

The Markets

International Equities

Credit & US housing problems dominate.

The December quarter was dominated by the repercussions from the US sub-prime crisis. Financial markets focused on large write-downs by global investment banks, ongoing illiquidity in money markets and growing concerns about the impact of the weak US housing market on the economy. Central banks responded with interest rate cuts (US, UK and Canada) and co-ordinated liquidity provision. The US government has proposed plans to limit the foreclosure of some sub-prime mortgages in default.

Global equity markets were weaker over the quarter, with losses concentrated in the Financial sector. Write-downs by major investment banks such as Citigroup, Morgan Stanley and UBS amounted to close to \$US 100 billion, primarily due to exposure to sub-prime mortgages and complex credit-related investments. While the Financial sector was weaker and further write-downs are expected, the ability of these major banks to attract new investments from Middle Eastern and Asian official investment funds was seen as an important stabilising factor.

The **US** sharemarket declined by 3.3%, with Financials down 15%. Performance outside of Financials was broadly flat, with strength in Energy (crude oil rose from \$US82 to \$US96 a barrel) and Defensive sectors outweighing weakness in the Consumer Discretionary sector. **Europe ex-UK** finished down 2.1%, the **UK** was up 0.4% and **Japan** lost 8.6%. Overall international equities (hedged) returned -2.8% for the quarter.

Outlook: Global sharemarkets face risks from economic weakness that may result from the US housing market curtailing consumer spending or credit market issues impairing the Banking sector. Markets may take confidence in the prospect of a benign resolution to these problems, the solid growth being experienced in Europe and Asia and further cuts in US interest rates.

Australian Equities

Financials weaker, BHP Billiton aims for mega merger.

The Australian market finished the quarter down 2.7%. The major detractor from market performance was the fall in the Financial sector driven by declines in insurers (-8.1%) and Listed Property (-13.1%). The Property sector was hit after Centro Properties (-86%), an owner/Listed Property Trust (LPT) manager of shopping centres in the US and Australia, revealed it was unable to refinance due to credit market problems and may have to sell assets and cut dividends, this raised concerns about other companies in the sector who may face similar problems.

BHP Billiton announced that it had been in merger talks with Rio Tinto (+23.8%), while the Rio board rejected the initial offer BHP said it would continue to pursue the takeover. If successful it would be the largest takeover ever seen. BHP declined 9.9%.

Outlook: With the Australian sharemarket looking fully priced future returns will unlikely match the recent strong performance. Robust domestic growth and ongoing commodity demand from China are major positives for the market, though weaker global growth and higher domestic interest rates pose threats.

Global Fixed Interest

US bonds rally.

US bond yields fell as the collapse in the US housing market raised concerns about consumer spending and investors feared banks may restrict lending to businesses and households going forward. The US Federal Reserve (Fed) lowered interest rates from 4.75% to 4.25%, citing the downside risks to growth from housing and credit market problems. Officials have however continued to voice concerns about inflation risks. US ten year yields dropped from 4.6% to near 4%.

The Bank of England (BoE) lowered rates by 0.25%, the move was not fully anticipated by markets and was seen as "insurance" against risk of economic weakness stemming from the UK housing market. The European Central Bank (ECB) left rates unchanged but took a number of steps to boost liquidity in short-term money markets. Japanese bonds rallied on signs of weaker growth in Japan.

The Reserve Bank of Australia (RBA) raised interest rates from 6.5% to 6.75% in November following evidence that inflation would continue to breach the upper-end of the 2-3% inflation target band. Australian bond yields rose as markets swung to the view that the strength in domestic conditions would continue to dominate global influences on Australian interest rates.

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

High yielders rally after credit concerns ease.

The **US Dollar** finished the quarter lower against the **Euro** and **Japanese Yen**, with supportive relative interest rate differentials helping the Euro hit an all-time high just below 1.50. Increased risk aversion helped to support the Yen. In contrast, growing concern over the outlook for the UK economy saw **Pound Sterling** lose ground against the US Dollar.

Despite a volatile quarter, the **Australian Dollar** finished relatively flat against the US Dollar at around US\$0.88. Broad-based US Dollar weakness and healthy domestic fundamentals saw it reach US\$0.94 in November before global growth concerns pushed it and other commodity based currencies lower. Returns on foreign currency exposure (international equities) were 1.2% over the quarter.

Outlook: With much of the bad news priced into rate expectations, the US Dollar remains undervalued against the other majors. The Euro should remain supported by interest rates in the short term, but is unattractive on a valuation basis, while the Yen remains undervalued. The Australian Dollar continues to be supported by interest rate differentials but is slightly expensive from a valuation perspective.

Financial markets (%)

	Level	% Return*			
	Dec-07	1 month	3 months	Fin Year	1 year
Sharemarkets					
Australia (S&P/ASX 200)	6340	-2.72	-2.73	3.00	16.07
World (MSCI World ex Aust)	1132	-0.74	-3.03	-3.42	4.39
US (S&P 500)	1468	-0.69	-3.33	-1.37	5.49
UK (FTSE 100)	6457	0.45	0.43	-0.85	7.36
Europe (MSCI Europe ex UK)	1347	-0.95	-2.06	-4.74	6.57
Japan (Topix)	1476	-3.61	-8.64	-16.34	-11.11
Currencies					
Australian Dollar/US Dollar	0.878	-0.72	-0.78	3.49	11.40
Australian Dollar/Euros	0.601	-0.32	-3.49	-4.40	0.47
Australian Dollar/Yen	98.09	-0.01	-3.63	-6.38	4.44

* Sharemarket returns inclusive of dividends, in local terms.

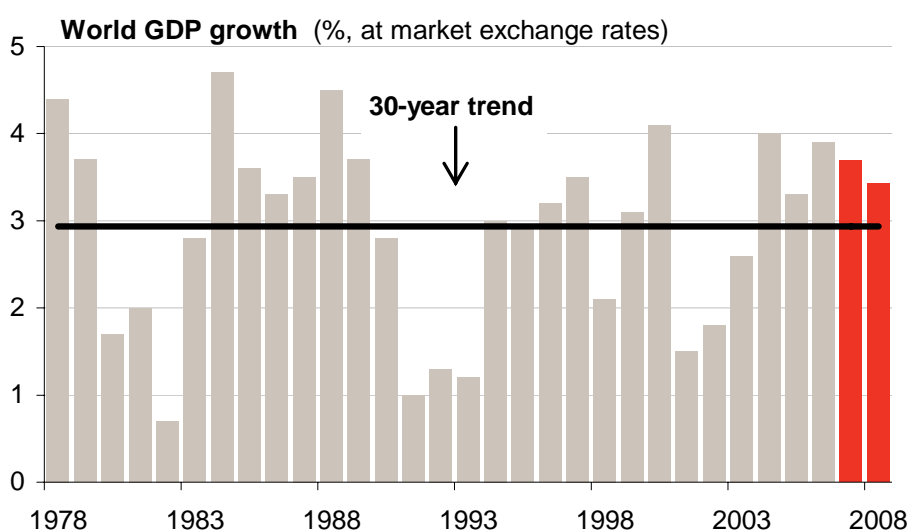
Economist's View

International Economies

Global economy weighed down by US slowdown, financial market adjustment.

Financial markets showed renewed signs of strain over recent months, as major banks continued to report write-downs on sub-prime and related assets. In response, major central banks provided a massive, co-ordinated injection of liquidity into the financial system to ease short-term funding pressures. Nevertheless, there are emerging signs that borrowing constraints imposed by dysfunctional credit markets are starting to affect business operations in the real economy.

The outlook for the global economy has softened somewhat over recent months. The marked slowdown in US housing has spread to mortgage and related financial markets. To date, the secondary effects on other sectors of the US economy, and indeed, other major economies have been surprisingly limited. Booming conditions in emerging economies like China and India continued to sustain demand, providing an important offset to the weakness in the US. Overall, some moderation is expected, but we are likely to see sufficiently strong demand in other regions to support above-trend growth in 2008.



US

The US economy remains in a parlous state. We are still seeing a severe contraction in the housing sector. Partial indicators for housing continue to hit recessionary lows, as builders take more aggressive steps to unwind a large supply of unsold inventory. There are broader signs of outright declines in residential house prices, which will weigh on household wealth and confidence. That said, the US consumer continued to spend with great zeal, relatively untroubled by the reduction in housing wealth and the increases in import and gasoline prices. Meanwhile, the business sector is showing worrisome signs of slowing, with major survey indicators falling steadily towards year end. The news is not all downbeat, however, with US exporters enjoying a substantial boost from a falling US Dollar and robust external demand. Moreover, the labour market has been extremely resilient thus far, showing few signs of job losses outside of the afflicted construction and manufacturing sectors. Overall, the risk of a US recession is probably the highest since 2001, but the most likely scenario continues to be a moderate downturn, rather than an outright recession.

US inflation has accelerated, primarily due to higher oil and import prices. However, the Federal Reserve Bank (Fed) is expected to be more concerned with diminishing demand growth and threats to financial system stability, with further easing in interest rates likely in the first half of 2008.

Eurozone

Activity in the Eurozone economy has been firm, supported by sustained recoveries in both domestic and external demand. Consumer spending continued to report healthy growth, buoyed by ongoing improvement in the labour market. Business investment growth has slowed modestly after a period of strong growth. Exports continued to do well, notwithstanding the impacts of the higher currency and weaker US demand. Looking ahead, business survey indicators have slowed from their cyclical peak, but levels remain consistent with firm growth heading into 2008. The spill-over from the US sub-prime mortgage market has affected European banks, posing some risks to corporate earnings. The sharp rise in headline inflation is a source of concern, although the European Central Bank (ECB) is likely to be patient in this difficult market environment.

Japan

The Japanese economy has emerged from its recent soft-patch, with output rebounding in the third quarter. Consumption growth remains subdued, with soft wage outcomes and a modest deterioration in the labour market weighing on the household sector. Changes in building standards have temporarily influenced the housing sector, with residential investment falling sharply in the most recent quarter. However, tentative signs are emerging that the housing sector has begun to recover. The external sector continues to provide a substantial boost to the economy, with strong demand from Europe and Asia offsetting weak demand from the US. The consumer sector finally moved out of mild deflation, with consumer prices lifted by higher energy prices. The return to positive inflation will allow the Bank of Japan to resume policy tightening, with the next move expected in mid 2008.

China

The Chinese economy continued to show robust momentum, reporting double-digit growth again in the third quarter. The expansion remains broadly-based, with retail spending, consumer confidence, industrial production, fixed investment and money growth all rising strongly. Inflationary pressures have been strong, but remained concentrated in specific food categories. Officials have reacted to the strong data with sustained tightening measures and currency appreciation. This gradual reduction in policy stimulus is likely to continue for some time. We continue to expect a more moderate pace of growth this year.

Interest Rates (%)

	Level	QIC forecast		
	Jan-08	3 months	6 months	1 year
Australia	6.75	7.00	7.00	7.25
US	4.25	4.00	3.50	3.50
Canada	4.25	4.25	4.25	4.25
Europe	4.00	4.00	4.00	4.00
UK	5.50	5.25	5.00	5.50
Japan	0.50	0.50	0.75	1.00

Australian Economy

Strong growth and inflation amidst financial market uncertainty.

Economic growth in Australia continued to accelerate strongly, supported by robust gains in domestic demand and an extraordinary income boost from high commodity prices. Consumer spending remains robust, sustained by strong employment and wages growth, particularly in mining-related sectors and regions. Indeed, consumers showed no sign of easing, despite the headwinds posed by higher oil prices, higher official interest rates and financial market volatility. Business investment faltered in the latest reading, but this follows a massive multi-year boom in activity. Exports have yet to take off, despite the new investment in capacity, partly due to the ongoing impact of the drought on rural exports.

To date, the impact from the US sub-prime mortgage market has had some impact on domestic conditions, but these effects have been small, relatively to the US and the UK. That said, a broader pass-through of higher borrowing costs is starting to occur in consumer and business lending rates, which will provide a modest tightening in domestic financial conditions in 2008.

After sixteen years of expansion, the economy is showing clear signs of capacity constraints, particularly in the labour market. Inflationary pressures have started to emerge on a more persistent basis, lifting core inflation to the top of the official target band in the third quarter. The Reserve Bank of Australia (RBA) has signalled a tightening bias from here. Barring a significant deterioration in financial market conditions, we expect two further rate rises in 2008.