

## The Markets

### International Equities

#### Global equities plunge as financial crisis worsens

Global equity markets fell precipitously in October, prompted by a sharp worsening in the financial crisis, a seizure of money markets and a deteriorating outlook for global growth. For most equity markets it was the worst month since October 1987. The sharp increase in equity market volatility and risk aversion saw the Volatility Index (VIX) spike to record levels. Commodity prices also fell, crude oil declining from US\$100 to near US\$66 per barrel. Emerging markets were particularly hard hit as the panic spread, emergency International Monetary Fund (IMF) loans were organised for Iceland, Hungary and the Ukraine.

Policy makers around the world took aggressive actions during the month in a bid to arrest the deteriorating conditions. These measures included an unprecedented coordinated interest rate cut by key central banks including the US Federal Reserve (Fed), the European Central Bank (ECB) and the Bank of England (BoE), while individual governments moved to guarantee bank deposits and recapitalise banks by purchasing stakes in major banks. China also announced a number of measures to stimulate growth.

Of the major markets, the Japanese market underperformed (-20.3%), as exports suffered from the sharply stronger yen. The UK and Australia fared comparatively better (-10.5% and -12.6% respectively), cushioned by weaker currencies. The US market fell 16.8% while Europe ex-UK equities recorded a 14.8% fall. Emerging markets fell 22.3%. Traditional defensives outperformed as investors concerned with the financial crisis and weakening global growth abandoned financials and cyclical sectors. Hedged international equities fell 19.0% in the month.

**Outlook:** Equity valuations currently appear quite undervalued on a number of measures. However investors are naturally cautious given the likelihood of lower earnings as the global economy faces a 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 Equities lower

The Australian equity market fell sharply in October (-12.61%), although it still fared better than most other key offshore markets. Resources (-18.5%) underperformed the broad market, with major resource names retreating in line with weaker commodity and oil prices, and as investors downgraded their expectations for global growth. Listed property suffered further declines (-25.2%) amidst concerns over refinancing and asset sales. Banks performed relatively better (-4.4%), benefiting from an Reserve Bank of Australia (RBA) interest rate cut and the guarantee of bank deposits announced by the government.

**Outlook:** Valuations on the Australian market appear attractive, though international markets look cheaper still. We expect Australian equities to recover over the medium-term, though underperform global equity markets. Interest rate cuts by the RBA may provide a boost to the market.

## Global Fixed Interest

### Bond yields marginally lower

Despite slowing economic growth and interest rate cuts, long-term bond yields were only marginally lower in the month on concern over an increased supply of bonds to fund various government rescue packages.

The US ten year bond yields increased to 3.98% from 3.8%, while two year bond yields fell from 2% to 1.6%. UK bond yields also increased to 4.5% from 4.4%, while a weakening European economy and ECB interest rate cuts saw German bond yields fall to 3.9% from 4.0%. The return on the Lehman Global Aggregate Index was -0.81% on a currency hedged basis.

Australian bond yields continued to decline from 5.40% to 5.17% over the month, as the 1% cut by the RBA was more aggressive than expected, and as signs of slowing economic momentum continue to surface. Three year bond yields fell to 4.46% from 5.36% as further aggressive interest rate cuts are priced by the market.

Outlook: Australian bonds remain relatively expensive, as market expectations for interest rate cuts appear somewhat aggressive. Global bonds appear fair value considering the downside risks to growth.

## Currencies

### Volatile month in currency markets

Renewed financial market stresses and sharp falls in share markets prompted large movements in exchange rates in October. Many emerging market currencies as well as high yielding and commodity linked developed currencies suffered large declines.

Weaker commodity prices and a rate cut by the RBA saw the largest monthly decline in the Australian dollar since the currency's float. The Australian dollar fell from around US\$0.79 to a low of US\$0.60, before rebounding towards the end of the month to US\$0.66. The RBA confirmed it had intervened in the currency to help stabilise the market. The US dollar rallied strongly against most major currencies, including the Euro and British pound, while the Japanese yen continued to gain from the unwinding of yen carry trades. Returns on foreign currency exposure were 16.1% (international equity benchmark).

Outlook: The sharp fall in the Australian dollar has been taken into attractive territory from a valuation perspective, even 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 is now considered marginally expensive.

### Financial markets (%)

	Level	% Return*			
	Oct-08	1 month	3 months	Fin Year	1 year
Sharemarkets					
Australia (S&P/ASX 200)	4018	-12.61	-17.99	-21.73	-37.79
World (MSCI World ex Aust)	716	-16.56	-24.79	-26.08	-38.73
US (S&P 500)	969	-16.80	-23.11	-23.76	-36.10
UK (FTSE 100)	4377	-10.55	-18.26	-21.28	-32.30
Europe (MSCI Europe ex UK)	799	-14.82	-23.43	-24.24	-41.29
Japan (Topix)	867	-20.26	-32.93	-33.77	-45.44
Currencies					
Australian Dollar/US Dollar	0.660	-16.36	-29.85	-31.25	-28.81
Australian Dollar/Euros	0.520	-7.35	-13.69	-14.58	-18.78
Australian Dollar/Yen	64.89	-22.52	-36.17	-36.22	-39.27

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

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## Economist's View

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### Key Points

- **Major equity markets fall sharply in October**
  - **Ongoing financial dislocations continue to weigh on global activity**
  - **Falling commodity prices and slowing trading partner growth dampen the Australian growth outlook**
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## International Economies

### Financial markets fall sharply

Global equity markets have fallen sharply in recent weeks, with most advanced markets falling around 15% to 20% in October on concerns the global economy will fall into recession. In response, government authorities continue to implement various policies to help stabilise the global financial system, with the US, Euro area and UK governments providing capital to major banks. In addition, most global central banks have responded by easing monetary policy in October and early November, with the US, Japan, UK, Euro area, Sweden, Norway, Switzerland, Canada, Australia, New Zealand, China, India and South Korea all lowering rates. Furthermore, the US Federal Reserve (Fed) continues to adopt additional measures in attempt to ease strains in financial markets, including announcing temporary reciprocal currency arrangements with more central banks and creating a Commercial Paper Funding Facility (CPFF) and a Money Market Investor Funding Facility (MMIFF) to improve liquidity in these markets. While global policy initiatives have helped ease pressures in short term debt markets, conditions remain particularly fragile.

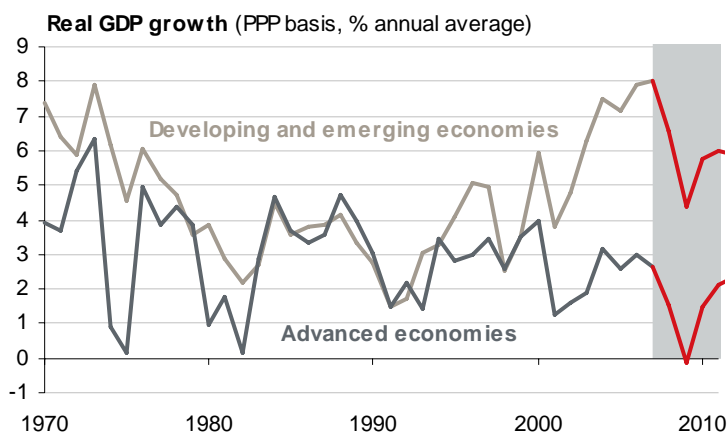
### Ongoing financial dislocations continue to weigh on global activity

The dislocation in financial markets, leading to large declines in equity prices, continued falls in house prices, and the disruption in the provision of credit, have conspired to undermine private sector spending throughout the global economy. The fall in house prices followed by the fall in equity prices is destroying household wealth and consumer confidence. In the US, the fall in real total household wealth is approaching the largest decline in fifty years. Similar declines are being experienced in most advanced economies including the UK, the Euro area, Canada, Japan and Australia. As a consequence, we now expect private consumption expenditure to fall in most major economies over coming quarters and for the fall in spending to rival the declines experienced in the recessions of the early 1990s and 1980s, and mid 1970s. Rising credit spreads and falling equity prices, combined with restrictions on access to credit, are leading to a sharp rise in the cost of capital. Businesses are responding by scaling back their plans for capital expenditure and we expect negative investment growth in most advanced economies over 2009.

The financial market crisis, which until recently has been concentrated in the advanced economies, is now spilling over into emerging market economies exposed to foreign sources of funding. Iceland, Hungary, Ukraine and Argentina have been the first to experience severe difficulties associated with the credit crisis. In addition, even those emerging market economies not exposed directly to the credit crisis are being impacted through trade linkages with the slowing advanced economies. Economic growth in China has slowed from around 12% in 2007 to around 9% in 2008, partly in response to slowing export growth as global demand stalls.

Given deteriorating conditions in both advanced and emerging economies, we expect a global recession in 2009, with average growth slowing to below 2% over the year, modestly slower than the pace that was experienced in 2001. The recession, however, is expected to be more severe in the advanced economies, with negative growth in 2009, an outcome worse than the mid 1970s and early 1980s recessions. Growth in emerging and developing economies is expected to slow to around 4½%, which is almost half the rate experienced in 2007, but still modestly above the rate achieved during the 2001 recession. Our forecasts assume

further aggressive loosening of monetary policy, with interest rates being cut to 0.25% in the US, 1% in the UK and 1.25% in the Euro area by the end of 2009. Further fiscal stimulus packages are likely to be enacted around the world, with Japan recently announcing a ¥5 trillion package and the US and UK considering additional policies. While these measures may boost near-term growth relative to our baseline forecast, further deterioration in public finances will weigh on growth over the longer-term.



## Interest Rates (%)

	Level	QIC forecast			
	Nov-08	3 months	6 months	1 year	
Australia	5.25	4.50	4.00	4.00	
US	1.00	0.50	0.25	0.25	
Canada	2.25	2.00	2.00	2.00	
Europe	3.25	2.25	1.75	1.25	
UK	3.00	2.00	1.50	1.00	
Japan	0.30	0.30	0.30	0.15	

## Australian Economy

### ***Falling commodity prices and slowing trading partner growth dampen the Australian growth outlook***

The deterioration in the global growth outlook over recent months has weighed heavily on global commodity prices, with significant implications for the prospects of the Australian economy. Oil prices have fallen from around US\$145 per barrel in mid-July to around US\$60 per barrel, while most other commodities have also fallen sharply from their peaks. Given the recent fall in commodity prices, Australia's terms of trade is likely to decline next year, removing an important source of stimulus to the economy. Together with slowing trading partner growth and softening domestic activity, these factors are likely to cause businesses to significantly scale back their investment intentions.

The combination of a weak external environment and a pullback in investment spending are likely to weigh further on employment growth, increasing the risks of a recession. However, policymakers have reacted swiftly to the deteriorating outlook, with the Reserve Bank of Australia (RBA) cutting interest rates by 2% since September and the Federal Government announcing a fiscal stimulus package worth \$10.4 billion or around 1% of Gross Domestic Product (GDP). Further monetary policy easing and moderating inflation should also help support real disposable incomes and consumer spending in 2009, although spending is likely to remain subdued in the near-term given declining household wealth following falls in equity and house prices. The recent sharp fall in the Australian dollar will provide some support to exporters, although it will also place upward pressure on import prices. While these factors will cushion the slowdown in 2009, we expect growth in the Australian economy to be the weakest since the recession of 1991.