

The Markets

International Equities

Markets start year poorly.

January ended as one of the worst starts to the year for equities in recent memory. Investors continued to be cautious of equities, fearful of further credit market woes and concerns about the strength of the US economy. Weak manufacturing and employment data from the US added weight to these fears along with concerns over the credit ratings and solvency of monoline insurers. Markets were further spooked when Europe fell over 7% on the 21st, a fall consequently related to an alleged rogue trader at Societe Generale.

Markets were boosted towards month end when the US Federal Reserve (Fed) cut interest rates 1.25% including an emergency 0.75% cut before its scheduled meeting. Details of a fiscal package worth around A\$165 billion were finalised by US lawmakers while support for the monoline insurers continued to be discussed by regulators and banks.

US shares ended the month down 6%, while **Europe ex-UK** finished down 12.6% on broad based selling. The **UK** lost 8.9% and **Japan** was down 8.8%. Overall hedged international equities finished the month down 8.2%.

Outlook: Global growth concerns and further uncertainty surrounding sub prime losses may restrain equity performance over the coming months. Equities are currently fair to cheaply priced which may lend support to the markets, while any positive economic surprises in the US will also benefit equity markets.

Australian Equities

Market falls 12 days in a row.

The Australian share market finished the month down 11%, after a 12 day losing streak which culminated in a 7% single day fall. The market subsequently rebounded after the Fed cut rates by 0.75% and followed this up with a further 0.5% cut less than a week later. The domestic market was also disrupted during the month when a registered broker failed to settle trades, the first time this had happened in Australia for over 30 years.

Allco Finance was one of the worst performers of the local market down 46% including a single day fall of 34%. The sell off was broad based with few stocks being spared. Woolworths was among the main detractors, despite reporting continued strong growth.

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

Global bonds rally.

Global bonds rallied as data in the US indicated a deterioration in manufacturing and employment into the end of last year. Elsewhere signs began to appear that economic conditions were beginning to slow into the year end. Europe, the UK and Japan all showed signs of a slowing economy which caused yields to fall and bonds to rally. Money market spreads have receded from the highs of last year during the month with co-ordinated efforts by central banks bringing a welcome relief to these markets.

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

Benchmark returns for hedged global bonds was 1.8% for the month.

Outlook: Global bonds appear to be modestly over priced with US bonds pricing in a relatively pessimistic scenario, Australian bonds represent good to fair value.

Currencies

US Dollar weaker after rate cuts.

The **US Dollar** finished the month lower with indications that the economy may be headed for a recession. Interest rate cuts didn't help the Dollar which ended the month down around 2% against its trading partners. The **Japanese Yen** was stronger as investors saw it as a relative safe haven in the volatile markets. The strength of the Australian economy and the potential for further rate increases here lent support to the **Australian Dollar**.

Returns on foreign currency exposure (international equities) were down 1.1% over the quarter.

Outlook: Despite being under valued against the majors, the US Dollar may be under pressure in the short term due to the poor sentiment surrounding its economic outlook. The Japanese Yen also looks cheap particularly against the Euro.

Financial markets (%)

	Level	% Return*			
	Jan-08	1 month	3 months	Fin Year	1 year
Sharemarkets					
Australia (S&P/ASX 200)	5650	-10.80	-15.70	-8.20	1.60
World (MSCI World ex Aust)	1037	-8.30	-13.00	-11.50	-6.00
US (S&P 500)	1379	-6.00	-10.60	-7.30	-2.30
UK (FTSE 100)	5880	-8.90	-12.10	-9.70	-1.90
Europe (MSCI Europe ex UK)	1176	-12.60	-16.40	-16.70	-9.20
Japan (Topix)	1346	-8.80	-16.80	-23.70	-20.80
Currencies					
Australian Dollar/US Dollar	0.892	1.60	-3.70	5.20	15.20
Australian Dollar/Euros	0.603	0.40	-5.90	-4.10	1.10
Australian Dollar/Yen	94.90	-3.30	-11.20	-9.40	1.30

* Sharemarket returns inclusive of dividends, in local terms.

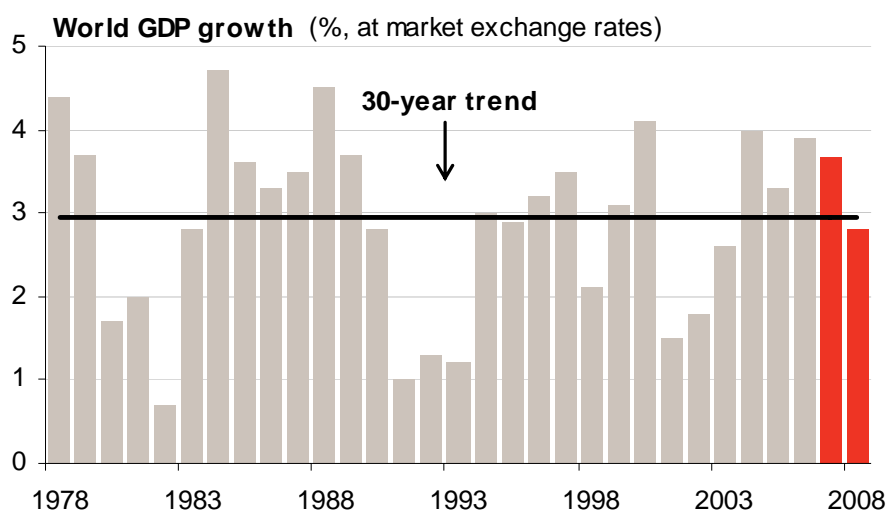
Economist's View

International Economies

Global financial markets hit by concerns that the US economy may fall into recession.

Financial market strains continue to intensify, highlighted by sharp falls in global equity markets during mid-January. Markets are increasingly concerned that the US economy may slip into recession, which could exacerbate pressures on financial institutions' balance sheets. The US Federal Reserve (Fed) has responded aggressively to deteriorating financial market conditions, making an emergency 0.75% interest rate cut in mid-January before lowering rates a further 0.50% at its scheduled meeting at the end of the month. On a positive note, pressures in short-term money markets have eased in recent weeks, while large financial institutions with deteriorating balance sheets have been able to obtain capital. Nonetheless, conditions in financial markets remain fragile.

The outlook for the global economy continues to deteriorate. Signs are emerging that borrowing constraints imposed by dysfunctional credit markets are starting to affect business operations in major developed economies. Indeed, recent data suggests growth slowed markedly in the December quarter. While emerging markets continue to expand strongly, trade spill-overs are expected to result in more moderate growth in 2008. Overall, growth in the world economy is expected to slow to a below-trend pace in 2008.



US

The US economy slowed markedly in late 2007 and growth is expected to remain particularly weak in the first half of 2008. Recent data indicates a deepening of the housing contraction, with housing starts and new home sales continuing to fall. Residential house prices are declining, which will weigh on household wealth and confidence. While the housing downturn has been underway for about 2 years, concerns about the state of the economy intensified in recent weeks following more broad-based signs of weakness. Prior to December, labour market conditions remained solid, with steady gains in income and wages supporting consumption growth. However, more recent data indicates a softening of the labour market, while consumer spending was subdued over the holiday season. Furthermore, the business sector is showing worrisome signs of slowing, with major survey indicators falling in recent months. The US economy is expected to remain weak in coming quarters and there is a significant risk that it may fall into recession.

Despite elevated inflation readings, the Fed is expected to continue to cut interest rates due to concerns about the growth outlook. Additional economic stimulus is expected on the fiscal side, with a \$150 billion package currently being considered by the Senate. The majority of the package is directed towards individuals and, if enacted quickly, could begin to boost activity from May.

Eurozone

Activity in the Eurozone economy has slowed over recent months. Indicators for business and consumer confidence continue to ease, with sentiment falling particularly sharply in the Service sector. Industrial production and new orders slowed toward the end of the year, although exports remain resilient in the face of substantial headwinds from the strong currency and weak US demand. Consumer spending has slowed, but should remain supported by ongoing improvement in the labour market. Credit conditions have tightened following the fallout from the US sub-prime crisis. However, elevated inflation remains a concern for the European Central Bank (ECB), resulting in a high threshold before rate cuts will be considered. The ECB is likely to remain on-hold, unless the resilience of the global economy falters.

Japan

The Japanese economy has slowed from the strong pace recorded in early 2007. Consumption growth remains lacklustre, with soft wage outcomes and falling confidence weighing on the household sector. Changes in building standards have temporarily dampened residential investment, although activity has begun to recover gradually. Business sentiment has eased, particularly at small firms due to deteriorating profit margins. The external sector continues to provide a boost to the economy, with strong demand from Europe and Asia offsetting weak demand from the US. The Consumer sector has moved out of mild deflation, with consumer prices lifted by higher energy costs. The Bank of Japan (BoJ) is expected to remain on-hold in coming months, before tightening policy in late 2008.

China

The Chinese economy continues to expand strongly, although growth slowed modestly over the second half of 2007. The economy has slowed in response to policy tightening directed at both the domestic and Export sector. Indeed, growth in exports, industrial production and fixed asset investment all eased slightly towards the end of the year. Retail spending continues to rise strongly, although part of the increase is due to higher food prices. Inflationary pressures have been strong, but remain concentrated in specific food categories. Officials have reacted to the strong data with sustained tightening measures and currency appreciation. Growth in China is expected to decelerate in 2008, but remain around double-digit rates.

Interest Rates (%)

	Level	QIC forecast		
	Feb-08	3 months	6 months	1 year
Australia	7.00	7.00	7.00	7.00
US	3.00	2.75	2.25	2.25
Canada	4.00	3.50	3.00	2.75
Europe	4.00	4.00	4.00	4.00
UK	5.50	5.25	5.00	5.00
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 continues to advance strongly. Consumer spending has picked-up in recent quarters, supported by tight labour markets, income tax cuts and further gains in house prices. The pace of spending has shown no sign of slowing in recent months, despite the headwinds posed by higher interest rates. Although business investment was lacklustre in the September quarter, business conditions remain favourable. Indeed, forward-looking indicators continue to suggest solid growth in investment, particularly in non-residential construction. Export volumes outside the rural sector are beginning to pick-up, with stronger growth expected to continue as a number of new projects and infrastructure upgrades are completed.

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 to 7% in February. Slowing global growth combined with the cumulative impact of recent increases in interest rates, including those made independently by financial institutions in January, is expected to be sufficient to contain inflationary pressures. Nonetheless, risks remain that the RBA may need to tighten rates further.