

A quarterly publication from QIC - November 2008

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While initially I was frustrated by the prospect of a forced time of convalescence in August this year, I chose instead to use the time to reflect on,

research and question some of my more strongly held views.

As many of you may be aware, I have always questioned the extent to which Central Banks (and in particular the US Federal Reserve) can influence the longer-term direction and strength of the global business cycle. I feel most commentators and analysts overestimate the influence (mainly via interest rates) monetary policy has on economic demand and supply factors. A colleague recently gave me the Alan Greenspan (US Federal Reserve Chairman 1987-2006) book *'The Age of Turbulence'* to read. I think the gift was intended as a joke. However, with an open and objective mind I set about reading the 700-odd page book.

On reading, I quickly realised that my worst fears were confirmed – Alan Greenspan really didn't know what he was doing. This is all verified in his own words, on page 390 in the chapter entitled "The Conundrum", where he admits that central banks didn't have much, if any, influence on bringing down the level of global inflation in the 1980s and 1990s. The outcome, he suggests, was the result of the forces of globalisation – particularly the globalising of the relatively low cost workforces in Asia.

The tragedy of Greenspan's tenure at the US Fed was that, in spite of his correct explanation for disinflation offered above, he continued to pump cheap liquidity into the global economy for nearly two decades. It was the sustained availability of cheap credit that led to the global credit crisis we are now enduring – it was and is Alan Greenspan's baby.

Of course Greenspan wasn't the only villain in the current debacle. He merely provided the foundation. We also had successive failures of regulators and rating agencies, which further compounded the problem. It is of little use to blame greed. Greed, or more benignly self-interest, is a fact of life, a result of nature. It forms the basis of capitalism – as noted by Adam Smith back in 1776. However, we know that unfettered self-interest, which is what greed is, requires regulation. Hence the existence of regulators.

So what lessons can we learn from the credit crisis, and what measures can governments, regulators and financial markets put in place to avoid a repeat of history?

The key lessons are that regulators and policy makers must be alert when doing their job. If too much cheap credit had not been available, the resulting credit bubble would not have been able to grow. And if regulators had been more vigilant on mortgage lending standards and on capital adequacy as banks became more leveraged, as well as on the conflicts of interest relating to how the business models of ratings agencies work, then we would not be where we are now.

Finally, if final investors had exercised more due diligence on their own accord ('let the buyer beware'), then the prices they paid for assets that we now know are worthless would have reflected their real value, and therefore nipped the bubble in the bud. However we have been here before. There are throughout history plenty of examples of bubbles leading to this ultimate outcome. And, I dare say, it will probably happen again in the future.

On the economic front, I must say that I wasn't surprised to see the recent significant falls in commodities prices and the Aussie dollar: I don't mean to sound self-congratulatory (well, maybe just a little bit), but keen readers of *The View* may remember that in the May 2008 edition I raised doubts about the sustainability of commodity prices and the Aussie dollar, which at one stage almost hit parity with the US dollar.

As the fallout from the credit crisis and the extreme volatility in financial markets continue to have significant implications for client portfolios, we are and continue to be committed to informing our clients of the latest developments. I trust that our regular QIC News (Email) Alerts and our team of client relationship managers are keeping you well informed about market developments and the impacts on your portfolios.

The recent turmoil in financial markets has presented QIC with some of the most significant challenges we have ever faced, particularly in terms of the liquidity issues in currency and cash markets. I am pleased to report that we have dealt with

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each challenge with the professionalism and creativity that I expect from the QIC team. I also want to thank our clients for constructively working with us to overcome the various challenges.

However, in challenging times, when fear is the dominant emotion, opportunity often presents itself for the savvy investor. Across all the asset classes we manage, portfolio managers continue to uncover investment opportunities where markets

have clearly overreacted and securities are undervalued.

A great example of this is in the area of infrastructure debt. Here the QIC Global Fixed Interest team has identified good opportunities for investors to benefit from currently undervalued yet high quality debt securities (see full article on the back page).

I hope you enjoy this latest edition of 'The View', and 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 McTaggart
Chief Executive

Economic and market snapshot

The outlook for the global economy has deteriorated sharply, with the fallout from the credit crisis leading to large declines in sharemarkets, continued falls in house prices and restrictive borrowing conditions. This is undermining business and consumer spending throughout the global economy.

The fall in house prices combined with declining sharemarkets are destroying household wealth and consumer confidence. In the US, the fall in household wealth is approaching the largest decline in fifty years, and similar declines are also being experienced in the UK, Europe, Canada, Japan and Australia. As a consequence, consumer spending in most major economies is expected to fall to a similar extent as the declines that were experienced in the recessions of the early 1990s and 1980s and in the mid 1970s. The higher cost of borrowing and more restrictive lending conditions have also caused businesses to scale back their plans for capital expenditure.

The financial market crisis is now spilling over into emerging market economies that are exposed to foreign sources of funding. Iceland, Hungary and Argentina

were the first of these emerging economies to experience severe difficulties associated with the credit crisis. In addition, many economies with trade linkages to the slowing advanced economies are also being impacted. Economic growth in China has slowed from around 12% in 2007 to around 9% in 2008, partly in response to slowing export growth.

Given deteriorating conditions in both advanced and emerging economies, we expect a global recession in 2009, with average growth below 2% over the year, modestly slower than the pace that was experienced in 2001. The recession, however, is expected to be more severe in the advanced economies, with negative growth in 2009, an outcome similar to the recessions in the mid 1970s and early 1980s.

The deteriorating global growth outlook has seen global commodity prices fall significantly. Oil prices have fallen from around US\$145 per barrel in mid-July to around US\$60 per barrel, while most other commodities have also fallen sharply. The recent fall in commodity prices has removed an important source of

stimulus for Australia's economy. With slowing trading-partner growth and softening domestic activity, we also expect businesses to significantly scale back their investment intentions.

This weaker environment is likely to lead to higher unemployment and increase the risk of a recession. However, the Reserve Bank of Australia has reacted swiftly and cut rates by 2%, and the Federal Government promptly announced a package worth \$10.4 billion (or around 1% of GDP) to 'pump prime' the economy. Further interest rate cuts and falling inflation should help support consumer spending in 2009, and the recent sharp fall in the Australian dollar will also provide some support to exporters. While these factors will cushion the slowdown in 2009, we expect growth in the Australian economy to be the weakest since the recession of 1991.

QIC Forecast	Australia			US			Europe		
	Current	Dec-08	Jun-09	Current	Dec-08	Jun-09	Current	Dec-08	Jun-09
Interest rates	5.25%	4.75%	4.00%	1.00%	0.75%	0.25%	3.25%	2.75%	1.75%
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Economic growth	4.3%	2.4%	1.4%	2.0%	1.5%	-0.5%	2.7%	1.1%	-0.1%

Cash enhanced funds out of favour but returns expected to improve

The credit crisis has taken its toll on cash enhanced fund returns, and QIC has not been immune to these impacts. While the QIC Cash Enhanced Fund consists of a diversified pool of highly rated securities, the panic in credit markets has seen the short-term value of these securities suffer. The Government's decision to guarantee bank deposits has also made these cash enhanced type investments seem not as attractive to investors less focused on prospective performance, as these securities are not covered by the guarantee.

While the current environment for cash enhanced funds seems grim and we are yet to see any significant improvement in returns, the outlook is much more positive. Specifically:

- Following coordinated global action to support the financial system, we anticipate that the values of the securities in cash enhanced funds will recover as confidence gradually improves, delivering stronger returns to the cash enhanced funds.
- As interest rates continue to fall, and with the market predicting an official cash rate below 4% by mid 2009, cash enhanced funds are expected to outperform official cash rates significantly.
- The QIC Cash Enhanced Fund remains invested in more than 170 high quality securities, 98% of which are rated either A, AA or AAA by Standard and Poor's. In addition, the portfolio is not exposed to sub-investment grade credit or structured credit securities such as CDOs (collateralised debt obligations).

Is it time to buy equities yet?

In these turbulent times, it is sometimes difficult to imagine that asset class values do tend to revert to equilibrium levels – particularly when they deviate significantly from these long-term trends.

The decision-making process behind QIC's dynamic asset allocation approach in our multi-sector portfolios relies heavily on our modelling of long-term equilibrium values for all major asset classes. Prior to the credit crisis, our models pointed to overvaluation in equity markets, and we reduced our equity exposure accordingly before the crisis hit in mid 2007.

With the recent significant falls in equity markets, our modelling suggests that most equity markets are now trading under their long-term fair value levels, which suggests the potential for above average, long-term returns. These signals, combined with our qualitative analysis, have meant that we have begun to increase equity exposure in our multi-sector portfolios.

While equity prices appear more attractive than they were, we are aware that in the current volatile environment they could become even more attractive. It is during these times that we will look to further increase our equity market exposure.



Financial Market Snapshot

Key Market Indicators (as at 30 October 08)	FYTD	1 Year	3 Year	5 Year	10 Year
Australian Shares	-21.7%	-37.8%	0.7%	8.7%	8.4%
International Shares (Unhedged)	-2.2%	-20.2%	-2.4%	2.5%	-0.1%
International Shares (Hedged)	-28.5%	-39.7%	-5.5%	2.7%	1.6%
Australian Bonds	7.4%	10.6%	6.2%	6.2%	5.7%
International Bonds (Unhedged)	38.3%	42.6%	9.9%	6.5%	4.1%
International Bonds (Hedged)	4.9%	9.2%	6.7%	7.2%	6.9%
Direct Property (Australia)	-0.2%	5.8%	13.5%	13.0%	11.1%
Listed Property (Australia)	-26.5%	-55.5%	-12.0%	-0.3%	4.3%
Inflation (CPI)	–	5.0%	3.6%	3.2%	3.2%

Infrastructure debt – a good opportunity in tough market conditions

Susan Buckley, Managing Director, Active Management explains why.

As the credit crisis continues to wreak havoc on financial markets, the slowdown in global economies and the predicted higher loan default levels have led debt investors to increasingly seek opportunities that exhibit a stable underlying credit portfolio.

One such opportunity that has emerged is in infrastructure debt. Infrastructure is the physical assets that provide essential services to the general population, and many of these assets are funded through the loan market.

Infrastructure as an asset class has historically delivered high risk-adjusted returns that are not highly correlated with other sectors, including equities and listed property. This is largely due to its steady (and often regulated) cash flows, high barriers to entry and historical record of withstanding economic downturns. These relatively lower risk returns mean that infrastructure debt investments (i.e. loans to finance infrastructure) will become more important in portfolios, particularly portfolios that have a need for longer-dated assets, such as superannuation funds.

Despite their attractiveness and increasing investor demand, infrastructure debt investments have not escaped the credit sell-off that has occurred in the last 12 months, and have undergone a price depreciation similar to that experienced by the broader credit market.

Through our investment scorecard process, we have identified that much of this price action has been the result of indiscriminate and forced selling, and has been overdone. This has created a significant opportunity for investors to gain access to these loans at discounted prices. While the high barriers to entry will limit the ability for less experienced investors to gain access to these assets, experienced investors who understand infrastructure will be well placed to take advantage of the current opportunity.

QIC prefers to invest in global infrastructure debt through leveraged loans. Loans provide a number of benefits over high yield bonds, including stronger security, greater protection and historically higher recovery rates. We believe infrastructure loans currently present a strong opportunity to generate high returns with an attractive risk profile when compared to similarly rated bonds and loans.

QIC also provides a range of innovative infrastructure debt solutions to clients, and we have developed extensive capabilities in sourcing global infrastructure deals and assessing their relative value. We also conduct extensive bottom-up research to assess the business and financial risks of the company, and to mitigate any risks to our clients.

Now is an opportune time to access infrastructure debt at a discounted price. To find out more about how you can benefit from this opportunity, contact your QIC Relationship Manager or download the full Red Paper from the Knowledge Centre at www.qic.com



Susan Buckley
Managing Director
Active Management



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