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The View

A quarterly publication from QIC - May 2009

Message from Doug

Diversified and independent thinking across asset classes is central to QIC's approach to investing. We operate as a 'Village of Boutiques', which essentially means that each asset class undertakes its own research, arrives at its own views on markets and is clearly accountable for its portfolio positions and subsequent investment performance.

Complementing this high level of autonomy is a process of formal and informal peer review of the views of our various boutiques. QIC's economists, portfolio managers and I continually challenge each other about our views and analysis. We have a culture where people are free to express their opinions and are encouraged to challenge each other's views - even my own views!

Recently we have been debating the *'Drivers of the recovery and the long-term issues post the GFC'.*

In this issue of The View, I will share some of the insights from our discussions from a broader economic view, while each of our boutiques will give you their analysis of the challenges and opportunities specific to their asset class.

Recovery signs

There was little debate about the recovery indicators we are looking for, which are primarily:

- healthier banks and reducing credit spreads and borrowing costs, including evidence of new credit (loan) growth
- a more confident consumer/household – assisted by house price stabilisation and a slowing in job losses
- a recovery in business confidence and a reduction in excess production capacity.

Drivers and impediments to the recovery

Much of our debate, and indeed the general market economic debate, centres on what will be the drivers (and impediments) to recovery.

Here are some of the issues we have been discussing:

Amount of excess production capacity currently in the system
Strong growth in emerging markets resulted in excess demand in the global economy in the first half of 2008, as evidenced by the acceleration in commodity prices. The collapse in economic activity in the last six months however has seen the global economy quickly move from excess demand to excess capacity. In the US economy, capacity utilisation is at its lowest level in more than 50 years, and the unemployment rate, which is currently 8.5 per cent, is expected to reach 10 per cent by year end, which is around five percentage points higher than the equilibrium unemployment rate.

Benefits of a mark-to-market economy – unlike Japan
It is wrong to assume that the US is in the same position as Japan was in the early 1990s, and is thus faced with a 15 year period of weak economic growth. While asset bubbles preceded both Japan's decline and the current US recession, the US will emerge from this much faster and stronger than Japan did from its downturn. This is because, unlike Japan, the US is a mark-to-market economy. US financial firms were forced to face up to their problems and deal with them, with the generous help of taxpayers, and then move on, which is what we see occurring now. Arguably, the mark-to-market system exacerbated the asset price decline in the US and forced a much deeper restructuring than might otherwise have occurred. In contrast, Japan did not reprice its bad debts and other overpriced assets in the 1990s and early 2000s, and slowly accumulated cash to bolster its balance sheets by turning off credit creation. However, economies cannot function for long without credit.

No free-kick from currency devaluation
Typically in recessions only some economies fall into deep recession while others remaining less affected. In such cases, the currencies of the weaker economies typically devalue, which boosts their international competitiveness and helps their economic recovery. The current recession, however, is strongly coordinated across all economies, therefore the conditions for significant devaluation are largely absent.

The exception is in countries where the recession has threatened national solvency (e.g. Iceland and Hungary). In such cases, the negative economic impact of the flight of foreign capital far outweighs any positive impact on trade from a weaker currency.

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Global Fixed Interest

Susan Buckley
Managing Director
Active Management

While there has been a modest improvement in confidence in the fixed income space, market liquidity remains challenging, with many market participants unwilling to trade.

While market uncertainty will continue in the short term, confidence, liquidity and asset values will recover. As a result of an indiscriminate sell-off in late 2008 and early 2009, good investment opportunities exist. In particular, we are investing in the credit of Australian banks, which are relatively stronger than their global peers, as well as selected US financial institutions, where governments are committed to fixing the problems in their financial system.

With recent evidence of rising corporate defaults and low recovery rates, our comprehensive credit research process is crucial. This research has seen us favour selected defensive and counter-cyclical credit. The strong defensive characteristics of selected infrastructure loans also currently offer particularly good value.

Using the latest available instruments, including global interest rate and credit derivative strategies, the QIC GFI Alpha Fund continues to deliver double-digit returns. Importantly, the synthetically-created fixed interest instruments we use allow us to remain nimble and responsive, which is vital in the current market.

Global Real Estate

Rob Carter
Head of Global
Real Estate

Shopping centre and office building valuations are currently falling due to funding issues and the economic downturn, and we expect to see a further softening of valuations as we move through 2009.

QIC's high-quality property portfolio, which has a bias towards strong performing shopping centres, has been impacted less than other portfolios holding secondary assets. Robina Town Centre, located on the Gold Coast, is a good example of a high-quality QIC asset that is performing well in the current environment. Stage 2 of the Robina Town Centre expansion was opened on 2 April 2009 and, despite the current economic climate, all new stores were fully leased for opening day. More than 71,000 people visited Robina on opening day and visitor numbers remain strong.

QIC Real Estate did not buy any major shopping centres during the 'good times' because the overheated pricing would have diluted our clients' returns. During that period we focused our attention on expanding our existing shopping centres, as that represented better value for our unitholders. We believe that due to the liquidity issues being faced by some companies, a number of high quality, tightly-held shopping centres will become available for purchase at sensible pricing in the next 12 months.

Global Infrastructure

Ross Israel
Head of Global
Infrastructure

There is presently a great deal of activity in the infrastructure sector, but only a limited number of transactions are actually being finalised. There are a significant number of distressed players, many of which are listed funds. Listed infrastructure entities with high debt levels and/or complex structures are out of favour with a risk-adverse stockmarket that has a deep suspicion of highly-geared companies and a desire for clear and simple alignment of interest. As a result, the share prices of listed infrastructure funds in Australia and elsewhere are at historic lows, while their net asset backing has risen to historic highs.

In this environment, listed funds are selling assets and deleveraging their balance sheets to create credibility around the valuations of their portfolio. As a consequence, there is now a much greater availability of assets than has been seen for some time. Vendors (sellers) are now favouring private sale processes, where they can provide the flexibility demanded by potential buyers and avoid the embarrassment of an inadequate price being made public. Transactions are also often structured to avoid triggering any repayment of debt, as this is highly destructive of value given the favourable debt terms agreed prior to the global financial crisis (GFC).

This environment is providing unique opportunities to acquire minority interests in high-quality strategic assets.

International Equities

Greg Clarke
Director
Implemented Equities

There has recently been a big 'flight to quality' in global equity markets, and stocks with conservative balance sheets (i.e. low debt) and greater earnings visibility are being favoured. With the market currently driven by risk aversion, deleveraging and wildly fluctuating sentiment rather than fundamentals, there are significant opportunities for skilled stock selectors.

While there has been significant intervention by governments and central banks globally, there will be sectors of the economy that will prove to be relatively resilient while others will be disrupted for an extended period. QIC's international equities portfolios remain exposed to stocks with healthy earnings growth and improving profit margins, which should continue to be rewarded as investors switch their focus to earnings sustainability. Favoured sectors include health care, materials, financials and industrials.

Capital Markets

Troy Rieck
Managing Director
Capital Markets

Investment markets move through cycles. There are times when markets produce extraordinary returns and times when these returns dissipate quickly. While returns may change, risk is always present, and the wise investor will always seek to manage those risks that they can identify and mitigate. Risk management is not something that should only be considered in times of pain.

Some years ago QIC established processes to manage counterparty and liquidity risks for our clients. These processes are now being adopted elsewhere in the industry as best practice. We have always had a strong focus on the management of strategic exposures to ensure they remain in line with our clients' chosen policy. This is especially important in the current environment where there are high levels of market volatility.

We also manage downside risk providing exposures that deliver true diversification with equity markets.

We do not see any short-term change to recent market conditions, and we encourage all our clients to prioritise risk management regardless of market movements.

Implemented Absolute Return

Aongus O'Gorman
Director
Implemented
Absolute Return

We continue to expect that volatility and rapid changes in volatility will be a constant factor in the near term. We believe this environment presents strong opportunities, and we are well positioned to benefit from changes in volatility and relative price movements within and across markets.

As the current heightened levels of fear dissipate and as markets become more focused on fundamentals, our absolute return portfolios are in a good position to capture returns from more fundamentally-driven strategies.

Our managers employ a diverse and complementary range of strategies and have the scope to adjust their positions based on new information and take advantage of any opportunities these changes produce. Risk is spread across a broad range of positions in bond, equity, currency and commodity markets.

While opportunities in credit markets have been attractive for some time, recent aggressive government policy combined with significant fiscal stimulus has resulted in a number of particularly attractive opportunities.

Australian Equities

Simon Hudson
Director
Australian Equities

We are increasingly optimistic with regard to Australian sharemarket returns over the medium to long term, particularly given the severe sell-down in 2008 and early 2009. Volatility during the last twelve months has been at unprecedented levels, both in terms of degree and duration, however, it is finally beginning to moderate. This is critical as it means that capital markets are stabilising, which in turn provides a more certain capital foundation from which companies can operate. There are of course still significant near-term risks as the economic slowdown impacts the earnings of corporates, and as markets assess the depth and duration of the earnings cycle. Our analysis then focuses on which companies are best able to manage themselves in this environment.

In the short term, with balance sheets under pressure and/or debt refinancing either too expensive or just not possible, we will continue to see further capital raisings, reductions in capital expenditure and dividend cuts. Financially strong companies with experienced management teams will take advantage of the current environment and significantly enhance their earnings profiles over the medium to long term. Consequently, our major portfolio positions are companies with earnings certainty and/or defensive growth opportunities in the deteriorating earnings environment. However, due to the extent of the equity market sell-down, we are also increasingly looking for mispricing opportunities, where companies are well positioned to take advantage of the eventual recovery.

Strategy

Adriaan Ryder
Managing Director
Strategy

Major global markets have suffered from a severe 'correction' over the past twelve to eighteen months. As a result, we now see considerable long-term value in most asset classes, and we believe that the outlook for long-term investment returns for most funds has improved considerably.

While we still see significant risk for asset class returns over the short term, our long-term outlook for equity markets is very positive, and we have increased some portfolio weightings above long-term averages.

Our medium-term view (3-5 years) is that bonds will return less than we would expect over the longer term given the low cash rates associated with the current credit crisis. As such, we are currently maintaining bond weightings below long-term averages.

Impact of deleveraging, and has the debt been used wisely?
Not by everyone. It is clear that debt and leverage were used and abused by the financial sector, which is why it has to contract from 20 per cent of world GDP to something close to the 7 per cent it was previously. This contraction has brought about world economic retreat as confidence and liquidity have evaporated. However, not everyone has abused debt and needs to deleverage (as many assume). In my view, households and non-financial corporates generally have strong balance sheets and P&Ls, and, while suffering from the calamities of the global recession, many do not need to pay down debt themselves. Thus, when confidence returns, so will spending.

Long-term issues post GFC

Are we going to pay via higher inflation and interest rates?
In response to the GFC, policy-makers have injected an unprecedented amount of monetary and fiscal stimulus into the global economy. Eventually, this stimulus will need to be withdrawn as the impact of the GFC on the economy fades. A concern is that policy-makers may be too slow in withdrawing the stimulus once the GFC has passed, resulting in an overheated economy, an outbreak of inflation and high nominal interest rates. Fiscal and monetary policy typically impacts the economy with lags. This means that the move towards tighter policy must begin in advance of strong evidence of sustained economic recovery. Compounding this problem is the fact that the pick up in employment tends to lag behind the recovery in production, so policy tightening may be required at a time when the unemployment rate is still elevated. This can make the appropriate timing of policy restraint politically unpopular and lead to a delay in monetary and fiscal tightening, which has the outcome of elevated inflation and interest rates.

Smaller financial sector
Without question we will see the financial sector shrink from its heady heights of 2007 as both balance sheets shrink and employment in the sector falls. Much of this adjustment has already occurred. To be frank, the global financial sector got too big for its boots and was ultimately creating product and selling to itself with no end consumer in sight. These 'ponzi-like' transactions underwrote large salaries and bonuses for some time.

Will central banks use interest rates to attack asset bubbles in the future?
The issue for central banks is that they provided too much liquidity in the first place, promoting asset price bubbles. But too much liquidity led to no liquidity – the credit crisis – and so more liquidity was provided to solve the problem. When credit markets return to normal and credit multipliers expand again, they will do so on a much larger monetary base. Now, either that excess liquidity has to be extracted from the system – by raising interest rates with tighter monetary policy – or it will find a safety valve through inflation. The question is whether it will be goods and services inflation (i.e. CPI inflation), which used to be the case, or asset price inflation, as has been the case in recent years. I don't know the answer, but I think central banks should target both. Unfortunately, I do not think this is part of their current thinking.

The GFC has brought about a level of suffering that should not have occurred. So what will we learn from it? A renewed focus on ethical standards, moral restraint and caution. A new respect for risk. A desire for simplicity and understanding. And we will maintain these standards until we forget and do it all over again!

I hope you enjoy this latest issue of The View. As usual, I would appreciate any feedback, questions and challenges you have for me and the QIC team. Please send them directly to me at d.mctaggart@qic.com.

Doug

Doug McTaggart
Chief Executive

Financial market snapshot

Key Market Indicators (as at 30 April 2009)	*FYTD*	*1 Year*	*3 Year*	*5 Year*	*10 Year*
Australian Shares	-24.2%	-28.8%	-6.4%	6.7%	6.2%
International Shares (Unhedged)	-15.4%	-22.7%	-10.9%	-1.7%	-2.9%
International Shares (Hedged)	-31.8%	-36.2%	-11.3%	-0.1%	-1.0%
Australian Bonds	12.3%	12.8%	7.0%	6.6%	6.2%
International Bonds (Unhedged)	30.4%	26.6%	7.5%	5.0%	4.4%
International Bonds (Hedged)	11.1%	10.6%	8.5%	7.7%	7.3%
Direct Property (Australia)	-10.4%	-10.3%	7.0%	9.4%	9.5%
Listed Property (Australia)	-46.8%	-56.9%	-23.6%	-8.6%	1.0%
Inflation (CPI)	-	2.5%	3.0%	2.9%	3.2%