QIC Outlook
Market & Economic
Dynamic Investment Solutions

30 September 2011

The Markets

International Equities

Equity markets were under pressure again in September, rounding out a very poor quarter for risk assets. The Morgan Stanley Capital International (MSCI) All Countries World (ex Australia) Index fell 6.24% in local currency terms over the month and 14.91% over the quarter. In unhedged Australian dollar (AUD) terms, returns were flat for the month and down 8.93% for the quarter.

The September quarter was a difficult period for equity markets. The MSCI All Countries World (ex Australia) delivered its worst quarterly performance since December 2008. A number of factors contributed to the sell-off including the US political debate over increasing the debt ceiling and disappointing global growth. However, it was Europe's failure to adequately deal with their sovereign debt issues that led global investors away from risk assets. The quarter began with concerns that Greece would be forced to default if it was unable to access funds from the larger European countries. The US unemployment rate edged higher during the quarter which left equity investors concerned that the recovery would stall. The US Federal Reserve (Fed) failed to announce a third round of quantitative easing (QE3), which disappointed the market. By the end of the quarter focus shifted to the European banking sector and its exposure to sovereign debt.

New Zealand was the only developed country to generate positive market returns during the month of September (2.4%) and over the quarter (0.6%). Japan (-10.7%) and Switzerland (-11%) were among the best performers over the quarter. The US and UK finished largely in line with the benchmark. European markets were the underperformers with Greece (-42.3%), Germany (-25.4%), France (-24.3%) and Spain (-26.1%) all suffering major setbacks. Emerging markets (EM) underperformed developed markets over both the month and the quarter. Turkey (-3.3%), Morocco (-3.7%) and South Africa (-1.33%) were the strongest performers in the September quarter, while China (-25.1%) and Hungary (-33.7%) were among a number of markets that fell in excess of 25%.

A key theme throughout the quarter was one of defensive sector outperformance. Consumer staples (-4%), utilities (6.7%) and telecommunications services (-6.4%) all generated strong outperformance relative to the benchmark. Cyclical industries such as materials (-21.3%), energy (-18.4%) and industrials (-20.9%) all drastically underperformed the index. Financials were impacted by sovereign debt related issues and returned -20.4% for the quarter.

Outlook: Fear intensified in September and stocks retreated on concerns that financial distress emanating from Europe could spread globally. We continue to share those concerns, however equity markets appear to be pricing in a very poor outcome and this is reflected in the low valuations. Company earnings expectations are stubbornly refusing to come down from their reasonably solid growth numbers in direct contrast to investor nervousness.

There now appears to be a co-ordinated global push to address the European debt situation and find a way of alleviating any impacts of default by Greece or breakdown in the banking system. Whilst economic data releases are still poor and giving some mixed signals, significant deterioration is not apparent: particularly in the US, where leading business confidence signals, while low, are relatively stable. Equity market performance will now be driven by sentiment around Europe which, if fears prove unfounded, is likely to see share prices revert to more normal (or higher) valuations.

Australian Equities

The S&P/ASX200 Index returned -6.13% during the month of September to finish the quarter down (-11.58%). The September quarter was one for the history books as the Australian market was impacted by a convergence of global factors. While the main focus was the fallout from the European sovereign debt crisis, other key drivers included the US debt ceiling debate and the slowing global economy. The earnings season in Australia was strong at the aggregate level, however, below the surface, it is clear that a two speed economy is underway. Resources and banks generated the strongest results, while Australian industrials struggled to report growth in earnings, impacted by the strong Australian dollar and sluggish economy. During the quarter, analysts' expectations for earnings over the next 12 months were pared back, as CEO's highlighted difficult trading conditions.

Telecommunication was the only sector to generate positive performance over the September quarter (12%). Other defensive sectors including utilities (-1.3%) and consumer staples (-1.8%) outperformed the benchmark. The S&P/ASX200 Index was led down by the energy (-16.2%) and materials sectors (-18.4%) as the market priced in slower global growth. Over the month of September, it was the defensive sectors, such as telecommunications (2.2%) and consumer staples (2.5%) that managed to post positive returns. Materials were the poorest performers over the month, falling 12.9%.

While the market's attention was focused on the global economy, domestic economic data during the September quarter was generally disappointing. The unemployment rate edged up to 5.3% in August as employment growth stalled. GDP grew 1.2% over the second quarter, which was ahead of expectations but left the annualised rate at just 1.4%. Consumers remained cautious as reflected by private sector credit growth remaining weak at 3% annual growth.

Outlook: September saw continued nervousness that global growth could come under pressure should European debt problems lead to either sovereign default or loss of confidence in their financial system. This scenario would also effect Asian growth. Australia has been a beneficiary of sustained high growth in the region which has underpinned commodity prices which have been positive for resource company earnings. September saw some weakness in that support from mildly weaker Chinese data, combined with fears of breakdown in Europe.

Valuations suffered accordingly, reaching new lows based upon forward-looking earnings. We suspect that these earnings may be slightly inflated, however they are less demanding than many of their foreign counterparts. In a relative sense, Australian equities continue to be supported by attractive valuations within a solid domestic and regional economic environment with no sovereign debt issues.

Global Fixed Interest

The September quarter was one of rallying bond markets and falling risk markets. Developed markets bond yields fell to extreme levels as the European crisis worsened and the US Fed enacted 'Operation Twist' in an attempt to counteract weakening economic data. Over the quarter, US 10-year Treasury yields moved 124 basis points (bps) lower to 1.92%, while German Bunds rallied 114 bps to 1.89%. Australian 10-year bonds also performed well, with yields finishing September at 4.22%, from 5.22% at the end of June.

As global growth expectations fell over the quarter, so did breakeven inflation. Credit spreads widened as the European crisis weighed on global credit markets. US high yield credit spreads moved 282 bps wider to 8.07%, while investment grade spreads widened 85 bps to 2.38%. US dollar (USD) denominated EM debt also traded lower, with spreads increasing by about 160 bps.

The Reserve Bank of Australia (RBA) kept the cash rate target steady at 4.75% through the September quarter. In the latest RBA minutes the Board expressed a preference to wait for evidence of the impact of the global crisis on the Australian economy before making changes to the cash rate. Cash returned 0.39% over the month and 1.23% for the quarter.

Outlook: The outlook for the major developed economies and bond markets remains highly dependent on the fiscal response of policymakers, with unconventional central bank monetary policy having limited effect. In particular, the outlook for the US economy appears more dependent on the implementation of fiscal policy such as Obama's jobs

package, than the Fed's 'Operation Twist'. However, the Fed has been successful in keeping bond yields lower than they would be otherwise. As a result, expected bond returns over the next few years are likely to struggle to keep pace with inflation.

With ongoing turmoil in Europe, the European Central Bank (ECB) is likely to reduce rates before the end of the year. However, if Europe is to avoid a recession, European governments must protect the major economies of Italy and Spain from the impact of a managed default by Greece. Against this backdrop, core European bond yields are unlikely to materially increase from the current low levels.

In Australia, the RBA appears more open to reducing the cash rate if it sees evidence of global economic weakness impacting on the Australian economy. There are also some concerns over the Chinese economic outlook due to the unwinding of the property market boom, local government non-performing loans and the potential for high inflation to cause social unrest. Despite these concerns, Australian bond yields are likely to rise over the coming years given their current depressed levels.

Currencies

Risk aversion rose sharply in the September quarter, with economic data pointing to a renewed risk of recession in the US and Europe. Policymakers in the US responded promptly, with the US Fed announcing an easing in policy via 'Operation Twist' and President Obama outlining a near-term stimulus to the economy, largely via tax cuts. The increase in risk aversion since the end of July resulted in a sharp appreciation of safe haven currencies such as the yen and USD, with the USD index rising by almost 7% over the quarter, and the yen rising by 4.5% against the USD. The other safe haven currency, the Swiss franc, rose by nearly 16% during the first half of the quarter, but finished the quarter 8% weaker, after the Swiss National Bank announced it would defend a floor of 1.2 francs to the euro early in September.

Concerns over the risk of a disorderly default of Greek sovereign debt and the flow on effects to the European banking sector continued to weigh on the euro, which fell by 7.5% against the USD over the quarter. At US$1.33, the euro is now at its lowest level since the start of this year when it briefly moved below US$1.30. With growth expectations in Europe being sharply downgraded in recent months, the ECB has become decidedly more dovish, opening the door to rate cuts after having increased rates as recently as July. The UK pound fell 3% over the quarter, with the probability of further quantitative easing in the UK rising as the economy remains weak.

The downward revision to investors' forecasts for global growth led to sharp falls in commodity prices and commodity currencies, with oil prices 17% lower at US$79 per barrel and metals prices around 20% lower over the quarter. The Australian dollar (AUD) fell by 10% against the USD to US$0.964, its lowest level this year. The Canadian dollar (CAD) and NZ dollar (NZD) also fell by 8% over the quarter. The larger decline in the AUD may reflect a revision to investors' expectations for monetary policy, with markets now pricing rate cuts from the RBA by the end of this year. EM currencies were also hard hit, with central banks in Brazil, Indonesia and South Korea intervening to slow the decline in their currencies against the USD. Despite this, currencies in Poland, Hungary, Mexico and Brazil fell by up to 20% against the USD during the quarter.

Outlook: After its sharp appreciation over the September quarter, our estimates of purchasing power parity (PPP) suggest that the USD is now only slightly undervalued. The USD is outside its fair value ranges based on PPP against the AUD and yen, has moved back within its fair value range against the CAD, and remains within its fair value range against the euro and UK pound.

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

Financial markets (%)

Sharemarkets	Level as at 30-Sep-11	1 month return	3 month return	Financial YTD return	1 year return
Australia (S&P/ASX 200)	4008	-6.13	-11.58	-11.58	-8.56
Developed World (MSCI World ex Aust.)	775	-6.07	-14.91	-14.91	-4.84
World (MSCI AC World ex Aust.)	295	-6.24	-14.91	-14.91	-5.86
US (S&P 500)	1131	-7.03	-13.87	-13.87	1.14
UK (FTSE 100)	5128	-4.74	-12.93	-12.93	-4.41
Europe (MSCI Europe ex UK)	745	-4.52	-19.80	-19.80	-14.05
Japan (Topix)	761	-0.25	-9.44	-9.44	-6.06
Currencies					
Australian Dollar/US Dollar	0.97	-9.25	-9.22	-9.22	0.38
Australian Dollar/Euro	0.72	-2.61	-1.90	-1.90	2.14
Australian Dollar/Yen	74.91	-8.52	-13.36	-13.36	-7.38

Sharemarket returns are inclusive of dividends, in local terms.

Economist's View

Key Points

- Volatility remains high as the prospect of imminent Greek default unnerves markets
- Bernanke and Obama ramp up monetary and fiscal policy in the US
- European policymakers struggle with the prospect of Greek sovereign default
- Australian economy holding up for the time being – RBA takes a more dovish line

International Economies

Volatility remains high as the prospect of imminent Greek default unnerves markets

Risk aversion remained elevated in global financial markets in September as ongoing concerns over sovereign default in Europe and the potential for the US economy to slip back into recession weighed on sentiment. From the end of August to 6 October, global equity markets fell by 4.5 per cent, as measured by the MSCI World Index (local currency). Volatility in equity markets remained high, with the VIX measure of volatility of the S&P500 rising from 32 to 38 over the same period. The Australian market performed in line with the global average, with the S&P/ASX200 falling by 5.3 per cent.

Consistent with ongoing risk aversion, global bond yields continued to fall over September with US 10-year bond yields shedding 24 basis points (bps). Australian 10-year yields fell by 21 bps, in line with the fall in US yields, while the yield on Australian 2-year bonds fell by 16 bps as the market continued to factor in aggressive easing by the Reserve Bank of Australia (RBA).

Ongoing concerns about European sovereign default risk led to a 6.5 per cent decline in the euro against the US dollar (USD). The Australian dollar (AUD) weakened sharply against the USD, falling by 9 per cent since the end of August as the weaker outlook for the global economy weighed on commodity currencies. Unlike typical periods of risk aversion, the Swiss franc (a safe-haven currency) fell by around 11 per cent as the Swiss National Bank intervened in the market announcing a floor of 1.20 Swiss francs to the euro.

Bernanke and Obama ramp up monetary and fiscal policy in the US

In response to the deteriorating economic outlook, President Obama outlined a jobs plan to inject a further US$447 billion into the struggling US economy. Any stimulus, however, is unlikely to be enacted until November and will be coupled with more detailed legislation from the Joint Committee on Deficit Reduction to find US$1.5 trillion of fiscal savings. Furthermore, in the current political climate, the expenditure components of the package will meet fierce resistance from Republican members of Congress and, in the absence of the expenditure measures, the impact of the package on US economic growth will be greatly diminished. If Congress decides to exclude the expenditure items from the package, its size will reduce from 3 per cent to 1.6 per cent of gross domestic product (GDP). Our current view is that the package is unlikely to get through Congress in its entirety, with only the tax cuts likely to be passed. Nonetheless, the tax cuts will have a stimulatory impact on the economy. We estimate that the tax measures will result in an additional 0.4 percentage points to annual average growth in 2012, bringing our US real GDP growth forecast to 2.3 per cent.

The US Federal Reserve (Fed) has also announced additional stimulus in response to the deteriorating outlook. The Fed indicated that it expects to maintain 'exceptionally low levels for the federal funds rate at least through mid-2013' and announced the implementation of Operation Twist, designed to flatten the US sovereign yield curve. The Fed also decided to shift the reinvestment of principal payments on its agency debt and mortgage-backed securities (MBS) holdings to MBS rather than Treasuries, thereby seeking to lower interest rates on mortgages and boost the flagging housing market. We have estimated that the impact of Operation Twist on the US 10-year sovereign bond yield is -15 bps.

European policymakers struggle with the prospect of Greek sovereign default

The primary driver of the current wave of negative sentiment is the deterioration in prospects for the Euro area as policymakers struggle to come to terms with the prospect of Greek sovereign default. Contagion fear is also engulfing Spain, Italy and even France, as the spreads between the respective 10-year sovereign bond yields to the 10-year German yield come under pressure. Without a clear plan among European policymakers of how to best handle the Greek crisis, the prospect of the situation dragging the Euro area economy into recession is escalating. Evidence is now emerging that the region's economy may have already entered recession given the levels of business sentiment in September.

In our opinion, however, the exposure of European banks to Greek sovereign debt is a problem that could be handled by appropriate policy measures. According to data from the European Banking Authority (EBA) December 2010 stress tests, the total exposure of European banks to Greek sovereign debt amounted to €90.9 billion, which represented 9.1 per cent of banks' core tier one capital (CT1). In terms of French and German bank exposures, Greek sovereign default would result in losses of 3.7 per cent and 3.8 per cent of French and German CT1, respectively. While not insignificant, potential losses by French and German banks are manageable, requiring modest recapitalisation that can be achieved through retained earnings.

However, in addition to direct exposures to Greek sovereign debt, European banks also have exposures to Greece via Greek private-sector financial institutions and corporations. In the case of France, the EBA stress test results show that Societe Generale, Credit Agricole and BNP Paribus have exposures totaling around €40 billion, or approximately four times their collective exposure to Greek sovereign debt. These more substantial exposures pose a more serious risk to the banking system. However, their total size (at somewhere around €200 billion) could be still covered by a modest increment to the size of the European Financial Stability Facility.

In addition, wholesale default across the Greek private sector is a more likely outcome if Greece were to leave the European Monetary Union (EMU). French and German policymakers, along with the ECB, clearly understand this risk and have been vocal in their commitment to Greece maintaining its EMU membership. Nonetheless, the risks to financial markets of policy apathy in Europe is extreme, and the ability of European policymakers to make good on recent statements of developing measures to recapitalize the banking system is critical to an orderly restructuring of Greek debt.

Interest Rate Forecast (%)

	Level at 07 Oct 2011	Dec-11	QIC forecast Mar-12	Sep-12
Australia	4.75	4.75	4.75	5.00
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	1.00	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

Australian economy holding up for the time being – RBA takes a more dovish line

Recent economic data releases, which have generally exceeded forecasters' expectations, have indicated that the Australian economy is, thus far, weathering the financial storm. In particular, rebounding coal exports drove Australia's trade surplus to $A3.1 billion in August, and with signs that industrial activity in China is also holding up, ongoing demand for Australian coal and iron ore exports look promising. August data also showed the collapse in consumer spending feared by many commentators is yet to materialise, with nominal retail sales growing at 0.6 per cent for the second consecutive month.

Despite the promising economic data, the RBA signalled a more cautious outlook for the Australian economy over coming months and kept the cash rate on hold at 4.75 per cent. This is unsurprising given the shock to global financial markets since July and the downgrades to the economic outlooks of the US and Europe.

Pricing in futures markets indicates investors expect the RBA to cut rates by around 75 bps by the end of the year. We expect the RBA to remain on hold until September 2012, in line with our view that there will be an orderly default of Greek sovereign debt and that the US economy will not lapse into recession. Beyond September 2012, we expect the RBA to resume its cycle of tightening monetary policy as the impact of capital expenditure by the mining industry tests the capacity constraints of the Australian economy.

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