MACQUARIE FUNDS GROUP
Economic Commentary
December 2008

Market highlights for the month were:

- Global equity markets were volatile but finished the month little changed, while global bond markets rallied.
- The most notable development was the US Federal Reserve's mid-month move to an effective zero interest rate target and the adoption of non conventional policy instruments. The remaining G7 central banks all made major cuts.
- Data on the real economy continued to be weak in developed economies with the US Payrolls printing an astonishing -533K fall in November. Elsewhere, Chinese industrial production data displayed an appreciable slowing.
- In Australia, the RBA met markets expectations and cut rates by a further -100bps to 4.25%. Analysts expect significant further RBA easing in 2009.

Global equity markets were volatile over December, though finished the month little changed.

While currency markets were choppy, the USD ended the month lower while a sharp fall in UK cash rates also saw sterling weaken sharply into year end.

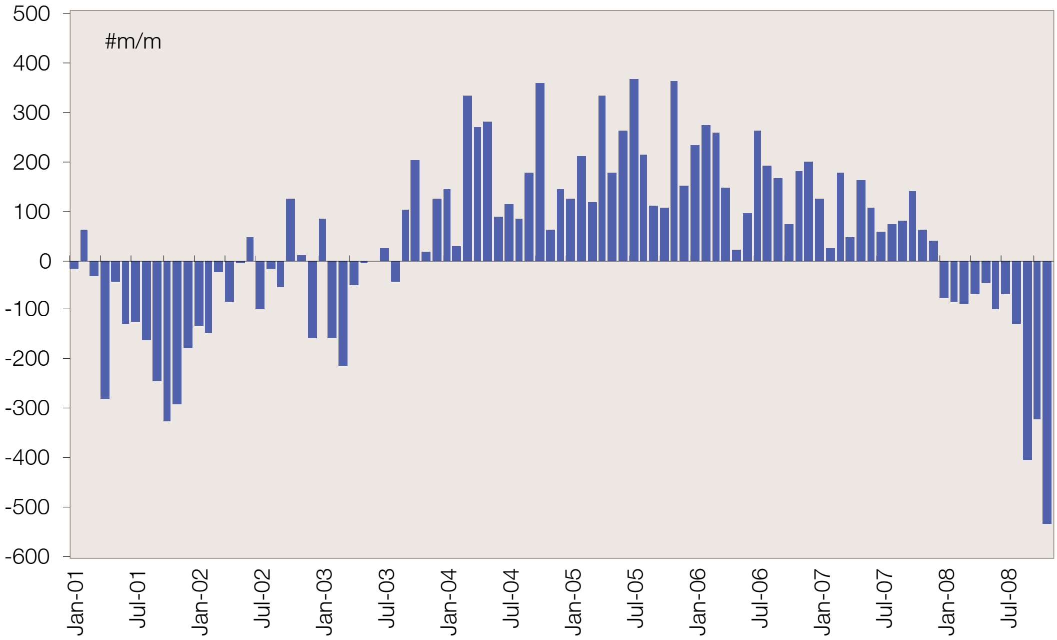
Meanwhile global bond markets rallied as central banks made further sizeable cuts to policy rates and governments introduced additional measures aimed at alleviating market dislocations.

The most notable economic development in December was the US Federal Reserve's mid-month move to an effective zero interest rate target (officially the Fed Funds rate now sits in a band of 0.00% to 0.25%). This has necessitated the Fed to adopt non conventional policy measures, though it appears unlikely they will adopt a monthly reserve target like that seen in Japan earlier this decade. In the months ahead, the Fed will buy debt securities to support the mortgage and housing markets and further ahead, they are considering the purchase of long-dated Treasury securities to aid market liquidity and ensure the economy benefits from the current historically low level of short term rates. Such seemingly drastic Fed action came against the backdrop of continued financial market dislocations and the consequent effects on the real economy. Other central banks also saw it necessary to make outsized policy moves in the month, with the Bank of Japan also returning to an effective zero rate.

In the US, another significant event was the Bush Administration's announcement it would use $13.4bn of TARP funds to bailout US automakers in the form of 3-year discounted rate loans to Chrysler and GM, conditional upon significant restructuring taking place. In addition, speculation over the form of the new Obama Administration's fiscal package gathered momentum. Analysts suspect it will be worth as much as US$1 trillion and will include substantial personal income tax cuts and public infrastructure spending.

The negative feedback loop from tighter credit conditions to the broader real economy has become apparent in recent months as data continues to weaken in major developed economies. In the US, non-farm payrolls shocked the market falling by -533K jobs in November, a loss more than double that seen in the previous month. Housing data was also surprisingly weak, with starts and permits plunging to new lows thought to be well below measures of underlying demand. Falling crude oil prices saw gasoline and headline inflation fall in the month, providing some support to households in the face of weaker incomes and asset prices. Households continued to repair their balance sheets with the savings rate rising further in the month, providing banks with some much needed liquidity. Finally, both ISM surveys fell further, signalling further declines in US production in the December quarter. Together the weak data prompted analysts to undertake a significant reassessment of 2009 growth prospects, such that the consensus now expects the worst recession since the early 1980s to occur.

US - Non-Farm Payrolls



Data in other developed economies also remained weak. Business surveys across the euro area and UK are suggestive of a prolonged period of weakness in industrial production, while consumer confidence measures point to lacklustre household spending. In Japan, business investment outlook deteriorated as leading indicators plunged in the month. There was further evidence that emerging economies are also in the midst of a slowdown, albeit a relatively benign one at this stage. Chinese industrial production growth has slowed significantly; however, Chinese authorities are responding quickly to the slowdown by undertaking several measures, most notably the abolition of lending quotas previously strictly imposed on domestic banks.

In Australia, the RBA met market expectations in December and cut rates by a further -100bps to 4.25%. Analysts expect significant further RBA easing in 2009. The Rudd Government also announced further fiscal stimulus in the form of infrastructure spending. Since the collapse of Lehman Brothers, Australian policymakers have responded with significant stimulus measures, which coupled with the depreciation in the Australian dollar, should provide significant support to the economy. However September quarter GDP data released in the month, showed subdued household spending and net exports. Higher frequency monthly data showed a continued slowing in employment growth, and weaker business confidence. On the positive side, interest rate cuts appeared to have gained traction in the economy with consumer confidence strengthening and housing mortgage approvals strengthened for the first time in ten months.

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