

December Quarter 2008 Review & Outlook

Australia

- The RBA continued its aggressive attempts to provide stimulus to the slowing economy, by cutting the official cash rate by 2.75%, to 4.25%, over the last quarter of 2008.
- The national unemployment rate remained steady through the quarter. However, recent trends in job advertising and job cuts across various sectors of the economy have economists predicting recession-like levels of unemployment in 2009.
- Expect Australia's economy to slow, as mining and finance sectors continue to face considerable stress.

Global

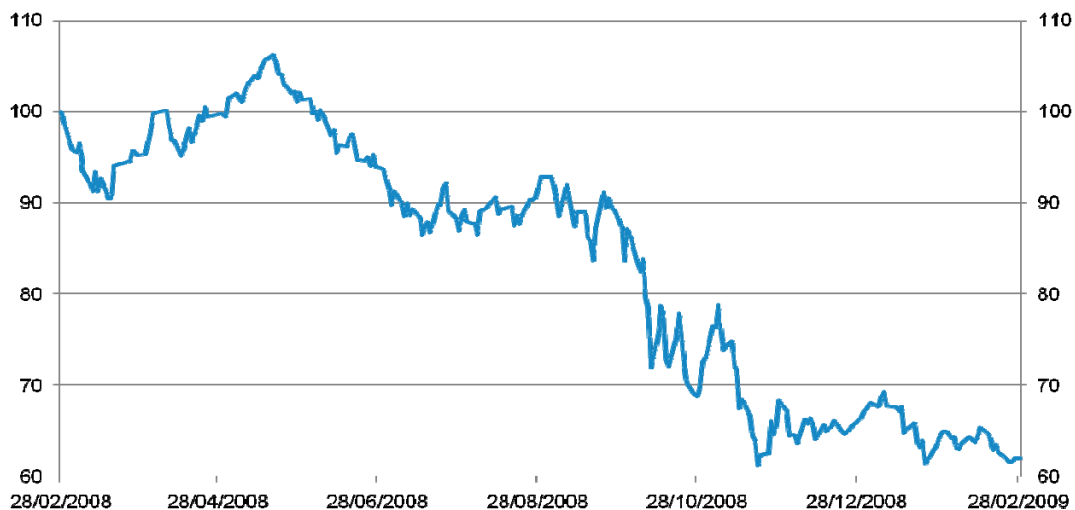
- The US, UK and Euro bloc officially entered recessions during the last quarter of 2008. With sentiment continuing to deteriorate, a quick rebound to positive growth is not expected.
- The US Federal Reserve took the unprecedented move of cutting the official FED Fund Rate to a band of 0%–0.25% — the lowest historical level. This represents a dramatic last resort by the FED's open market operations to attempt to free up credit markets and provide stimulus to the system.
- During December the oil price hit \$35 — a fall of over \$112 from the highs of July 2008. The fall is partly due to fears of weakening demand globally.
- Expect the economic growth to continue to slow across most regions.

Australian Shares

The domestic equities market posted its 5th consecutive decline over the quarter, returning negative 18.5%.

Concerns continue over the future direction of the Australian economy and the continued lack of clarity around corporate earnings. Falling P/Es suggest that some stocks are starting to look attractive based on valuations and yield. However, greater certainty regarding company earnings and the near completion of capital raisings are required before it is likely to recommend an aggressive position in the sector.

The Australian share market has fallen 38% in the past 12 months



But over the past 10 years, it's still up 81%



Global Shares

Global shares continued to decline over the quarter, returning -11.2% for the period. All major regions posted negative returns. Returns for global shares on an unhedged basis benefited from the falling Australian dollar, which buffeted the poor global share returns in local currency terms.

The major economies of the world are either in, or in danger of, entering recession. The future stability of corporate earnings is unclear and could further disappoint. IN US\$ returns, the benefits of a falling Australian dollar to unhedged international investors are likely to diminish, as the dollar is now trading below its long-term average.

Global & Australian Listed Property

Global and Australian REIT (real estate investment trust) markets continued to be impacted by price volatility and the quarterly declines were severe.

Both global and Australian REITs are beginning to look attractive on valuations. However, short term volatility is expected to continue, as many companies struggle to manage debt levels as asset values fall.

On the domestic front, trusts with conservative gearing, a focus on quality domestic assets and no exposure to funds management and development activities are likely to be the better performers over the short term.

Global Fixed Interest

Global bonds are now showing less value, as the 'flight to quality' during the quarter continued to drive down ten year bond yields in the major bond markets.

Real rates remain negative and the increase in supply of US bonds will be very significant in coming quarters, as the US Treasury finances the expanding budget deficit.

Australian Fixed Interest

At year end, bond yields ranged from 3.07% for three year bonds to 3.99% for ten year bonds; however, both yields continue to lag the official cash rate of 4.25%.

Investors are likely to continue to flock into the safety of cash and Australian bonds until the global financial system is stabilised and economic growth returns. Investors seeking higher yield will first gravitate towards corporate bonds and hybrids and eventually high yield shares, as risk appetite increases again.

Cash

Given the decline in the official cash rate, investors will need to allocate back to growth assets at some stage. That said, investors also need to be mindful that inflation is retreating quickly so the real rate on cash may still be reasonable. As stated previously, while valuations for equities are beginning to look attractive, economic pressures and earnings uncertainty remain persistent issues, particularly in the short term.

Australia has held up well to the first wave of the global financial crisis tsunami. However, the second wave, that of a global recession, threatens to breach the sandbanks. The Australian economy grew by 0.4% in the June 08 quarter and a tiny 0.1% in the September 08 quarter. The economy is clearly slowing sharply, with the last two results equivalent to an annualised growth rate of just 1.0% pa.

The Reserve Bank of Australia (RBA) has moved swiftly to cut the cash rate from 7.0% to 4.25% since September 2008, while the Government implemented an \$8.4bn stimulus package over the Christmas period. Earlier in 2008, the Government continued to lower income tax rates and took the unprecedented move of effectively guaranteeing the Australian banking system. The RBA has also been active in providing increased liquidity for the banking system.

Given the deteriorating global outlook (including Asia) and the rapid retreat in inflation, it is expected that the RBA will continue to cut the cash rate during 2009. Current research expects the cash rate to fall to 3.25% by June 30 and to 2.75% by year's end. The Government is also likely to materially increase spending to help buffer the anticipated fall in consumption and business investment. It is expected that the Federal Budget will move into deficit, as tax revenues decline from slower growth and spending increases. The Government will enter a deficit from a position of relative strength (relative to most developed countries), as current public debt levels are negligible.

As house prices fall in the UK and US, there are increasing concerns that the Australian housing market could be next. Concerns about falling wealth are having a major negative impact on consumer spending. However, if consumers do not spend, businesses will suffer and jobs are eventually shed, which worsens the situation further. Rising unemployment could be the straw that eventually breaks the back of the Australian housing market.

The focus for the Government is to try to maintain spending at levels that will, in turn, help to contain job losses. Unfortunately, commodity price weakness has already seen job losses in the mining sector, while the finance sector is also shedding jobs rapidly. If business investment falls rapidly more jobs will be lost, as one company's capital expenditure is another company's revenue. The decline in consumption and business expenditure could swamp any increase in Government expenditure, causing the economy to contract.

Australia's economic vulnerability is also linked to the current account deficit. Most of the current account deficit relates to interest payments on net foreign debt (totalling \$657bn). Australian banks and companies have borrowed most of this debt and it will need to be refinanced or repaid in coming years. The global financial crisis has made this task much more difficult and the Government has already had to lend its AAA rating to the banks to help them roll their debt. Meanwhile, Australian companies will increasingly need support from the domestic debt and equity markets to replace their foreign debt.

Overall, it seems that Australia's exposure to the global economy, via commodity exports and foreign debt, means the economy will be unable to avoid a recession over 2009. The two key sectors of the economy – mining and finance – will be under great stress. The Government can help to lessen the pain, but the scale of the global recession may prove too overwhelming. In this circumstance, the best outcome may be a recession that is not too deep and not too long. The Australian economy is likely to decline by around -1.0% over 2009.

Global

The impact of the credit crunch continues to reverberate around the globe. Arguably the worst country to be impacted by the flow-on effects of the credit crunch is the **United States**, which, over the quarter, officially entered a recession. The quarter's growth figure is yet to be released but expectations are for an annualised figure of -6.0% — the worst decline since WWII. The US Federal Reserve took an unprecedented course of action by cutting interest rates to zero, while the new President, Barack Obama, is preparing a second and much larger economic stimulus package of US\$850bn.

In addition, the US Treasury and Federal Reserve have been busy bailing out the US financial sector, which is swaying under the weight of credit losses. A US\$700bn Troubled Asset Relief Program (TARP) was approved by Congress to support the troubled finance sector. According to Treasury forecasts, the US budget deficit will likely exceed US\$2 trillion by 2010, while total government debt will reach \$8.1 trillion (58% of GDP).

The global financial crisis has sparked a de-leveraging cycle and demand shock, which have led to asset and consumer prices falling. The US share market fell 37% during 2008, while US house prices fell, on average, 18% for the year to November 2008. The large decline in consumers' net wealth, coupled with tight credit conditions, has led to a sharp pull-back in consumer demand.

In turn, the price of goods and services has declined sharply and production has been cut back. US inflation has declined significantly, with the CPI falling to 0.1% pa — indeed deflation now looks likely. Industrial production fell 7.8% over 2008, while the unemployment rate has increased to 7.2%. Negative growth in the US of around 1.9% over 2009, with fiscal stimulus likely to buffer the headline figure.

Europe also slid into recession, resulting in the ECB slashing the cash rate by 125bp to 2.0% during December and January. European growth is widely expected to come in at an annualised rate of -2.0% for the quarter. Inflation fell to 2.1% in November and the ECB expects it to fall to 1.1% – 1.7% over 2009.

The European Commission has recommended a €200bn (1.5% of GDP) stimulus package similar to that provided in the US, but individual countries continue to debate the details. It seems the member states outside France and Germany have deeper economic troubles — particularly Ireland, Spain and Greece. It is expected that European growth is to decline by around -1.3% over 2009.

The **UK** is in a deeper recession than Continental Europe, as debt levels are higher and the decline in the housing and financial sector has been greater. The BOE has slashed the cash rate to 1.5%, while the Government has been busy providing support for the stumbling banking sector and recently announced a £20bn stimulus package. The UK government budget deficit is set to rise to £118bn (8% of GDP) over the year. It is expected that the UK economy is to contract by around 1.6% over 2009.

Asia has not been immune from the ramifications of the credit crisis. The region remains heavily reliant on demand from the US and Europe, which has had an adverse impact on growth.

Japan entered a recession during 2008, meaning the G3 is now in a synchronised recession. This, in turn, makes it very difficult for any one country to export its way out of the slowdown. Japanese machinery orders fell by a record 16.2% in November, while factory output dropped 8.1% and exports fell 26.7%. Japan looks to be headed for a deep recession, with some analysts predicting the economy will contract by 3% (12% on an annualised basis) over the December quarter of 2008.

The Nikkei depreciated 59% over 2008 versus the US dollar. The Bank of Japan has cut interest rates to 0.1%, from 0.3%, and the Government is mulling over a stimulus plan, although with a public debt to GDP ratio of 158%, its options are severely limited. Deflation is likely to re-emerge as a problem for the Japanese economy during 2009. It is expected that the Japanese economy will contract by around 1.5% over 2009.

China's economy was also impacted by the global economic slow down during 2008, with exports slumping and its property boom ending abruptly. Foreign capital is retreating as US and European banks withdraw funding. GDP is expected to grow by an annualised rate of 6.8% over the December quarter of 2008, down from 9% in the preceding quarter. The Chinese Government has announced a 4 trillion yuan (\$585bn) stimulus package that is focused on developing new infrastructure over the next three years. However, the immediate growth impact of this package is likely to be minimal, so GDP is expected to fall further over 2009. China's growth rate is expected to fall to around 6% over 2009.

Review

It was a disappointing close to the year for local share investors, with the Australian share market (as measured by the S&P/ASX 300 Accumulation Index) falling –18.5% for the quarter, the fifth consecutive quarterly decline. For the 12 month period ending 31 December 2008, the benchmark returned –38.9% — the worst annual return on record.

The Australian share market continued to endure a broad selloff. This was sustained by a stream of weak economic data emanating from offshore and seemingly confirming a deep global recession. October and November were particularly poor, with the local stock exchange registering sharp falls despite the RBA's extreme interest rate policy action throughout the quarter. The benchmark reached its lowest point of the year on 20 November, representing a fall of over 50% from its record high in November 2007. Volatility remained a constant market theme, illustrated by the market falling by 8.3% on 10 October (the biggest ever one-day fall), only to rise by 5.5% on the next trading day.

The market continued to punish companies with uncertain debt funding arrangements during the quarter. Oz Minerals entered a voluntary suspension from official listing on 2 December, as it attempted to refinance its loan facilities with a number of financiers. Similarly, Rio Tinto's shares were sold off heavily in late November when BHP Billiton withdrew its takeover offer for the firm and the market became concerned that Rio would be forced to offload assets to reduce debt. Qantas and British Airways briefly entertained the possibility of a tie-up in early December, though the deal subsequently fell through shortly after announcement as the parties could not reach agreement on the leadership of the merged entity. Meanwhile the Westpac-St George merger came to fruition on 1 December, after St George shareholders voted in favour of the merger, creating Australia's largest financial services company.

The quarter was also notable for the spate of capital raisings by Australian banks. The four major banks each completed successful capital injections in mid-December. This involved the banks selling a mixture of stocks and bonds to improve balance sheets weakened by rising defaults and varying levels of exposure to distressed corporates. The placements received solid support from institutions at a substantial discount to trading values, inevitably putting downward pressure on banking shares over the remainder of the month. Meanwhile, a number of companies surprised the market with dividend cut announcements, including Pacific Brands' 65% reduction to its interim dividend. Fairfax Media, Macarthur Coal and Macquarie Media Group were among the firms to announce dividend cuts in the quarter. Companies with high debt exposures are especially susceptible to this and there is an expectation that more boards will take this action to preserve cash, as opposed to returning it to shareholders via distributions.

Compared to other global markets the Australian share market outperformed the US, Asia and Japan (in local currency terms) during the quarter, although the domestic market marginally underperformed Europe.