

2008 MARKET COMMENTARY.

Asset classes – The year that was... financial year 2007-08

Australian shares had a weak financial year, falling 12.12%. This is the first year of negative returns since financial year 2002-03 and came despite the sharemarket reaching a record high on 1 November 2007.

Leading the Australian sharemarket lower were problems flowing from US sub-prime lending, higher interest rates and concern over the ability of many companies to generate profit growth given the challenging environment.

International shares also provided negative returns over the financial year. Returns were held back for much of the same reasons as the local sharemarket. In Australian dollar terms international shares returned -21%. The strong Australian dollar held back returns in the local currency with the MSCI index falling 10.7% in US dollar terms.

After eight years of returns above 12% per year, the Australian listed property index fell significantly. It fell 36.4% and underperformed the broader sharemarket. Over recent years, the listed property sector had undergone significant transformation. Trusts expanded offshore, increased development activity and used debt to fund their expansion. Once the US sub-prime lending problems hit, debt concerns led to significant falls in share prices. Global listed property also had a poor year, falling 32.3% in AUD.

It's not all doom and gloom, with global resources having another positive year. Strong demand from China and predominantly higher commodity prices led to strong returns. The sector was up 18.8% in AUD over the financial year.

Global listed infrastructure had a modest year, flat in USD yet negative in AUD terms. Its defensive nature and high demand held returns up over the financial year. The sector fell 11.9% in AUD over the financial year.

Fixed interest markets provided better returns than in recent years. They returned 4.42% in 2007-08, compared with around 4% in 2006-07 and 3.4% in 2005-06. Returns were higher over the financial year as bond yields drifted up. Cash had a somewhat stronger result, returning 7.34%. Four increases in official interest rates during the financial year assisted returns.

Despite the recent volatility in financial markets it's important to remember that occasional negative returns are a natural part of market behaviour. Shares are a long term investment and see both good and bad times. Remember it's time in the market not timing the market that can be important.

All Ordinaries Index... here we go again!

Early in 2007-08 the sharemarket reached record levels. Economic growth was strong, the resources sector was booming and interest rates were not regarded as a problem. There was some market volatility in July and August but after each downturn, share prices recovered.

However, in November 2007 market conditions changed. The Reserve Bank of Australia announced its intentions to slow the pace of economic growth by lifting official interest rates. At the same time, problems flowing from US sub-prime lending saw global interest rates increase. This has become known as the sub-prime crisis, credit crunch or the liquidity crisis. Higher interest rates meant increased borrowing costs for business, the cancellation of expansion plans, reduced demand for mortgage finance and less disposable income for consumers. None of this was good news for business profits and share prices fell.

Over the course of 2007-08 the weakest sectors included the consumer discretionary sector (-40.3%) and the financial sector (-31.7%). Both were hurt by the impact of higher interest

rates. Among consumer discretionary companies ABC Learning (-83.1%), Harvey Norman (-39.1%) and David Jones (-45.2%) all fell. The financial sector includes banks, listed property trusts and insurance companies. The listed property trust sector fell 37.7% with Centro Properties Group down 97.1%. Among the banks National Australia Bank was down 30.7% while Commonwealth Bank fell 22.6%. AMP was down 29.4% and QBE Insurance fell 24.3%.

There were sectors of the sharemarket that managed to provide positive returns despite the higher interest rate environment. A range of commodity prices remained firm ensuring solid profits for the resources sector. Oil, gas, coal and iron ore prices rose substantially leading to strong performances from BHP Billiton (26.6%), Rio Tinto (38.7%) and Woodside Petroleum (49.8%).

No financial year would be complete without takeovers, mergers and other corporate activity. During 2007-08 corporate activity included Wesfarmers purchasing Coles Group, BHP Billiton bidding for Rio Tinto and Westpac bidding for St George Bank. Higher borrowing costs saw bids by private equity firms dry up in the second half of the financial year.

In 2008-09 higher interest rates seem likely to persist. This is likely to hold back both economic growth, growth in company profits and keep returns from Australia shares relatively subdued compared to earlier years.

Bouts of market volatility do occur from time to time. The Australian sharemarket has suffered several bouts since 2005 for varying reasons. These have included higher US interest rates, higher Australian interest rates and concerns over the pace of economic growth. After each fall, the market has rebounded and reached a new high. It's important to focus on the long term when investing in the sharemarket.

Listed property trust price index

After providing solid returns for the past 8 years, the listed property sector provided disappointing returns in 2007-08. After three years of strong gains, investors started to take profits and question the listed property market's ability to continue to reach new heights. With markets already anxious, bad news out of the US with sub-prime losses and turmoil in global credit markets, Australian listed property stocks took a fall. Investors were concerned over the level of debt in the property sector, higher interest rates and the expansion of the sector into offshore markets such as the US.

As investors became increasingly nervous, and news out of the US deteriorated, the property market fell. From October 2007 to March 2008, the property market recorded six straight monthly falls. The index fell 41% from its peak in February 2007 to its trough in March 2008. The majority of the falls occurred in November and December 2007 when Australian property trust, Centro Properties Group announced it was struggling to refinance its debts. Adding to the sector's difficulties was the effective closure of global debt markets. Losses due to sub-prime were mounting and lenders were reticent to loan funds to anyone. Any lending undertaken was at significantly higher interest rates. Given a spate of expansion in the Australian listed property sector, some trusts were holding large amounts of short-term debt that needed to be refinanced and there were doubts that this would occur.

With the large falls in the listed property sector, many of the stocks are now trading at more attractive valuations. The indiscriminate selling over recent months has left opportunities to buy solidly performing trusts at reasonable levels. The outlook for the sector remains cautious, with poor investor sentiment potentially driving returns lower in the short-term. Over the medium term, the property market is exhibiting solid underlying fundamentals and relatively attractive valuations. This indicates that the property sector has room to grow in 2008-09 if sentiment improves.

The Australian economy... slowing from a high

The Australian economy has recorded positive economic growth for 17 consecutive years, with economic growth at 3.6% for the year ending March 2008. This was above its long term

average of 3.3%. The pace of growth was softer than recent quarters, which saw a peak in the growth rate at 4.7% for the twelve months ending September 2007.

Economic growth continues to be driven by the strong resources sector, fuelled by robust growth of emerging economies such as China and India. Firm business and government spending has also assisted growth, when combined with private sector spending on large infrastructure projects. A long period of uninterrupted economic growth has led to capacity constraints and strong domestic demand over the financial year. Inflationary concerns and strong growth from Australia's terms of trade (export prices compared to import prices) led to the RBA lifting interest rates. The higher interest rates have started to cool the economy from a high. The Reserve Bank of Australia raised interest rates four times over the financial year, from 6.25% to 7.25%, as it was determined to slow economic growth.

The impact of the campaign of lifting interest rates has started to be felt. The first-half of 2008 was characterised by weakening economic conditions in Australia. Higher mortgage payments, volatility in the sharemarket and higher petrol prices have seen consumer sentiment fall. This has now flowed into softer retail sales, down from 8.3% growth for the twelve months to December 2007, to 4.7% for the twelve months to April 2008. The RBA will watch consumer demand closely when determining its next move in official interest rates.

Unemployment in Australia remains at historically low levels, with the unemployment rate at 4.3%. Firm demand for labour continued in the financial year, driven by the mining and construction industries with unemployment falling to as low as 4.0% in February 2008. Since this time employment growth has slowed a little, in line with touches of weakness in economic growth. Job ads have fallen and some increase in the unemployment rate is expected over the remainder of 2008. This will assist the containment of wages and helps to minimise a breakout of wage inflation.

Another sign of the slowing economy is weakening housing credit growth. Housing credit growth peaked around 22% year on year in mid 2004 during the housing boom. Housing credit growth had slowed to around 14% year on year in September 2006. With higher interest rates, housing credit growth since slowed to 10.6% over the 12 months to 31 May 2008. This is not good news for the already anaemic housing sector. If less people are borrowing money to fund home purchases, building approvals will also fall. Given the pace of population growth and migration, demand for housing should rise over time, especially when combined with the recent undersupply of housing.

The above paints a rather sobering view of the current prospects for economic growth in Australia. The economy appears to be cooling, in line with the plan of the RBA to put downward pressure on inflation. If inflation does not moderate, the RBA should not hesitate to lift interest rates still further. The RBA forecasts economic growth to slow to 2.25% by December 2008. Despite the slower pace of economic growth expected over the remainder of 2008, medium term drivers of the economy remain. Australia's economic position is sound, with more than one source of growth.

But... commodity prices are rising

The chart shows the Reserve Bank of Australia's Commodity Price Index in Australian dollar terms. The index is an indicator of the prices received by Australian commodity exporters. Commodity prices have risen 30% in this financial year to 30 June 2008. Driving this rise have been strong gains in copper, aluminium and the bulk commodities.

Coal contract prices have been settled by a number of coal miners at large premiums over current spot prices. Tight supply and strong demand pushed coking coal contract prices over 200% higher. Thermal coal contract prices are due to rise around 125% for the same reasons. Iron ore producers who have already benefited from several years of price gains are set to negotiate at least a 85% gain in contract iron ore prices. This is on top of the 9.5% rise in 2007, the 19% they received in 2006 and 70% negotiated in 2005. These price gains have a dramatic impact on Australia's terms of trade (ratio of export prices to import prices) and the pace of Australia's economic growth. Some commodity prices have fallen. Lead, zinc and nickel have all retreated on the back of concerns over weaker demand given

a slowing US economy. Higher inventories levels also led to weaker prices.

Australian exports

With rising commodity prices and strong demand for our natural resources, Australia's exports have been rising. Australia's major export destinations include Japan (15%), China (12%), Korea (6%), Europe (8%), India (5%) and the US (4%). Although exports have risen due to price gains in the commodities mentioned above, in volume terms export growth has not lived up to expectations. Ports, railways and roads are clogged. Capacity constraints are restricting Australia's export growth. As capacity constraints are gradually reduced, export growth is likely to pick up. Large price increases negotiated for the bulk commodities and volume growth should drive Australia's exports higher. This will also improve our current account deficit which has been hovering around record levels.

A large amount of infrastructure is expected to be built in Australia over the next few years. There is approximately \$48 billion of construction work that has been approved but yet to be done. This work is largely centred in the resource rich states of Western Australia and Queensland and should greatly add to Australia's ability to export. With prices and volumes set to rise, economic growth should accelerate. The RBA is watchful of the upside risks to economic growth from exports and Australia's terms of trade. If pressures flow through to inflation, the RBA is prepared to lift interest rates.

Emerging market infrastructure spending

What's the reason that Australia's exports are in such high demand? Not only is Australia looking at undertaking a sizeable amount of construction spending on infrastructure itself, so too are the emerging economies. The emerging economies are countries such as China, India, Brazil, Russia and other smaller Asian economies who are growing rapidly and increasing their living standards. Over the next decade it's estimated that these economies will spend US \$21.7 trillion (AU \$23 trillion) on infrastructure such as roads, bridges, railways, ports, water facilities and energy needs. Remember, \$1 trillion is 1000 billion dollars!

In order to complete their planned construction, natural resources such as coal, iron ore and base metals are needed. Australia is well placed to meet their needs given our large holding of such resources and our proximity to Asia. Infrastructure is required as these emerging economies undertake the process of urbanisation and industrialisation. Income levels rise and the nature of society changes, people move from farms into the cities and living standards rise.

For example, China's infrastructure needs include:

- 1300 gigawatts of new generating capacity by 2030 – an average of 59 gigawatts per year. To put this in context, all the power stations in the UK produce 75 gigawatts per year
- 17,000 km of expressways by 2020 – annual average is 1,400 km
- 300,000 km of rural roads or 25,000 km per year
- \$42 billion of railway investment – 17,000 km per year
- An additional 97 airports or 8 per year

It's important to remember that this infrastructure spend is only from emerging economies. Developed economies such as the US, Europe and the UK also have infrastructure plans and will also require natural resources, adding to total demand and pricing pressures. Australia is well placed to benefit from this demand and it is a medium term factor leading to growth in Australia's economy.

Inflation... has ticked up

Australia's inflation has ticked up. It currently stands at 4.2% for the twelve months to 31 March 2008 and has accelerated from 2.4% a year ago. Leading the inflation rate higher have been higher petrol, food and housing costs. The RBA, when determining official interest rates, prefers to look at underlying inflation. This measure of inflation strips out volatile items and provides the RBA with a better understanding of the underlying price pressures within

the economy. On this measure, the underlying inflation rate stands at 4.25%, well above the RBA's target band for inflation of between 2% and 3%. As a result the RBA has tightened interest rates four times over the past twelve months. Slower economic growth over the remainder of the year should lead to lower inflation. The RBA has forecast inflation to fall back within its target band by the end of 2010.

Economic growth is also forecast at 2.75% for the same period. If the economy does not slow as the RBA expects, and inflation remains high, the RBA may have no choice but to lift interest rates again. Time will tell.

Interest rates... going up?

Interest rates have risen over the past twelve months on the back of economic growth and inflationary pressures. The other part of the story is that the standard variable mortgage rate has risen in excess of movements in official interest rates. As of 30 June 2007, the official cash rate was 6.25% and the standard variable mortgage rate was 8.05%, a difference of 1.8%. As of 30 June 2008, the official cash rate was 7.25% and the standard variable rate was 9.45%, a difference of 2.2%.

Over the financial year, mortgage holders on average faced a further 0.4% rise in mortgage rates outside of changes in the official cash rate. But what was the reason? The answer starts with the demise of the US sub-prime mortgage market in November 2007. After several years of rapid growth in below- best mortgages in the US, defaults started to rise. Large investment banks who held these sub-prime mortgages and generated revenue through securitising them began to report losses. Sentiment fell and when combined with a weakening US economy, credit markets shut down. A credit crunch occurred. Interest rates rose and funding became increasingly difficult and costly to secure. Higher funding costs for Australian banks resulted. The banks passed on much of these higher funding costs to borrowers.

As we wrote earlier, higher interest rates have started to impact the economy. Consumer sentiment is down, retail sales have slowed and housing credit growth has softened. The economy will need to continue to show signs of a slowdown for the RBA to leave rates on hold in the remainder of 2008.

Profits and the sharemarket... rise and fall together

Company profits have been steadily rising since the lows of 2001, with the sharemarket and profits moving in sync until recently. Profit growth figures have largely been driven by resources companies. Financial and industrial companies' profits have seen softer growth in recent times. This has meant profits for the broader sharemarket have continued to rise but not at the same pace seen in 2005/06. Over 2007 the sharemarket rose strongly and disconnected somewhat from company profits. The recent large sharemarket falls since November brought the sharemarket and profits back into line and suggests the sharemarket has room to grow.

Australian sharemarket... not expensive, not cheap either

The Australian sharemarket is trading within the fairly valued range. After pushing towards the relatively expensive range in mid 2007, the falls in late 2007 pushed the sharemarket towards the relatively cheap region. A slight correction in recent times has seen the market trading around fair value.

US house prices... are falling

What's influencing the global economy and global sharemarkets?

The largest factor at the moment is the US economy. The US economy is slowing and could be in recession. This began with a weak US housing sector triggered by sub-prime mortgage defaults and overbuilding in some parts of the US. With sub-prime defaults at record highs and an over supply of US housing, house prices have fallen dramatically. Prices have fallen around 16% for the twelve months to April 2008. With lower house prices, US consumers feel less wealthy and are less likely to consume goods and services. With the US consumer

making up around 70% of the US economy, a weak consumer and a weak housing sector translates into a weak US economy. Some commentators believe that US house prices will continue to fall due to the large oversupply still in the market. If this occurs, the US economy is set to be weak into 2009. Weak house prices lie behind the large losses recently made by US banks.

What will get the US moving again?

There are five sign posts that will help the US economy recover.

1 Lower interest rates. The US Federal Reserve has acted aggressively in cutting interest rates from 5.25% to 2.00%. Lower interest rates have worked in the past and they should work again. This time is somewhat different in that credit markets must regain confidence and aid economic recovery through lower market interest rates.

2 The US dollar has fallen and exports are rising. A lower US dollar is helping the export sector, especially to Europe, Japan and Asia. With the US dollar lower, exports are cheaper and volumes should rise. This should support the US economy and multinational companies who are tapped into the export market.

3 Tax cuts worth \$150 billion. US consumers have been handed tax cuts, this should help the consumer sector.

4 Fed helps JP Morgan Chase purchase Bear Stearns. This provided a signal to the financial markets that the US Fed would provide a great deal of support to rebuild trust and ensure financial markets returned to normal operating conditions. The sharemarket rebounded following the Fed's efforts.

5 Lower oil prices. Oil prices have risen significantly over twelve months, up around 90% since June 2007. Driving the oil price higher have been strong demand, geopolitical issues, a low US dollar and speculation. Higher oil prices are adding to inflationary pressures and dampening the US economy. If oil prices retreated this should boost economic growth, cool inflationary pressures and allow the US Fed to cut interest rates again if needed.

Rest of the world... a mixed outlook

The global economy performed well in 2007-08 with a growth rate of around 5%. The economic outlook for 2008 looks softer, dragged down by a weak US economy, tighter credit markets, high oil prices and higher interest rates. There is a divergence of economic growth between the developed economies (eg US, Europe, Japan) and the developing economies (China, India, Russia). Developing economies are set to continue growing at a relatively fast pace when compared to the slower growth rates of the developed economies.

The US economy has seen economic growth weaken under a weak housing sector, tighter credit markets and a slow consumer sector. Weakness has started to spread into the labour market where unemployment has risen and job losses have been recorded. The US Fed has cut interest rates aggressively. Growing concerns over inflation has led to questions over the next move in official interest rates by the Fed.

Over the last financial year, Europe has performed reasonably well. The economy has been growing, mainly driven by the larger economies of France and Germany. The European economy has experienced productivity growth and has lifted its efficiency. Economic growth has been held back by the strong euro and higher interest rates. The European Central Bank has left interest rates on hold over the financial year, yet has maintained its tightening bias. Inflationary pressures suggest interest rates may rise over the remainder of 2008.

As mentioned earlier, China continues to record very strong economic growth. Economic growth stands at 10.6% for the twelve months to 31 March 2008. The ongoing process of urbanisation is driving economic growth and demand for resources. This growth has led to the build-up of inflationary pressures in the economy, although much of this is due to higher food prices. The Chinese government has shown an increasing willingness to adopt tighter financial conditions in an attempt to grow their economy at a more sustainable pace.

The Indian economy is also growing but is behind China in its process of urbanisation and rise in living standards. The Indian economy grew at 9% for the twelve months to 31 March 2008 and has been driven largely by its construction and export sector. The Indian economy

does face problems: Unlike China it is running a large budget deficit with politics often influencing spending decisions.

The risks to the Australian economy

The outlook for the Australian economy is positive despite the expected short term slowdown. There are however some risks that could upset this relatively sanguine view, these centre around the global economy and inflationary pressures.

The global economy has begun to slow, dragged lower by the US. In 2007, global economic growth was recorded at 5% by the International Monetary Fund (IMF). The forecast growth rate for 2008 is 3.7% which is below the trend pace of growth of recent years. The risk for Australia is that global growth slows further than expected and hits our trading partners more significantly than is expected. If the US economy moves into a deep recession and infects China and the emerging economies, Australia's economy is likely to slow more than currently anticipated. The good news is that China is growing because of fundamental changes to its society. Its growth is coming as a result of growing domestic demand with rising income levels leading to consumption growth. This should continue independently of any slowdown in the US. But if the world slows more than anticipated, China should slow and this should have a negative impact on Australia.

Other risks to the Australian economy come from internal sources. One risk is that the RBA decides to lift interest rates one time too many and significantly slows the Australian economy. This is possible given higher debt burdens faced by households and rising cost pressures from other sources. The rising cost of mortgages, petrol and food has reduced households disposable income and leaves households more vulnerable to higher interest rates. If interest rates do rise further, the Australian economy may slow more than the RBA desires. This could be bad news for the sharemarket.

Recent strong economic growth has led to capacity constraints. As the economy grows, so does demand. If supply is not forthcoming this puts upside pressure on prices. Australia is currently experiencing capacity shortages, with supply not increasing at a fast enough rate to prevent price rises. Capacity is tight in the infrastructure space and has been compounded by the resources boom and by 17 years of consecutive economic growth. Our ports, rail networks and energy supply have reached, or are reaching, full capacity. It will be very difficult for the economy to continue to grow at the same pace without additional infrastructure being built. Inflationary pressures should continue to emerge until supply catches up with demand. The good news is that both the private sector and public sector recognise the shortage in infrastructure and steps have been taken to address this. The recent Federal and State government budgets announced large spending on infrastructure projects with the Federal Government setting up a \$10 billion Building Australia Fund.

Despite these risks and the short term slowdown driven by the RBA lifting interest rates, Australia's economic outlook over the medium looks positive. Australia's population is growing and we are tapped into the fast growing emerging economies. As always there are risks but Australia seems well positioned to face them since we have a budget surplus and interest rates can be reduced if required.

Summary

- 2007-08 Financial Year was challenging
- High interest rates should slow the Australian economy in 2008-09
- Australia has many drivers of growth. Almost too many!
- The remainder of 2008 should be a bumpy ride
- The Australian sharemarket has room to grow with earnings over time.