

The Markets

International Equities

Major markets down

Global stock markets started the month poorly as concerns about a possible US recession and the downgrading of US banking stocks saw investors exit the market. Globally concerns continued over the solvency of the monoline insurers with fears that a downgrade of their credit ratings would cause larger write-downs in financial balance sheets. These concerns were allayed mid month as Warren Buffet offered a lifeline to the major bond insurers. Further relief came as the major credit agencies maintained the credit ratings of the major insurers thus averting the potential systematic crisis that investors feared.

Most of the major markets ended the month lower with the US the worst performer down 3.2%. Japan and Europe were down 1.6% and 0.6% respectively while the UK finished the month up 0.5%.

Outlook: The prospects of a US recession will restrain any share market rallies over the coming months. 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

Market down slightly after reporting season

The Australian market finished February down 0.7%. Resources were stronger over the month with the Energy sector up 12.5% and Materials sector up 10.6%. BHP-Billiton, Rio Tinto and Woodside were the main positive drivers of the index, beneficiaries of very strong commodity prices over the month.

In contrast the Financial sector had a poor month down 12.5%. Finance or Property related companies comprised the 10 largest negative contributors to the overall index. The poor sentiment was driven by concerns that the credit crisis that originated in the US could potentially cause further systematic problems in financial markets and impact the Australian Financial sector.

Outlook: Despite the recent fall the Australian market does not look especially cheap. While domestic growth and strong demand from China may support earnings, weaker global growth and higher interest rates may weigh the market down.

Global Fixed Interest

Bonds rally into month end

Investors began the month confident that the 1.25% of US rate cuts made in January would help the US economy maintain some positive momentum. Bond yields were flat or in some cases up over the month after the large downward moves of January. Yields were higher in Australia where the Reserve Bank (RBA) deliberated over a 0.50% interest rate hike before settling on a 0.25% increase. The strength of the Australian economy and further rhetoric from the RBA also supported yields in Australia.

The Australian economy remains strong however inflation is now at the top of the RBA's band. Despite markets pricing in a rate increase in February Australian 10 year bond yields fell.

The benchmark return for hedged global bonds was up 0.6% for the month.

Outlook: Bonds appear to be over priced after rallying for several months. Australian bonds appear to be the exception however and look very attractive.

Currencies

US Dollar weaker

The **US Dollar** started the month firmer as investors were confident that last months interest rate cuts would help the US economy avoid recession. Sentiment soon began weakening however and the US Dollar ended the month down 2% on a trade weighted basis. Recession concerns saw the US Dollar fall against all the major currencies except the **British Pound**. The **Swiss Franc** and **Japanese Yen** rallied towards the end of the month as risk aversion increased and investors purchased traditional safe haven assets. The **Australian Dollar** had a strong month reaching USD 0.94. The local currency was supported by higher commodity prices and widening interest rate differentials.

Returns on foreign currency exposure (international equities) were down 3.9% over the month.

Outlook: Conflicting pressures on the US Dollar cloud the outlook. The poor economic situation weighs on sentiment while its traditional role as a safe haven supports the currency. The Euro is currently seen as overvalued against the USD and Yen.

Financial markets (%)

	Level	% Return*			
	Feb-08	1 month	3 months	Fin Year	1 year
Sharemarkets					
Australia (S&P/ASX 200)	5572	-0.70	-13.90	-8.80	-0.70
World (MSCI World ex Aust)	1017	-1.70	-10.60	-13.00	-6.40
US (S&P 500)	1331	-3.20	-9.70	-10.30	-3.60
UK (FTSE 100)	5884	0.50	-8.10	-9.30	-1.30
Europe (MSCI Europe ex UK)	1168	-0.60	-13.90	-17.20	-7.90
Japan (Topix)	1324	-1.60	-13.50	-24.90	-23.50
Currencies					
Australian Dollar/US Dollar	0.935	4.80	5.80	10.30	18.70
Australian Dollar/Euros	0.616	2.20	2.30	-1.90	3.30
Australian Dollar/Yen	97.40	2.60	-0.70	-7.10	4.30

* Sharemarket returns inclusive of dividends, in local terms.

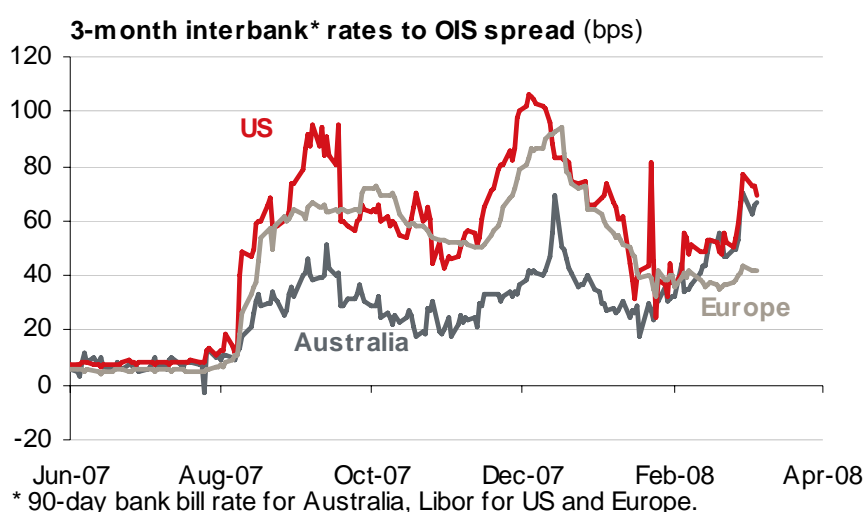
Economist's View

International Economies

Financial market turmoil continues to weigh on the global economic outlook.

The ongoing turbulence in global financial markets has continued over the past month. Money markets are experiencing renewed strain, with spreads between interbank lending rates and expected interest rate rising markedly in both the US and Australia over recent weeks. Part of the increase is no doubt seasonal, with liquidity risk premiums rising prior to the end of recent quarters due to concerns over funding pressures. However, part of the increase likely reflects rising counterparty credit risk premiums, given the mounting losses being reported by major financial institutions and concerns over the potential size of writedowns.

There is considerable uncertainty regarding the likely impact of these financial market strains on global economic activity. Global growth is expected to slow to a below-trend pace in 2008, driven by weak growth in the US and a marked slowdown in other major developed economies. Developing economies are also expected to slow, although growth is generally expected to remain relatively strong in these countries.



US

Conditions in the US economy continue to deteriorate, increasing concerns that the economy may experience a recession in the first half of 2008. Growth in the economy held-up for much of 2007, before slowing sharply in the December quarter as the housing downturn and tighter credit conditions began to affect the economy more broadly. Further declines in house prices and cuts in construction are expected in coming quarters, given the large number of unsold homes. Consumer spending has been flat over recent months, hampered by rising energy prices and falling household wealth following declines in both equity prices and house prices. Deteriorating labour market conditions have also dampened spending, with payroll employment falling for the first time since 2003 in January. Business activity has also weakened in recent months according to key survey indicators, while the external sector continues to provide some support to the economy due to the weak dollar. Overall, we expect growth to be particularly weak over the first half of 2008, before rebounding in the second half of the year as conditions in housing and financial markets begin to stabilise.

Inflation remains elevated in the US, due largely to the steep run-up in oil prices and rising food prices, although it is expected to moderate over the course of 2008. The US Federal Reserve (Fed) has cut interest rates aggressively over the past 6 months, lowering the federal funds rate by 2.25% since September. Further cuts are expected in coming months given the deteriorating economic outlook.

Eurozone

Activity in the Eurozone economy has slowed over recent months, with real GDP rising 0.4% in the December quarter about half the pace of the previous quarter. Household consumption fell for the first time in six years in the December quarter, while growth in business investment and exports also eased. More timely business survey indicators suggest that growth remains modestly below trend in early 2008. Elevated inflation readings remain a concern for the European Central Bank (ECB), with headline inflation up 3.2% over the year to February, well above the bank's target of close to, but below, 2%. As a result, the ECB is expected to keep interest rates unchanged in the near-term, although lower rates may be warranted if domestic or international conditions weaken further.

Japan

The Japanese economy recorded surprisingly strong growth in the December quarter, due to strong exports and business investment, although growth in the latter is likely to be revised lower. Consumption growth remained subdued in the quarter, although retail sales have rebounded strongly in January. Changes in building standards continued to weigh on residential investment in the quarter, but more timely data suggests construction activity has begun to recover. The expansion in the economy is expected to continue, albeit with growth slowing below trend in 2008. Consumer price inflation has picked up over recent months, with the increase largely driven by rising energy prices. We continue to expect the Bank of Japan (BoJ) to gradually normalise interest rates, but the next increase is not expected until late 2008.

China

The Chinese economy continues to expand strongly, rising by 11.4% in 2007. Growth is expected to decelerate in 2008, but remain around double digit rates. Inflation has risen to a fresh 11 year of 7.1% in January, predominately due to increases in specific food items. Further policy tightening measures are expected in 2008.

Interest Rates (%)

	Level	QIC forecast		
	Mar-08	3 months	6 months	1 year
Australia	7.25	7.25	7.25	7.25
US	3.00	2.25	2.25	2.25
Canada	3.50	3.00	2.75	2.75
Europe	4.00	4.00	4.00	4.00
UK	5.25	5.00	4.75	4.75
Japan	0.50	0.50	0.50	0.75

Australian Economy

Rising inflation prompts Reserve Bank of Australia to lift rates.

Economic growth in Australia remains strong, with real Gross Domestic Product (GDP) rising 0.6% in the December quarter to be 3.9% higher over the year. While the pace of output growth eased modestly, domestic demand remained particularly strong as more demand was met with imports. Consumer spending has picked up in recent quarters, supported by tight labour markets, income tax cuts and further gains in house prices. However, tentative signs have emerged that household demand is beginning to slow, with consumer confidence, household credit and retail sales slowing somewhat in recent months. Business investment remains strong, adding to the growth of the economy's productive capacity. Recent developments in commodity markets suggest further gains in Australia's terms of trade in 2008, providing additional support to incomes and spending.

The economy is continuing to show clear signs of capacity constraints, particularly in the labour market. Inflationary pressures intensified in the December quarter, with core inflation up 3.6% over the year, well above the official target band. The Reserve Bank of Australia (RBA) responded to these pressures, lifting the cash rate by 0.25% in both February and March. Given the marked increase in funding costs, further increases in interest rates by financial institutions in excess of the RBA move may be announced. We expect the RBA to leave interest rates unchanged for the remainder of the year, with the cumulative impact of past policy decisions, tighter credit conditions and slower global growth sufficient to restrain inflation. Nonetheless, risks remain that the RBA may need to tighten rates further in May.