June Quarter 2009 Review & Outlook

Australian
The Australian economy is proving resilient thus far, with the economy yet to officially enter recession (two negative quarters of economic growth).

The Government is likely to continue providing fiscal stimulus to help buffer the fall in private demand that is expected. It is expected that the Budget will stay in $50-60bn deficit (representing 5-6% of GDP) for some time, as tax revenues decline as a result of slower growth and spending increases.

The slowdown in economic growth is likely to have an impact on the unemployment rate. The unemployment rate is expected to climb to 7.0% during the year and 8.5% in 2010.

All in all, the Australian economy is likely to perform better than most developed economies, primarily because its financial system is stable and Public debt levels are low. Expansionary fiscal and monetary policy is likely to be effective in cushioning the economy. However, the severity of the global recession and global credit crisis will still have a major impact, so a mild to moderate recession has to be expected. Expectations are for the Australian economy to contract by 1% over FY10.

Global
While the global economy and financial markets appear to be on the mend, many commentators and research houses are wary of the high debt levels that now burden both the private and public sectors of Europe and the US. While China is a net surplus country and is expected to continue growing during 2009, it is unreasonable to expect China alone to rescue the global economy. It is expected that the global recession will deepen over FY 2010, stabilising in 2011.

Credit conditions are likely to remain tight, with bond yields expected to rise over 2009/2010.

Deflation is more likely to occur in the short to medium term due to a build up of excess capacity. The risk of inflation may increase later, largely due to 'money printing', notably by the US.

Commodity prices are likely to remain subdued until production is cut back to meet lower levels of demand. However, prices could rise in nominal terms, if the US further increases money printing.

Australian Shares
The Australian share market (as measured by the S&P/ASX 300 Accumulation Index) recorded a solid return of 11.5% for the June quarter.

Despite this recent market optimism, it would be mindful to remain cautious about the outlook for local equities, investors still face the prospect of a slow and long road to recovery.

Central to this cautious view is the large amount of equity capital raised and its dilutive impact on EPS and DPS in the short term. In addition, the domestic market may have further downside if earnings decline by more than expected in 2009 and 2010. The upcoming FY09 reporting season in August will therefore be a key to providing further clarity around these issues. This will be the time to reassess the outlook for Australian equities.

Global Shares
Over the quarter, global shares returned 3.8% (as measured by the MSCI World ex Australia Index in $A).

Many remain sceptical of the likelihood of a quick recovery in the US economy and view the recent rally in equity markets as unsustainable. It is still too early in the macro-economic cycle to see a recovery in the US economy and hence company earnings.

Global & Australian Listed Property
Domestic REITs returned 16.2% for the quarter. While valuations are attractive on certain A-REITs, the sector continues to face a number of issues primarily concerning gearing, refinancing and bank covenants. For many A-REITs these issues have been exacerbated by derivative contracts to interest rate movements.

Global REITs returned 24.1% for the quarter. Many research houses and analysts believes that the global property sector is generally undervalued. However, for this value to be realised, a significant positive catalyst will be required.

Over the long term, the global property securities sector is expected to deliver solid high single-digit returns. The volatility currently seen in the sector may see returns over the short term materially above or below this forecast. This period will extend if the major global economies continue to deteriorate further.

Global Fixed Interest
Global fixed interest returned 2.2% for the quarter. The investment case for global bonds remains unattractive, given yields range from 3.5% on US 10 year bonds to 4.3% on 30 year issues. The return seems inadequate given the supply of most issues will increase dramatically as governments issue debt to finance ballooning budget deficits.

Australian Fixed Interest
Australian fixed interest returned -1.3% for the quarter. The long end of the yield curve has begun to rise, with 10 year bonds currently at 5.5%, up from their lows of 4.0% earlier in the year. Bond yields have the potential to rise even though inflation is likely to be a non-issue in the short term.

Given bond yields have already risen a touch and corporate bond yields are still relatively high (post credit crisis), many research houses and analysts see reasonable value in Australian bonds but warn that we could see higher government bond yields yet (hence bond prices would fall).

Cash
Cash returned 0.8% for the quarter. The official cash rate is down to 3.0% and the RBA looks to be on hold in the short term.

There are many spectators that expect the RBA will need to cut by another 50bp before the end of 2009, just to keep interest rates from rising as the economy weakens. Looking ahead, the expectation is that investors will have the opportunity to increase exposure to bonds and equities, when the risk/reward trade-off becomes more compelling.

Australian Economy
The Australian economy is proving resilient thus far, with the economy yet to officially enter recession (two negative quarters of economic growth). However, the last four quarterly growth figures of 0.4%, 0.2%, -0.6% and 0.4%, clearly show the economy is slowing. Another negative result in the June 09 quarter will confirm Australia is effectively in a mild recession.

The Reserve Bank of Australia (RBA) and the Federal Government have moved quickly to counter the negative effects of the global credit crisis and evolving global recession. The RBA has moved swiftly to cut the cash rate by 425bp to 3.00%, over a period of eight months, while the Government has implemented two stimulus packages equivalent to $52bn, or 4-5% of GDP. In addition, the Government has continued to lower income tax rates and provide deposit/debt guarantees for the Australian banking system and State Governments. The RBA has also been active in providing increased liquidity for the banking system.

How deep will Australia's recession be?

To date, Australia seems well positioned relative to most developed economies. Consider these positives points;

- The Banking system is stable and functioning;

- Monetary policy has been more effective in Australia – borrowing rates have come down with the cash rate;

- The Government is in a relatively strong financial position to provide fiscal stimulus;

- The unemployment rate remains relatively low, at 5.7%;

- House prices have proven fairly resilient to date;

- The oil price decline has kept led a on petrol prices and inflation is now declining; and

- China (our major export partner) seems to be still growing.

During FY10 it is likely the RBA will continue to cut the cash rate, given the deteriorating global outlook and to ease the pressure on Australian banks to increase loan rates in response to rising funding costs. It is expected that the cash rate will fall to 2.50% by year end. The Government is also likely to continue providing fiscal stimulus to help buffer the fall in private demand that is expected. The budget will likely stay in $50-60bn deficit (representing 5-6% of GDP) for some time, as tax revenues decline from slower growth and spending increases. Note the Government will be going into deficit from a position of relative strength (relative to most developed countries), in that current public debt levels are negligible relative to GDP.

What then are the negatives that could lengthen and deepen the recession? The global credit crisis has led to tight credit market conditions, falling asset and commodity prices and a deep recession across OECD countries. The Australian share market is down around 45% from its November 07 highs, wiping $700bn in value (hence investor wealth) from market capitalisation. So far the Australian housing market is proving remarkably resilient, but with house prices falling in most OECD countries, many economists are worried the relatively expensive Australian housing market could succumb if unemployment rises. Concern about falling asset prices is having a major negative impact on consumer and business sentiment.

While consumer spending is holding up reasonably well (most probably due to Government cash handouts), business investment is falling sharply. The banks have reduced mortgage rates, but business lending rates still remain relatively high as the banks seek to increase interest margins. This could be self-defeating if business investment continues to slump.

Another area of weakness, moving forward, will be trade or net exports. As iron ore and coal contracts roll over to much lower prices (down between 30-40%), Australia's export income will fall markedly, as will Government tax and royalty revenue. The Qld, NSW and WA state economies will all come under pressure, as the boom in iron ore and coal prices fades.

Australia's current account deficit betrays a large foreign debt position. Most of the current account deficit relates to interest payments going offshore on net foreign debt, totalling A$678bn. Australian banks and companies have borrowed most of this debt and it will need to be refinanced or repaid in coming years. The global financial crisis has made this task much harder and the Government has already had to lend its AAA rating to the banks to help them roll their debt, while Australian companies will increasingly need support from Australian debt markets to replace their foreign debt.

All in all, the Australian economy is likely to perform better than most developed economies, primarily because its financial system is stable and public debt levels are low. Expansionary fiscal and monetary policy is likely to be effective in cushioning the economy. However, the severity of the global recession and global credit crisis will still have a major impact, so a mild to moderate recession has to be expected, many commentators have an outlook on the economy to contract by 1% over FY10.

1.3% over 2009 and a recovery of 1.9% over 2010. Developed economies (which represent about 65% of global GDP) are expected to contract by between -3.0 to -3.5% over 2009, while developing economies (35% of global GDP) are expected to slow significantly but still grow by between 1.5 to 2.5%. The IMF expects a weak recovery in developed economies and a moderate recovery in developing economies.

The US looks to be in a severe recession, with the last two quarterly GDP figures showing the economy shrinking at a rate of around 6.0% pa (annualised). The unemployment rate has increased to 9.6% (the highest since 1983), with payrolls falling at a rate of around 500,000 people per month. The financial crisis has wiped out a great deal of US wealth, with the S&P500 down around 45% and house prices down on average 33%, since the peak in 2007. US consumers have, not surprisingly, gone into their shells and are seeking to pay down debt. The savings rate in the US has jumped to 5.7% — the highest level since 1995. This is bad news for US consumption, which had grown to represent over 70% of the US economy. With consumption in decline, production in the US (and globally) has to be cut and jobs are being lost in huge numbers.

Fiscal and monetary policy have been turned to maximum stimulus, with the US Federal Reserve cutting interest rates to zero and printing money to buy US mortgage backed securities and US bonds, in an effort to keep a lid on mortgage rates. The Federal Government is spending huge amounts supporting the financial system and the real economy and is expected to run a budget deficit exceeding US$2trillion, or 14% of GDP. These efforts seem to have stabilised the US economy in the short term.

However, the bigger picture is that the US economy is heavily indebted, with US$42 trillion in debt across the private sector and US$10 trillion in debt across the public sector, against an economy worth US$14 trillion. The US has many years of low growth ahead, as consumers reduce spending to pay down debt and the Government will eventually have to reduce spending and/or increase taxes to pay down debt. The IMF forecasts the US economy to contract by 2.8% over 2009.

Europe does not look much better than the US, with its two most recent quarterly GDP figures suggesting the economy is shrinking at a faster rate than the US, at around 8.0% pa (annualised). Unemployment in Europe (currently at 9.5%) also looks likely to exceed 10% by the end of 2009. It seems the member states outside France and Germany have deeper economic troubles, particularly Ireland, Spain, Italy, Greece and various Eastern European states. The ECB has cut the cash rate to 1.0% and, like the US Federal Reserve, is embarking on some limited ‘quantitative easing’ (purchase of bonds to try and keep bond yields low). However, Europe still seems reluctant to investigate the solvency of its banks, particularly those with Eastern European exposure, while Germany seems very reluctant to provide fiscal stimulus. This complacency could hinder the Euro zone’s recovery.

The UK seems to be acting more decisively than Europe, but is still in a deep recession because debt levels are higher and the decline in the housing and financial sectors has been greater. The BOE has slashed the cash rate to 0.5% and is also engaging in ‘quantitative easing’, while the Government has been busy providing support for the banking sector and the real economy, with a £20bn fiscal stimulus package. The Government’s Budget deficit is set to rise to £118bn (12% of GDP) over the year. The IMF expects European growth to decline by 4.8% and the UK economy to shrink by 4.7% over 2009.

The Japanese economy shrank an alarming 4.0% (16.0% annualised!) in the Mar 09 quarter. Export volumes have declined sharply and the Yen has strengthened, causing major problems for the export dependent economy. The Nikkei sank 24% over FY09 and the recent Tankan survey reported that business confidence has fallen to record lows. The Bank of Japan has cut interest rates to 0.1% from 0.3% and the Government is mulling over a new stimulus plan although, with a public debt to GDP ratio of 165%, its options are limited.

Deflation will probably re-emerge as a problem for the Japanese economy during 2010. The IMF expects the Japanese economy to shrink by 6.8% over 2009.

China has moved decisively to head off the collapse in global trade that has harshly affected similar export-dependent economies like Japan, Korea and Germany. The Chinese Government released a 4 trillion Yuan (US$585bn) stimulus package that is focused on stimulating internal consumption and investment. At the same time, Chinese State owned banks lent US$1.2 trillion in the first six months of 2009 — more than was lent over the entire 2008 year! There are signs this massive stimulus is indeed boosting economic growth, but there are concerns about its sustainability. The IMF expects China's economy to grow by 8% over 2009.

Review

The Australian share market (as measured by the S&P/ASX 300 Accumulation Index) rose by 11.5% during the quarter, recouping some of the market's losses over the last year. For the 12 month period ending 30 June 2009, the benchmark returned -20.3%.

Compared to the four major international regions, the Australian share market underperformed during the June quarter. In local currency terms Asia, Japan, Europe and the US posted returns of 24.6%, 20.2%, 15.5% and 16.1% respectively. However, over the year to June Australia fared better, outperforming Japan (-30.0%), the US (-27.0%), and Europe (-24.8%). Australian shares lagged relative to Asia though, with the latter declining a less severe 13.5%.

The Australian share market trended sideways for much of the quarter, before a mini rally in late May and early June pushed the S&P/ ASX 300 index temporarily through the 4000 barrier.

The share market's mild recovery was driven largely by improved investor sentiment and confidence that the worst of the global financial crisis had passed. In particular, the Australian economy continued to hold up relatively well (compared to global peers), having avoided a technical recession and with 1Q 2009 GDP figures surprising on the upside. The government's aggressive fiscal stimulus, combined with declining interest rates, also had the desired impact in stabilising the economy, for the short-term at least.

By quarter's end, the share market's positive return was a welcome relief for investors after six consecutive quarterly declines. However, the sustainability of the recovery remains the key issue for investors going forward and many believe that earnings risk remains to the downside. For investors, the upcoming full year reporting season in August 2009 will provide a further signal as to the state of corporate earnings and future growth prospects.

In company news, there were a number of capital raisings during the quarter (at various discounts to market price), as companies continued to seek to reduce net debt and improve their capital structures. To date, 14 of the top 20 ASX listed companies have raised a total of approximately $35 billion in capital over the course of 2008/2009, with the exceptions being BHP, WOW, TLS, WPL, ORG and FGL.

Two of the more notable capital raisings were those announced by ANZ and RIO.

ANZ was the last of the big four banks to raise capital via its $2.5 billion institutional placement and retail share purchase plan. The raising is intended to allow the company to pursue strategic growth opportunities and strengthen its balance sheet.

RIO's $15 billion rights issue was at a significant discount of 57% to market price and will enable the company to repay its debt obligations. In addition, RIO also announced that it had signed an agreement with BHP to establish a production joint venture in regards to their Western Australian iron ore assets. The joint venture is expected to provide cost and strategic synergies. RIO subsequently also announced the transaction with Chinalco would not be pursued.

In terms of merger and acquisition activity, Kirin's proposed takeover of Lion Nathan was approved by the ACCC during the quarter, while CSL had its takeover proposal for global biotechnology company, Talecris Biotherapeutics Inc, blocked on competition grounds by the US Federal Trade Commission.

Stock Performance

There was a wide dispersion in returns between the best and worst performing stocks over the course of the financial year, highlighting the importance of stock selection, particularly during periods of high volatility. The five best performing stocks in the ASX 50 (in terms of share price movement) for the financial year ending 2009 were:

- Lion Nathan (35.3%)
- Coca Cola Amatil (22.8%)
- ASX (17.8%)
- Toll Holdings (15.8%)
- Woolworths (7.8%)

The top two performing stocks for the financial year operate within the Food Beverage and Tobacco industry (sub industry of Consumer Staples). In addition to their earnings proving to be relatively resilient throughout the economic downturn, which underpinned their respective share prices, both Lion Nathan (LNN) and Coca Cola Amatil (CCL) were also beneficiaries of consolidation within the sector. In the case of LNN, its share price surged following a takeover proposal by Japanese brewer Kirin. Kirin's cash offer of $12.22 per share was at a 47% premium to the prior closing price of $8.31. Prior to the takeover by Kirin, LNN had made a bid for CCL earlier in the year.

The five worst performing stocks in the ASX 50 (in terms of share price movement) for the quarter were:

- Bluescope Steel (-72.2%)
- Fortescue Metals (-68.2%)
- GPT (-66.6%)
- Leighton Holdings (-53.3%)
- Rio Tinto (-51.2%)

The materials sector, in general, was hit hard by the downturn in economic growth and decline in demand for commodities over the course of the year ending June 2009. At the stock level, BlueScope Steel (BSL) which was forced to raise capital at a 40% discount to strengthen it balance sheet, and Fortescue Metals (FMG) which had some production set backs in regards to its Pilbara iron ore project, were two examples of stocks that were hit hardest by the slowdown.

Sector Performance

All but one sector of the market posted a negative return for the financial year. Information Technology was the best performing sector, rising by a modest 1.0% over the year, with performance driven by the sectors' two stocks, Computershare and Iress.

The Healthcare and Consumer Staples sectors were the two next best performing sectors, posting returns of -3.0% and -7.0% respectively. These sectors benefited from investors seeking relative 'safe havens' or companies with 'defensive' characteristics. RMD, RHC and COH were examples of stocks that performed relatively strongly during the year, helping to offset some of the losses in larger cap healthcare stocks such as CSL and SHL.

The Materials and Industrials sectors were the worst performing sectors during the year, returning -35.0% and -34.0% respectively. Both sectors make up a large portion of the overall Australian market and contributed to the overall declines over FY2009.

Outlook
Research Houses and Analysts remain cautious about the outlook for local equities, believing investors still face the prospect of a slow and long road to recovery which is reflected in a "Slightly Underweight" position to domestic equities. Whilst the local market has more than likely seen its lows in March and that economic conditions stabilised in the second quarter of 2009, there are a number of key issues that need to be considered before increasing the allocation to Australian equities.

Central to this cautious view is the large amount of equity capital raised and its dilutive impact on EPS and DPS in the short term. In addition, the domestic market may have further downside if earnings decline by more than expected in 2009 and 2010. The upcoming FY09 reporting season in August will therefore be a key to providing further clarity around these issues.

The extent of the market's correction from its peak implies that Australian equities are trading on a forward market Price to Earnings Ratio (PER) of around 12-13x, versus an historical average of 14x. Whilst the market would appear cheap based on valuation alone, factors such as those mentioned above and the potential for rising bond yields (which would be a negative for equities) as a result of rising fiscal deficits across the OECD, continue to outweigh the benefits of a broad based move back into equities at this time.

The financing environment for many companies remains challenging in the near term. However, quality companies with strong balance sheets should be well positioned to survive this difficult period.

Review
Over the quarter, global shares achieved a modest gain, rising by 3.8% (as measured by the MSCI World ex Australia Index in $A). Pleasingly, the rise was global in scale, with all major regions delivering positive returns in local currency terms.

The 12 months ending 30 June 2009 paint quite a different picture, with regional share markets all posting negative returns. Global shares declined 16.3% over the year, with Japan, the US and Europe declining 30.0%, 27.0% and 24.8% respectively. Asia fared the best and fell by a less severe 13.5%.

There has been a recent encouraging, albeit moderate, improvement in market sentiment. However, overall conditions remain clouded and are expected to remain so in the near term.

United States
US shares rose by 16.1% (local currency) over the quarter. The US economy has been in recession for the better part of 18 months, but there are signs that the Administration's fiscal policy may be starting to take effect. US consumer confidence improved in May and has continued to rise from its record lows in February as the Government's stimulus injection spurred a rise in consumer income. Whether this proves to be a 'false dawn' is a matter for conjecture and the economy continues to be adversely impacted by a number of headwinds, including a weak labour market which could derail the pace of recovery. US unemployment is at 25-year highs.

Europe
Similar to their US counterparts, European investors experienced an improvement in fortunes over the quarter, with European markets registering a rise of 15.5% (local currencies). Similar themes weighed on Europe, as rising unemployment across the Euro zone dampened consumer confidence and spending. Unemployment in Europe is the highest in a decade, with Spain, for example, grappling with an unemployment rate of close to 20%. Counteracting this issue remains a key policy agenda item for most governments.

Japan
Japanese shares rose by 20.2% (local currency) for the June quarter, as consumer sentiment was buoyed by Prime Minister Aso's stimulus measures, which included a cash handout of 12,000 yen for every resident. This result was achieved despite Japan's unemployment rate reaching a five-year high in May. However, on a brighter note, industrial production increased for the third consecutive month in May, signalling the economy may be breaking free from the depths of its worst post-war recession.

Asia
Asian shares recorded the best gains among regional markets, rising by 24.6% (in local currency terms) for the quarter. In an encouraging sign for global investor confidence, net inflows to emerging market equity funds were close to US$27 billion in the second quarter of 2009, an all-time record. There is a mounting view that emerging markets, and notably Asian economies like China, will recover faster than developed economies. Those investors seeking exposure to higher growth markets and companies appear to be increasing their allocation to emerging equities at the expense of developed equities. The relative success of this 'call' will depend on the ability of Asian markets to withstand the ongoing soft demand for their products and services from developed markets.

Currency
During the quarter the Australian dollar (AUD) appreciated against all of the major currencies (USD, EUR, JPY, GBP). Positive currency movements typically increase returns for hedged AUD investors; however dampen returns for unhedged AUD investors. Over the quarter the AUD appreciated against the USD by 18.1%, the EUR by 10.8%, the JPY by 15.2% and GBP by 1.4%.

The AUD closed the quarter at US 81.14c, substantially higher than the March 2009 close of US 68.73c. However, the AUD remains significantly below the peak of almost US 98.5c achieved in mid-July 2008.

The strong rally in the AUD was supported by generally lower volatility in currency markets and a rise in overall risk appetite. The currency was particularly strong in May, rising 10.4% against the USD during the month, as sentiment turned against the US. In particular, concerns increased regarding the growing level of US government debt. The RBA elected to hold interest rates firm in May and June which, combined with better than expected data, rising equity markets, narrowing credit spreads and overall lower market volatility, instilled further confidence in the AUD.

That said, the AUD was more volatile in June as it fluctuated on concerns about global growth. This serves as a reminder that, whilst there is some confidence in the "green shoots" of recovery, confidence remains a fragile commodity.

The direction of the AUD will largely be dependent on the direction of interest rates, commodity prices and the relative strength of the USD. It should be noted that the AUD is within one standard deviation band of its long-run average.

Outlook
Despite the recent improvement in global equity performance, lingering doubts remain regarding the pace of global economic recovery, which will likely continue to weigh on investor sentiment. While it seems that the darkest days of the recession may be behind most economies, aided by government and central bank stimulus programs, there continue to be a number of challenges for economies to contend with. These challenges include labour market weakness, subdued corporate earnings and anaemic profitability. While emerging market equities have enjoyed a recent minor recovery, mainstream global equity portfolios are dominated by the large deficit economies such as the US and Europe and it is here that economic problems are the most ingrained. Given this, it is difficult to confidently make a case for an increased allocation to global shares.

The global financial crisis is likely to restrain company earnings and constrict global economic growth. While the P/E for the global market has come down, the forward looking earnings part of the equation remains uncertain.

Review: A-REITs

The S&P/ASX 300 A-REIT Accumulation Index posted a total return of 16.2% for the June 2009 quarter, outperforming the broader domestic equity market by 4.7%. The strong performance of the A-REIT sector was largely due to its largest stock, Westfield Group (WDC), rising 13.2%.

While 'safe haven' stocks had been the best performing A-REITs in previous quarters, there has been a distinct change in market sentiment in recent months. A number of 'risky' stocks bounced back strongly in the June 2009 quarter. For example, the stock prices more than doubled for Macquarie DDR Trust (MDT), Tishman Speyer (TSO), Centro Retail Group (CER), Valad Property Group (VPG) and Macquarie Countrywide (MCW). The rally was long overdue and many smaller A-REITs are still trading at very large discounts to their Net Asset Values.

The worst performing A-REITs were Commonwealth Office Property Trust (CPA) and Aspen Group (AEZ), which were the only two stocks in the sector to deliver negative returns over the quarter.

Capital raisings continued to occur, with GPT (GPT), Stockland Group (SGP), Bunnings Warehouse Property Trust (BWP) and Charter Hall (CHC) raising substantial amounts of equity in recent months.

Outlook: Australian REITs

Potential catalysts, which may mark the 'beginning of the end' of these tumultuous times, will include further corporate activity and an increase in physical real estate asset sales.

While capitalisation rates have softened in the direct property market, they have not come under the same pricing pressure as the A-REIT sector. Hence, investing in A-REITs now appears a cheaper way to gain exposure to commercial property markets.

While it is possible that further dilutive capital raisings may continue to hamper A-REIT returns, this has become less likely given the significant amount of equity that has already been raised.

Many commentators hold the view that A-REITs with conservative gearing, a focus on quality domestic assets and no exposure to funds management and major development activities, are likely to continue to provide 'safe havens' over the short term.

Despite the recent rise in the stock price of some 'risky' A-REITs, many smaller stocks could easily see their stock price double again over the next 12-24 months, given the large discounts to Net Asset Value that still exist. However, there is also a real risk that a number of smaller stocks may fail.

A-REIT returns will depend heavily on the broader economic environment and in particular, the availability of credit and physical real estate sales. Given the level of economic uncertainty that still exists, high volatility is likely to persist throughout the remainder of 2009.

While valuations are attractive on certain A-REITs, the sector continues to face a number of issues, primarily concerning gearing, refinancing and bank covenants. For many A-REITs these issues have been exacerbated by derivative contracts to interest rate movements.

Investors should also be cognisant of the concentration issues in the A-REIT sector. As at 30 June 2009, Westfield represented around 45% of the S&P/ASX 300 A-REIT Index. While having a large portion of the portfolio invested in Westfield will result in returns that more closely resemble the S&P/ASX 300 A-REIT Accumulation Index, it also clearly increases the concentration risk. This is a potential weakness of the A-REIT sector, as the returns of most funds will suffer if Westfield Group either delivers negative returns, or if the stock underperforms the sector.

Review: Global REITs
Global listed real estate returned -38.4% in local currency terms over the 12 months to 30 June 2009.

Global real estate posted poor returns in 2008 (-43%), reflecting declining asset values and a deteriorating outlook for rents and vacancies. However, since early March 2009, the sector has moved away from pricing in a 1930s-style depression with no recovery in sight, to a position where investors have been prepared to look through the trough in the cycle and take on more risk.

With investors looking at taking on more risk, defensive REITs (categorised as 'Investors' in the chart below) have underperformed 'Developers' over the recent quarter.

The deterioration of fundamentals such as rents, vacancies and income has begun to impact earnings and is expected to flow through in coming quarters. There could potentially be a fall in price of the medium and smaller REITs, where balance sheets remain highly geared and interest covers are tight.

Over the calendar year to date, the worst performing regions were Australian and UK Investor stocks. The best performing region was Hong Kong, driven by its strong developer exposure.

Outlook: Global REITs
Many believe that the global property sector is generally undervalued. However, expect that for this value to be realised, a significant positive catalyst will be required. In the mean time, negative sentiment will continue to drive the high levels of volatility in the sector, making it impossible to provide short-term return forecasts with any degree of confidence. The extent and duration of this volatility will also be a function of the major economies throughout the world.

A protracted or synchronised recession across major global economies could see further downward pressure on stock prices.

The downturn in the global property securities sector has slowed the pace of the sector's development over the short term. However, the following key characteristics will continue to define the growth of global real estate securities markets over the longer term:

- Increased investment opportunity set – the global real estate universe offers investors diversification, income and now value;

- Disparity between real estate cycles of different countries;

- Low level of securitisation of property in global markets relative to the mature Australian market;

- Developing markets, in a capital formation stage, present opportunities due to inefficiencies associated with a lack of public market research.

Importantly, the global property securities sector offers investors a level of diversification that is impossible to achieve through a purely Australian portfolio.

Over the long term, it is expected that the global property securities sector will deliver solid high single digit returns. The volatility currently seen in the sector may see returns over the short-term materially above or below this forecast. This period will extend if the major global economies continue to deteriorate further.

Review: Cash
The Australian cash market delivered a return of 0.8% for the quarter and 5.5% over the 12 months to June 2009. The official cash rate ended the quarter at 3.0%, with the RBA cutting

the cash rate target by 0.25% in April. The yield on the 90 day bank bill rose 6 basis points during the quarter, to close at 3.2%.

Australian and International Fixed Interest

Relative to previous quarters, the June quarter proved rather uneventful from a monetary policy perspective. However, there is no longer much room for further conventional monetary policy easing (i.e. rate cuts). During the quarter the only notable actions were those of the European Central Bank (ECB), which reduced the European benchmark rate on two separate occasions (both 25bps each). The ECB remains under pressure to follow the lead of its US and UK counterparts and reduce nominal rates to near zero in response to the global economic slowdown. The Reserve Bank of Australia (RBA) also cut early in April to 3.0%, although it has held fire since.

The market's relative dislike of 'safe' government bonds gathered pace over the quarter. This is evident in the chart above, which plots Australian and US benchmark 10-year yields.

In the prior quarter (Q408) government bond yields fell significantly as markets digested the Lehman Brothers collapse. Since then, benchmark government bond yields have increased markedly, as markets are no longer factoring in a 'world is going to end' scenario. Based on yields alone, government markets appear to have retraced back to pre-Lehman levels.

Rising bond yields resulted in a reversal of fortune for Australian Fixed Interest (AFI), with the sector declining 1.3% over the June quarter. Global fixed interest fared somewhat better, rising 2.2%. Nonetheless, the AFI sector still boasts strong returns of 10.8% for the year, well above growth sectors and cash.

Despite the retracement of yields to pre-Lehman levels, investors should be mindful that world is now different. Not only have central bank monetary policies become extremely accommodative throughout the developed world, but governments also opened their purses by committing to Keynesian inspired deficit spending (and consequently borrowing) in support of their economies following the general retrenchment of the private sector (i.e. businesses and consumers). These actions may prove to be beneficial for overall economic activity, although they pose significant headwinds to investors in government debt.

Should the governments' Keynesian actions prove satisfactory in reviving private sector economic activity, a likely consequence will be tightening monetary policy. Moreover, the increase in the supply of government bonds will place pressure on prices to fall. Further, any 'reversion to the mean' would see interest rates rise. In a nutshell, either rising rates and/or increased supply will likely push yields up and erode the price of government debt. Notably, yield curves (i.e. Australia and US) have become 'normal' and steepened. Normal and steep yield curves are an indication that markets expect rises in interest rates, although the timing of such actions is less clear. Generally, in periods of steep yield curves, shorter-dated assets (i.e. less duration sensitive) are preferable.

Credit Markets

The June quarter proved to be historic for the US auto industry and credit markets. Chrysler filled for Chapter 11 bankruptcy protection, with the assistance of the US Government, on 30 April 2009. Whilst this was an important event, the 'real show' was General Motors (GM). As had been anticipated, GM followed the path laid down by Chrysler and likewise filled for Chapter 11 bankruptcy protection on 1 June 2009. The GM collapse was the fourth largest corporate failure in US history (Lehman #1 and Washington Mutual #2). Somewhat extraordinarily, despite these outcomes, both credit and equity markets continued to rally.

In spite of the Chrysler and GM events, June essentially proved to be a 'good news' quarter for credit markets. Buoyed by optimism on the back of germinating economic "green shoots" and the view that the markets have avoided the 'Armageddon' scenario, investors opened their wallets and rediscovered an appetite for risk. As a result, credit markets rallied strongly in the quarter. Bloomberg reported that the spread in yields between US Treasuries and US investment-grade corporate debt fell to its lowest level, of 3.31%, since 10 September (i.e. pre the Lehman event).

The US central bank has continued with its Quantitative Easing programme, although the effectiveness of this has been questioned. The Federal Reserve has been purchasing US Treasuries as a means to suppress yields and help keep US 30 year mortgage rates below 4.5%. This is the level the US Treasury believes is required to stabilise / revive the US property market. However, as mentioned earlier, US Treasury yields continue to climb and, most significantly, the 30-year mortgage rate averaged 5.42% as at 25 June 2009 (source: Freddie Mac survey). The mortgage rate is up from 4.85% on 26 March. US house prices (as measured by the S&P Case Schiller Index, 20 cities) have continued to fall, although at a slower pace. For the year to April 2009 the index is off 18.1% and almost 33% from its peak in Q2-2006.

Morgan Stanley and Goldman Sachs, repaid the money they received under the TARP initiative. The motivation for doing so is most likely a combination of factors; a show of strength and a way of limiting government intrusion in their operations,

Fixed Interest Outlook

Both Australian and global fixed interest remains unchanged, in a relative sense, Australian fixed interest is more attractive than global fixed interest given the interest rate differentials and a more favourable economic backdrop. However, the steepening Australian yield curve is cause for reflection.

When considering the likely drivers of return for the fixed interest sector, it is worth highlighting that an investment in a fixed interest fund typically provides exposure to a broadly equal split of government bonds and corporate bonds.

In June 2009 a number of US banks, including J.P. Morgan, Morgan Stanley and Goldman Sachs, repaid the money they received under the TARP initiative. The motivation for doing so is most likely a combination of factors; a show of strength and a way of limiting government intrusion in their operations,

In terms of Australian government bonds, the long end of the yield curve is starting to rise, with 10-year bonds currently at 5.5%. This is notably higher than the lows of 4.0% seen earlier in 2009. Government bond yields have the potential to rise further, even though inflation is likely to be a non-issue in the short-term. A major headwind for the sector will be the $250bn in new issuance that will hit the market over the next four years, as the Federal and State Governments run large fiscal deficits. This level of new issuance is very significant given the Australian bond market is currently worth around $135bn and the market cap of the ASX is around $1,050bn.

In contrast, corporate bond yields remain at relatively high levels (post credit crisis) and offer reasonable value. The relative attractiveness of corporate bonds and the fact that domestic government bonds have already risen a touch, is supportive to Australian fixed interest. However, we could see higher government bond yields yet (and hence lower bond prices).

The investment case for global fixed interest is less attractive, given government bond yields remain at low levels, ranging from 3.5% on US 10-year bonds to 4.3% on 30-year issues. The return seems inadequate given the supply of most issues will increase dramatically as governments issue debt to finance ballooning budget deficits. A positive case for global government bonds might only be made if the expectation was for the global economy to enter a lengthy period (5 years+) of deflation. However, this is not a likely scenario. The expectation is that, at some point in the future, central banks and governments will be successful in jump starting inflation, either by conventional or non-conventional means (money printing).