QIC Outlook
Market & Economic
Dynamic Investment Solutions

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The Markets

International Equities

Global equity markets fell sharply in August. The Morgan Stanley Capital International (MSCI) All Countries World (ex Australia) Index fell 7.0% in local currency terms over the month. In unhedged Australian dollar (AUD) terms, returns were -5.03% for the month.

Global investors were shaken by the ongoing sovereign debt problems facing the Euro zone. Rumours emerged that a number of large European banks may need to undertake substantial capital raisings in order to meet capital requirements. In addition, Standard and Poor's removed their AAA rating on US government debt. These factors set off a round of severe risk aversion sending the MSCI All Countries World (ex Australia) Index down 13.2% mid August. Most markets (ex Europe) did manage to stage a recovery rally into the end of the month.

Economic news generally disappointed the market and investors moved to price a slowing global economy. In the US, second quarter gross domestic product (GDP) was revised lower to 1% which was well below the market's initial expectations of 1.8%. Business and consumer sentiment indicators turned down sharply. Chinese Manufacturing Project Management Institute (PMI) weakened once again to 50.7 indicating only a slight expansion.

All developed-country markets experienced negative returns in the month of August. European markets were by far the weakest with Greece (-28%), Germany (-18.7%) and Italy (-14.9%) all leading the market lower. Asian markets were also weak with Japan and Singapore falling 9.0% and 9.5% respectively. The US and UK markets finished broadly in line with the developed market index. Canada (-1.1%) and New Zealand (-1.7%) were the best performing developed-markets. On average, emerging markets (EM) fell in line with developed markets over the month. South Africa (2.9%), Morocco (3.2%) and Peru (6.4%) were the strongest performers in August. Korea (-12.4%), Russia (-10.2%), Hungary (-16.2%) and Turkey (-12.8%) led the EM complex lower, all falling more than 10%.

All sectors in the MSCI index fell over the month. Defensive sectors were the outperformers with consumer staples (-1.0%), utilities (-3.4%) and telecommunication services (-3.4%) all outperforming the benchmark. Financials (-9.3%), energy (-9.2%) and industrials (-8.9%) were the sectors that led the market lower.

Outlook: Uncertainty over the outlook for the global economy and concerns over the European banking sector look set to continue for some time. We expect spikes in market volatility to occur around the time of various key events including the rolling of some European Union debt in September and October, and the US Government seeking approval for fiscal measures from Congress in November. Volatility leading up to these events will remain high as outcomes are uncertain.

Valuations remain cheap and are due in no small part to that uncertainty. Market observers remain extremely focussed on economic data for a lead as to whether things are better or worse than the existing poor consensus outlook. Should events transpire that broadly meet those poor expectations, we would expect some level of relief as this uncertainty lifts. Our longer term valuations attempt to look through this veil, and are favourable for equities in general. We therefore view the current volatility as a period of opportunity.

Australian Equities

The ASX 200 returned -1.91% during the month of August. August was a month of significant volatility as offshore factors continued to drive the local market. Standard and Poors downgrade of the US government's credit rating to AA kicked of a round of global equity market selling. Mid month, as selling pressure peaked, the Australian market had fallen 14.9%. When the selling finally eased the Australian market staged an impressive rally on the back of a good reporting season leaving it one of the better performing markets in August. Defensive sectors were the better performers in August with utilities (4.6%), telecommunications (5.8%) and consumer staples (0.5%) all rising. The worst performing sectors were energy (-5.4%) and materials (-4.7%).

As at the end of August, reported net profit growth for the financial year 2011 was 13% across the market. The majority of the earnings growth was delivered by the banking sector (12%) and the resources sector (30%). The weak domestic economy and strong AUD clearly impacted the industrials (ex financials) sector with earnings falling 6% on last year's results. A key theme that emerged during the month was one of restructuring and write downs. Bluescope (BSL) announced it would close its Port Kembla blast furnace resulting in 1,000 staff layoffs. Qantas also announced a restructure of its international operations which will result in another 1,000 job losses.

CEO's of Australian companies highlighted the difficult trading conditions and were reluctant to forecast substantial profits growth in the following year. As a result analysts revised earnings expectations for 2012 to lower levels. Despite high commodity prices resource companies indicated that rising cost pressures will erode margins over the next year.

On the economic front, the Australian unemployment rate moved up to 5.1% as employment growth stalled. On a positive note retail sales for July surprised to the upside rising 0.5%.

Outlook: The persistence of difficult corporate trading conditions across some of the more domestically focussed businesses is translating into more subdued expectations for 2012. Whilst earnings are being downgraded, valuations had already been reflecting a large amount of that uncertainty. This was apparent in the relatively good performance of the Australian share market versus global peers over the month.

Economically we continue to believe that Australia is well positioned should global GDP come under increasing pressure. This is due to the availability of various stimulatory tools including interest rates and fiscal policy. There are also potential benefits of the exchange rate weakening from current levels. Valuations continue to be supportive of Australian equities. However, global growth estimates could continue to be trimmed, leading potentially to more significant downgrades. This could lead to an additional leg down in valuations.

Global Fixed Interest

Sovereign bonds continued to provide strong diversification in August, with yields rallying as most of the riskier asset classes suffered sharp losses. Across the core global bond markets, yields have reached, or are close to reaching, the lows they made during the depths of the financial crisis in early 2009. Through the month, US 10-year Treasury yields moved 57 basis points lower to 2.22%, while German Bunds rallied 32 basis points to the same level. Australian 10-year bonds also performed well, with yields finishing August at 4.37%, from 4.80% a month earlier.

As global growth expectations fell through the month, so did breakeven inflation. Credit spreads widened as perceived default risk increased. US high yield credit spreads moved 168 basis points wider to 7.08% while investment grade spreads widened 55 basis points to 2.08%. US dollar (USD) denominated emerging market debt also traded lower with spreads increasing by about 50 basis points.

Outlook: The outlook for the global economy and bond markets is highly dependent on the policy response of both central banks and governments. With the global economy weakening and the probability of recession in the US rising, the US Federal Reserve (Fed) is likely to embark on some form of easing at their September meeting. However, though difficult to implement, a short term fiscal easing from the US Government is likely, also necessary in order for growth to gain enough momentum to avoid a new recession. Against this backdrop, US bond yields are likely to remain well supported over the coming months.

Pressures across Europe continue to build, as evidenced by the decision of the Swiss National Bank to effectively peg their currency against the Euro in order to halt its ongoing appreciation. The approach across Europe continues to be to delay addressing structural issues, with the hope that these will be resolved over time. With growth weakening across the continent, the European Central Bank looks to be on hold. This should support core European bond yields, whilst peripheral yields are likely to continue to be volatile.

In Australia, the Reserve Bank of Australia (RBA) has taken a more neutral stance given the risks to the economy, particularly from external factors. However, market pricing continues to be well ahead of the RBA, with several easings in the cash rate priced for the remainder of the year. If these easing do not eventuate, then there is the potential for bond yields to rise materially. Offsetting this is the support Australian bond yields are getting from the diversification of global central bank reserves in a global low yield environment.

Currencies

Risk aversion continued to rise over August, with economic data pointing to renewed risk of recession in the US and Europe. In response, safe haven currencies such as the Yen and Swiss Franc continued to appreciate over the month, despite intervention efforts from their central banks. The Swiss Franc was particularly volatile in the last month, trading in a 12% range, after the Swiss National Bank pursued alternative strategies for weakening the Franc, before finally announcing a floor of 1.2 Francs to the Euro.

The USD, which typically benefits during periods of rising risk aversion, was weighed down over the month by cyclical and structural factors. In terms of structural factors, concerns over the policymakers' abilities to address US public finances present significant headwinds to the USD. In terms of cyclical factors, the current weakness in US activity has increased the probability of an expansion of the Fed's quantitative easing programme, possibly as early as September. Concerns over the risk of sovereign default also continued to rise in peripheral European countries over August weighed on the Euro which fell by almost 2% against the USD, while the Sterling also fell over the month as the weakness in domestic data raised the probability of further quantitative easing in the UK.

The downgrade to global growth prospects weighed heavily on most commodity prices, gold being the exception. The price of oil fell by 7.3%, while other commodity prices also fell (the Economist industrials/metals index fell by 11%). As a result, the commodity currencies (Australian and Canadian dollar) fell most sharply, by 4.2% each over August and early September.

Outlook: Our estimates of purchasing power parity (PPP) suggest that the USD is undervalued against all major currencies, reflecting both cyclical and structural factors as outlined above. The USD is outside its fair value ranges based on PPP against the commodity currencies and the Yen, but remains within its fair value ranges against the Euro and Sterling.

We expect the USD to strengthen only modestly from current levels, based on the valuation signal from our PPP models. Partly offsetting the strength of the valuation signal is the relative interest rate outlook which prevents a sharp rally in the USD over the forecast horizon, especially against the $A where the valuation signal is strongest.

Financial markets (%)

Sharemarkets	Level as at 31-Aug-11	1 month return	3 month return	Financial YTD return	1 year return
Australia (S&P/ASX 200)	4296	-1.91	-7.51	-5.81	1.92
Developed World (MSCI World ex Aust.)	827	-6.95	-10.85	-9.41	8.45
World (MSCI AC World ex Aust.)	316	-7.00	-10.72	-9.24	7.58
US (S&P 500)	1218	-5.43	-8.90	-7.36	18.50
UK (FTSE 100)	5394	-6.62	-8.97	-8.61	6.73
Europe (MSCI Europe ex UK)	782	-11.03	-17.78	-16.00	-5.64
Japan (Topix)	770	-8.38	-7.98	-9.22	-2.14

Currencies					
Australian Dollar/US Dollar	1.07	-2.50	0.51	0.03	20.32
Australian Dollar/Euro	0.74	-2.69	0.35	0.73	6.21
Australian Dollar/Yen	81.90	-3.41	-5.39	-5.28	9.58

Sharemarket returns are inclusive of dividends, in local terms.

Economist's View

Key Points

- Sovereign default risk and fear of US economic recession undermine investor confidence
- Is the US heading for recession?
- Australian economic activity rebounds in the June quarter led by consumer spending and mining investment
- Weak Australian labour market to keep RBA on the sidelines

International Economies

Sovereign default risk and fear of US economic recession undermine investor confidence

Global equity markets fell sharply in August as concerns around sovereign risk and fear of a recession in the US weighed heavily on investor sentiment. Equity markets began to slide as brinkmanship over raising the US debt ceiling fostered fears of a technical default by the US government. Between 27 July and 2 August, when an agreement was finally reached, the S&P 500 dropped almost 6 per cent. Concern over the sovereign debt crisis engulfing Spain and Italy, where 10-year government bond yields rose well above 6 per cent, combined with large downward revisions to the US national accounts, also weighed on equity markets. The S&P 500 fell almost 5 per cent on 4 August due to the escalation of debt fears in Europe and concerns about a growth slowdown in the US.

Standard and Poor's downgrade of the US credit rating from AAA to AA+ on the weekend of 6-7 August, combined with sovereign debt fears in Europe spreading to France, sparked another round of falls in equity markets. The S&P 500 fell 6.7 per cent bringing the cumulative decline in the US index to around 20 per cent at its low point on 8 August.

The Fed statement that noted the potential for further policy stimulus and the expectation that the Fed would maintain 'exceptionally low levels for the federal funds rate at least through mid-2013' helped arrest the decline in equity markets. The European Central Bank's (ECB) intervention by purchasing Italian and Spanish government bonds in the secondary market lowered 10-year government bond yields by around 100 basis points (bps) in these countries and provided further stability to global financial markets. From the low point on 8 August to the time of writing on 8 September, the S&P 500 has rallied by around 9 per cent, but with an extremely high level of volatility.

Is the US heading for recession?

The US national accounts release for the June quarter contained significant benchmark revisions dating back to 2003. The revisions revealed a deeper recession than previously thought, and lowered the level of real GDP in first quarter of 2011 by 1.6 per cent. The national accounts also showed that growth in the first half of the year averaged an anaemic 0.8 per cent annualised: just above recessionary levels. In response, we and most other economic forecasters have revised down the outlook for US growth in the second half of the year. Despite this, economic data for July revealed a US economy that was recovering from its weak patch in the first half of the year. Motor vehicle sales rose sharply in July and held the elevated production levels in August; industrial production surged and durable goods orders also rose in excess of expectations. While August business sentiment indicators were mixed at the regional level, the national ISM manufacturing and non-manufacturing indexes failed to show a collapse of confidence in August. On the contrary, the manufacturing ISM remained above 50, indicating that the sector continued to expand, while the non-manufacturing ISM rose over the month from 51to 53.3.

However, the outlook for the US consumer remains clouded. Although July consumer spending was robust, personal income growth was weak and the US household boosted spending by reducing its rate of saving. Given weak August labour market data and recent financial market turmoil, the US household will be challenged to maintain July rates of spending in the face of weak income and asset-price growth. While we expect positive growth in US consumer spending

in the second half of the year, the growth rate in the largest component of US aggregate demand will remain below trend, as will the rate of growth in economic activity.

Despite sluggish consumer spending, a US recession is still not our central case. Our annualised growth forecasts for US real GDP in the third and fourth quarter of 2011 are 1.6 per cent and 2.1 per cent respectively.

There are a number of reasons that lead us to think the US can still avoid recession.

• Temporary factors weighing on growth in the first half of the year appear to be unwinding. As mentioned, recent US auto sales data showed a large rebound in July and will be sustained throughout the remainder of the quarter.

• Oil prices (even before recent events) have fallen sharply, improving the real disposable income of the household sector via lower gasoline prices.

• The balance sheets of US corporations are robust and earnings growth has been strong. The well-capitalised nature of US businesses has been reflected in the recent behaviour of US corporate credit spreads, which have only risen marginally, despite the current turmoil. The fact that corporate credit spreads have not spiked sharply indicates investors' willingness to continue lending to the US corporate sector. This is in stark contrast to the period of the global financial crisis (GFC), where US spreads on investment grade credit spiked to record levels.

• The US household sector is also better positioned than during the GFC. It has raised its rate of saving and significantly lowered its debt servicing burden. This leaves the consumer better positioned to smooth consumption during a period of slower growth.

• Finally, because the availability of credit in short-term money markets has been largely unaffected by recent events, the forced selling of assets associated with the GFC is not part of the current story.

However, the risk to the outlook is certainly on the downside. While most forecasters continue to agree with our view that the US will not enter recession, we have estimated that there is a 25 per cent probability of the US entering recession over the coming 12 months.

Interest Rate Forecast (%)

	Level at 07 Sep 2011	QIC forecast Dec-11	Mar-12	Jun-12
Australia	4.75	4.75	4.75	4.75
US	0.00 - 0.25	0.00 - 0.25	0.00 - 0.25	0.00 - 0.25
Canada	1.00	1.00	1.00	1.00
Europe	1.50	1.50	1.50	1.50
UK	0.50	0.50	0.50	0.50
Japan	0.00 - 0.10	0.00 - 0.10	0.00 - 0.10	0.00 - 0.10

Australian Economy

Economic activity rebounds in the June quarter led by consumer spending and mining investment

The June quarter national accounts showed that the Australian economy rebounded strongly from the effects of the March quarter floods. Robust business investment and consumer spending led to a rise of 1.2 per cent in real GDP over the quarter, having fallen by 0.9 per cent in the March quarter. Business investment continues to benefit from capital expenditure by the mining sector, with new capital expenditure intentions indicating that the mining boom will continue to drive strong investment over the current financial year.

Weak Australian labour market to keep RBA on the sidelines

While market sentiment was boosted by the national accounts data, it was immediately dashed by the release of very weak labour market data for August. Over the month, 9,700 jobs were lost, against expectations that 10,000 jobs would be created. As a result, the unemployment rate rose to 5.3 per cent from 5.1 per cent in July.

The day before the national accounts data was released, and two days before labour market data was released, the RBA left the cash rate at 4.75 per cent at its August Board meeting. In the minutes of the meeting, the RBA reiterated its view that capital expenditure by the mining sector would boost economic activity over the current financial year, but remained cautious regarding the prospects for the US and European economies. Given the deterioration in the Australia labour market, we remain of the view that the RBA will keep rates on hold until the second half of 2012.

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