

# MACQUARIE FUNDS GROUP

## Economic Commentary

### August 2008

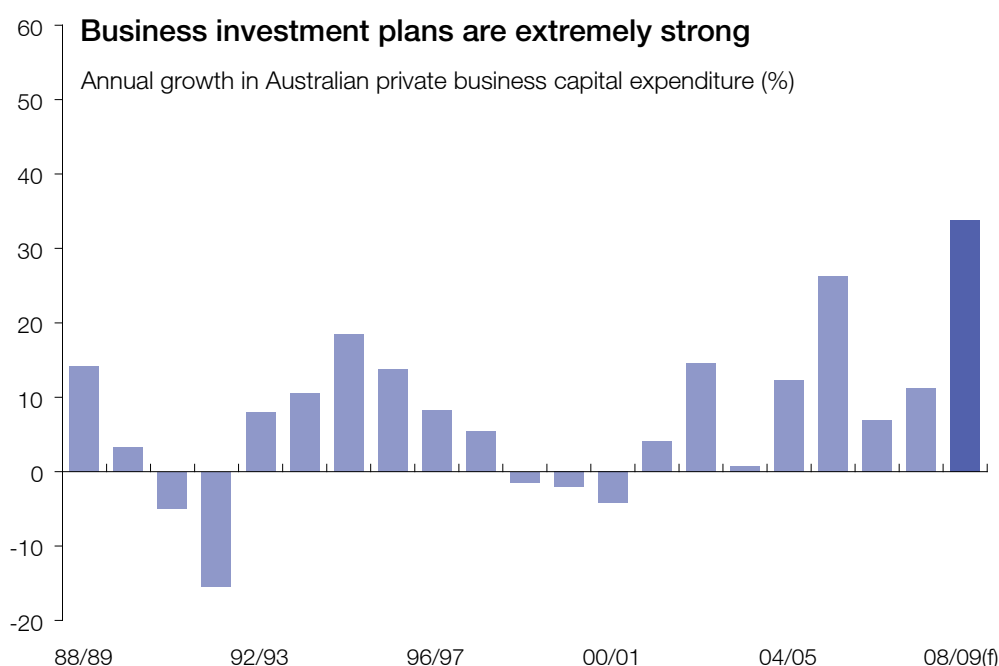


#### Market highlights for the month were:

- > Global bond yields fell on a combination of weaker activity, easing inflation concerns and a flight to quality as financial strains continued;
- > The spread between Australian and US bond yields narrowed sharply as the market moved to forecast a narrowing in the differential in official interest rates over the period ahead;
- > Credit spreads widened on increased concerns over the solvency of US Government Sponsored Enterprises;
- > The Australian equity market improved modestly on a relatively positive reporting season as well as expectations for interest rate cuts;

- > The US dollar strengthened significantly in the month on weakening growth prospects across the globe and falling commodity prices. The Australian dollar subsequently underperformed.

The key development in Australia during August was the adoption of a clear easing bias by the Reserve Bank of Australia (RBA) following their meeting at the start of the month. Despite continued elevated readings for inflation, clear evidence of a significant moderation in demand against a backdrop of a further unwanted tightening in financial conditions prompted the RBA to conclude there was "scope to move to a less restrictive monetary policy stance".



Source: ABS and Macquarie Funds Group

The Reserve Bank subsequently acted on this bias by cutting rates by 25bps to 7.00% at their September meeting. The RBA did not pre-commit to further easing, couching the cut in terms of moving to a less restrictive setting for policy, whilst reaffirming their commitment to bringing inflation back down over time. Domestic markets have moved to factor in a series of rate cuts over the coming year. But with the RBA not expecting inflation to fall back to within the target band until the second half of 2010, and tax cuts and the terms of trade now providing stimulus to the economy, we believe the Bank could cut rates by less than is currently expected in the near term. A further upgrade to what was already an extremely strong pipeline of business investment plans also suggests the environment for firms may not be as bad as many fear. A more substantial move in rates back to neutral would, in our view, require indications of a more marked slowing in the economy than is evident to date.

The US economy grew strongly in the June quarter, driven by exports and a tax rebate induced rise in consumer spending. But while the data flow in the past month has tended to surprise on the high side of expectations, further signs of deterioration in the labour market (with the unemployment rate rising to 5.7%) and a sharp fall in real consumer spending in July raise the likelihood the economy will weaken substantially from here. In particular the fall in consumer spending in the month all but guarantees real consumer spending will contract in the current quarter for the first time since 1991.

Outside the US, most indicators released during August point to a clear broad-based slowing in activity amongst the major advanced economies. GDP is reported to have contracted in the euro area and Japan in the June quarter, while growth in Canada remained anaemic. Growth in the UK is now reported to have slowed to a standstill, with most indicators suggesting the economy is poised to contract in the second half of the year. Housing activity and prices continue to decline at a rapid pace, while the labour market has clearly begun to deteriorate. In response to these developments, the Bank of England acknowledged that while inflation remains elevated for now (and is set to accelerate further in August), it will likely fall below their target over the forecast horizon should interest rates remain at current levels.

Finally in China, recent activity indicators have hinted at the possibility that the economy is slowing more sharply than expected. While some slowing in China's rapid pace of growth is to be expected, it is unclear at this stage how much of the recent signs of softening reflect a clear change in the underlying cyclical trend versus a temporary lull on the back of Olympics related shut downs in industrial production and construction activity (which affected several cities, and not just Beijing as is commonly believed).

Inflation across the globe rose further in the latest month, with headline inflation reaching 5.5% in the US. Core inflation in many countries also surprised to the high side of expectations. But a sharp fall in energy prices has helped to ease concerns over inflation over the period ahead. Along with the indicators of weaker activity across the advanced economies, this has prompted markets to pare back their expectations for rate hikes in the US and the euro area, while the market has moved to factor in a rate cut before the end of the year in the UK.

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## Contact details



Macquarie Funds Group Client Service on 1800 814 523  
8.30 am to 6.00 pm, Monday to Friday (Sydney time)



[www.macquarie.com.au/mfg](http://www.macquarie.com.au/mfg)  
email: [mfg.clientservice@macquarie.com](mailto:mfg.clientservice@macquarie.com)



Macquarie Funds Group  
PO Box R1723, Royal Exchange NSW 1225