

The Markets

International Equities

Equities down amid further financial turmoil

Global equity markets ended the quarter lower, as renewed concerns over financial sector prospects and worsening market stress from the credit crisis culminated in the failure of a number of major global and US financial institutions in September. With markets having stabilised somewhat early in the quarter as the oil price eased, investors turned their attention to weakening global growth and the continued turmoil in the financial sector. This ultimately saw the takeover of Fannie Mae, Freddie Mac, and AIG by the US Treasury in late September, as well as the collapse of Lehman Brothers and a number of other global and US financial institutions. With the extreme financial market turmoil and the risk of further failures still rife, the US Treasury announced the \$US 700 billion Troubled Asset Relief Program (TARP) aimed at stabilising a very distressed market. While the Program should help restore some investor confidence, delays in its legislation so far has only served to add to the already heightened volatility in the near term. Prohibitions against short-selling were introduced by a number of countries, prompting sharp rallies in some stocks.

Within global equities, consumer staples (+2.5%) and health care (+0.6%) rose, while materials (-30.8%) and energy were weaker (-24.7%). Financials fell 4.2%. All the major markets ended the quarter lower. The US was down 8.4%, Japan was down 16.9%, Europe was down 11.1% and the UK was down 12.0%. Hedged International equities returned -11.97% over the quarter.

Outlook: Volatility is expected to remain high amid the heightened levels of fear and risk aversion. With most central banks either easing or on-hold, valuations at reasonable levels, potential for further fiscal support by authorities and sentiment negative, there is potential for equity markets to rally. However, this is offset somewhat by the deteriorating cyclical conditions globally.

Australian Equities

Global outlook remains dominant driver

Global concerns dominated the Australian market which ended down 10.4%. Resources surrendered recent gains, losing 28.4% over the quarter as commodity prices eased and concerns over global economic growth came to the fore. Financials enjoyed a short lived bounce before the global financial turmoil took over, ending the quarter up marginally (+0.9%). The Australian Securities and Investment Commission (ASIC) introduced a ban against further short selling in September, prompting recoveries in some heavily shorted securities. Market relief from a turn in the Reserve Bank of Australia (RBA) interest rate cycle proved short lived, as this was more than offset by concerns of financial market collapse and a broader slowdown in the global economy. Listed property was relatively stable, down 1.3%.

Outlook: There are a number of factors that should support Australian shares such as; reasonable valuations, high dividend yields, likely lower interest rates and the banks being well capitalised. The lower Australian Dollar 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 if the global economy and/or China slows significantly.

Global Fixed Interest

Bonds rally on slowing global growth and risk aversion

Subsiding stagflation fears, weakening global growth, and a renewed wave of flight to quality all conspired to fuel a sharp rally in global bond markets. The yield on the US 10 year bond fell to 3.83% as investors flocked to safe haven assets. Domestically, Australian bond yields fell sharply to 5.40% as the RBA eased interest rates. Credit spreads widened, though those of Fannie Mae and Freddie Mac fell following the Treasury takeover. The return on the Lehman global aggregate index was 2.02% over the quarter.

Outlook: Bonds are generally expensive in most markets, though the pronounced cyclical risks make this pricing somewhat justified. Lower headline inflation and weaker growth should allow the UK and European central banks to lower rates. The RBA is likely to cut rates and there is some risk of lower rates in the US.

Currencies

Australian Dollar sharply weaker

The weakening global economic outlook and the ongoing credit crisis dominated currency markets during the quarter. The US dollar recorded broad gains against other major currencies as concerns over economic growth spread to other economies. The Euro, British pound and Canadian dollar all retreated against the US dollar. The Japanese yen was the strongest performer over the quarter, benefiting from its safe haven status. The Australian dollar fell sharply from US\$0.96 to US\$0.79 (-17.8% over the quarter) as the RBA began to ease rates, with the fall exacerbated by a general aversion to risky assets. This is the largest quarterly decline in the Australian dollar since it was floated. Returns from foreign currency exposure were 14.8% on the international equity benchmark.

Outlook: We see the Australian dollar as somewhat undervalued, but it remains exposed to further concerns about the global growth environment. The outlook for the US dollar is now more mixed, valuations are less attractive and the 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*			
	Sep-08	1 month	3 months	Fin Year	1 year
Sharemarkets					
Australia (S&P/ASX 200)	4601	-9.85	-10.44	-10.44	-26.76
World (MSCI World ex Aust)	860	-10.82	-11.41	-11.41	-25.01
US (S&P 500)	1166	-8.91	-8.37	-8.37	-21.98
UK (FTSE 100)	4902	-12.86	-12.00	-12.00	-21.19
Europe (MSCI Europe ex UK)	938	-11.25	-11.06	-11.06	-29.40
Japan (Topix)	1087	-12.63	-16.94	-16.94	-31.42
Currencies					
Australian Dollar/US Dollar	0.789	-8.41	-17.80	-17.80	-10.87
Australian Dollar/Euros	0.562	-4.00	-7.80	-7.80	-9.75
Australian Dollar/Yen	83.74	-10.40	-17.68	-17.68	-17.72

* Sharemarket returns inclusive of dividends, in local terms.

Economist's View

Key Points

- **Global credit crisis intensifies, US government responds with the Troubled Asset Relief Program**
- **European banks come under pressure**
- **Growth outlook in developed economies deteriorates**
- **The Reserve Bank of Australia (RBA) cuts interest rates by 1% in October and 0.25% in September**

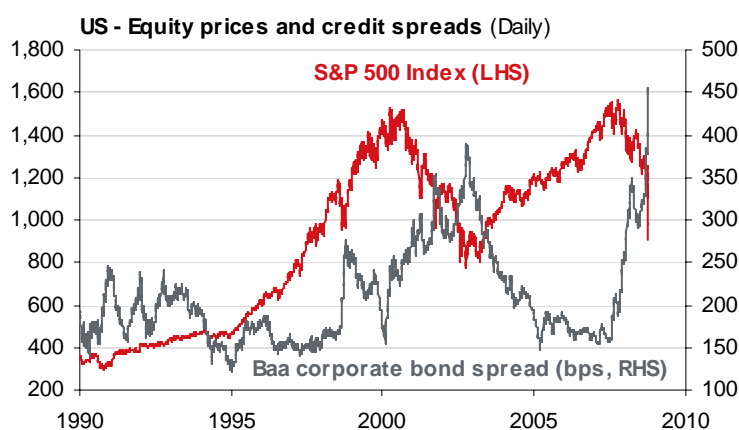
International Economies

US government passes Emergency Economic Stabilisation Act

Financial markets have deteriorated markedly over recent weeks, with strains in credit markets intensifying and equity prices falling sharply. Recent market movements have been driven by concerns over the health of the global financial system, following a series of major events.

In early September, the US Government seized control of mortgage giants Fannie Mae and Freddie Mac in a bid to stop a collapse in the mortgage market. A week later, US investment bank Lehman Brothers filed for bankruptcy while Bank of America purchased embattled Merrill Lynch for US\$50 billion. The US Federal Reserve (Fed) also provided a US\$85 billion credit line to ailing insurer American International Group (AIG), contending that its disorderly failure would severely threaten global financial stability. A sharp decline in credit and equity markets followed these shocks, leading to a proposal of a US\$700 billion Troubled Asset Relief Program (TARP). After initial rejection of the program by the US Congress, the TARP was eventually passed through both Houses in the first week of October.

The TARP is designed to stabilise financial market confidence by removing risky assets, in the form of residential and commercial mortgages, from private sector balance sheets. The impact of the TARP will depend on a number of factors including the overall size of the expenditure package in relation to the amount of assets at risk and the extent and timing of market reaction to the package. According to a number of estimates, including our own, the US\$700 billion TARP should be sufficient to purchase all outstanding subprime mortgages. Removing the most risky assets from private sector balance sheets should reduce the probability and duration of an extreme credit event. However, with the US and Organization for Economic Cooperation and Development (OECD) economies now in a recessionary phase, even if the TARP alleviates current extremes in financial markets, credit spreads will remain elevated and asset prices will remain depressed for some time to come.



European banks come under pressure

Financial market conditions have also deteriorated sharply in the Euro area. Authorities brokered a €50 billion (US\$68 billion) rescue of German bank Hypo Real Estate following bail outs of financial institutions, Dexia and Fortis. The rescue came the day after a European Union (EU) summit that rejected a co-ordinated Euro-wide package along the lines of the US TARP. With economic and financial market conditions continuing to deteriorate, EU policy makers will come under increasing pressure to organise a co-ordinated approach to the financial market crisis. In the UK, the government announced a large fiscal package in early October, whereby the government will take an equity stake in troubled UK financial institutions in order to promote financial stability.

Growth outlook deteriorates

Despite the TARP being passed by Congress, the combination of a sharp deterioration in credit and money markets, plunging equity prices and concerns over global financial system stability have weighed heavily on markets in recent weeks. In a coordinated response, central banks in the US, Europe, UK, Canada, Sweden and Switzerland lowered interest rates by 0.50% and China cut rates by 0.27% in early October. Asian banks followed suit, with South Korea, Taiwan and Hong Kong also cutting rates. With strains in money markets intensifying, central banks continue to actively provide liquidity and adopt other initiatives to help improve market conditions.

Nonetheless, the global economic outlook continues to deteriorate, with the major developed economies of the US, UK, Euro area and Japan in the midst of a recession. Domestic demand is expected to be particularly weak in the US, UK and Euro area, although lower commodity prices and a more competitive exchange rate should provide some support. While growth in emerging markets is forecast to slow due to deteriorating export performance, domestic demand is expected to remain relatively robust, providing some support to the global economy.

Global authorities are expected to continue to adopt various measures to help ease tensions in financial markets. We expect interest rates to be cut globally, with significant reductions in the UK and the Euro area. Furthermore, governments around the world will be announcing additional initiatives to ensure financial market stability. The outlook for global interest rates remains heavily dependent on financial market conditions if actions by global authorities fail to ease current financial market tensions further cuts will be required.

Interest Rates (%)

	Level	QIC forecast		
	Oct-08	3 months	6 months	1 year
Australia	6.00	5.50	5.25	5.00
US	1.50	1.25	1.25	1.25
Canada	2.50	2.00	2.00	2.00
Europe	3.75	3.25	2.75	2.25
UK	4.50	3.75	3.50	3.25
Japan	0.50	0.50	0.50	0.50

Australian Economy

The Reserve Bank of Australia (RBA) cuts interest rates by 1% in October and 0.25% in September

While Australia has not been immune from the uncertainty surrounding global financial markets, the economy has weathered the financial storm relatively well, owing to robust bank balance sheets and limited exposure to sub-prime related assets. Australia also continues to benefit from robust emerging market growth as Chinese demand for Australia's commodity exports remains healthy. Despite strength in the external sector, economic activity within Australia is moderating as tighter credit conditions are constraining domestic demand. Consumption expenditure fell in the June quarter and the outlook remains sluggish given signs of a softening labour market.

With financial market strains intensifying, the RBA cut interest rates sharply by 1% in October, following a 0.25% cut in September. Due to increased funding costs, major commercial banks only lowered standard variable mortgage rates by around 1.05% over this period. The combination of a deteriorating global economic outlook, heightened risk aversion (leading to an unwind of carry trades), falling commodity prices and the surprise RBA decision, saw the Australian dollar fall below US 70 cents after trading as high as US 98 cents in mid-July. The RBA is expected to continue to ease monetary policy over the remainder of 2008 and into 2009. We now expect the RBA to reduce interest rates to about 5.25% by early 2009, with further cuts to follow. However, as highlighted above, the future course of monetary policy will be heavily dependent on developments in global financial markets.