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Executive summary. Economic growth slowed across most major global economies in the September quarter. The most concerning slowdown was observed in emerging markets, and in particular China, where lower domestic and foreign demand is depressing growth. The announcement that China will be spending over USD 150 billion on infrastructure projects to stimulate economic growth was received positively by the markets. However, this has been greeted with some scepticism as some of these projects are already under way and the other projects, already in the pipeline, were being fast tracked.

The US economic recovery continues but at a slower pace although with stable economic indicators, and a recent rise in housing prices and consumer spending. The approaching US presidential election has led to uncertainty over the fiscal stimulus plans of the next elected government.

The European economy continues to show weakness with growth lower in 2012 than in previous years with many economies now in recession. Some progress has been made resolving the sovereign debt crisis through new stimulus programs, a new permanent bailout fund and plans for a euro-wide banking supervisor.

Australia's economic indicators are continuing to support a resilient economy. Australian GDP growth for the June quarter was just below trend, inflation and unemployment are low, and the household savings ratio is back above 10% of disposable income due to household deleveraging.

The international economy

The US economy grew at an annualised rate of 1.7% in the June quarter, down from 2.0% in March and 4.1% in December. Employment levels* continue to grow at a slow pace although the participation rate has been falling for close to six consecutive years as discouraged workers give up their search for employment. There has been some positive news with housing prices surprising on the upside rising 5.9% year to date and consumer spending up over 3%, the highest rate since 2006. But Vanguard senior economist in the US, Roger Aliaga-Díaz, has said that due to the uncertainty surrounding US fiscal policy and the European sovereign debt crisis, many US companies are suspending capital spending, investing and hiring.[1] Until these uncertainties are removed, Aliaga-Díaz believes that economic activity will remain subdued.

In mid-September the Federal Reserve (Fed) announced plans for a third round of quantitative easing (QE3). The Fed cited weak economic growth and labour market conditions as the key motivations for further stimulus. The Fed's QE3 program will involve the additional purchase of mortgage-backed securities until labour market conditions improve. The Fed also extended its 2014 commitment to hold short-term interest near zero until mid-2015.[2]

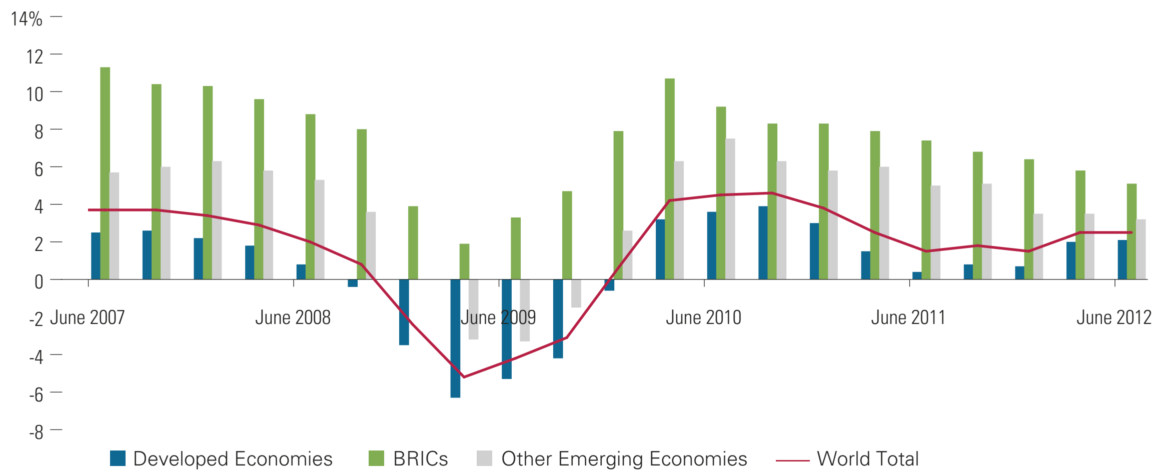
The sovereign debt crisis in Europe continues to have a negative impact on the economy. Great Britain, Italy, Spain, Portugal and Greece are among many economies now in recession, while Germany, France, Ireland, Switzerland and others are now producing only slim GDP growth. Unemployment rates have hit record highs in the euro zone, with the highest rates observed for the economies of Portugal, Italy, Ireland, Greece and Spain. More than 20% of Spanish and Greek and 15% of Irish and Portuguese civilians are unemployed.**

There is ongoing concern about the euro zone as some of the countries that borrowed heavily to fund fiscal stimulus after the global financial crisis, may struggle to repay their debt. The European Central Bank (ECB) has lowered interest rates and also announced further plans to intervene in bond markets through a new bond purchase program (see details in the International bonds section below). The euro zone's permanent bailout fund, the European Stability Mechanism (ESM), was approved in the German courts, despite prior strong opposition by Germany. The ESM, which replaces the temporary bailout fund, the European Financial Stability Facility, will provide initial aid of EUR 500 billion to troubled member states.

Emerging economies have slowed considerably in 2012 after driving global growth over the past five years – especially the BRICs (Brazil, Russia, India and China) which were the main drivers of growth (see figure 1). The biggest concern is the decline

* As measured by non-farm payrolls in the United States.
** FactSet data dated 28/8/12

Figure 1 World GDP growth by region (% change year-on-year)



Regional aggregates are calculated using real GDP weighted averages, fixed to 2010
Source: Factset data dated 30/9/12

in Chinese GDP growth from a peak of 12.1% in March 2010 to 7.8% in June 2012. Reduced fiscal stimulus introduced in 2008, and policies aimed at reducing property speculation have led to diminished growth. Aliaga Díaz believes that lower economic growth around 7 - 8% is more reasonable and indicative of a soft landing. If China's economy were to suffer from a hard landing then the risk for Australia and countries dependent on China's growth would be greater – but at this stage the biggest impact is being felt by the Australian mining companies that were undergoing major expansion plans on the back of China's demand for commodities. The impact of the slower growth in China is not likely to be felt in the non-mining sectors in the short term.

The release of low inflation data, led the Bank of China to cut a number of key interest rates in June and July. China has room for further monetary stimulus in the form of lower rates due to higher interest rates than in most other economies. China's leadership handover is expected to conclude in March 2013 with the change in government likely to have a strong impact on the future direction of the economy, and on the possibility of further stimulus.

The Australian economy

The Australian economy has continued to be resilient in 2012. Data for the 12-month period to June 2012 showed Australian economic growth steady at 3.7% (trend is 3.8%), inflation fell to 1.2%—below the Reserve Bank of Australia's (RBA) target band of 2-3%—and unemployment slightly weaker at 5.1% in August. As a result, the RBA has kept official interest rates on hold since June.[3] The sound fundamentals of the Australian economy indicate that it is in better shape than most developed nations.

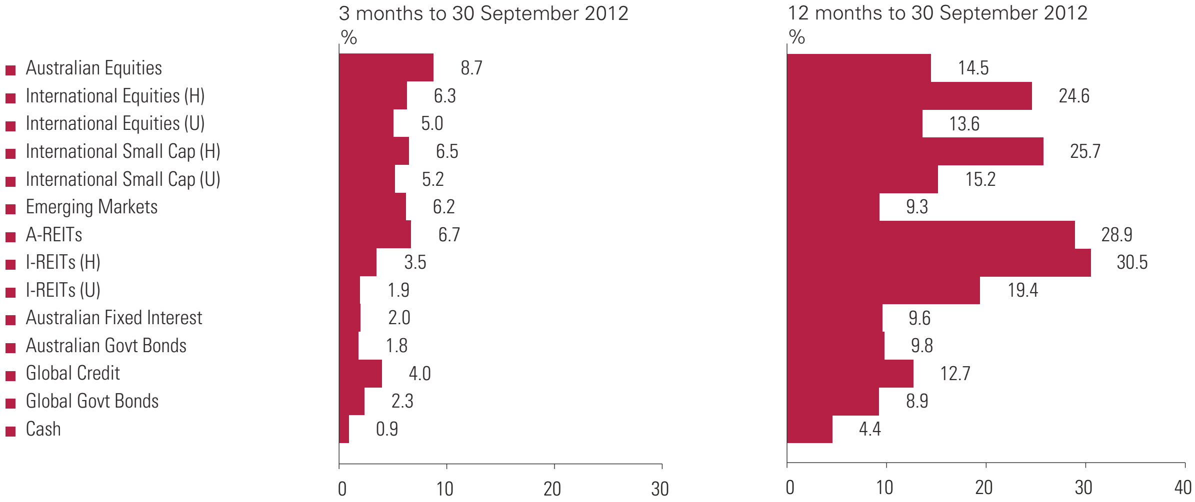
Commodity prices have fallen since their peak in early 2011. Iron ore prices jumped recently, up over 10% but are still over 40% down from a year ago. Crude oil prices are up over 20% for the quarter due to higher demand from the US and India. Coal prices have continued to be weak, down over 50% in the last 12 months, with BHP and Rio Tinto, among the major companies cutting back coal mining, citing weak prices, high costs and the strong Australian dollar affecting profitability.

Market summary

International equity markets

Global equity markets saw positive returns across most regions in the September quarter with the MSCI World excluding Australia up 5% and 6.3% hedged in Australian dollars. Investor sentiment was boosted by further ECB policy action that

Figure 2 Asset class performance



Source: FactSet data dated 30/09/2012, Barclays Live data dated 30/09/2012 included a lowering of key interest rates in July and the announcement of a new bond purchasing program in September. These actions are designed to improve borrowing conditions for debt-ridden euro zone members.

The MSCI Emerging Markets Total Return Index was up for the quarter, by 6.2% and year to date, by 9.3% – as all equity markets were helped by the measures taken to support the euro zone debt crisis.

Hedged returns, in particular, did better than unhedged returns in the year to date and also in the September quarter, as the Australian dollar continued to trade higher.

The Australian equity market

The Australian market was up 8.7% for the quarter ended 30 September 2012 and 14.5% for the year to date. The strongest sectors for the quarter were Information Technology and Health Care and for the year to date, Health Care and Telecommunications (see figure 3). The weakest performing sectors for the quarter included Consumer Discretionary and Utilities. Materials was the weakest for the year on the back of falling commodity prices, and softer demand. The major banking stocks have performed well this quarter, the largest contributors to the market's return and BHP has also been one of the larger contributors, despite the weaker outlook for exports of commodities.

International bonds

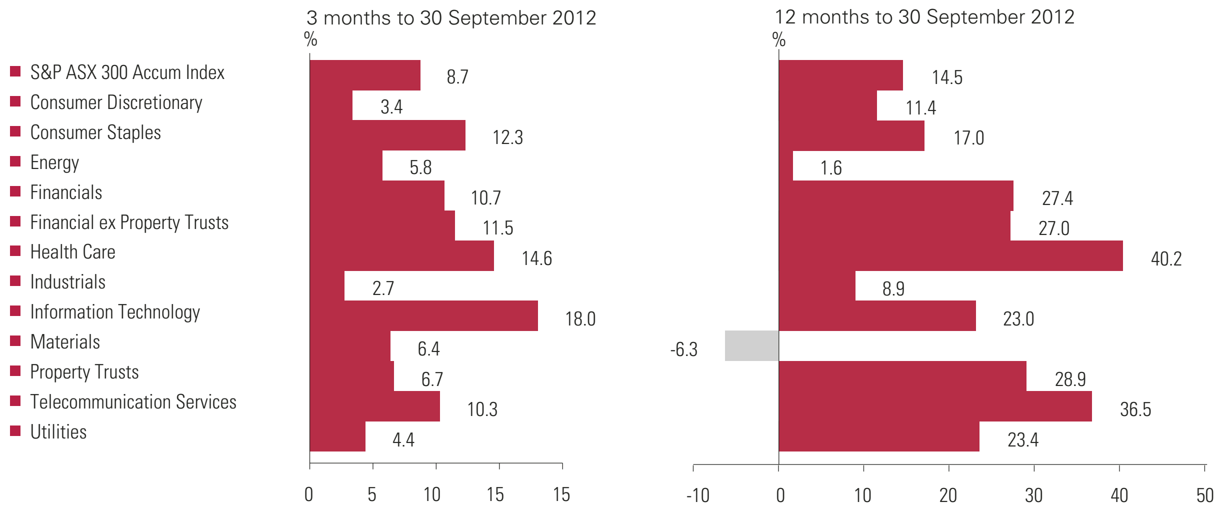
In many safe haven bond markets, bond yields hit historical low levels in late July because of investors' increased levels of risk aversion (see figure 4). Bond yields have bounced back somewhat since 26 July when the head of the European Central Bank (ECB), Mario Draghi, promised to do 'whatever it takes' to save the euro.

Draghi attempted to fulfil his promise in September when he announced fresh plans for intervention in euro zone government bond markets. The program, 'Outright Money Transactions' (OMT), involves the unlimited purchase of sovereign bonds with between one-to-three year maturity subject to debtor nations complying with a series of conditions relating to fiscal and economic reform.[4]

The ECB's actions are the result of the lack of success of past monetary policy which rendered interest rate cuts ineffective. The program also seeks to provide liquidity to crisis-ridden economies that have paid extremely high yields in recent times to borrow in the market. The high yields have caused debt repayments to climb making it nearly impossible for those economies to pay down debt.

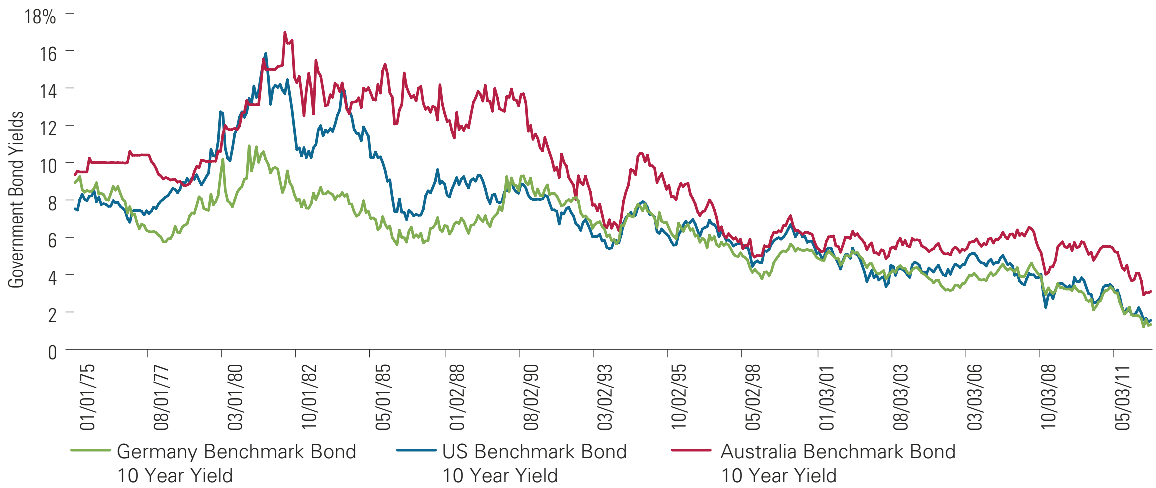
There is more optimism around the success of the latest intervention by the ECB. According to Vanguard chief economist in the UK, Peter Westaway, one of the major concerns is whether

Figure 3 Australian Equity Index sector level performance



Source: FactSet data dated 30/09/2012

Figure 4	Safe haven bond yields at historical lows



Source: FactSet. Data cover the period 1/1975 to 9/2012

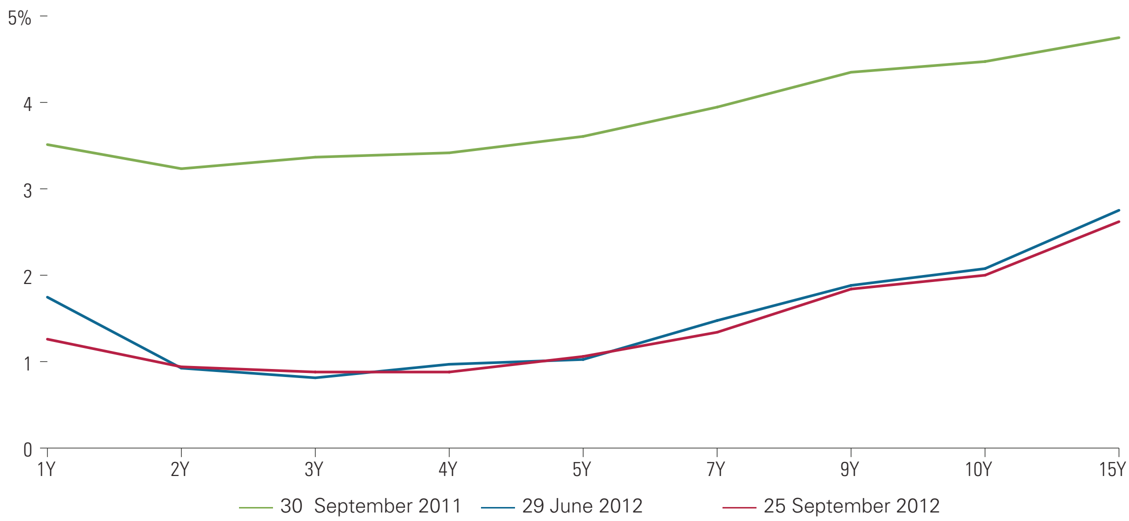
countries such as Spain ask for the support in the first place because of the stringent conditions that accompany the assistance including fiscal cuts and closer scrutiny of economic policy.

The Australian bond market

Domestic government bond yields across most maturities were almost unchanged for the quarter except at the short end (see figure 5). Another 25 basis points cut is being priced into markets. The high Australian dollar and relatively high domestic interest rates may not be supportive of the economy as the mining boom and capital expenditure peak. The Australian dollar has been helped by foreign net buyers of Australian Government bonds until the June quarter. Net buying by foreigners was nearly AUD 18 billion of bonds in the March quarter turning to net selling of about AUD 3.2billion in the June quarter– this is after foreign investors buying over AUD 50 billion in the previous 12 months or so.#

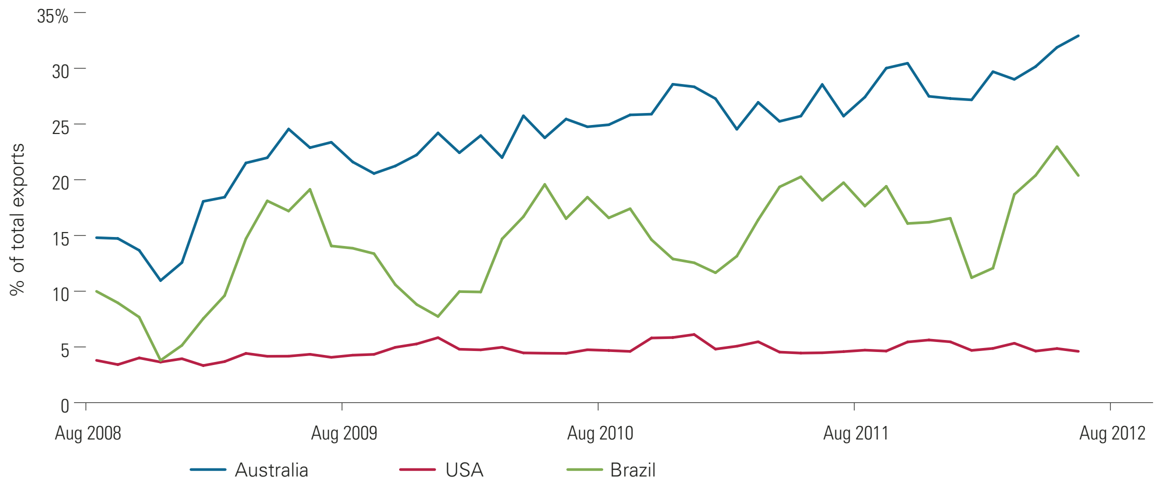
Australian Bureau of Statistics, 25/9/12

Figure 5	Australian Yield Curve



Source: FactSet data dated 30/09/2012

Figure 6 Exports to China



Source: FactSet data dated 30/09/2012

The rise and rise of China..?

A major underlying bolster to Australia's economy in recent times has been China's economic growth. The continual demand from China for resources, especially iron ore, has encouraged investment into mining related activities, which in turn has helped support economic growth. Although the mining sector contributed positively to GDP growth and all mining related activity is approximately 18% of total GDP (mining alone is about 7% of GDP), the services sector, which includes the financial services and health sectors, is also a major contributor at about 16% of GDP##.[5]

The slowdown in China's economy is due to monetary tightening by the Chinese government, endeavouring to engineer a soft landing. The Chinese economy had been showing signs of overheating with double-digit economic growth, fears of a property bubble from years of pent-up demand (locals have only been able to buy and sell property in the last 25 years) and, more recently, inflationary concerns and a 40% rise in food prices, impacting those least able to afford it. GDP growth has fallen from double digits to just over 7%. External forces such as the slowdown in Europe have affected China but for the most part slower economic growth has been self-induced.

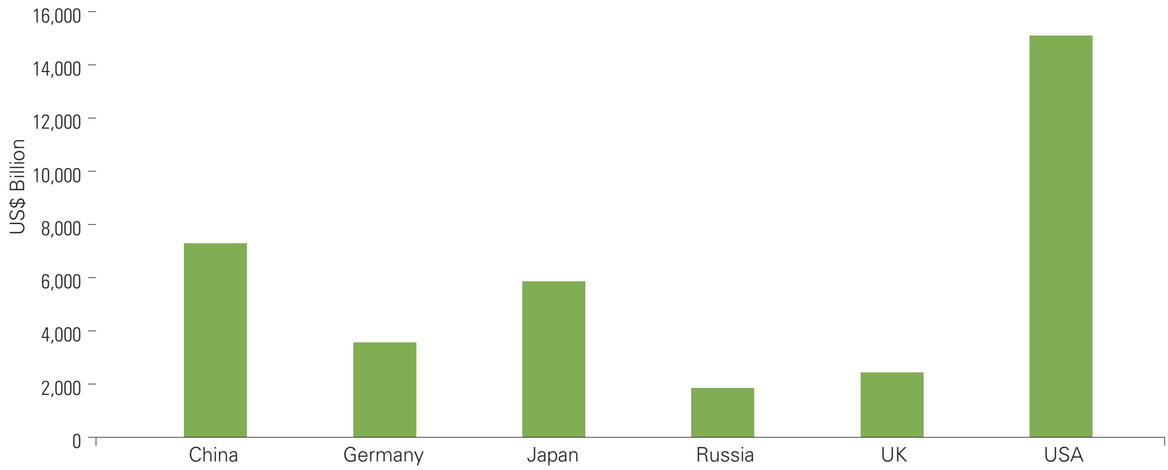
Australian Bureau of Statistics (September 2012)

Not only does Australia depend on the growth of China's economy (exports to China are over 25% of total exports) but many other countries are exposed to China, through trade. Brazil, which has seen a strong economy on the back of exports to China, is also showing signs of slowing Chinese demand with falling exports to China (see Figure 6). The US is less exposed to a weaker China with exports to China remaining constant in the last five years at around 5% of total exports.

The recently announced infrastructure projects have been seen as positive but the future direction of the economy and further economic stimulus will be determined by the incoming government. The ongoing emergence of China as an economic power is based on forecasts that China's economy will be 18% of the world economy^, the biggest economy in the world by 2030; double that of the US economy, currently the largest based on size (see Figure 7).[6]

Factors that contributed to China's rise to a global economic powerhouse are its land mass, population and the rapid industrialisation from communism. But challenges such as an ageing population may result in a skills shortage and affect China's progression up the supply chain to higher value added industries[7]; and the political environment may cause setbacks if the lack of democracy and freedom result in a backlash against the government, or vice versa (as we saw during the Tiananmen Square protests of 1989).

Figure 7 Size of economy in 2011, USD billion^



^ Weighted by world share of GDP, trade, and net capital exports

Source: The World Bank data for 2011, dated September 2012

Events over the last fifty years, have seen the emergence of other economic 'powerhouses' such as, Russia, and Japan, but their subsequent political and economic demise prevented them achieving longevity. The success of China depends on many factors including economic management and politics.

There is some evidence, that infrastructure expenditure may previously have been supported to maintain moderate growth - resulting in ghost cities that now sit empty. Infrastructure expenditure has fallen from growing at 40% to now only growing at 2%.[8] There is also a degree of scepticism about the economic numbers that are released by the Bank of China (remembering that China's GDP data has only been made public in the last year).

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^ Weighted by world share of GDP, trade, and net capital exports

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