

31 May 2009

The Markets

International Equities

Equities extend rally in May

Global share markets ended May higher, although with smaller gains than the previous two months. The rally was helped by generally better than expected economic data, the so-called 'green shoots'. Uncertainty and investor concerns over the health of the US banking sector was also alleviated somewhat with the release of the US Treasury's bank stress-test results, and the subsequent successful capital raisings by a number of large US banks. Indicators of liquidity in money markets have improved. However, disappointing US consumer spending data released recently served to highlight the continuing fragility of the global economy.

As further signs of global economic stabilisation become apparent, investors have increasingly cast their concerns about the sustainability of government debt. This was exacerbated by ratings agency Standard and Poor's placing the UK credit rating on negative watch. In addition, the worldwide outbreak of swine flu and nuclear tests in North Korea further added to short-term market volatility and uncertainty.

Major developed share markets ended the month higher. The US and UK markets gained 5.59% and 4.68% respectively, while Europe (ex-UK) shares were up 4.67% for the month. Japanese shares outperformed other markets, ending the month 7.18% higher. Hedged international shares gained 5.94% in May.

Outlook: Equity valuations currently appear quite attractive on a number of measures, as sentiment has significantly improved. Evidence that policy measures are beginning to take effect and an exhaustion of selling pressures could allow the rally to continue. However, investor caution may return given the likelihood of sharply lower earnings brought about by the global economic crisis.

Australian Equities

Australian shares make a small gain

The Australian market gained 1.36% in May, underperforming other major equity markets. The strengthening Australian dollar (AUD) and a number of capital raisings all provided headwinds for investors. The energy and materials sectors performed strongly on the back of higher commodity prices and hopes that economic growth in China will improve. While the materials sector performed strongly, Rio Tinto underperformed as speculation mounted over the future of its deal with Chinalco. The insurance and telecommunications sectors underperformed the broader market, the latter due to the uncertainty over the future of Telstra, with the recent departure of its CEO and the announcement of the National Broadband Network.

Outlook: There are a number of factors that should support Australian shares, reasonable valuations, high dividend yields, lower cash rates and the fact that Australian banks are relatively well capitalised compared to global peers. However, valuations are not as attractive as in other markets.

Global Fixed Interest

Bonds weaker on supply and fiscal concerns, better economic outlook

Global bond yields continued to move higher in May amidst buoyant equity markets and economic data that beat market expectations. Also weighing on bond markets were persistent concerns over bond supply and the amount of debt major governments have undertaken to expand fiscal spending. This was exacerbated by Standard and Poor's placing the UK credit rating on negative watch, and led some to question the security of the US's own credit rating. The US 10 year bond yield closed the month higher at 3.67%. Australian 10 year bond yields were also higher, ending the month at 5.29% amidst general weakness in global bonds. Credit spreads contracted on the improved outlook, and the return on the Barclays Capital Global Aggregate Index was 0.39%.

Outlook: Bonds are good value once the outlook for a prolonged period of lower interest rates is factored in, and despite concerns about government debt. The Reserve Bank of Australia (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 over the medium term.

Currencies

US dollar (USD) weighed by fiscal concerns

Risky currencies strengthened as economic data continued to exceed analyst expectations and equity markets continued to climb. The USD suffered as safe-haven support for the currency abated and investors became more concerned about the effect of mounting US fiscal debt. Both the euro and the Japanese yen (JPY) gained ground against the USD. The AUD also strengthened against other major currencies, ending the month at US\$0.80, amidst increased investor confidence. Returns on foreign currency exposure were -5.86% (international equity benchmark).

Outlook: We see the AUD as somewhat above its fair value and it remains exposed to further concerns about the global growth environment. The outlook for the USD is now more mixed, valuations are somewhat attractive but the reliance on foreign investor purchases of Treasuries remains. We expect the euro to weaken as the region is likely to experience relatively lower economic growth.

Financial markets (%)

Sharemarkets	Level as at 31-May-09	1 month return	3 month return	Financial YTD return	1 year return
Australia (S&P/ASX 200)	3818	1.36	15.54	-23.21	-28.94
World (MSCI World ex Aust.)	700	5.78	24.24	-26.43	-32.52
US (S&P 500)	919	5.59	25.83	-26.36	-32.57
UK (FTSE 100)	4417	4.68	16.96	-18.12	-23.67
Europe (MSCI Europe ex UK)	761	4.67	25.06	-25.16	-33.44
Japan (Topix)	897	7.18	20.07	-30.49	-34.79
Currencies					
Australian Dollar/US Dollar	0.80	8.95	25.30	-16.59	-16.05
Australian Dollar/Euro	0.57	1.99	12.42	-7.15	-7.83
Australian Dollar/Yen	76.41	5.70	22.23	-24.89	-24.09

Sharemarket returns are inclusive of dividends, in local terms.

Economist's View

Key Points

- Global economy at a turning point, positive growth in most economies by year end
 - The recovery will be gradual, above-trend growth not expected until 2012
 - Weak inflation or mild deflation expected in most countries in 2009 and 2010
 - Central banks begin to normalise interest rates in late 2010 or 2011
 - Australian real GDP growth unexpectedly rises by 0.4% in first quarter of 2009, a brighter outlook?
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International Economies

Global economy at a turning point, positive growth in most economies by year end

The global economy is at a turning point, with the March quarter representing the largest contraction in growth. A recovery is expected to commence in the second half of the year as the coordinated global fiscal stimulus begins to boost demand. Global growth will continue to improve in 2010 as fiscal expansion peaks and financial market conditions continue to normalise. Nonetheless, the recovery in 2010 will be tepid, with most advanced economies still recording below-trend growth.

Looking at the outlook for individual economies:

- China commenced a recovery in the first quarter of 2009, with incoming economic data revealing strong growth in the second quarter of the year due to substantial fiscal and monetary stimulus. Other Asian economies are also exhibiting signs of stabilisation. Activity was flat in South Korea in the March quarter after declining more than 5% previously. Furthermore, real gross domestic product (GDP) growth was less negative in the first quarter of the year in Taiwan, Thailand and Singapore. Overall, developing Asia is expected to outperform due to a slowdown in the pace of de-stocking and a recovery in China, with growth in the region rising from 5% in 2009 to 7.7% in 2010.
- The US and Japan are expected to lead the recovery in the advanced economies. Real GDP growth is expected to become positive in the third quarter of 2009 in both economies. The recovery is expected to be stronger in the US given the magnitude of the fiscal package, with activity rising 1.9% in 2010 after falling 2.5% in 2009. Japan should also receive support from fiscal stimulus and a rebound in exports due to the stronger Asian region. Activity in Japan is expected to rise 1.4% in 2010 after falling 7.2% in 2009 due to the sharp downturn in late 2008 and early 2009.
- UK and the Euro area are expected to recover more slowly, with flat growth over the second half of the year. The recovery is expected to take hold in 2010. Growth in the UK is expected to fall 3.9% in 2009, recovering modestly to 0.1% in 2010. In the Euro area, growth is expected to fall 4.2% in 2009 before rising 0.8% in 2010.
- Emerging Europe and Russia are expected to underperform. Economies in emerging Europe with heavy reliance on exports and foreign sources of finance have been the worst performers in the global economy over recent quarters. Exchange rates have depreciated sharply in these economies and, to prevent an even sharper devaluation and to stem the outflow of foreign capital, some central banks have left monetary policy unchanged or lowered rates only gradually. Emerging Europe is expected to fall around 2% in 2009 and rise only 1.4% in 2010.

The recovery will be gradual, above-trend growth not expected until 2012

While the global recovery will begin to gain traction in 2010, we don't expect a sustainable recovery until 2012. After 2012 the sharp deterioration in public finances will place a significant headwind on the medium-term prospects for the global economy. Government debt is forecast to rise to over 100% of GDP by 2012 in the US, 80% in both the UK and Germany and 210% in Japan. Most advanced economies will be required to rebuild their fiscal positions once their

economies commence a sustainable recovery. As a result, we do not expect significant above-trend growth in coming years. Unemployment rates are likely to fall more gradually and global growth over the next decade will be much weaker than the growth experienced in the recent past.

Rising investor concern over increasing government debt, compounded by an announcement from Standard and Poor's to place the AAA rating on UK sovereign bonds on a negative outlook, has pushed government bond yields higher over the past month. Yields in the UK have increased 0.30% since the end of April, while yields in the US and Germany advanced around 0.50%. The recent run-up in bond yields is preventing a more substantial decline in the cost of debt faced by firms, despite a further moderation in corporate bond spreads over the past month.

Weak inflation or mild deflation expected in most countries in 2009 and 2010

Global inflationary pressure is expected to be weak in 2009 and 2010. Most major economies are expected to experience either mild deflation or low inflation in 2009 due predominately to past falls in commodity prices. US, Japan, China, Taiwan, Thailand, Singapore, Sweden, Switzerland, Spain, Portugal and Ireland have already experienced declines in consumer prices over the past year. Mild deflation or modest inflation is expected to persist in 2010 and 2011 as excess capacity and labour market slack places downward pressure on prices and wages. However, we do not expect deflation to become firmly entrenched, with almost all economies experiencing an increase in prices in 2011.

Central banks begin to normalise interest rates in late 2010 or 2011

The weak inflation outlook will result in only a gradual normalisation of interest rates, with most central banks not beginning to lift rates until late 2010 or 2011. The pace of normalisation will be heavily reliant on how quickly authorities reign in their fiscal deficits over the medium term.

Interest Rate Forecast (%)

	Level at 05 Jun 2009	Sep-09	QIC forecast Dec-09	Jun-10
Australia	3.00	2.50	2.50	3.00
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	1.00	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

Real GDP growth unexpectedly rises by 0.4% in first quarter of 2009, a brighter outlook?

The Australian economy expanded by 0.4% in the first quarter of 2009, following its first contraction in eight years in the December quarter. Activity has been cushioned by the sharp improvement in our trade balance following the 35% fall in the AUD between mid-2008 and early March 2009. Looking ahead, the contribution to growth from net exports will decline while imports recover as the sharp de-stocking of inventories wanes, while the recent 23% rally in the AUD since early March will pressure Australia's traded-goods sectors.

Consumer spending has also remained relatively resilient making positive contributions to GDP growth since the December 2008 quarter. Government handouts increased consumption in the March quarter, and we expect a similar result in the June quarter following the March-April cash handouts. However, consumption is expected to remain relatively subdued in 2009/10, driven by falling real disposable income as a result of declining employment and moderating wage growth.

Business investment fell sharply in the March quarter after remaining surprisingly resilient in late 2008. Real business investment fell 6.1% in the March quarter. Firms also significantly scaled back capital expenditure intentions for the 2009/10 financial year. Business investment is expected to decline consistently throughout 2009 and 2010, with the elevated cost of capital, weak economic outlook and falling terms of trade weighing on investment.

Dwelling investment also fell sharply, down 5.6%. However, demand for housing continues to rebound, with building approvals picking up over recent months following an increase in the First Home Owners Grant and a sharp reduction in mortgage rates. This is expected to flow through to higher dwelling investment towards the end of the year. On average, we expect dwelling investment to decline 8% in 2009, before rising 8% in 2010.

We expect growth to decline 0.2%, on an average annual basis in 2009, followed by a mild recovery to 1.4% growth in 2010. The unemployment rate will peak at around 8.25% in early 2010 and remain around 8.1% until 2011. Although recent rates of economic activity have been stronger than the RBA expectations, the inflation outlook remains weak. We continue to expect the RBA to cut rates to 2.5% in the second half of the year.

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