

The Markets

International Equities

Equities down as Investors look for safety

Equity market moves over the quarter were dominated by the continuing global credit market disruptions and the poor economic outlook in the US. The turmoil was such that the US Federal Reserve (Fed) took unprecedented actions during the quarter to help shore up what appeared to be an extremely fragile market. While the Fed cut rates 2.0% in the US and loosened its lending standards to banks, it also began lending to other financial institutions and backed the bail out of Bear Sterns whose imminent failure may have caused further damage to the already strained financial system. This created an extremely unpleasant environment for global equity market investors over the quarter.

Despite rallying from mid March, all the major markets ended the quarter lower. Japan was down 17%, Europe was down 15.5% and the UK was down 10.5%. Despite concerns around its economic outlook, the US fell the least among the majors, down 9.4%. Hedged International equities returned -11%.

Outlook: After the poor start to the year equities may find support over the coming months as risk aversion decreases and the panic of the last few months subsides. With most central banks currently cutting or on hold and valuations at reasonable levels there is potential for equity markets to rally.

Australian Equities

Market concerned on global outlook

Global concerns dominated the Australian market which ended down 14.4% over the quarter. Reporting season passed almost unnoticed as investors were distracted by concerns of financial market collapse and a recession in the US. Also weighing on the domestic market were two rate increases by the Reserve Bank of Australia (RBA), which continued to highlight the risk of inflation, and the collapse in price of several high profile listed companies. Financials were the main lagging movers in the index along with BHP Billiton and Woolworths. A rally towards the end of March however showed signs that investors are beginning to believe the worst of the turmoil is over. Listed Property returned -18% for the quarter.

Outlook: The direction of the Australian market will likely be dictated by the global outlook. If investors start entering risky trades again, the Australian market will rally along with other global markets despite valuations not being as attractive as markets elsewhere.

Global Fixed Interest

Bonds rally as risk aversion spreads

Bonds rallied strongly over the quarter as investors sold risky assets in favour of holding the traditional safe haven assets of bonds. The ongoing turmoil in financial markets proved fertile ground for bond investors who saw yields fall and prices rally across the global bond markets. With the Fed cutting rates 2.0% over the quarter, yields on US 10 year bonds reached a low of 3.30%, the lowest level in almost five years. Despite the RBA raising rates twice yields on Australian bonds also fell over the period. By quarter end investor confidence started improving which saw bond markets give back some of their gains. The return on the Lehman global aggregate index was 3%.

Outlook: After aggressive cutting by the US Fed the bond rally may reverse as investor panic settles. While there is still a large amount of uncertainty around the global and particularly the US outlook bonds may ease along with investor risk aversion.

Currencies

USD softer on economic concerns

The economic outlook in the US and ongoing global credit market concerns dominated currency markets during the quarter. The **US Dollar** weakened around 5% against its trading partners since the start of the year as US interest rates plunged and the economic outlook deteriorated. The **Canadian Dollar** also retreated due to its links with the US and the **British Pound** also fell. The **Japanese Yen** and **Swiss Franc** were the strongest performers of the quarter due to their traditional status as a safe haven and in the case of the Yen a move back to its fair value. The return on currency exposure (international equities) was -1.6%.

Outlook: Despite attractive valuations the outlook for the US Dollar continues to remain mixed. The negative impacts of cyclical factors such as lower interest rates have dominated recently, however its attractive valuation may offer support in the coming months. The **Euro** has continued to rally despite being widely considered as overvalued.

Financial markets (%)

	Level	% Return*			
	Mar-08	1 month	3 months	Fin Year	1 year
Sharemarkets					
Australia (S&P/ASX 200)	5356	-3.31	-14.39	-11.83	-7.04
World (MSCI World ex Aust)	993	-2.09	-11.80	-14.81	-9.72
US (S&P 500)	1323	-0.43	-9.44	-10.68	-5.08
UK (FTSE 100)	5702	-2.20	-10.49	-11.25	-6.26
Europe (MSCI Europe ex UK)	1134	-2.72	-15.47	-19.48	-13.17
Japan (Topix)	1213	-7.55	-17.01	-30.57	-28.05
Currencies					
Australian Dollar/US Dollar	0.913	-2.41	3.96	7.60	13.00
Australian Dollar/Euros	0.576	-6.50	-4.07	-8.29	-5.07
Australian Dollar/Yen	90.86	-6.69	-7.37	-13.28	-4.75

* Sharemarket returns inclusive of dividends, in local terms.

Economist's View

International Economies

Ongoing strains in financial markets weigh on the outlook

The global economy continues to be hampered by ongoing turbulence in financial markets. Markets remain particularly sensitive to adverse news on the health of financial institutions, whose balance sheets continue to come under pressure from significant credit related writedowns due to their sub-prime exposures. Since the crisis commenced, major banking institutions have revealed around US\$230 billion in writedowns and credit losses. The challenges faced by the industry were highlighted by a significant deterioration in the liquidity position of Bear Stearns, the fifth largest investment bank in the US, which required emergency funding before entering takeover discussions with JP Morgan Chase. The amended takeover proposal valued Bear Stearns at around US\$2.4 billion, down from around US\$18 billion in April last year, and included the support of the US Federal Reserve (Fed) which will lend \$29 billion to purchase a pool of the bank's less-liquid assets. During March, the US Fed, combined with other global central banks, also announced additional policy measures to help boost liquidity and promote orderly markets. Nevertheless, conditions remain fragile, with many securitisation markets effectively closed and interbank funding markets under strain.

Major financial institution losses since the beginning of 2007 (US\$ billion)

Bank	Writedown	Credit Loss	Total
UBS	\$38		\$38
Merrill Lynch	\$25		\$25
Citigroup	\$21	\$3	\$24
HSBC	\$3	\$9	\$12
Morgan Stanley	\$12		\$12
IKB Deutsche	\$9		\$9
Bank of America	\$7	\$1	\$8
Deutsche Bank	\$7		\$7
Credit Agricole	\$7		\$7
Credit Suisse	\$6		\$6
Other	\$70	\$13	\$83
Total	\$206	\$26	\$232

Recent developments continue to suggest that the global economy will slow to a below-trend pace in 2008. Growth is expected to slow around the world, with the downturn most severe in developed countries. Growth in Emerging Market economies is expected to slow mainly through weaker exports, with domestic demand generally forecast to remain solid.

US

The US economy slowed markedly in late 2007, advancing by a weak 0.1% in the December quarter. The economy is expected to experience a recession in the first half of 2008, weighed down by a deepening of the housing downturn and tighter credit conditions. Falling house prices, combined with declining equity market wealth, are beginning to weigh on consumption. However, more important for the consumption outlook is the deterioration evident in the labour market. Payroll employment fell in January and February for the first time since 2003, although the unemployment rate has remained broadly unchanged over the past 6 months. While we expect the economy to remain particularly weak in the first half of 2008, growth is set to improve later in the year, supported by a US\$150 billion fiscal stimulus package and a stabilisation in housing conditions.

The US Fed has aggressively lowered interest rates due to the deteriorating conditions, cutting the federal funds rate a further 0.75% in March to bring the cumulative easing to 3.0% since September. Elevated inflation remains a concern, although it is expected to moderate in coming quarters due to a slowdown in demand and a levelling-out of energy and commodity prices. We expect the federal funds rate to be lowered a further 0.5% in April, with rates subsequently remaining on-hold for the rest of the year.

Eurozone

Growth in the Eurozone economy slowed in late 2007 and more timely business indicators suggest that activity remained below-trend in early 2008. While household spending showed signs of weakness in late 2007, the limited evidence available for 2008 suggests a modest recovery in consumption. Labour market conditions are favourable, with the unemployment rate remaining unchanged at 7.1%, the lowest rate since the early 1980s. Elevated inflation readings remain a concern for the European Central Bank (ECB), with headline inflation up 3.5% over the year to March according to the flash estimate. While this is likely to lead the ECB to leave rates unchanged in the near-term, we expect rates will be lowered by 0.5% in the second half of 2008 given our forecasts of below-trend growth, slowing global activity and a moderation in inflation.

Japan

The Japanese economy recorded surprisingly strong growth in the December quarter, due to strong exports and business investment. However, exports and business investment are expected to moderate in 2008 due to the slowing US economy and weakening profit growth, consistent with the recent deterioration in business sentiment. Consumption growth is expected to remain subdued, although improving wages are likely to help support spending. Overall, momentum in the economy is expected to ease, with growth slowing to a below-trend pace 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 to gradually normalise interest rates, but the next increase is not expected until 2009.

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 8.7% in February, exacerbated by the lunar new year holidays and recent snowstorms. Food prices continue to account for most of the increase, with non-food price inflation up a more modest 1.6% over the year. We expect further policy tightening measures in 2008.

Interest Rates (%)

	Level	QIC forecast			
	Apr-08	3 months	6 months	1 year	
Australia	7.25	7.25	7.25	7.25	
US	2.25	1.75	1.75	1.75	
Canada	3.50	2.75	2.75	2.75	
Europe	4.00	4.00	3.75	3.50	
UK	5.25	5.00	4.75	4.75	
Japan	0.50	0.50	0.50	0.50	

Australian Economy

RBA shifts towards more balanced stance

Economic growth in Australia advanced strongly in 2007, driven by buoyant domestic demand. Consumer spending accelerated late in the year, supported by tight labour markets, income tax cuts and further gains in house prices. The economy is continuing to show clear signs of capacity constraints, particularly in the labour market, with the unemployment rate falling to 4% in February. A further increase in the terms of trade in 2008 is likely to provide additional support to incomes and spending. However, tentative signs are emerging that domestic demand is beginning to cool, with consumer confidence, household credit, retail sales and business confidence all slowing somewhat in recent months.

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 interest rate 0.25% in February and March. Banks have continued to raise mortgage rates by more than the increase in the RBA interest rate, with the major banks lifting rates by an additional 0.25-0.3% since January. While inflation is likely to pick up in the March quarter, slowing global growth combined with the cumulative impact of recent increases in interest rates is expected to be sufficient to contain inflationary pressures. Recent rhetoric from the RBA has become more balanced, although concerns about inflation pressures remain. We continue to expect the RBA to leave rates on-hold for the remainder of the year.