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The December Quarter

Volatility remained the key theme over the December quarter (accelerating through into January), with conflicting economic data and increased risk aversion resulting in erratic daily swings in share market indicies. Most major equity markets ended the quarter down. Sub-prime issues continue to weight on investor sentiment, with local stocks such as Centro (which in turn triggered a broad-based sell-off in the listed property trust sector) feeling the contagion effects of the credit crisis. As domestic inflationary pressures continue to build, Australian bond yields have risen and in what has been one of the most challenging periods in recent history, cash has been the best performing asset class.

Global Economy

A slowing US economy and the crisis in global credit markets have undoubtedly increased the risks to the global economic growth outlook. The extent to which the developing Asian economies (particularly China and India) can themselves withstand a slowdown in the US will be determined largely by the severity of the US downturn.

The chance of recession in the world's largest economy, the **United States**, has increased, with falling house prices, rising fuel costs and the increasing cost of credit expected to slow US consumption. With the US consumer under pressure, economies that are heavily reliant on the US for their export markets (Japan and Europe) are also vulnerable. The US Federal Reserve cut interest rates by 100 basis points in 2007 to 4.25% and, as at the day of writing, has now added further reductions totaling 125 basis points in January, taking the Fed Fund rate to 3%. The comments by the Fed Reserve in making the most recent reduction on 30 January has left the door open for further rate cuts in the short term, evidencing a determination to avoid a sustained slow down, but at the same time, serving to highlight the seriousness of the economic situation. Stagflation (falling growth and rising inflation) is now a real possibility in the US.

Economic growth in **Europe** is beginning to show signs of easing, with deteriorating credit conditions, slowing demand and weaker export growth under a strong Euro. The European Central Bank (ECB) remains on hold, while the Bank of England (BOE) has moved to an easing bias, cutting rates by 25bp to 5.50%. **Japan** continues to struggle, with heightened political uncertainty adding to already weak economic results. Core inflation remains close to zero and, with Japanese exporters also facing a slowing US economy, growth is likely to remain subdued in 2008. Developing **Asian** economies, especially China, remain robust, and are relatively well placed to withstand a slowdown in the US due to large foreign reserves, relatively closed financial systems and solid domestic demand.

Domestic Economy

Notwithstanding increased risks, the Australian economy remains in reasonably good shape. Strong growth (with GDP above 3.5%), unemployment at 30-year lows, a federal budget that is in surplus, and exposure to rapidly growing Asian economies are supportive of continued domestic growth. The Australian economy does, however, face risks, with rising inflationary pressures (resulting from capacity constraints),

rising interest rates, and drought being key threats to the domestic growth outlook. Furthermore, whilst the local economy may have 'de-coupled' somewhat from that of the US, it is not immune from the global influences of slowing global growth and higher funding costs (evidenced by the recent interest rate increases imposed by Australian banks independently of the Reserve Bank of Australia (RBA), in order to cover the higher costs of wholesale funding).

The RBA policy stance is finely balanced between these opposing global and domestic factors; however, the recent strong retail sales figures, together with the December CPI number, have tilted expectations towards further tightening. Widening interest rate differentials and firm commodity prices should remain supportive of the AUD.

OUTLOOK

Australian Shares

Rising interest rates and a slowing US economy are expected to provide the domestic share market with headwinds over the course of 2008. The market is not expected to match the impressive double digit returns of the past five years. However, the Australian economy is expected to remain in relatively good shape, due to our exposure to the growing Asian economy. Increasing wages and higher oil prices are expected to place further pressure on inflation. Until inflation risks abate and the picture around the US economy becomes clearer, continued share market volatility, both domestically and abroad, will remain the norm.

The up-coming reporting period for Australian companies (February/March) will be critical. Whilst relative value (ie price/earnings) appears compelling for many Australian companies given recent share price falls, their attractiveness hinges on the maintenance of recent earnings momentum. Investors/brokers will be looking to assess the strength of reported earnings coupled with the guidance provided by management. Any companies delivering lower than expected earnings and/or soft earnings guidance will be punished.

Overall, the Australian share market is expected to have solid earnings prospects for 2008 and we are comfortable maintaining a **neutral** weighting on Australian shares, with an emphasis on proven growth (fund) managers and quality stocks (ie scale businesses with pricing power, a focus on margin management and low gearing). Resources and Financials (notwithstanding recent mark-downs) are likely to outperform over the next 6 months.

Axiom

Global Shares

Global growth is expected to moderate in 2008, falling from 5.1% in 2007 to 4.5% in 2008 according to IMF forecasts, primarily driven by US economic performance (or lack thereof), which will weaken further over the near term. US economic signals suggest the deteriorating business climate is not confined to just the housing and financial sectors.

Emerging Asian growth economies are less reliant on US trade than in previous economic downturns and generally exhibit stronger economic fundamentals such as low inflation (outside of China), strong domestic demand, large foreign reserves and current account surpluses. While it is unlikely that China, India and other East Asian economies can continue to grow at existing levels in the face of weaker demand from developed economies, the regional outlook remains positive with these economies expected to provide some cushioning effect to the global economic slowdown.

Hence, our view on global shares has been framed based on the two distinct “growth” sectors. The emerging situation in the US and knock-on effects in Europe and Japan, dictate an **underweight** allocation to these markets (ie underweight benchmark aware international funds). Under-performance here is likely to be exacerbated by a weakening US dollar. Given the likely continued growth in Asia, we are **neutral** on the Asian and developing markets.

Listed Property

Over recent months the Listed Property Trust (LPT) sector has been severely affected by the credit crisis, which has seen the availability of debt finance reduce and interest costs increase. The most affected Australian LPT was the Centro Properties Group (CNP), after it announced that it had not been able to refinance $2.7b of maturing debt facilities. This saw its price reduce by over 80%. Highly geared LPTs, particularly those with exposure to the weakening US economy, have been the hardest hit over the last quarter (Macquarie DDR Trust and Reckson New York)

The considerable volatility seen in the global real estate sector over the last six months is likely to continue. It is likely that rising funding costs and evaporation of some debt financing, together with continued outflows from property, could see property yields loosen in several key markets (including the UK and the US), which could put further downward pressure on the sector’s valuation. Domestically, increased financing costs, the strong Australian dollar, combined with historically low yields, suggest that capital growth from domestic property portfolios will be limited over the foreseeable future.

We hold an **underweight** position on Australian and Global LPTs

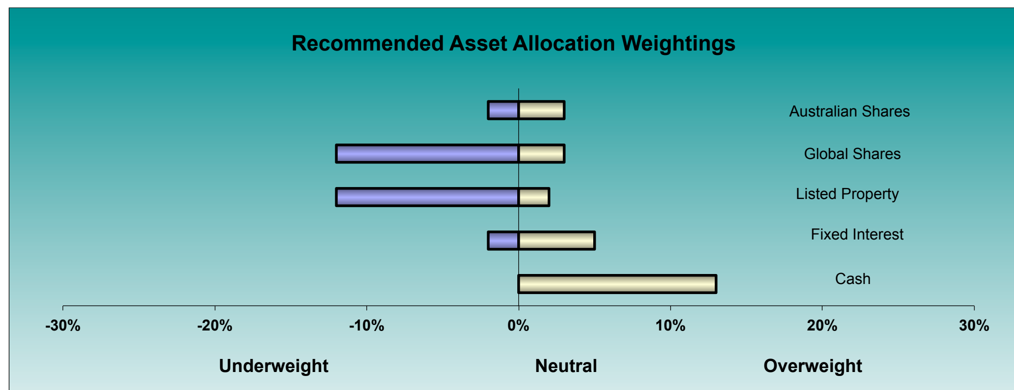
Fixed Interest

With continuing inflationary expectations the structure of the domestic yield curve has now shifted to provide a premium (albeit small) in favour of term rates. Combined with a broader defensive portfolio view, we have now moved to a **neutral** weighting on fixed interest.

Cash

Cash represents the residual of our views on the other asset classes and as such, we have an **overweight** position on cash, particularly in the short term.

A summary of our views on asset allocations follows:



Key Risks

The downside risks to the outlook include:

- **US economy** – the question of how much and for how long the US economy slows will be crucial to global share markets. The extent, nature and timing of the proposed fiscal stimulation package (~USD 150 billion) will also have a significant impact
- **Australian corporate earnings** – company profit results over February and March that support current earnings expectations will be a key to domestic share market growth in the near term.
- **Inflation** – risks remain on the upside and with the new Government's tax cuts still firmly on the agenda, further rises in interest rates are inevitable.
- **Oil prices** – supply issues persist and rising fuel prices are a key contributor to inflationary pressures around the globe.
- **Commodity prices** – any protracted weakness (albeit unlikely given Asian growth expectations) will have an impact on the resource sector with knock-on effects here domestically.

Regards

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