QIC Outlook
Market & Economic

April 2008 Go Further

The Markets

International Equities

Strong Rebound in Shares

Higher global share markets demonstrated an improvement in financial market confidence during April. This confidence reflected some hope that the worst of the credit-market crisis was over following policy responses from the US Federal Reserve (Fed), more recently the Bank of England (BOE) and UK Treasury, and with proposals being considered by the US government to prevent a wave of home foreclosures.

The US equity market rallied 5.3% as credit markets stabilised and as the first-quarter profit reporting season was better than feared. To date first quarter earnings were 2% below expectations, if financials are excluded results have bettered expectations by 3%. Investment banks did announce additional writedowns but these were less than had been expected. The US Financial sector rose 6.3%, Information Technology 6.9% and Energy gained 10.9% as crude oil touched US$ 120 a barrel on supply disruptions.

Europe ex UK rallied 6.2%, the UK gained 7.1%. Japanese equities finally found some respite, rising 12%, with a weaker Yen and a higher inflation helping the market. Global equities rose 6.5% in hedged terms.

Outlook: Given that equity valuations are currently undemanding, signs of a recovery in the US or a pick up of growth in Europe or Japan will help support equities.

Australian Equities

Resources-lead Recovery

The Australian market finished April up 4.5%. Resources gained 10.5% over the month as the market reflected the large increases in bulk commodity prices likely to be achieved by BHP Billiton and Rio Tinto. Origin Energy rose 52.3% following a takeover offer from a UK gas company. The Financial sector rose 4.2%, though banks rose a modest 2.3% with ANZ Bank declining after it increased provisioning levels. Listed Property gained 4.3% in April.

Outlook: Valuations on the Australian market appear slightly cheap to fair value. 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 yields rise

While some economic data in the US pointed to weak housing activity and consumer confidence, other data indicated that activity was likely to be sub-par but not disastrous. US bond yields rose, the ten year yield increasing to 3.7% from 3.4%, and the yield curve flattening as markets priced in less interest rate cuts from the Fed. In late April, the Fed cut rates by 0.25% to 2% and indicated a shift to a more neutral stance.

The European Central Bank (ECB) continued to reiterate its reluctance to cut rates given that inflation remains well above its target. The BOE cut rates by 0.25% and announced plans to increase liquidity in markets by accepting mortgage-backed securities for funds. The benchmark return for hedged global bonds was down 0.1% for the month.

Domestically, the Reserve Bank of Australia (RBA) left interest rates on hold and indicated a less-hawkish stance as evidence built that previous rate cuts were beginning to take effect. A higher than expected first-quarter Consumer Price Index (CPI) saw the market price out any cut in rates for 2008. The Australian ten year bond yield rose from 6.05% to 6.3%.

Outlook: Global bonds appear to be fairly valued after the rise in yields through April. 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

Australian Dollar Stronger

The **US Dollar** was marginally stronger against the other majors in April as the market began pricing in a temporary pause in the Fed's aggressive easing cycle. The **Euro** finished the month broadly unchanged after rallying strongly in the first quarter, while the **Japanese Yen** and **Swiss Franc** were weaker as the risk environment improved. The **Australian Dollar** continued its strong run despite signs that the RBA will leave rates on hold, rising from 0.91 to a high of over 0.95 against the US Dollar. Returns on foreign currency exposure were -4.6% on the international equity benchmark.

Outlook: While the marginal rebound in the US Dollar during the month suggests that its attractive valuations may finally be providing some support, downside cyclical risks remain. The Euro remains the most overvalued of the major currencies, while valuations and a less supportive fundamental environment have resulted in the outlook for the Australian Dollar turning negative.

Financial markets (%)

	Level	% Return*			
	Apr-08	1 month	3 months	Fin Year	1 year
Sharemarkets					
Australia (S&P/ASX 200)	5595	4.50	0.40	-7.80	-5.60
World (MSCI World ex Aust)	1051	6.10	2.10	-9.60	-7.40
US (S&P 500)	1386	5.30	1.40	-6.00	-4.30
UK (FTSE 100)	6087	7.10	5.20	-5.00	-2.10
Europe (MSCI Europe ex UK)	1193	6.20	2.70	-14.50	-12.20
Japan (Topix)	1359	12.00	1.90	-22.20	-18.80
Currencies					
Australian Dollar/US Dollar	0.942	3.20	5.60	11.10	13.20
Australian Dollar/Euros	0.605	5.10	0.40	-3.60	-0.80
Australian Dollar/Yen	98.50	8.40	3.80	-6.00	-1.00

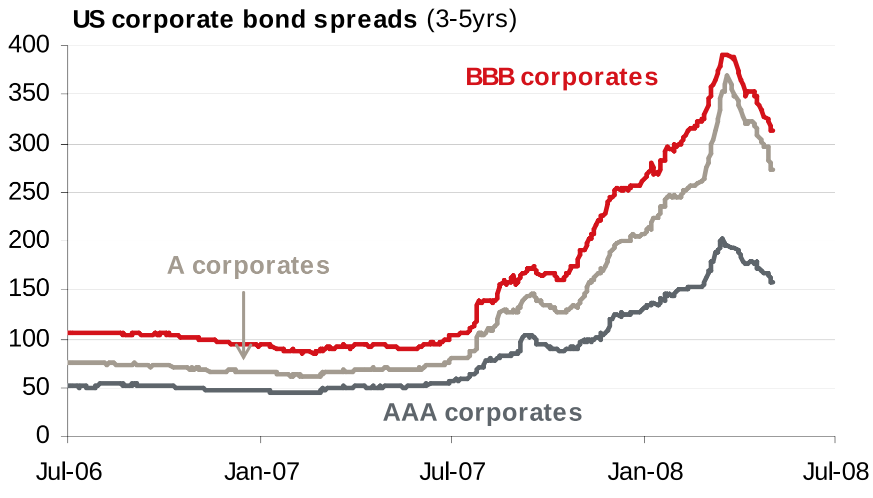
* Sharemarket returns inclusive of dividends, in local terms.

Economist's View

International Economies

US Federal Reserve continues to lower rates, but is now likely to pause

Conditions in global financial markets have improved modestly in recent weeks, with credit spreads beginning to ease from their lofty peaks and equity markets rebounding around 10% since mid-March. The Federal Reserve's (Fed) involvement in the rescue of Bear Stearns appears to have helped restore some degree of confidence in the financial system. Nonetheless conditions are still fragile, with spreads in interbank money markets remaining elevated and banks continuing to write-down investments on mortgage-related securities. The Fed, combined with the European Central Bank (ECB) and Swiss National Bank, recently announced an expansion of their liquidity measures to help ease short-term funding pressures. Financial market conditions are likely to remain difficult until the extent and distribution of mortgage-related losses becomes clear, systemically important financial institutions strengthen their balance sheets and the risk of a more severe deleveraging process dissipates. Continued uncertainty surrounding the prospects for the US economy and housing market will also weigh on sentiment.



"Source: Bloomberg"

The financial market crisis has significantly dampened the outlook for the global economy. Global growth is expected to slow to a below-trend pace, with activity in advanced economies slowing significantly. Growth in developing economies is also expected to slow, but remain above trend. Headline inflation around the world continues to increase, boosted by continued increases in food and energy prices. Sharp increases in global food prices since late 2006 are a particular concern in many developing countries, where food comprises a large proportion of expenditure. Both oil and food prices are expected to remain elevated in 2008, although moderating global growth is expected to provide some relief for oil prices.

US

Growth in the US economy has stalled since late 2007, with real Gross Domestic Product (GDP) rising at a 0.6% annualised pace in the December and March quarter. The ongoing housing downturn continues to weigh heavily on activity, while a marked slowdown in the pace of consumer spending has also dampened growth. Falling house prices and slowing real disposable income growth, reflecting weaker employment conditions and higher energy and food prices, have weighed heavily on the household sector. Further deterioration in the labour market is expected to continue to hamper spending, although tax rebates associated with a $152 billion fiscal stimulus package should begin to provide support in coming months. Conditions in the business sector are also weakening, with some pull-back in production, orders and capital spending plans. However, manufacturing sentiment remains higher than previous recessions, with strong exports due to the weak dollar providing some relief. We continue to expect a mild recession in the US economy in 2008 and a modest recovery in 2009.

The Fed has continued to lower interest rates due to the deteriorating conditions, cutting the federal funds rate a further 0.25% to 2% in April. However, the accompanying statement hinted that it may be the last rate cut in the current cycle. Elevated inflation remains a concern for the Fed, although it is expected to moderate in coming quarters due to a slowdown in demand and a levelling-out of energy and commodity prices. While we now expect interest rates to remain on-hold for the remainder of 2008, there remains a risk of further cuts if economic conditions deteriorate more than anticipated or financial market conditions do not continue to gradually improve.

Eurozone

Growth in the Eurozone economy moderated in late 2007 and recent business surveys suggest below-trend growth will continue in coming quarters. Household spending has remained subdued in early 2008, while more recent consumer confidence readings continue to ease. In contrast, labour market conditions remain favourable, with the unemployment rate at its lowest level since the early 1980s. Elevated inflation readings are still a concern for the ECB despite a modest fall in the headline inflation rate to 3.3% over the year to April. We continue to expect the ECB to leave rates unchanged in the near-term due to inflation concerns, before easing rates modestly in late 2008 as the economy slows.

Japan

While the Japanese economy expanded strongly in late 2007, momentum in the economy is expected to moderate in coming quarters, with growth slowing to a below-trend pace. Both business and consumer confidence continue to head lower, while industrial production eased over the March quarter. In contrast, exports continue to provide significant support to the economy despite moderating global activity. Consumer price inflation has picked-up over recent months, due predominately to higher food and energy prices, although measures of underlying inflation have also returned to positive territory. 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 eased from its peak in March, but remains high with prices up 8.3% over the year. We expect the recent trend of moderating, but still solid, growth and easing inflation to continue over 2008.

Interest Rates (%)

	Level	QIC forecast		
	May-08	3 months	6 months	1 year
Australia	7.25	7.25	7.25	7.00
US	2.00	2.00	2.00	2.25
Canada	3.00	2.50	2.50	2.75
Europe	4.00	4.00	3.75	3.50
UK	5.00	4.75	4.50	4.50
Japan	0.50	0.50	0.50	0.75

Australian Economy

Further signs of a slowing economy, but inflation remains a concern

Momentum in the Australian economy has eased in recent months following strong growth in domestic demand over 2007. The recent interest rate increases have weighed on the household sector, with retail sales volumes declining in the March quarter, household credit growth slowing and consumer confidence falling to its lowest level since 1993. More modest gains in house prices over the March quarter (with price falls recorded in Sydney, Perth, Darwin and Hobart) is also weighing on the sector. Business confidence about the economic outlook has also fallen well below average levels, although the latest capital expenditure plans remain strong. While momentum has eased, a number of factors should continue to provide support to the economy. Solid labour market conditions should continue to underpin spending, while a further gain of around 15% in the terms of trade, due to higher iron ore and coal prices, will provide an additional boost to incomes. Overall, we expect growth to slow to a below-trend pace in 2008.

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. However, the cumulative 1% of tightening by the Reserve Bank of Asutralia (RBA) since August last year, combined with additional increases in bank lending rates due to higher wholesale funding costs, is exerting a significant restraining influence on the economy. Consequently, we expect the RBA to leave rates unchanged for the remainder of 2008, provided demand growth continues to moderate.