

## March Quarter 2008 Review & Outlook

### Australian Economy Overview

The global economic outlook continues to deteriorate but so far the Australian economy is proving relatively resilient. However, the last four quarterly growth figures show a contraction is underway. The Australian economy is expected to contract by 1% over 2009.

The RBA decided to keep the official cash rate at 3.25% in March following five consecutive rate cuts. However, in its April meeting the RBA decided to resume its rate cutting policy, reducing rates by 0.25%, bringing the cash rate to 3%. During 2009 it is expected that the RBA will continue to cut the cash rate, given the deteriorating global outlook (including Asia) and the rapid retreat in inflation.

Unemployment is expected to climb to 7.5% during the year and 8.5% in 2010, which could see house prices declining by 5% over 2009.

The Australian economy is likely to perform better than most developed economies, primarily because its financial system is stable and public debt levels are low. Expansionary fiscal and monetary policy is likely to be effective in cushioning the economy. However, the severity of the global recession and global credit crisis will still impact, so a mild to moderate recession has to be expected.

### Global Economy Overview

Global economic activity continued to decline on the fears of a deepening global recession. The International Monetary Fund (IMF's) latest forecast on economic activity indicates a decline of about ½ to 1 percent in 2009 on an annual average basis, before recovering gradually over the course of 2010.

Within the G7, the recession is expected to deepen over 2009, with the depth and length dependant upon global policy response and co-ordination.

Deflation is more likely in the short to medium term due to the major reduction in credit and aggregate demand, in turn leading to excess capacity. However, money printing could lead to inflation re-emerging later.

It is expected that the Japanese recession will worsen over 2009 and China to slow to a 6% growth rate in 2009.

Commodity prices are likely to remain subdued until production is cut back to meet lower levels of demand.

### Australian Shares

The Australian share market (as measured by the S&P/ASX 300 Accumulation Index) posted its sixth consecutive quarter of negative returns, falling by 1.8% for the March quarter.

The extent of the market's correction from its peak means that Australian equities are trading on a forward market Price to Earnings Ratio (PER) of around 10-11x, versus an historical average of 14x. Whilst the market would appear cheap based on valuation, factors such as the uncertainty over the sustainability of future earnings and the view that there is more downside risk to FY09 and FY10 earnings, continues to outweigh the benefits of a broad based move back into equities.

### **Global Shares**

Over the quarter, global shares fell by 11.8% (as measured by the MSCI World ex Australia Index in \$A). Asia was the only major regional sharemarket index (in local currency terms) that made a positive return over the period.

In terms of currency, the AUD is now comfortably within the one standard deviation band of its long-run average and is in fact currently trading very close to its long-run average.

Concerns regarding global growth and future economic weakness continue to dominate economic sentiment. It is expected that the global financial crisis will result in a slow down in company earnings and a pull back in global economic growth. While the P/E for the global market has come down, the forward looking earnings part of the equation remains uncertain.

### **Global & Australian Listed Property**

While valuations are attractive on certain A-REITs, the sector continues to face a number of issues primarily concerning gearing, refinancing and bank covenants.

While capitalisation rates have started to soften in direct property markets, they have not yet come under the same pricing pressure as the A-REIT sector. Hence, investing in A-REITs now appears to be a cheaper way to gain exposure to the property market. However, investors should be wary that further dilutive capital raisings could continue to hamper listed property returns.

Many commentators believe that the global property sector is generally undervalued. However, some of them expect that for this value to be realised, a significant positive catalyst will be required. In the mean time, negative sentiment will continue to drive the high levels of volatility in the sector, making it impossible to provide short-term return forecasts with any degree of confidence.

### **Global Fixed Interest**

With respect to global fixed interest, the investment case for global bonds (particularly sovereign bonds) is unattractive given yields range from 1.7% on 5 year notes to 3.6% on 30 year issues. The return seems inadequate given the supply of most issues will increase dramatically as Governments issue debt to finance ballooning budget deficits.

On a relative basis, valuations in certain segments of credit markets look relatively cheap. Many of these assets are trading at 'distressed' prices, pricing in a significant increase in credit defaults. While price volatility is expected to continue, the concerted effort by governments to get credit markets functioning again is a positive sign, which may present investment opportunities in quality investment grade credit securities.

### **Australian Fixed Interest**

Relative to global yields, Australian yields are slightly more attractive and investors will continue to flock into the safety of cash and bonds until the global financial system is stabilised and economic growth returns. It is expected that investors seeking higher yield will first gravitate towards corporate bonds and hybrids and eventually high yield shares, as risk appetite increases again.

### **Cash**

Despite some positive signs emerging, particularly in domestic equity markets and cash rates trending down, the risk of further downward price pressure may impact growth assets. This is particularly likely in equities markets, as company earnings uncertainty remains high. Cash rates are falling rapidly but with deflation a real threat, capital protection has become a priority as asset prices continue to fall. It is expected that the cash rate will fall to 2.75% by June 30 and to 2.0% by year end. However, inflation is also likely to fall significantly over the year, as the economy slows and commodity prices tumble.

## AUSTRALIAN ECONOMY

**Australia's** economy is proving resilient thus far, with the economy yet to enter recession. However, the last four quarterly growth figures of 0.6%, 0.4%, 0.1% and -0.5%, clearly show a contraction is underway. Another negative result in the March 09 quarter is widely expected and will confirm Australia is in recession.

The Federal Government and Reserve Bank have moved quickly to counter the negative effects of the global credit crisis and evolving global recession. The Reserve Bank of Australia (RBA) has cut the cash rate by 425bp to 3%, over a period of 9 months, while the Government has implemented two stimulus packages equivalent to \$50bn or 4-5% of GDP. In addition, the Government has continued to lower income tax rates and provide deposit/debt guarantees for the Australian Banking system and State Governments. The RBA has also been active in providing increased liquidity for the Banking system.

### **How deep will Australia's recession be?**

To date, Australia seems well positioned relative to most developed economies. Consider these positives points:

- The Banking system is stable and functioning;
- Monetary policy has been more effective in Australia – borrowing rates have come down with cash rates;
- The Government is in a relatively strong financial position to provide stimulus;
- The unemployment rate remains relatively low, at 5.2%;
- House prices have proven fairly resilient to date;
- The oil price decline has led to cheaper petrol prices and inflation is now declining; and
- The lower AUD helps exporters remain competitive.

During 2009 it is likely the RBA will continue to cut the cash rate given the deteriorating global outlook (including Asia) and the rapid retreat in inflation. It is expected that the cash rate will fall to 2.75% by June 30 and 2% by year end. The Government is also likely to continue providing fiscal stimulus to help buffer the fall in private demand that is expected. The Budget is expected to move into \$30-40bn deficit as tax revenues decline from slower growth and spending increases. Note the Government will be going into deficit from a position of relative strength (relative to most developed countries), in that current public debt levels are negligible relative to GDP.

What then are the negatives that could lengthen and deepen the recession? The global credit crisis has led to tight credit market conditions, falling asset and commodity prices and a sharp fall in consumer and business confidence. Consumer spending has slowed sharply, while business investment also shows signs of falling sharply. The Banks have reduced mortgage rates, but business lending rates still remain relatively high as the Banks seek to increase margins. This could be self-defeating if business investment slumps.

The Australian share market is down around 50% from its November 07 highs, wiping \$700bn in value (hence investor wealth) from market capitalisation. With house prices falling in the UK and US by nearly 20%, many economists are worried the relatively expensive Australian housing market could be next. Concern about falling wealth is obviously having a major negative impact on consumer spending. However, if consumers don't spend, business suffers and jobs are eventually shed, which worsens the situation further. Rising unemployment could be the straw that breaks the back of the Australian housing market.

So the key is for the Government to try and keep spending at high enough levels to contain job losses. The trouble is commodity weakness has already seen job losses in the mining sector, while the finance and auto sectors are also shedding jobs rapidly. If business investment falls rapidly, more jobs will be lost because one company's capital expenditure is another company's revenue. The decline in consumption and business expenditure could swamp any increase in Government expenditure and the economy would shrink.

Another area where the Australian economy is vulnerable is the current account deficit; most of the current account deficit relates to interest payments on net foreign debt, totalling A\$678bn. 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 harder and the Government has already had to lend its AAA rating to the banks to help them roll their debt, while Australian companies will increasingly need support from Australian debt markets to replace their foreign debt.

All in all, the Australian economy is likely to perform better than most developed economies, primarily because its financial system is stable and Public debt levels are low. Expansionary fiscal and monetary policy is likely to be effective in cushioning the economy. However, the severity of the global recession and global credit crisis will still impact, so a mild to moderate recession has to be expected. The Australian economy is expected to contract by 1% over 2009.

### **GLOBAL ECONOMY**

Global GDP is estimated to have fallen by an unprecedented 1.25% (5.0% pa annualised) in the last quarter of 2008. The IMF has revised down its 2009 forecast for global growth to -0.5% to -1.0% - the weakest growth forecast since World War II. Developed economies (which represent about 65% of global GDP) are expected to contract by between -3.0% and -3.5%, while developing economies (35% of global GDP) are expected to slow significantly but still grow by between 1.5% and 2.5%. The IMF expects a gradual recovery in 2010, conditional on comprehensive policy steps to stabilise financial conditions and continued fiscal stimulus.

**The US** officially entered recession in 2008. The US economy contracted by an annualised figure of -6.3% in 4Q08 - the largest decline since WWII. The US Federal Reserve has cut interest rates to zero, while the Obama administration has gained approval for a second and much larger fiscal stimulus package worth US\$877bn (6% of GDP). In addition, the US Treasury and Federal Reserve have been busy supporting the US financial sector, which is swaying under the weight of credit losses. Recent initiatives include a private/public partnership to buy toxic assets from the Banks. At the same time the US Federal Reserve has implemented 'quantitative easing', whereby it directly buys US debt securities to lower the yield curve. 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 that has led to asset and consumer prices falling. The US share market fell 38% over the year to 31 March 08 while US house prices fell, on average, 19%. 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 prices of goods and services have declined sharply and production has been cut back. Inflation has been vaporised, with the CPI falling to 0.1% pa; indeed deflation now looks likely. Industrial production fell 11.2% on the year to 31 March 08, while the unemployment rate increased to 8.5%. The IMF forecasts the US economy to contract by 2.6% over 2009.

**Europe** has also slid into recession surprisingly quickly, resulting in the ECB slashing the cash rate to 1.25%. The European economy contracted by an annualised rate of -6.0% in the Dec 08 quarter. Inflation has fallen to 1.2% by March 2009 and is expected to remain subdued for most of 2009. The European Commission has released a €200bn stimulus package (1.5% of GDP) but individual countries continue to debate the details. It seems the member states outside France and Germany have deeper economic troubles, particularly Ireland, Spain, Greece and various Eastern European states. The IMF expects European growth to decline by -3.2% over 2009.

**The UK** seems to be in a deeper recession than Europe because debt levels are higher and the decline in the housing and financial sector has been greater. The Bank of England (BOE) has slashed the cash rate to 0.5% and is also engaging in 'quantitative easing', while the Government has been busy providing support for the Banking sector and recently announced a £20bn fiscal stimulus package. The Government's Budget deficit is set to rise to £118bn (11% of GDP) over the year. The IMF expects the UK economy to shrink by 3.7% over 2009.

**The Japanese** economy shrank an alarming 3.3% (13.2% annualised) in the Dec 08 quarter. Export volumes have declined sharply and the Yen has strengthened, causing major problems for the export dependent economy. The Nikkei sank 59% over 2008 and the recent Tankan survey reported that business confidence has fallen to record lows. The Bank of Japan has cut interest rates to 0.1%, from 0.3% and the Government is mulling a new stimulus plan, although with a public debt to GDP ratio of 158%, its options are limited. Deflation will probably re-emerge as a problem for the Japanese economy during 2009. The IMF expects the Japanese economy to shrink by 5.8% over 2009.

**China's** economy was also exposed during 2008, with exports slumping and its property boom ending abruptly. Foreign capital is retreating as US and European Banks withdraw funding. China's growth rate has fallen to 6.8%, down from the heady 12% rates of 2006. The Chinese Government has eased monetary policy and released a 4 trillion yuan (\$585bn) stimulus package that is focused on developing new infrastructure over the next three years. However, the impact on economic growth is likely to be gradual. The IMF expects China's economy to grow by 6% over 2009.

#### **Australian Market Review**

The Australian share market (as measured by the S&P/ASX 300 Accumulation Index) posted its sixth consecutive quarter of negative returns, falling by 1.8% for the March quarter. For the 12 month period ending 31 March 2009, the benchmark returned -29.8%.

Compared to other global markets the Australian share market outperformed three of the four major international regions (in local currency terms) during the March quarter. However, the Australian market underperformed versus Asia. Over the year to March, the Australian share market outperformed relative to the regional markets of the US, Europe, Japan and Asia. There was no respite from the broad sell off in equities throughout January and February, as the market continued its downward trend. The flow of weak global economic news, confirmation of rising unemployment and a series of earnings downgrades from some of Australia's largest companies (including announced cuts to dividends), continued to weigh heavily on investor confidence and ultimately resulted in the market hitting a 5 year low on 6 March.

Investors returned to the market, seeking oversold companies that appeared attractive on valuation and in the belief that the worst of the sell off had passed. Time will tell if this proves to be correct. The rally was led in part by the big four banks, which took the lead from gains in US financial stocks, on signs of economic conditions stabilising and large cap resource stocks.

A key theme that emerged late in the quarter was the switch from defensive stocks into cyclical stocks, as investors sought to take on more risk. This was evidenced by renewed interest in the resources sector, with investors buying back into oversold energy and mining stocks. There was also some takeover activity during the period, with Chinese investors seeking to acquire interests in a number of Australian mining companies such as Rio Tinto (RIO), OZ Minerals (OZL) and Fortescue Metals Group (FMG). The most notable of the deals was that between Chinalco (a leading Chinese diversified resources company) and RIO. Under the terms of the transaction, Chinalco has proposed to acquire RIO's iron ore, bauxite, aluminium and copper assets, whilst also potentially increasing its shareholding in RIO from 9% to 18%. The deal allows RIO to raise funds in order to repay debt and strengthen its balance sheet.

In other company news, ANZ was the first of the major banks to announce a reduction in its dividend payout, also citing the need to strengthen its balance sheet which has been weakened by rising defaults. The market viewed this announcement favourably, preferring this course of action versus a capital raising. NAB soon followed, with a similar announcement regarding its dividend.

The February reporting season proved to be one of the weaker for Australian companies in recent times. However, this was not a major surprise to the market, which had already priced in these lower earnings expectations and on balance, these expectations were met. Company guidance on future earnings remained limited and Lonsec believes that, in light of persisting economic headwinds, earnings risks remain on the downside. There were some pockets of good news, with solid results reported by JB Hi-Fi (JBH), Cochlear (COH) and Commonwealth Bank (CBA). JBH's result was particularly impressive given the difficult trading conditions experienced by many retailers. The company reported a record half year profit and increased its dividend payout on the back of its store roll out and solid sales across all its categories, including home entertainment.

### **Australian Market Outlook**

The view is to remain cautious about the outlook for local equities, believing the March recovery is likely to be one of a series of bear market rallies, rather than a sustained recovery. The deteriorating economic backdrop and uncertainty surrounding future earnings for corporate Australia are expected to persist as headwinds to a sustained recovery. The recent February reporting season confirmed the difficulties confronting many Australian companies, as they reported earnings downgrades and tempered their outlook statements. A number of Australian companies also remain in survival mode and have tapped equity markets in order to raise capital. It is expected the financing environment for many companies to remain challenging in the near term, but that quality companies with strong balance sheets should be well positioned to weather this difficult period.

The extent of the market's correction from its peak means that Australian equities are trading on a forward market Price to Earnings Ratio (PER) of around 10-11x, versus a historical average of 14x. Whilst the market would appear cheap based on valuation, factors such as the uncertainty over the sustainability of future earnings and the view that there is more downside risk to FY09 and FY10 earnings, continues to outweigh the benefits of a broad based move back into equities at this stage.

The next reporting season later in July and further announcements in regards to capital raisings, are likely to be catalysts for a re rating of Australian equities.

### **International Market Review**

Over the quarter, global shares fell by 11.8% (as measured by the MSCI World ex Australia Index in \$A). Asia was the only major regional share market index (in local currency terms) that made a positive return over the period.

For the 12 months ending 31 March 2009, results for the major regional markets were all negative - not surprising given the difficult market environment that global shares declined 24%. The US and Europe suffered similar fates, with declines of 37.9% and 37.2% respectively. Japan was close behind, with a decline of 36.5%. Asia was the best performer, albeit still negative, down 33.8% for the year. The difference between the best performing region (Asia) and worst (US) in local currency terms for the 12 month period ending 31 March 2009 was 4.1%. The difference between the best and worst performing region has continued to narrow, reflecting the global impact of the financial crisis.

Commentary for the major regions follows, although overall conditions remain difficult, and are expected to remain so in the short term.

### **United States**

US shares fell by 10.0% (local currency) over the quarter. The broader economy continues to be adversely impacted by a number of headwinds, including ongoing deleveraging and difficult credit conditions. In light of job losses, declining equity and housing wealth, consumer sentiment and spending are weak. Policy actions are being taken to stabilize financial markets and institutions, however, the near term economic outlook is weak, with earnings announcements for many companies also expected to be weak.

### **Europe**

European share markets collectively fared slightly worse than the US for the quarter, falling by 11.5% (local currencies). Conditions in the UK and Europe are little different to the US, with most areas witnessing an increase in unemployment, lower consumer spending and continued declines in business investment as a result of the continued tight credit conditions.

### **Japan**

Japanese shares fell by 9.2% (local currency) for the March quarter. The recession deepened over the quarter, with a continued downturn in external and domestic demand. Credit conditions have tightened in Japan, however, this has been to a lesser extent than in other advanced economies. Economic activity is expected to remain subdued in the near term.

### **Asia**

Asian shares rose by 2.7% (in local currencies) for the quarter. This small gain follows a sharp decline in Asian share markets in 4Q08. The Asian economies are generally decelerating due to the collapse in external demand, in addition to a number of factors hampering domestic demand. Investor concerns about the US situation continue to outweigh confidence in the Asian growth story. However the larger and less open Asian economies are expected to be less severely affected, in relative terms, by the global economic downturn.

### **Currency**

During the quarter the Australian dollar (AUD) depreciated against the USD, but rallied against other major currencies (EUR, JPY, GBP). Declining currency movements typically dampen returns for hedged AUD investors; however improve returns for unhedged AUD investors. Over the quarter the AUD weakened against the USD by 0.8%, but appreciated against the EUR by 5.5%, the JPY by 7.8% and GBP by 0.2%.

The AUD closed the quarter at US 69.1c, marginally lower than the December 2008 close of US 69.3c. However, the AUD remains significantly lower than the peak of almost US 98.5c achieved in mid July 2008.

The AUD stemmed its relative decline against other major currencies over the preceding quarters, with economic data showing that the Australian economy was outperforming other advanced economies. By quarter end, markets were starting to contemplate an end to the RBA's easing cycle. Furthermore, the risk aversion in currency markets tempering the performance of the AUD subsided over the quarter.

The direction of the AUD will largely be dependent on the direction of interest rates, commodity prices and the relative strength of the USD. Note that the AUD is now comfortably within the one standard deviation band of its long-run average and is in fact currently trading very close to its long-run average.

### **International Market Outlook**

Concerns regarding global growth and future economic weakness continue to dominate economic sentiment. While inflationary concerns have dissipated as oil and commodity prices have eased, the economic outlook continues to be influenced by the follow on effects of the subprime situation. As such, the likelihood of a significant market rebound in the short term appears relatively slim. That said, the government and central banks' stimulus programs are all aimed at reducing the severity of the slowdown.

It is expected that the global financial crisis is to result in a slow down in company earnings and a pull back in global economic growth. While the P/E for the global market has come down, the forward looking earnings part of the equation continues to be uncertain.

As mentioned earlier, a fall in the AUD will benefit global equities strategies managed on an unhedged basis; however, with the AUD moving within the range of the long term average value, it is fair to say that the dollar does not look as expensive as it did at the end of 2007 and mid 2008.