

The Markets

International Equities

Global shares weaken further

Global share markets continued to deteriorate in November, with a number of markets reaching new lows during the month. Market volatility remains elevated, although to a lesser extent when compared to the extremes of October. Commodity prices continued to decline as investors revised down their outlook for global growth, and in particular Chinese growth. This saw crude oil continue its fall to trade near \$US50 per barrel.

Policy makers around the world continued their efforts to stabilise market conditions, with the major central banks reducing interest rates further while individual countries continued to introduce various fiscal stimulus packages. The US Federal Reserve (Fed) moved to provide liquidity to the commercial paper market by establishing a US\$800 billion facility to purchase agency and asset-backed bonds. There were also discussions about the Fed purchasing government debt (previously used by Japanese authorities), and some have seen this as the start of quantitative easing in the US. The Treasury expanded the scope of the Troubled Asset Relief Program (TARP) to include securities backed by consumer loans, although markets were disappointed with the reduced focus on purchasing distressed securities from banks. Citigroup received further capital from the government and a guarantee over approximately US\$300 billion in risky assets. China also announced additional stimulus packages and reduced interest rates.

All major share markets declined during the month. Japanese equities lost 3.7%, while Europe ex UK fell 6.1%. The UK share market outperformed other major markets (-1.4%), as a weaker Sterling helped support UK earnings. The US market underperformed (-7.2%) on a weaker earnings outlook. The diversion of TARP funds to non-banks also impacted US financials negatively. Hedged international shares declined by 6.5% in November.

Outlook: Equity valuations currently appear quite undervalued according to a number of measures. However, investors are naturally cautious given the likelihood of a sharp decline in 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 lower

Australian shares lost 6.2% in November as global factors continue to influence the local market. Resources outperformed (-1.8%) despite further signs of Chinese weakness, falling commodity prices and the collapse of BHP's attempted takeover of Rio Tinto. Outside of the resource sector, cyclical sectors and banks continued to decline while defensives outperformed. Listed property outperformed (+0.2%) after suffering steep falls last month.

Outlook: Valuations on the Australian market appear attractive. We expect Australian equities to recover over the medium term but underperform compared to global equity markets. Interest rate cuts by the Reserve Bank of Australia (RBA) may provide a boost to the market.

Global Fixed Interest

Bond yields sharply lower

Key global bond yields were generally lower over the month as it became increasingly apparent that global interest rates are likely to remain low for an extended period of time. Deflation fears also gained traction among investors.

The US two-year bond yield fell from 1.56% to 1%. Given the limited scope for short-end yields to fall further, investors turned their attention further out the yield curve to drive the US ten-year bond yield down sharply from 4% to nearly 3%. The Bank of England's (BOE) aggressive policy-easing saw UK bond yields fall from 4.5% to 3.8%. Despite less dovish rhetoric from the European Central Bank (ECB), German bond yields fell from 3.9% to 3.3% due to continued weakness in the economic dataflow. The Barclays Capital Global Aggregate Index, formerly known as Lehman Global Aggregate Index, returned 3.1% on a currency hedged basis.

Australian bond yields fell from 5.2% to 4.6% as the RBA cut interest rates by 0.75% at the start of November. Three-year yields also declined from 4.6% to 3.5%, as markets are now priced for the RBA to swiftly lower interest to an accommodative monetary policy position.

Outlook: Australian bonds remain somewhat expensive. Given the momentum in economic data and interest rates this may remain until some signs of policy traction are seen. Global bonds appear to represent fair value considering the downside risks to growth.

Currencies

Volatile month in currency markets

Currency markets remained volatile in November, although substantially less so when compared to October. High yielding and commodity-linked currencies remained under pressure over the month.

The Australian dollar remained volatile after its steep fall in October, although it ended the month only slightly down, falling to US\$0.65 from US\$0.66. The US dollar continued to strengthen against most major currencies, including the Euro and Pound, while the Japanese yen continued to benefit from risk aversion. The return on foreign currency exposure was 0.6% on the international equity benchmark.

Outlook: The sharp fall in the Australian dollar has caused the currency to be undervalued according to our measures, even after factoring in the deterioration in the outlook for global growth. We continue to see the Euro and Swiss franc as expensive. The rally in the Japanese yen has taken it through our medium-term valuation target, and it is now considered expensive.

Financial markets (%)

	Level	% Return*			
	Nov-08	1 month	3 months	Fin Year	1 year
Sharemarkets					
Australia (S&P/ASX 200)	3743	-6.20	-26.10	-26.58	-39.95
World (MSCI World ex Aust)	671	-6.08	-30.11	-30.57	-39.85
US (S&P 500)	896	-7.18	-29.65	-29.23	-38.09
UK (FTSE 100)	4288	-1.38	-23.13	-22.37	-30.46
Europe (MSCI Europe ex UK)	747	-6.15	-29.05	-28.90	-42.92
Japan (Topix)	835	-3.72	-32.92	-36.23	-44.45
Currencies					
Australian Dollar/US Dollar	0.651	-1.30	-24.38	-32.14	-26.37
Australian Dollar/Euros	0.513	-1.36	-12.27	-15.74	-14.82
Australian Dollar/Yen	62.024	-4.41	-33.64	-39.03	-36.78

* Sharemarket returns inclusive of dividends, in local terms.

Economist's View

Key Points

- **Economic outlook worsens following further deterioration in financial markets**
 - **Government authorities continue to respond, but a further large fiscal package is required in the US**
 - **Australian economy stalls, but significant policy stimulus in the pipeline**
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International Economies

Economic outlook worsens following further deterioration in financial markets

Global equity markets continue to slide, with most major advanced markets falling approximately 5-10% during November to be down around 50-60% from their 2007 peak. Such a decline represents the largest bear market in US equities since the Great Depression. The continued sharp fall in household wealth is constraining global economic activity, leading to an intensification of the recessions underway in the US, UK, Japan and parts of the European Union during the December quarter. Consequently, we now expect global growth to slow to 1.2% in 2009, the worst outturn since the early 1980s.

Government authorities continue to respond, but a further large fiscal package is required in the US

Global central banks continue to aggressively cut interest rates to stimulate economic activity. Since early September, policy rates have been reduced by 0.75% in Canada, 1.0% in the US, 1.75% in the Euro area and Switzerland, 2.5% in Sweden and 3.0% in the UK and New Zealand. Many emerging market central banks have also lowered rates in recent weeks, including those in China, India, South Korea, Taiwan, Malaysia, Indonesia, Poland, Hungary, Turkey, Czech Republic and the Slovak Republic. We expect rates will continue to be aggressively cut in most economies over coming quarters, with rates approaching 0% in the US, Euro area, Japan and the UK.

A number of policy measures continue to be implemented in the US economy to stabilise financial markets. In mid November, US Treasury Secretary Paulson abandoned the original purpose of TARP, which was to purchase illiquid mortgage-related assets. Instead, the remaining funds will be used to continue to recapitalise financial institutions, to support securitisation of consumer loans (including credit cards, auto loans and consumer loans) and to reduce mortgage foreclosures. Indeed, later in the month the US Treasury invested US\$20 billion in embattled Citigroup, while the Fed and the Federal Deposit Insurance Corporation announced that it would provide protection against unusually large losses on Citigroup's US\$306 billion asset pool. Furthermore, to support credit markets, the Fed pledged up to US\$800 billion in additional funding to boost credit availability. This is to be split between lending to holders of certain AAA-rated securities backed by newly and recently originated consumer and small business loans (US\$200 billion) and to purchase the direct obligations and mortgage-backed securities of Fannie Mae, Freddie Mac and Ginnie Mae (US\$600 billion).

A number of fiscal stimulus packages were also announced last month to help boost economic activity. In the UK a series of expenditure packages and tax cuts were announced, increasing the budget deficit by 0.6% of Gross Domestic Product (GDP) over 2008-2009 and by 1.1% of GDP over 2009-2010, before a move to fiscal consolidation over 2010-2011, during which time the UK economy is expected to be in recovery. The European Commission (EC) announced a fiscal package worth €200 billion (1.5% of GDP), with member states funding €170 billion and the EC providing €30 billion of support. In Spain, the government announced a €11 billion stimulus package worth 1.1% of GDP. In China, the authorities announced a 4 trillion yuan package (14% of GDP) to be implemented over the next two years, although details of the package are limited and may include projects already earmarked in the budget.

However, our analysis suggests a further large fiscal package (around 4-5% of GDP) is required in the US. Such stimulus should prevent the economy from contracting in the second half of 2009 and boost the 2010 outlook, especially if it triggers an improvement in financial market conditions, although it is unlikely to materially alter the bleak near-term outlook.

Interest Rates (%)

	Level	QIC forecast		
	Dec-08	3 months	6 months	1 year
Australia	4.25	3.75	3.75	3.75
US	1.00	0.00	0.00	0.00
Canada	2.25	1.75	1.75	1.75
Europe	2.50	1.75	1.25	0.50
UK	2.00	1.50	1.00	0.50
Japan	0.30	0.30	0.30	0.00

Australian Economy

Australian economy stalls, but significant policy stimulus in the pipeline

The Australian economy has clearly stalled, with activity rising a weak 0.1% in the September quarter. Consumer spending remained subdued due to falling household wealth, while dwelling investment remained soft due to tight financial conditions. Growth in business investment slowed during the quarter, but continued to be supported by strong engineering construction associated with the mining boom.

Looking forward, growth in the Australian economy during 2009 is expected to be the weakest since 1991, although it should avoid a recession. Policy settings have been loosened significantly in recent months, with the RBA cutting rates by 3.0% since September to 4.25% in December and the Treasury announcing a \$10.4 billion fiscal stimulus package. Consumer spending is expected to rise modestly over the year, weighed down by weakening employment growth, but supported by the payments associated with the fiscal package in December. Although capital expenditure investment intentions for the 2008/09 financial year remain solid, the forthcoming decline in the terms of trade is expected to weigh on business investment in the 2009/10 financial year. Dwelling investment is expected to remain subdued in the near-term, but receive support in 2009 from the increase in the first home owners grant and the sharp decline in interest rates. Export growth is expected to slow due to deteriorating global activity, while import growth is expected to weaken sharply given the sharp fall in the Australian dollar and soft domestic demand.