

31 March 2011

## The Markets

### International Equities

Global equity markets lost ground in March as the Japanese earthquake and adverse geopolitical events dented investors' confidence. The Morgan Stanley Capital International (MSCI) All Countries World Index (ex Australia) fell 0.59% in local terms through March, but gained 3.17% over the quarter. In unhedged Australian dollar (AUD) terms, the benchmark lost 1.71% for the month and gained 3.50% over the quarter.

Economic data released through the month confirmed that the economic recovery in Europe and the US is holding course. European data was roughly in line with expectations. In the US, the unemployment rate dropped from 9.1% to 8.9% and measures of consumer confidence, industrial manufacturing and retail sales were in line with expectations. New home sales data disappointed, however, falling 17% over the month.

In developed markets, Singapore and New Zealand were relatively strong through March up 4.0% and 2.5%, respectively, while Japan was by far the weakest, falling 8.1% following the devastating earthquake and tsunami. Over the quarter, Greece (8.9%) and Italy (7.6%) posted strong performance, while Israel (-4.4%) and Finland (-3.7%) experienced the largest drawdowns. Emerging market countries outperformed developed countries over the month, but they lagged over the quarter. India and the Philippines gained in excess of 9% through March, while Morocco gave back last month's gains, falling 4.6%. Over the quarter, Russia (9.5%) and the Czech Republic (7.6%) had the most significant gains, while political uncertainty saw Egypt's equity market fall 21.3%.

Telecommunications (1.8%) and industrials (0.8%) were the strongest developed market sectors over the month. In contrast, utilities and financials fell 4.4% and 3.6% respectively. Over the quarter, all sectors gained with the exception of utilities, which was down 0.6%. The energy sector gained 12.4%.

The AUD rallied 3.8% in trade-weighted terms over the month and 4% over the quarter. This had the effect of decreasing returns across much of the portfolio when translated in AUD terms.

*Outlook:* Economic data continues to support undemanding valuations. The US, as the traditional engine of global growth, is delivering economic data that indicates the recovery is on track. In addition, the tax laws passed in the US allowing for accelerated depreciation this calendar year will incentivise a material increase in capital expenditure in the second half and stimulate employment and consumer sentiment towards year's end. There are challenges in managing potential inflation (a negative for equity returns) this is creeping up on the US Federal Reserve's (Fed) agenda. The quantitative easing (QE) program is expected to finish at the end of June. The equity market should take this as a sign that the recovery is entrenched. These medium-term factors should have a larger impact on equities than the ongoing debate over small parts of the US budget.

Looking across the Pacific to China, inflation concerns are rising. Dubbed the 'world's factory', rising prices coupled with a rising currency put upward pressure on prices of manufactured goods globally. Right now, inflation concerns are not negatively impacting equity prices, however interest is increasing.

## Australian Equities

The S&P ASX 200 Accumulation Index gained 3.23% for the quarter. While the benchmark gained ground during the first quarter of 2011, it remained in a well-established range.

In March, domestic investors were focused on information from the recent reporting season. Offshore events, such as unrest in the Middle East and North Africa (MENA) and the earthquake in Japan, only added to the increasing uncertainty emerging from a soft reporting season that was dominated by negative earnings revisions. The Australian government's announcement of its intention to introduce a carbon tax without clarifying the details of potential compensation only added to the uncertainty.

In major company news, BHP announced a \$5 billion off-market buy-back of BHP Billiton Limited shares. Insurance companies were hit by a series of natural disasters including severe flooding in Queensland and Victoria and earthquakes in Christchurch and Japan.

*Outlook:* Despite the impact of the recent natural disasters and geo-political events during the last quarter, we remain optimistic that equity markets can continue to consolidate recent gains over the remainder of the year.

Following the most recent company reporting season (February), the earnings outlook has been downgraded for domestically sourced industrial-based earning, but improved for synchronised global growth. We expect equity markets will reflect the dual-speed growth in the Australian economy, lower domestic growth, a higher AUD and rising domestic costs, affecting domestic and offshore earnings for companies without pricing power, versus the higher growth in mining and energy-related companies.

## Global Fixed Interest

March proved to be a dramatic month testing the global economy across a range of events, including the natural disasters in Japan Escalating political unrest in the MENA region continued, as did concerns about European peripheral debt burdens. There are signs that Chinese growth may be slowing, in part under the weight of ongoing policy measures.

Notwithstanding the challenges, global economic activity is proving resilient with markets recovering from these shocks in the second half of the month.

Global sovereign bonds experienced a volatile quarter with various geopolitical events anchoring yields that were otherwise inclined to rise, as economic data, particularly in the US, showed strength. US 10-year treasuries sold off, with yields increasing 18 basis points to 3.47%. German Bunds also sold off, moving 39 basis points higher, while the Australian 10-year bond yield fell 6 basis points to 5.49%.

Both US and Australian 10-year breakeven inflation moved higher over the quarter, but credit markets were resilient. While there was an episode of urgent selling immediately following the Japanese earthquake, global credit markets recovered to post an overall positive return for the month (and rallied over the quarter). US high yield spreads are now at 4.65%, while investment grade spreads are at 1.42%. Emerging market spreads widened through the quarter.

The Reserve Bank of Australia (RBA) kept the cash rate target steady at 4.75% through the March quarter. In its most recent Statement of Monetary Policy, the Board expressed comfort around its slightly restrictive monetary policy stance given the economic outlook.

*Outlook:* Mixed Australian economic data, combined with modestly restrictive monetary policy, an AUD above parity with the US dollar (USD) and underlying inflation at 2.25% (comfortably inside the RBA's 2-3% medium term target band) suggest that cash rates will remain unchanged over the next few months. However, we expect the RBA's modest monetary policy tightening cycle to recommence later in the year as strong investment intentions become confirmed in actual data, wage growth picks up further and underlying inflation returns towards the top of the RBA's target band.

Generally, markets are increasingly convinced of the sustainability of the global recovery, with emerging data continuing to support and reinforce this view. Arguably, future data releases will be less important than the communication and clarity of the Fed's exit policy. How and when the Fed communicates the unwinding of its emergency policy settings will be the next widely anticipated economic event to drive markets.

The outlook for tighter corporate credit spreads looks favourable as the economic recovery remains intact, borrowing conditions continue to ease, the European financials start to stabilise and investors continue to look for assets with yield. However, the prospects of rising oil prices, decelerating profit margins and tighter fiscal and monetary policy could limit the upside.

## Currencies

Exchange rate changes over the March quarter were relatively modest by historical standards, with the largest move being a 5.8% appreciation of the euro against the USD, as markets moved to price a tightening in monetary policy from the European Central Bank (ECB) at its April meeting. Despite substantial slack in the Euro area economy, which has kept core inflation around 1%, rising oil and other commodity prices have led to headline inflation rising to 2.4%, above the ECB's acceptable limit. Commentary from ECB President Trichet all but confirmed a move at the next meeting, leading to upward pressure on the euro over the quarter. We believe the tightening of monetary policy is premature, particularly given the excess capacity and low underlying inflation in the region, as well as headwinds to growth from a tighter fiscal stance. Growth in the region is likely to underperform going forward, leading to downward pressure on the euro despite only modest valuations in our long-term purchasing power parity (PPP) framework.

Over the March quarter, commodity prices posted solid gains due to the combination of strong economic data and rising geopolitical unrest in the Middle East and North Africa, with oil, gold and industrial/metal prices rising by 17%, 1% and 5% respectively. This provided support for commodity-exporting currencies, such as the Canadian dollar (CAD), which rose by 2.8% against the USD, while exerting downward pressure on commodity-importing currencies, such as the Japanese yen, Chinese yuan and Korean won. However, many currencies were also affected by the series of natural disasters in the Asian region, largely because of the impact on monetary policy. For example:

- Despite support from rising commodity prices, the AUD rose by just 1.1% against the USD in the quarter, with the impact of flooding in the eastern states in January expected to dampen growth in the short term and delay tightening by the RBA.
- Similarly, the earthquake that devastated Christchurch in February hastened the timing of monetary policy easing by the Reserve Bank of New Zealand (RBNZ), causing the NZ dollar to fall by 2.4% against the USD over the quarter, despite rising commodity prices.
- The yen also fell by 2.4% against the USD over the March quarter. While the earthquake and tsunami initially caused a sharp rally in the yen due to expected repatriation flows, coordinated intervention by the G7 successfully weakened the yen. This built on weakness in the yen associated with falling terms of trade and a downgrade to Japan's sovereign debt rating to AA- by Standard and Poor's in January.

Economic data remains solid, particularly in the US and core-Europe. While the US economy is currently experiencing above-trend growth and falling unemployment, Fed Chairman Bernanke remains optimistic that the low level of core inflation will allow US monetary policy to remain supportive of the economy, at least in the near term. This contrasts with tighter monetary policy in China since the middle of last year (and the expected tightening of monetary policy in Europe in April). With above-trend growth in the December quarter and rising inflation risk, policy tightening continues in Asia, with the People's Bank of China raising the key deposit and lending rates by a further 25 basis points in the March quarter, and the required reserve ratio by 100 basis points. This has supported the yuan, which rose by 0.9% against the USD over the March quarter. The Korean won also rose by 2.7% over the quarter as monetary policy was tightened. Monetary policy tightening in Asia is already starting to have an impact, with leading indicators in China showing signs of weakening over the March quarter.

*Outlook:* Our estimates of PPP suggest that the USD is undervalued against all major currencies, likely reflecting cyclical weakness associated with quantitative easing. However, only the commodity currencies (AUD and CAD) are outside their fair value ranges based on PPP. We therefore expect to see pressure on both currencies to depreciate against the USD over the medium term. Following its 2.4% fall in the quarter, the yen has moved back within its PPP fair value range. However, with interest rates likely to remain very low in Japan for an extended period, this is likely to continue to exert downward pressure on the yen, despite the lack of valuation signal. And despite a 5.8% appreciation in the quarter, the euro remains within its fair value range against the USD. However, we believe the ECB tightening which has underpinned the euro's recent strength will prove premature, with growth and inflation falling short of expectations. Hence, we expect to see downward pressure on the euro in the near term, despite only a modest valuation signal.

#### Financial markets (%)

Sharemarkets	Level as at 31-Mar-11	1 month return	3 month return	Financial YTD return	1 year return
Australia (S&P/ASX 200)	4837	0.67	3.23	16.41	3.44
Developed World (MSCI World ex Aust.)	926	-1.35	3.58	22.89	9.17
World (MSCI AC World ex Aust.)	354	-0.59	3.17	22.47	9.69
US (S&P 500)	1325	0.04	5.92	30.56	15.65
UK (FTSE 100)	5908	-0.94	1.10	22.96	7.44
Europe (MSCI Europe ex UK)	955	-2.26	2.70	14.32	5.30
Japan (Topix)	869	-7.61	-2.18	5.47	-9.23
Currencies					
Australian Dollar/US Dollar	1.03	1.56	0.89	22.44	12.67
Australian Dollar/Euro	0.73	-1.16	-4.63	5.68	7.43
Australian Dollar/Yen	85.71	2.73	3.10	14.67	-0.06

Sharemarket returns are inclusive of dividends, in local terms.

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## Economist's View

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### Key Points

- Earthquake and tsunami devastate north eastern prefectures of Japan
  - Turning points in global monetary policy
  - Weak start for Australian economic activity in 2011, but outlook remains favourable
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### International Economies

#### Earthquake and tsunami devastate north eastern prefectures of Japan

The effects of the earthquake and subsequent tsunami represent an enormous tragedy for the Japanese people. Fortunately, the economic impact is likely to be far less devastating, and potentially positive for the Japanese economy by 2012.

Results from simulations in our global economic model, which uses the latest estimates of production losses and reconstruction expenditures, show that the Japanese economy is likely to expand in 2012 as a result of the disaster, compared with our pre-earthquake forecast. There are two reasons for this result: (i) the expenditure required for rebuilding (around ¥15 to ¥20 trillion) is much larger than the likely value of lost production (around ¥4 to ¥6 trillion) and (ii) the excess capacity which currently exists in the Japanese economy means that underutilised resources can be mobilised to satisfy demand for rebuilding, rather than resources having to be diverted from other productive activities (as will be the case in Queensland during the post-flood rebuilding phase).

Over 2011, we expect the expenditure on rebuilding to almost totally offset production losses, with Japanese real gross domestic product (GDP) lower by only 0.3 per cent compared to our baseline forecast of 1.7 per cent annual average growth. In 2012, Japanese real GDP growth is boosted by 1 per cent point due to rebuilding, lifting our annual growth forecast to 3 per cent.

The impact on the global economy, however, is very small. Even though the Japanese economy is the third largest by size, it accounts for only 6 per cent of global GDP. Hence, the impact of lower growth in the Japanese economy of 0.3 per cent in 2011 is barely felt by the global economy. In 2012, the impact on global growth is positive, lifting our growth forecast from 4.5 per cent to 4.6 per cent.

Close trade links with the Japanese economy will affect the Australian economy through two channels. First, the disruption to economic activity in Japan will lower demand for exports. Initial estimates by the Federal Treasury suggest our export values could be \$2 billion lower in 2011, which is around 0.14 per cent of GDP. Second, Australian export volumes are boosted by the need to supply Japan during the reconstruction phase, with annual growth in exports rising by 0.3 per cent to 4.8 per cent. However, the boost to GDP from exports is offset by higher import volumes as the Australian dollar/Japanese yen exchange rate appreciates by around 1 per cent in response to the Bank of Japan's (BoJ) easing of monetary policy.

#### Turning points in global monetary policy

Divergence amongst major central banks over the direction of monetary policy is emerging as authorities in the advanced economies must decide when to begin monetary tightening. The European Central Bank (ECB) increased the main financing rate by 25 basis points (bps) at its April meeting, and is only the second central bank of the major developed economies, following Canada, to raise interest rates following the global financial crisis. The market expects the current move by the ECB to be the first in a cycle of rate hikes, which is expected to take the main refinancing rate to around 2 per cent by year end.

Within the US Federal Reserve (Fed), a polarisation in views is developing. Chairman Bernanke maintains a cautious view of the US economic recovery and focuses on inflation expectations, which he considers stable and modest, rather than current inflation rates, which he considers temporarily elevated by transitory factors such as oil and food prices. The more bearish members of the Federal Open Market Committee, such as President Plosser of the Federal Reserve Bank of Philadelphia, view the current rise in inflation as requiring a tightening of monetary policy beginning with an end to the second round of quantitative easing. Currently, market pricing appears to be more on the side of Bernanke, with the first hike in the Fed funds rate not expected until the first quarter of 2012, which is in line with our view that the Fed will wait until around the second quarter of 2012 to begin increasing official interest rates.

#### Interest Rate Forecast (%)

	Level at 08 Apr 2011	Jun-11	QIC forecast Sep-11	Mar-12
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

### Weak start to 2011, but outlook remains favourable

Recent developments in the Australian economy suggest a softer first half of 2011 than previously expected. Since the floods hit in January, our view has remained that the economy would contract in the first quarter of 2011 by around half a per cent, before rebounding strongly in the second quarter as production recovers in flood affected areas. Incoming economic data shows the trade balance fell into deficit in February, residential building approvals slumped in the first two months of the year and consumers have remained cautious. With the resumption of coal production at a number of mines taking longer than initially expected and other exporters losing competitiveness due to an increase in the Australian dollar, the rebound in growth in the second quarter will be slightly lower than we previously forecast. Nonetheless, our forecast for growth in the second quarter of 2011 remains high at 1.75 per cent, albeit down from our earlier forecast of 2.4 per cent.

The prospects for the Australian economy in the second half of 2011 and 2012 remain favourable, but present a number of challenges for policymakers. The mining investment boom is expected to push the unemployment rate further below 5 per cent, pushing up wages and inflation. Households are expected to gradually become less cautious in this environment and policymakers will need to prevent consumer spending rising too quickly to prevent a surge in inflation. While the flood levy will assist in restraining consumers, further interest rate hikes will also be required. Our view remains that the Reserve Bank of Australia will need to raise the cash rate in the second half of the year to 5.5 per cent, with further tightening required in 2012.

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