

31 January 2011

The Markets

International Equities

Global equity markets extended their run of robust performance through January as the economic environment, particularly in the US, continues to improve. The MSCI All Countries World Index (ex Australia) returned 1.4% for the month. A weaker Australian dollar (AUD) translated to higher unhedged returns, with the AUD unhedged index returning 4.6%.

Investor sentiment was boosted through January by a continuation of positive economic releases from the US. While employment data disappointed somewhat, consumer confidence surprised on the upside and new home sales jumped 17.5% over the month against expectations of 3.5%.

European releases were mostly in line with consensus forecasts; however, retail sales disappointed while the industrial production measure increased above expectations.

Most developed markets posted positive performance in January. With European sovereign debt concerns somewhat diminished, Greek equities gained strongly (15.2%), while Spain and Italy also underwent a significant rally. At the opposite end of the spectrum, Norway (-2.5%) and the United Kingdom (-0.3%) showed weakness. Emerging market countries were considerably weaker than developed. Egypt fell sharply (-20.2%) on political instability, while Peru and India also fell in excess of 10%. Hungary (7.1%) and the Czech Republic reversed some of their recent underperformance.

Within developed markets, the energy (5.8%) and financials (3.8%) sectors outperformed, while materials (-2.6%) and consumer staples (-2.3%) posted negative returns.

The AUD fell 2.4% in trade-weighted terms over the month. This had a positive effect on returns across much of the portfolio when translated into unhedged AUD terms.

Outlook: Equities pricing continues to be supported by sound economic fundamentals. In addition, corporate earnings and sales growth are coming in at, or above, expectations. The US, as a key driver of the global economy, is leading the improvement and in turn is serving to boost risk appetite for equities globally. Right now, the Chinese growth story is also supporting this environment, despite having marginally weaker (but still very strong) economic growth.

While we continue to see very strong earnings expectations for international shares supported by such positive news, we are mindful that equity markets can over-price recovery. We remain mindful of such risks and continue to watch for investors' over-enthusiasm above our expected long-run returns. However, we are comforted by the recent news flow.

Australian Equities

The Australian equity market rose strongly in early January ahead of the February reporting season, before concerns over unrest in the Middle East led to an increase in risk aversion. The market gave back most of its early gains later in the month. Continued inflation risks around China and the impact from the Queensland floods also impacted the raw material and insurance sectors. Woolworths lowered its guidance for earnings growth for the first time since 1993, citing weak discretionary spending.

The domestic materials sector underperformed the Australian market in January, along with IT and utilities, while the consumer staples, financials and REITs sectors all outperformed.

The S&P ASX 200 Accumulation Index gained 0.18% for the month.

Outlook: Conflicting forces are likely to influence Australian equities in the medium term. Fundamentals for the resources sector remain positive, as the Chinese economy continues to be managed for 9 to 10% annual growth and world growth remains strong, as US growth reaccelerates. Diversified mining companies Rio Tinto and BHP Billiton now have almost no debt, as well as strong, internally funded growth plans and excess cash to reward shareholders. Domestically, with household gearing at about 156% of income, debt servicing is placing pressures on households and consumer spending growth. These pressures should increase by year end, when the Reserve Bank of Australia (RBA) is likely to start increasing the cash rate again. Partially offsetting this negative impact, the strong labour market (with a current unemployment rate at a low 5%) should lead to stronger wages growth, supporting households' income growth.

Global Fixed Interest

Sovereign bonds yields across most major markets were little changed through January. The yield on 10-year US Treasury notes moved 8 basis points (bps) higher to 3.37%, while Australian 10-year bond yields declined by 3 bps, finishing January at 5.51%. European bonds moved more dramatically, with 10-year German bund yields climbing 19 bps to 3.16%.

Both US and Australian 10-year breakeven inflation moved slightly higher over the month. Credit markets continued to rally, with spreads making new multi-year lows. US high yields spreads are now at 4.91%, while investment grade spreads are at 1.5%. Emerging market spreads widened through the month.

The RBA kept the cash rate target steady at 4.75% through January. In its Statement of Monetary Policy, the Board expressed comfort around its current positioning for the economic outlook, with interest rates to borrowers slightly above their long-term average. Cash returned 0.43% for the month.

Outlook: The recent flow of economic data in the US has been very positive, showing good growth in consumer spending and a pickup in business spending. US growth expectations have been upgraded significantly. The labour market is expected to improve markedly in coming months, leading to sustainable, close-to-trend growth. Conditions have also improved in core European countries and UK inflation remains uncomfortably high. Global interest rates are likely to increase over the medium term.

In Australia, the recent serious flooding in Queensland and Victoria, combined with the low fourth quarter Consumer Price Index (CPI) result, is likely to result in cash rates remaining unchanged for some time. With activity data generally disappointing, inflation inside the target band, interest rates already above average levels and the level of the Australian dollar restraining some sectors of the economy, the RBA is well placed to sit back and monitor developments within the domestic and global economy in coming months. However, we still expect interest rates to rise again by year end.

The fundamental backdrop is supportive for corporate credit risk. While there has been an increase in shareholder-friendly activity, there is little evidence that companies, in aggregate, are becoming overly bullish. The largest are still deleveraging, cash balances remain stable, and share buybacks and dividend announcements have increased in line with cash flow generation - not in excess of it. While markets have taken their primary direction from sovereign events, economic data and company results have been surprising on the upside. Default rates are likely to stay low in 2011. Credit upgrades are currently outpacing downgrades. Finally, the amount of new issuance is expected to be lower than the amount of redemptions supporting demand for credit assets.

Currencies

Stronger global growth raises inflation risk from higher food and energy prices.

Policy measures introduced in the US at the end of 2010 have boosted the prospects for global growth over 2011, with survey data for January affirming the positive outlook. This, combined with stronger growth in developed markets, has led to rising commodity prices which has raised inflation risk globally. Following strong rises in the second half of last

year, agricultural commodity and metal prices continued to rise over January, while energy prices held their gains. Despite the rise in inflation risk stemming from commodities, there remains substantial slack in most developed markets, with inflation below target in the US and Japan. In Europe, however, the rise in commodity prices has combined with policy measures to push inflation to uncomfortably high levels. Markets have moved to reprice the risk of near-term tightening in the UK and Europe, leading to upward pressure on those currencies over January. During the month, the euro and Great British pound (GBP) rose by 2.2% and 2.3% respectively against the US dollar.

Rising inflation risk has resulted in continued policy tightening in developing markets, especially China. After the series of measures announced during the December quarter, the People's Bank of China (PBOC) raised the required reserve ratio by a further 50 bps in January. The Bank of Korea (BOK) also tightened policy by 25 bps in January, taking the official rate to a still accommodative 2.75%. Asian currencies were broadly stable against the US dollar over January. Also within the Asian region, the yen suffered a decline of 1.1% against the US dollar over January, as Standard and Poor's downgraded Japan's sovereign credit rating to AA-, warning that the government had no plan to deal with its mounting debt (which now stands at around 200% of GDP). The Australian dollar also fell 2.5% against the US dollar over January, as growth and inflation data softened and as flooding in the eastern states affected production, leading to downward revisions to the near term growth outlook.

Outlook: Our estimates of purchasing power parity (PPP) suggest that the US dollar is undervalued against all major currencies, likely reflecting cyclical weakness associated with quantitative easing. The AUD is above the fair value range based on PPP. In the absence of a second round of quantitative easing (QE2), we would expect downward pressure on the AUD in coming months. However, factoring QE2 into our estimates raises our forecast for the AUD to around parity, and extends the timeframe over which we expect the AUD to remain outside its PPP range into 2012. Like the AUD, the yen is also overvalued against the US dollar and outside its PPP fair value range. However, with Japan also participating in QE2, there will be less interest rate support for the yen and we may see pressure on it weaken. Other currencies remain within their fair value ranges against the US dollar.

Financial markets (%)

Sharemarkets	Level as at 31-Jan-11	1 month return	3 month return	Financial YTD return	1 year return
Australia (S&P/ASX 200)	4753	0.18	2.74	12.98	8.46
Developed World (MSCI World ex Aust.)	916	2.00	7.55	21.01	16.74
World (MSCI AC World ex Aust.)	350	1.41	6.62	20.38	16.73
US (S&P 500)	1286	2.37	9.23	26.19	22.19
UK (FTSE 100)	5862	-0.55	3.80	20.94	16.78
Europe (MSCI Europe ex UK)	962	3.13	4.02	14.80	12.52
Japan (Topix)	910	1.26	12.35	9.18	2.97
Currencies					
Australian Dollar/US Dollar	1.00	-2.74	1.71	18.04	12.17
Australian Dollar/Euro	0.73	-4.83	3.12	5.46	13.72
Australian Dollar/Yen	81.68	-1.75	3.46	9.29	1.37

Sharemarket returns are inclusive of dividends, in local terms.

Economist's View

Key Points

- Positive economic data offsets concern regarding Egypt's political stability
 - Strong momentum in global manufacturing in early 2011
 - Core inflation continues to fall in the US – ECB keeps monetary policy on hold
 - Data reveal slowing momentum in the Australian economy
 - Australian floods to subtract 1.5 percentage points from real GDP growth in 2011 Q1
 - Destruction of banana crop by TC Yasi to add 0.4 percentage points to inflation in 2011 Q1
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International Economies

Positive economic data offsets concern regarding Egypt's political stability

Geo-political concerns competed with economic data on financial markets this month, with the positive economic data generally winning the tussle against negative developments in Egypt. Equity markets were stronger over the month, rallying by around 5 per cent, while bond yields moved higher, with yields in the US, UK and Germany rising by around 30 basis points (bps).

Strong momentum in global manufacturing in early 2011

US and European manufacturing indexes pushed higher to levels not seen for some years, flagging strong momentum in the manufacturing sector across major developed economies in early 2011. Also, the release of Japanese industrial production data showed a rebound in activity in the last month of 2010, with the Ministry of Economy Trade and Industry expecting further strong gains in the New Year. Elsewhere in Asia, Chinese purchasing managers index (PMI) surveys point to ongoing expansion in the industrial sector after very strong growth in the last quarter of 2010 when real gross domestic product (GDP) rose at an estimated 12.7 per cent annualised rate.

Adding to the outlook was an overall positive tone from a raft of economic data emanating from the US. National accounts data showed that US GDP expanded by at an above-trend annualised rate of 3.2 per cent in the December quarter. While this was slightly below market expectations, real consumer spending was strong, rising at an annualised rate of 4.4 per cent, and business investment continued to grow at a robust annualised pace in excess of 4 per cent. In addition, dwelling investment also posted positive growth in the quarter. Incorporating the impact of various fiscal measures to be introduced in 2011, we expect real GDP growth to increase to above 4 per cent (annualised) in the March quarter.

Core inflation continues to fall in the US – ECB keeps monetary policy on hold

While US growth remains strong, core inflation continues to track lower. The release of December personal income and spending data showed that underlying inflation, as measured by the core Personal Consumption Expenditure (PCE) deflator (the inflation measure most closely followed by the US Federal Reserve) fell from 0.8 per cent year ended in November to 0.7 per cent year ended in December. The lack of inflation pressure continues to support the Federal Reserve's (Fed) dovish stance on monetary policy, which was reiterated at its January Board meeting where members voted unanimously to leave policy unchanged.

In contrast to the US, the inflation outlook has been deteriorating in the Euro area with data released for January showing consumer prices in the region are rising at a year-ended rate of 2.4 per cent, up from 2.2 per cent in December. However, the headline rate is currently being influenced by a number of one-off factors including the timing of value added tax (VAT) rate hikes and energy price increases. During the month, the European Central Bank (ECB) left the refinancing rate unchanged at 1 per cent, while recent comments by President Trichet surprised the market, which was expecting a more hawkish stance from the ECB.

Interest Rate Forecast (%)

	Level at 07 Feb 2011	Mar-11	QIC forecast Jun-11	Dec-11
Australia	4.75	4.75	4.75	5.50
US	0.00 - 0.25	0.00 - 0.25	0.00 - 0.25	0.00 - 0.25
Canada	1.00	1.00	1.00	1.50
Europe	1.00	1.00	1.00	1.00
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

Data reveal slowing momentum in the Australian economy

Data has pointed to a slowing in momentum in the economy leading into 2011. Households, in particular, remain cautious with retail sales volumes falling 0.3 per cent in the December quarter despite ongoing discounting by retailers. Employment gains also moderated in December, with the economy adding only 2.3 thousand jobs. Nonetheless, the unemployment rate fell to 5 per cent, its lowest level in two years, as the participation rate slipped. Consistent with the moderating growth data, inflation was softer than expected in the last quarter of 2010, rising by 0.4 per cent.

Australian floods and TC Yasi to subtract 1.5 percentage points from real GDP growth in 2011 Q1

We have now incorporated the impact of the recent floods, Tropical Cyclone (TC) Yasi and the Federal government's fiscal response into our forecasts of the Australian economy. In our analysis, the impact of the floods is felt most powerfully in the first half of the year, subtracting 1.5 percentage points from quarterly real GDP growth in the first quarter of 2011. Consequently, we now expect the Australian economy to contract by 0.7 per cent in the March quarter, the first fall in quarterly real GDP growth since the December quarter in 2008 and only the second quarterly decline in growth since 2000. The major contributors to the fall in GDP are the loss of production from Brisbane (-0.7 percentage points) and the loss of coal and agricultural production (-0.4 and -0.1 percentage points, respectively).

However, these losses are one-off, and combined with the impact of rebuilding we expect growth to bounce back, rising by 2.5 per cent in the second quarter of 2011 compared to our pre-flood forecast of 0.8 per cent over the quarter. Combined with the uncertainty over the near-term outlook created by the recent floods, the moderation in core inflation should mean the Reserve Bank of Australia (RBA) will keep rates on hold until the second half of 2011.

Destruction of banana crop by TC Yasi to add 0.4 percentage points to inflation in 2011 Q1

Initial reports indicate that damage to residential and commercial property by TC Yasi is less than originally feared. However, it appears that around 90 per cent of the banana crop has been destroyed, similar in size to the destruction caused by TC Larry in 2006. If the impact during TC Larry is a guide, we can expect the price of bananas to rise by

around \$10 per kilo. Bananas have recently been selling for around \$3 per kilo, hence, a \$10 per kilo increase would represent a 333 per cent increase in the price of bananas, which would add around 0.4 percentage points to March quarter inflation. Added to the boost to inflation caused by flood-impacted food prices, higher banana prices are likely to push year-ended inflation to around 3.5 per cent in the March quarter. While this is substantially higher than the top of the RBA's target range of 3 per cent, following its Tuesday meeting (where rates were left on hold at 4.75 per cent), the Board indicated that it would look through the temporary impact of adverse weather.

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