

# Economic review

8<sup>th</sup> January 2009

## Monthly snapshot of the Australian economy

- 2008 was a disastrous year for the global economy. Growth in advanced economies slowed dramatically. The IMF forecasts annual growth in advanced economies will be 1.5% in 2008 and just 0.5% in 2009.
- Falling demand in advanced economies and disruption in capital markets has resulted in the global financial crisis spreading to emerging economies. The IMF forecasts annual growth in emerging economies will slow from 8.0% in 2007 to 6.9% in 2008 and 6.0% in 2009.
- Australia's economic growth profile slowed in 2008 due to tight monetary policy in 1H09 and the worsening credit crisis from September. Growth slowed to 0.1% in 3Q08. Annual growth in 2009 is expected to remain sluggish due to labour market uncertainty.
- The rapid rise in inflation during 2007 and 2008 is likely to have peaked in 3Q08 at an annual rate of 5% due to recent falls in commodity prices and mortgage rates. Inflation should ease throughout 2009, towards the RBA's target zone of between 2% and 3%.
- The labour market is also weakening, with softer annual employment growth (from 2.8% in March to 1.5% in November) and a rise in the unemployment rate (from 3.9% in February to 4.4%). Over 2009, employment growth is set to soften further and the unemployment rate is expected to rise towards 6%.
- After substantial declines in asset prices during 2008, the outlook for investment markets in 2009 will depend on improved liquidity, a restored favourable business outlook and a period of stability in asset prices.



## Economic perspective

### Uncertainty is the key brake on economic activity in 2009

It is easy to forget the economic conditions which faced policy makers in the middle of 2008. In June, the Governor of the RBA, Glenn Stevens, said *“So inflation has picked up, and needs, over time, to be reduced. Reductions of inflation usually require a period of slower demand growth, and this episode is no different.”* The RBA believed Australia would be largely isolated from the global financial crisis by strong domestic demand and a buoyant export sector and so it remained vigilant to rising inflation and maintained a tightening stance for monetary policy.

However, with the worsening of the credit crisis in September 2008 the RBA rapidly shifted its economic focus from inflation to growth and reversed the policy decisions of 1H08. It cut the official cash rate (OCR) from 7.25% in September to 4.25% in December 2008. This was aimed at supporting domestic demand and improving the functioning of capital markets. The rate cuts also prompted a depreciation in the exchange rate that has provided further support to demand.

The urgency of the RBA's response was highlighted by the near recessionary economic conditions in 3Q08. Growth in the quarter of 0.1% highlighted the weakness of economic activity, particularly amongst households and the export sector. The recent shift in policy and improved credit market conditions may ensure 3Q08 was the low point in the current Australian economic cycle. While growth will remain sluggish over 2009 it will generally improve from the lows of September 2008.

Weak demand supported the RBA's view that the annual inflation rate likely peaked in 3Q08 at 5.0%. Inflation should ease throughout 2009 towards the RBA's target zone of between 2.0% and 3.0%. However, the rising fear of deflation in the US, Europe and Japan seems unlikely to eventuate in Australia given the further scope of policy mechanisms to support economic activity.

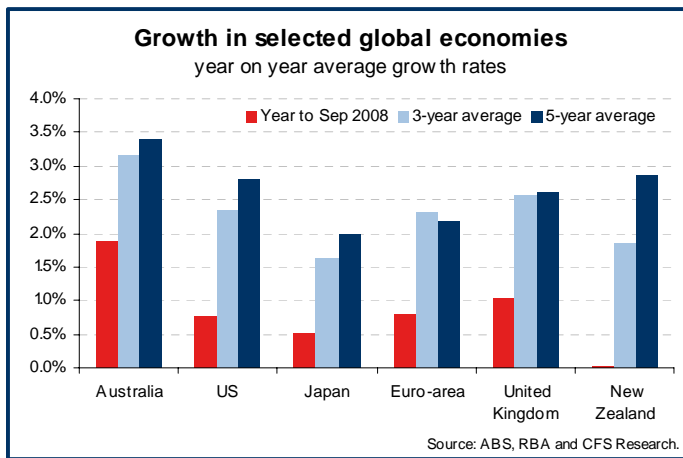
With a policy stimulus now in place, the key to the economic cycle in 2009 will be the labour market. The outlook for the labour market has weakened since September due to slower demand and a contraction in the financial services sector. This suggests a contraction in employment growth and a rise in the unemployment rate towards 6.0% by the end of 2009. Such weakness in the labour market may warrant further policy stimulus.

Household consumption is set to remain sluggish in 1H09, with a moderate recovery by the end of 2009. This outlook is influenced by the current policy stimulus and uncertainty regarding job security and incomes. The destruction in wealth caused by falling asset prices will also weigh on retail sales.

As a result of the onset of the global financial crisis, investment markets declined substantially in 2008. Uncertainty over the business outlook and persistent asset price volatility discouraged investment activity. A recovery in investment markets will depend on improved liquidity, a restored business outlook and a period of stability in asset prices. The actions of authorities to support markets will also be a pertinent driver of this recovery

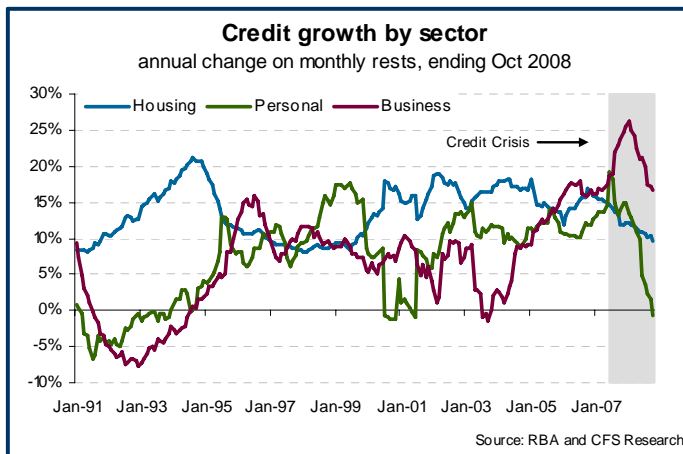
## Key economic indicators

### GDP growth



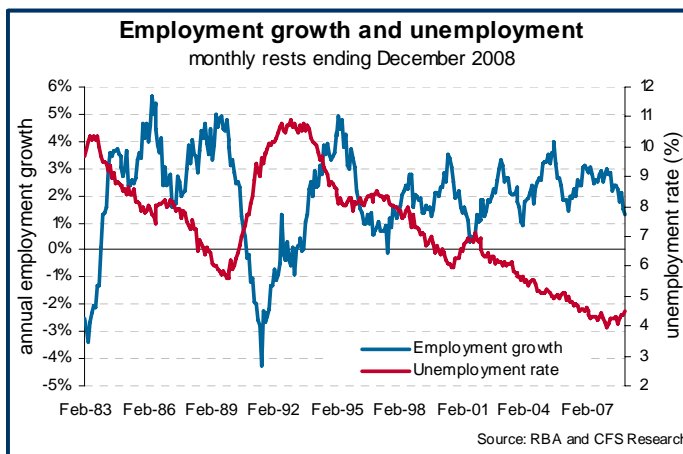
- Australian economic growth slowed substantially in 2008. In 3Q08, annual growth fell to 1.9% from a peak of 4.2% in December 2007.
- The outlook for growth will improve gradually as the monetary and fiscal stimulus begins to work. The CBA expects annual growth of between 1-2% in 2009.
- The IMF forecasts annual growth to slow in advanced and emerging economies in 2008 and in 2009.

### Lending markets



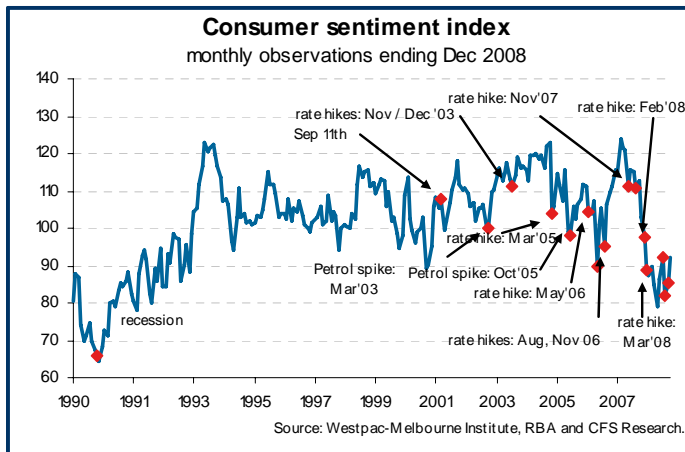
- The negative impact of the credit crisis on the real economy is best seen in the steep fall in lending growth during 2008.
- Stressed credit markets and a deteriorating outlook created difficulties for borrowers in obtaining finance, particularly business and personal finance.
- Lower interest rates and an improvement in credit markets should support a recovery in lending growth over 2H09, although this will be hindered by a weak labour market.

### Labour market



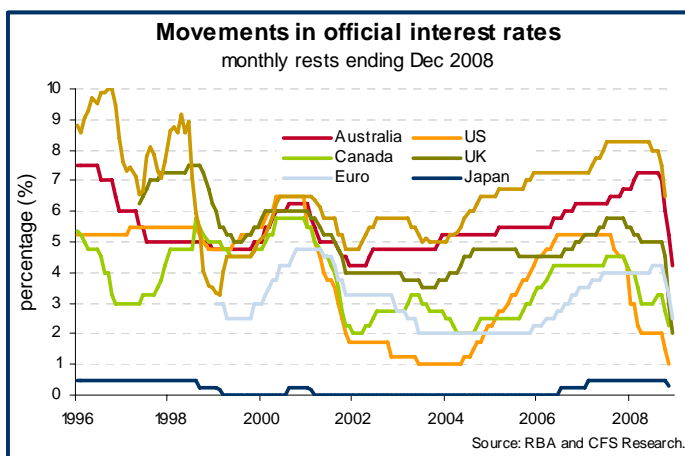
- Tightening labour market conditions since 2002 eased in 2008 as unemployment rose from a low of 3.9% in February to 4.5% in December and annual employment growth slowed to 1.3% from 2.8% in March.
- The main drivers of labour market deterioration have been uncertainty over future demand and a substantial fall in financial services activity.
- CFS Research expects labour market weakness to persist and the unemployment rate to rise towards 6% by the end of 2009.

### Consumer sentiment



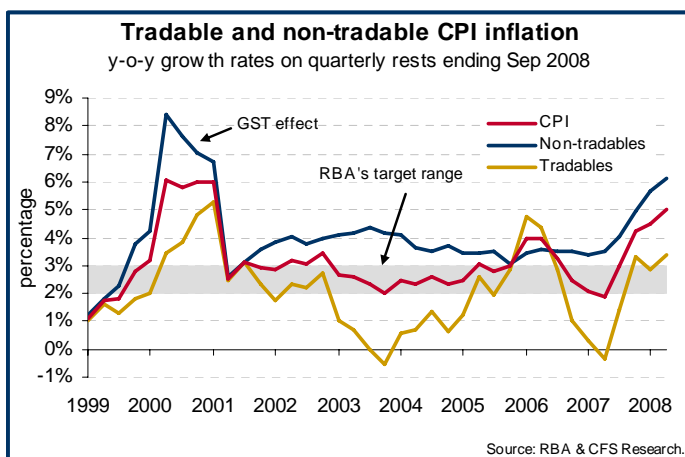
- Consumer sentiment fell precipitously in 2008. From near record highs at the end of 2007, sentiment fell to levels last observed in the recession years of the early nineties.
- Sentiment first fell due to successive interest rate rises. It remains sluggish with the adverse impact of the credit crisis negatively impacting the wealth and incomes of households.
- Consumer sentiment should stabilise in 2009 as stimulatory monetary and fiscal policy provides a buffer against rising unemployment.

### Interest rates



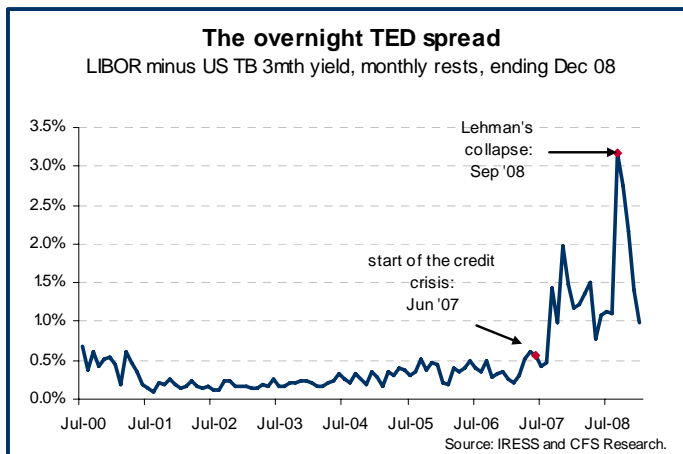
- RBA monetary policy shifted radically over 2008 in line with other central banks. The OCR rose to 7.25% in March before being slashed to 4.25% over the three months from September.
- This shift reflected the RBA's belief that interest rate cuts will relieve stress in credit markets and provide support to domestic demand.
- It is expected that interest rates will fall further by March 2009 to around 3.5%. A new tightening cycle is expected to commence in 2010 as the recovery in demand grows and capital market conditions improve.

### Inflation



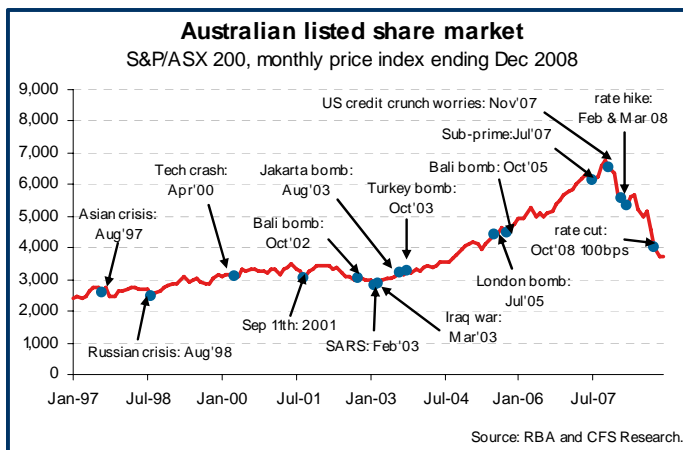
- In 3Q08 inflation rose to an annual rate of 5.0%; well above the RBA's target zone of between 2-3%.
- The drivers of high inflation were high commodity prices, excess demand and tight supply conditions. These factors have eased due to recent market turmoil.
- With commodity prices remaining below the highs of 2008 and slower domestic demand, inflation is expected to approach the RBA's target zone in 2009.

**Credit markets**



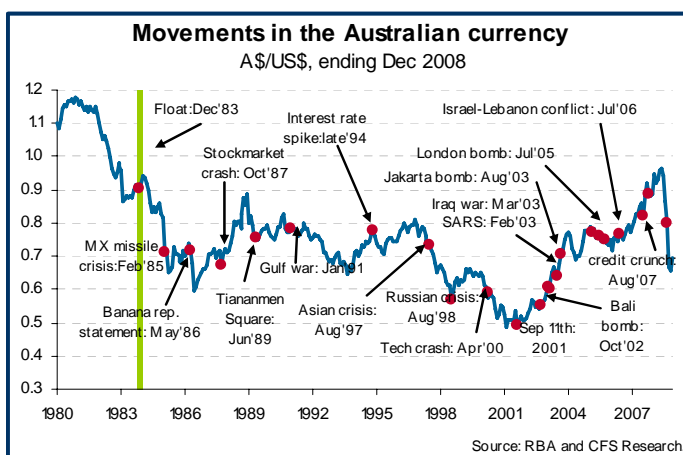
- Global credit market stress has been the key driver of slower global economic activity. It is best measured using the TED spread: LIBOR minus the yield on 3-month US T-bills.
- The TED spread first spiked in June 2007. It spiked again with the collapse of Lehman Brothers in September 2008.
- The recent improvement in the TED spread and a global commitment to lending markets by authorities should provide the basis for a global recovery in 2009/10.

**Equity market**



- The Australian stock market began 2008 below the record levels of 2007. During the course of the year, the S&P/ASX 200 fell 41.3%; most dramatically in the last four months of the year.
- Factors contributing to the market downturn include: a downward re-pricing of risk, a tightening in credit markets and a deteriorating business outlook.
- The S&P/ASX 200 is likely to stabilise in 2009 and post a moderate gain.

**Exchange rate**



- After reaching record highs of US\$0.96 in June, the Australian dollar fell as low as US\$0.60 in October before recovering in December to US\$0.71.
- The annual fall in the dollar of 21% reflected a flight from risky assets, the RBA's rate cuts and a large fall in commodity prices.
- The Australian dollar should rise over the course of 2009, supported by favourable interest rate differentials and an improvement in commodity prices from their current lows.

**CFS Research has a global reach and the expertise to tailor research to your needs.**

**Contact details**

Anthony De Francesco	Head of Research	+612 9303 3598
Mary Bonello	Research Assistant	+612 9303 3518

**DISCLAIMER**

Product Disclosure Statements (PDS) and Information Memoranda (IM) for the funds issued by Colonial First State Investments Limited ABN 98 002 348 352, Commonwealth Managed Investments Limited ABN 33 084 098 180, and CFS Managed Property Limited ABN 13 006 464 428 (collectively CFS) are available from Colonial First State Global Asset Management. Investors should consider the relevant PDS or IM before making an investment decision. Past performance should not be taken as an indication of future performance.

No part of this material may be reproduced or transmitted in any form or by any means without the prior written consent of CFS. This material contains or is based upon information that we believe to be accurate and reliable. While every effort has been made to ensure its accuracy we cannot offer any warranty that it contains no factual errors. We would like to be told of any such errors in order to correct them.

This material has been prepared for the general information of clients and professional associates of CFS. You should not rely on the contents. To the fullest extent allowed by law, CFS excludes all liability (whether arising in contract, from negligence or otherwise) in respect of all and each part of the material, including without limitation, any errors or omissions.

This material is intended only to provide a summary of the subject matter covered. It does not purport to be comprehensive or to render specific advice. It is not an offer document, and does not constitute a recommendation of any securities offered by CFS. No person should act on the basis of any matter contained in this material without obtaining specific professional advice.

Colonial First State Global Asset Management is the consolidated asset management division of the Commonwealth Bank of Australia ABN 48 123 123 124.

Copyright © CFS 2009

All rights reserved.