

MARKET OUTLOOK

31-March-2009

Economic Outlook

United States

The US economy will continue to face challenges in the coming months. Improvement in some economic data in February, including the closely watched housing indicator of sales and starts, and several measures of home prices, are welcomed. However, a more convincing period of stabilisation is required.

The biggest concern for the US is that the economy continues to shed jobs at a rapid pace and there is no immediate sign that this will ease. With the expectation of business investment continuing to fall in the face of margin compression negatively affecting corporate profit, the consensus forecast continues to expect another 600,000 decline in payroll in the coming months.

Europe

The depth of the recession in Europe has so far been more severe than in the US, primarily driven by the collapse in industrial production relating to sharp destocking as a consequence of falling global demand. Consumer spending, particularly in France and Germany, has not collapsed, with support from lower inflation boosting real income, and relatively small rises in unemployment. Employment is set to deteriorate more rapidly, however, and together with the modest rise in saving rates suggests weaker consumption ahead. Inventory adjustment will continue for the remainder of the first half of the year, but stimulus package initiatives by the two larger EU members could limit the fall in the GDP towards the end of 2009 with the increase in public sector spending.

Across the Channel, the deleveraging process in the UK will continue for some time despite policy makers having delivered massive stimuli through interest rate cuts, quantitative easing and the resulting decline in the exchange rates. The outlook for this year remains challenging for the economy.

Asia

Given the deepening recession in the US and Europe, the outlook for exports for most Asian countries is likely to deteriorate further in the coming months. China is no exception. Encouragingly though, the RMB4-trillion stimulus package introduced last November has started to work earlier than expected, with some improvements in industrial output, and an acceleration in bank lending growth and fixed asset investment. On consumption, retail sales have slowed but remain resilient. Domestic demand is likely to receive a substantial boost as the bulk of the stimulus package filters through in this quarter, which should support overall growth in the second half of this year.

The economic situation in Japan looks likely to worsen in the coming months. Further declines in industrial production are expected to continue due to the weakening of external demand. Unemployment is expected to rise further, despite some fiscal stimulus plans designed to support activity in the coming year. Importantly, with the latest round of falls in

inflation readings, many are concerned that the deflationary spiral could return. Further policy initiatives are needed.

Australia

[The market is divided as to whether the RBA will continue to ease interest rates in April. The data released in March continued to portray a weakening economy and the further slowing of the global economy makes a compelling argument to lean towards further rate cuts. Recent comments from RBA Deputy Governor Ric Battellino also suggest that the central bank has revised its growth forecasts down quite sharply for this year and is now forecasting a recession - a significant change from the RBA outlook in February.

Nevertheless, the second round of cash giveaways worth around \$4bn should have supported the economy in March, while there is another \$7bn due to be delivered sometime this month. With the Federal Budget due next month, further stimulus is expected even though it might not be as large as the already announced cash giveaways. This said, the RBA could sit on its hands again until after the Budget, keeping enough in reserve to adequately respond to the expected further rises in unemployment later this year.

Australian Sharemarket Outlook

Since March 8, the domestic market has rallied strongly. What remains to be seen is whether this is a typical bear market rally or the bottom of one of the worst cycles in history.

While there has been a clear shift from previously loved defensive stocks to cyclical stocks, as well as a dramatic sector rotation and an increase in the market's appetite for risk, it still seems too early to call the bottom.

The fact of the matter is that Australia is likely in recession, with unemployment increasing at a rapid rate, and general confidence not particularly bright. Predictions of a tough 2009 still seem correct despite this latest rally.

International Sharemarket Outlook

There are signs that confidence in the global economy is returning, with markets starting to look beyond the current global recession to see opportunities. US Treasury Secretary, Timothy Geithner's recent announcements on the Federal Reserve's Term Asset Lending Facility (TALF) and Congress pushing the Financial Accounting Standards Board (FASB) on changes to market accounting has had an impact on global markets.

Stimulus commitments from individual nations have been supplemented by a further \$US1.1 trillion in emergency financial aid resulting from the recent G20 meetings. At some stage these efforts will work, but this may not be for some time, possibly later this year, or in 2010. The potential risk with these stimulus packages is that they could fuel inflation, a thought far from most global leaders' minds for some time now.

All this said, economic data from the US and elsewhere is still dire. Exports continue to decline as does production, meaning that the end to this financial crisis is still uncertain.

Australian Fixed Income Outlook

When the RBA left the official cash rate unchanged at 3.25% following their March board meeting, they reasoned "there has already been a major change in both monetary and fiscal policy" and that "notwithstanding evident economic weakness at present, the Board judged that the stance of monetary policy was appropriate for the moment".

Prior to the board meeting in early April, it was considered likely to be a close call as to whether they would deliver another rate cut or pause for a second month. Following this meeting we now know that the board decided to reduce the official cash rate by 25 basis

points to 3.00%, however, even if they had paused for another month, the market had still discounted further rate cuts towards 2.5% by mid year.

The performance or direction of the overall fixed income market will be driven by the outcome of the nearer term economic releases, particularly those relating to the labour market. As always, trends in overseas markets will be influential.

International Fixed Income Outlook

The global economy has slowed hard with the major economic regions now in a recession. Policy makers have been responding and will continue to do so over coming months. Further rate cuts, where there is room, and fiscal measures can be expected to be announced.

Apart from the obvious economic concerns, another theme for this year is the growing supply of government bonds that will need to be issued to fund the fiscal stimulus packages that have been put in place around the globe. For now, this increased supply is being taken up by the market, and furthermore, both the Bank of England (BoE) and US Federal Reserve (FED) are also committing funds to buy longer dated bonds - a strategy known as quantitative easing.

Longer term fixed income yields still remain historically very low, and for good reason given the environment we have been in. As we move through 2009, market participants will look for signs of a stabilisation in the leading global economic indicators which have been falling sharply.

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