

SEPTEMBER 2008 QUARTER – ECONOMIC UPDATE.

The near-breakdown of financial markets was evident this quarter as the cost of credit soared, halting the ability of some intermediaries and market makers to re-finance. With banks unwilling to lend to each other, the cost of overnight cash spiralled, pushing institutions once considered resilient to the brink and, in some cases, beyond.

Major equity markets suffered over the quarter, with most posting double-digit share price falls. With the credit crisis in full swing, regulators took the unprecedented step of temporarily banning short selling on financial stocks in the US and UK. In Australia, ASIC and the Government went one step further, banning all short sales across the market for 30 days. With “thanks” to the increased costs of debt and a “flight to quality”, Australian Fixed Interest securities were the best performing asset class over the last 3, 6 and 12 months.

As the impact of the credit crunch in the United States continues, the third quarter saw some high-profile casualties in the shape of Lehman Brothers, AIG, Merrill Lynch, Fannie Mae and Freddie Mac as they either disappeared, were rescued by public capital injections or were swallowed up by major competitors. In early October, the US government was compelled to intervene in the markets, in an attempt to restore liquidity to the financial system by making available a \$700bn fund to purchase ‘troubled assets’. This action puts US government debt at over 70% of GDP, with falling house starts and prices, coupled with increased unemployment indicators, pointing towards an almost unavoidable recession. Any fall in GDP will increase the level of Government debt (as a % of GDP) towards levels not seen since the end of WWII.

Commodity prices reversed their recent growth trend, with key commodities all falling over the September quarter. Oil prices were off over 30%, to end the quarter at \$100.70/ barrel. Most metals and food commodities fell over 20% during the three month period. Gold fell just 5% as investors sought security in the precious metal. Many argue the fundamentals of supply and demand will maintain commodity prices; the counter view is that an imminent global economic downturn means prices cannot be sustained. The impact of the downturn on China’s growth, and therefore demand, will be vital to commodity prices.

Domestic Economy

Following 15 years of robust economic growth, strong headwinds to domestic growth are apparent in the form of tightening global credit market conditions, domestic capacity constraints, food and energy price increases and the threat of the slowdown in developed economies. Signs of a domestic slowdown are evident as the last 6 months have produced falling building approvals, retail sales and house prices.

Inflation remains above the RBA target of 2-3%, with the latest figures showing underlying inflation at 4.2%. The RBA is now faced with a juggling act of maintaining interest rates for long enough to stem inflation without maintaining the position for too long, which could see the domestic economy enter into a sharp slowdown. The RBA Cash Rate was cut by 25bps to 7.00% in September, the first rate cut in 7 years, offering suffering home owners in mortgage belts some light relief. At the October RBA Monetary Policy Committee meeting, the RBA Cash Rate was cut by 100bps to 6.00%, a cut double the size of consensus expectations. Recent market commentary is speculating on the ability, or lack thereof, of the nation’s banks to completely pass on the cut in official rates by the RBA. Increased costs of financing on the global stage could render the passing on of the full cut problematic for local lenders.

The domestic equity market finished the quarter down 10.7%, the fourth successive negative quarter, leaving the S&P/ASX300 down 27.1% for the year to September. Any positive sentiment from within the Australian market was predominately overshadowed by the playing out of the financial market crisis in the US. Notably, as the quarter drew to an end, the US congress rejected the first incarnation of the bail out proposal, sending the Australian market down 4% on the final day of trade for the quarter, no doubt impacting numerous equity managers’ quarterly results. The latest round of company reporting failed to provide clear profit guidance for 2009, such is the uncertainty looming over global markets and the impact this will have on earnings going forward.

Outlook

The Australian economy is expected to slow sharply, with the major risks being the global financial crisis and any slowdown in Asia. With the June quarter national accounts showing the Australian economy slowed to a modest growth rate of 0.3% (2.7% on the rolling year), the economy is facing a number of strong headwinds including: a global financial crisis, domestic infrastructure constraints, relatively high inflation and a slowdown in the global economy. The global financial crisis and increasing probability of a US-led global recession has seen the RBA become more concerned about growth prospects than inflation. The RBA expects inflation to fall from 4.5% to 3.0% over the next two years.

During the course of the September quarter, we have seen downward pressure exerted on the AUD from the beginning of a domestic interest rate easing bias, falls in commodity prices and the relative strength of the USD. The direction of the AUD will largely be dependent on each of these key variables.

Global Equities Review of Quarter

Due primarily to the cushioning effects of a falling Australian dollar, international shares rose by 2.5% over the September quarter (as measured by the MSCI World ex Australia Index in \$A). However, in local currency terms, all major regional sharemarket indices fell over the quarter with markets in US, Europe, and Asia experiencing hefty losses (in local currency terms). For the year ending September 2008, the poor 'annual' performance from global equities continued, returning -18.0%, reflecting the turbulent investment climate throughout much of this year. However, global investors fared slightly better in a relative sense than local investors, with the Australian market (S&P/ASX 300 Accumulation Index) returning -27.1% over the same period.

Performance across regional markets for the 12 months to the end of September 2008 was uniformly weak for the second quarter in a row. Japan continues to be the worst performing region, falling by 32.6% for the year; however, the decline in Asian markets resulted in similar underperformance. Returns from Asian equities depreciated rapidly in the last quarter with a 32.4% fall over the 12 month period. Europe fell by 27.5% while the US, ironically the impetus for the market selloff, experienced the least severe falls with a 21.5% retreat. The difference between the best performing region (US) and worst (Japan) in local currency terms for the 12 months ending September 2008 was 11.1%. In last quarter's report the difference between these countries was 16.8%.

A major difference between this quarter and the previous was the contrasting fortunes of the local currency. The Australian dollar has experienced a recent sharp fall against the major currencies, and the declining currency movements have dampened investor returns for hedged investors. Over the quarter the Australian dollar reversed its previous upward trend by weakening against the USD -16.9%, GBP -8.2%, JPY -18.2% and the EUR -4.9%. The steep decline in the Australian dollar over the quarter reflects the deteriorating economic outlook and investor preference for perceived traditionally safer assets like the US dollar and Yen. The extent of the currency weakness over this period has actually meant the Australian dollar has lost ground against the majors over the past 12 months to 30 September.

United States

US shares fell by 10.0% for the three months to the end of September 2008. The quarter was characterised by generally weaker economic data, all pointing to the early stages of a fairly severe recession in the US. September payroll numbers fell by 159,000, the biggest monthly reduction in five years. The housing market continued to reach new lows with US Commerce Department figures confirming the number of housing starts in August declined 6.2%, the lowest level of new activity since 1991. The outlook was no brighter with Building Permits, a sign of future construction activity, also weakening in the quarter by 8.9% on the month. Meanwhile the credit crunch juggernaut rolled on, impacting a number of major financial players and radically reshaping the Wall Street corporate landscape. The market continued to grapple with the scale of the liquidity issue and as the quarter wore on it became clear that major US government fiscal intervention would be required to kick-start credit markets and help release the necessary money flows underpinning the economy.

The breakdown in the functionality of markets and its impact on the economic outlook increased markedly in September as investors and corporates continued the rapid deleveraging. The bursting of the housing bubble, leaving many financial firms with balance sheets holding virtuously worthless assets and too much debt, continues to reduce available credit and depress asset values as these firms seek to improve capital by selling assets at whatever price they can.

Europe

European sharemarkets collectively fared slightly worse than their US counterparts, falling by 11.3% for the quarter. Returns on all major European bourses (FTSE, DAX and CAC 40) have all been negative over the last 12 months. August releases showed European GDP fell by 0.2% in the June quarter with the German economy contracting by 0.5% in the period. The economic situation weakened considerably in the UK with zero economic growth in the June quarter and the Nationwide Housing Price Index, a key barometer of residential property, falling by 10.5% on the year in August. This was the biggest recorded drop since 1990. The news was no better in other parts of Europe, with official Irish data confirming the good times were over for the one-time European tiger economy. Ireland entered a recession in September, brought on by a severe housing slump and consumer weakness.

Japan

Japanese shares suffered a major buffeting in the September quarter, falling by 17.5% as the economy faltered. Recent GDP figures reveal growth contracted by 2.4% on a year earlier in the June quarter, reversing a 3.2% rise in the March quarter. Meanwhile exports slumped by the most since the recession of 2001-02, accompanied by weaker housing investment and earnings data. Toyota delivered its poorest earnings growth in five years in August reflecting poor demand from US customers.

Meanwhile the political climate remained clouded as Prime Minister Yasuo Fukuda became the second Japanese Prime Minister to resign within a year in September. Taro Aso becoming Japan's 92nd Prime Minister later that month. Many commentators continue to suggest major economic reform and political vision are needed to improve Japan's economic prospects.

Asia

The news was no better beyond Japan, with Asian shares declining by 16.5% (in local currency terms) for the September quarter. It appears investor concerns about a US recession outweigh confidence in the Asian growth story, with few bright spots across the region. Over the quarter Industrial output fell in Singapore by 12.1% in August on a year earlier and house pricing indicators weakened for the first time in four years. Meanwhile, in September the Taiwanese central bank cut rates for the first time since 2003, citing the reduced inflationary pressures and a weakening global economic outlook.

According to IMF forecasts, China's growth rate is expected to slow from 11.5% to 10% due to recent tightening measures taken to curb rising inflation. Growth in India is also forecast to slow from 9% to 8.4%, with the rest of East Asia declining from 5.2% to 4.9%. In an attempt to curb rising inflation, India and Taiwan have both recently increased key lending rates and banks' reserve requirements.

Outlook

With no visible signs of improving global growth and concerns about future economic weakness intensifying over the quarter, pessimism continues to dominate economic sentiment. While inflationary concerns have broadly weakened as oil and commodity prices have eased, any hopes of a relatively short correction have evaporated as the subprime mess continues to weaken the economic outlook.

The International Monetary Fund continues to moderate its economic expectations, with global growth expected to slow to 4.1% over 2008 and 3.9% over 2009.

United States Outlook

Volatility on sharemarkets appears set to continue as it will take some months for the workout to take effect. The initial muted reaction to the package suggest the market has decided that, despite it possibly saving some financial firms, it will be unable to offset a painful global recession. Meanwhile, recent earnings data from major global firms including GE and Ford confirm the rapidly deteriorating profit outlook as US consumers remain under pressure. The share price weakness, so prevalent to date in the financial and housing stocks, has spread to other sectors of the economy including commodities and consumer discretionary. The gravity of the situation has prompted increased calls for more drastic and coordinated rate cutting action from the major central banks, an instalment of which appears to have been delivered through October's rate cuts.

Europe Outlook

The outlook in European markets continues to take its cue from the US and has continued to slide south. In September The European Commission cut its 2008 GDP forecasts for those countries tied to the Euro from 1.7% to 1.3%. A number of European economies teeter on the brink of recession including Italy, France, Germany, UK and Spain, where the construction market has severely contracted, triggering a spike in unemployment.

European leaders recently met at a summit in response to the global financial crisis and have called for increased banking regulation, stricter controls on credit rating agencies and greater transparency and limits on executive pay. These sentiments have also been echoed in Washington, suggesting greater regulatory oversight of financial operations is one major consequence of the current carnage.

Japan Outlook

Economic indicators have continued to weaken in Japan suggesting the world's second largest economy is moving closer to recession. The mood of Japanese manufacturers is the most pessimistic in five years with fears that the slowdown will weaken demand and a rising yen will lessen their competitive edge. The yen has continued a strong recent period of appreciation against the dollar.

Asia Outlook

The unshakeable resolve of those believing that Asian developing economies would provide a buffer against the downturn in the G7 economies suffered a serious credibility test as the movement of assets out of Asian equities gathered momentum. Most Asian sharemarkets have realised steep losses in 2008 — the Shanghai Composite, for example, was down 56% year to date to end of September. Growth in these economies is expected to soften as a result of a dip in global demand and, accordingly, the IMF has continued to moderate its growth expectations for Asian economies. Even so it expects China, India and much of developing Asia to continue to deliver robust economic growth in 2009. Factors deemed to work in the favour of companies in these economies compared to their developed counterparts are strong, deleveraged balance sheets with large cash levels able to withstand the tight credit environment, low levels of public debt and strong domestically driven demand and investment within their economy.

Asian central banks have followed the lead of their developed counterparts with recent rate cuts to stimulate growth. The China and Taiwan central banks cut the cost of borrowing in September. Other economies like Indonesia and Malaysia have recently kept rates on hold despite recording high inflationary pressures.

Please note that the above is provided as a economic update only. No action should be taken on this information without first seeking professional advice. If you have any questions please do not hesitate in calling our office on 07 33917566.