18	1.93	12.38	15.20
Australian Dollar/Euros	0.614	1.36	-0.43	-2.33	-0.25
Australian Dollar/Yen	100.65	2.20	3.36	-3.93	-0.17

* Sharemarket returns inclusive of dividends, in local terms.

Economist's View

International Economies

Growth in Japan and Europe resilient in the March quarter

While conditions in global financial markets have generally improved since mid March, conditions remain fragile. This was highlighted by Standard and Poor's downgrading the credit ratings of three major US investment banks in early June on concerns over further writedowns. Furthermore, the outlook for the global economy remains soft, with global growth still expected to slow to a below-trend pace in 2008, despite somewhat resilient growth in a number of economies during the March quarter.

US

Growth in the US economy was revised modestly higher in the March quarter, with the economy expanding an annualised 0.9% over the quarter. While the year-ended rate remained solid at 2.5%, this is due to strong growth in mid 2007, with the economy stalling over the last 6 months. Household consumption rose an annualised 1% in the March quarter, the weakest quarterly pace in 13 years. More recent data reveals the slowdown continued into the June quarter, with real personal consumption remaining flat in April. Residential investment continued to decline during the quarter, while business investment remained flat. The external sector continues to support the economy, with export growth remaining solid over the quarter, buoyed by the ongoing depreciation of the US Dollar and resilient global growth. Growth is expected to remain weak in the June quarter, before recovering modestly later in the year, aided in part by the significant fiscal stimulus package. Indeed, around $50 billion of tax rebates (out of an estimated $106.7 billion) have been issued to households by the end of May, with the majority of the remainder expected to be received by mid-July.

While headline inflation remains elevated, with the consumer price index (CPI) up 3.9% over the year to April, there has been some improvement in core inflation readings over recent months. In three month-ended terms, core consumer prices eased to an annualised 1.2% in April compared to 3.1% in January. Although the US Federal Reserve (Fed) has noted concerns about upside inflation risks, it expects prices to moderate in coming quarters. Overall, we continue to expect interest rates to remain on-hold for the remainder of 2008 in the US, although there still remains a risk of further cuts if economic conditions deteriorate more than anticipated.

Eurozone

Growth in the Eurozone economy rose a strong 0.8% in the March quarter, to be up 2.2% over the year. Household consumption remained subdued, rising 0.2% over the quarter, while business investment rose a solid 1.6%. Exports remained solid, with demand from Emerging Markets providing support. Growth was particularly strong in Germany, rising 1.5% over the quarter, supported by a weather induced pick-up in construction activity and a large inventory build. Elsewhere in the region, growth was solid in France over the quarter, soft in Spain and the Netherlands, while growth rebounded in Italy after contracting in the December quarter. Forward-looking business surveys continue to suggest more moderate, below-trend growth in coming quarters. Furthermore, the labour market has started to show tentative signs of weakness, with the number of unemployed rising in April for the first time since January 2006.

Elevated inflation readings remain a significant concern for the European Central Bank (ECB), with the headline inflation rate rising to 3.6% over the year to May. We continue to expect the ECB to leave rates unchanged in the near-term due to inflation concerns, before beginning to ease rates late in 2008 as the economy slows.

Japan

The Japanese economy has remained resilient, with real Gross Domestic Product (GDP) growth rising a robust 0.8% in the March quarter. In year-ended terms, growth slowed from 1.7% to 1% due to strong base effects. Private consumption rose a strong 0.8% over the quarter, but spending is expected to slow in coming quarters with more recent data pointing to a slight deterioration in the labour market. Business investment softened, falling 0.9% over the quarter, while residential investment rebounded 4.6% after declining throughout 2007 due to policy changes. The external sector continues to drive the economy, with exports rising a strong 4.5% over the quarter. However, more recent data reveals a significant fall in real exports in April, and combined with other softening partial data, suggests a more subdued outlook for the Japanese economy. Consumer price inflation eased to 0.8% over the year to April, with core inflation excluding food and energy remaining relatively flat over the year. We continue to expect the Bank of Japan (BoJ) 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, picking up to 8.5% over the year to April, due to sharp gains in food prices. We expect growth to remain strong in China in 2008, but slow to an annual pace slightly below 10%.

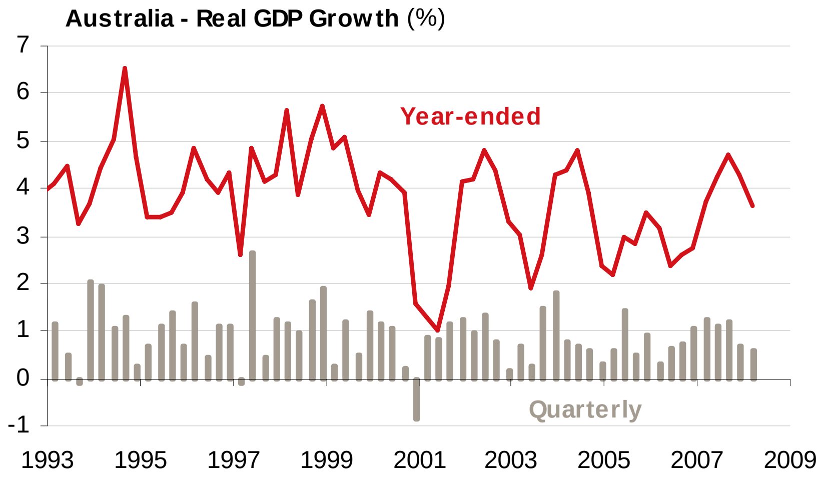
Interest Rates (%)

	Level	QIC forecast		
	Jun-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	2.75	2.75	2.75
Europe	4.00	4.00	3.75	3.50
UK	5.00	5.00	4.75	4.00
Japan	0.50	0.50	0.50	0.75

Australian Economy

Stronger-than-expected GDP growth in the March quarter, but momentum is slowing

The March quarter national accounts provided some support that momentum in the Australian economy is easing, although data revisions suggest the pace of growth in 2007 was stronger than initially estimated. Real GDP growth rose a stronger-than-expected 0.6% in the March quarter to be 3.6% higher over the past year, slightly below the 4.3% growth experienced over the year to the December quarter (revised up from 3.9%). However, growth was supported by resilient production and income, with expenditure GDP rising a softer 0.2% over the quarter. Household consumption slowed, rising 0.7% over the quarter about half the pace that was experienced over the second half of 2007. Tighter financial conditions have caused consumers to reign in their spending, although the tight labour market continues to provide support. Private business investment rose 1.5% over the quarter, with strong engineering construction partially offset by a fall in machinery and equipment investment. Private dwelling investment remained flat over the quarter, while the external sector detracted heavily from growth with exports rising a soft 0.5% due to weather-related disturbances and imports rising a strong 3.5%. Growth is expected to continue to moderate in coming quarters, weighed down by a further moderation in household spending.



Source: FactSet; QIC

Inflationary pressures remain a concern, with headline inflation picking up in the March quarter to 4.2% over the year, with similar gains recorded for underlying inflation. While inflation is expected to remain elevated throughout 2008, demand growth is beginning to show signs of moderation. As a result, we expect the RBA to leave rates unchanged for the rest of the year.