

Economic review

3 April 2009

Monthly snapshot of the Australian economy

Important economic data released throughout March 2009 continued to reflect a weak Australian economy.

- Growth:** GDP fell 0.5% in the quarter ending December 2008, the first fall in economic activity since the December quarter of 2000. Inventories subtracted the equivalent of 1.6% of GDP from activity. This was the largest fall in inventories since 1983. Non-farm GDP (which accounts for just under 98% of the economy) fell by 0.8% in the December 2008 quarter, after a 0.2% decline in the September quarter. With two negative quarters in a row we can say that the non-farm economy is in recession.
- Interest rates:** The Reserve Bank of Australia (RBA) left the Official Cash Rate (OCR) on hold at 3.25% in March 2009. This was the first pause since the RBA began to cut rates from 7.25% in September 2008.
- Labour market:** The unemployment rate rose to 5.2% in February, well up on the 3.9% low in February 2008. A further increase to 7.0% and above looks in prospect over 2009 and into 2010.
- Retail sales:** Annual growth in retail sales slowed in February as the positive impact of the fiscal stimulus, seen in December 2008 and January 2009, waned. Retail sales contracted 2.0% in February from a month earlier.
- Consumer sentiment:** Consumer sentiment remained at negative levels in March 2009. It fell a further 0.2% in March from the February 2009 survey. However, sentiment has stabilised at these levels over the last year.
- Home approvals:** After three months of strong growth in first home-buyer purchases, but continued weakness in new home approvals, the trend in approvals turned positive in March. However, the 7.8% rise in approvals on the month reflected strong apartment construction rather than private sector houses.
- Stock market:** Equity prices rose 7.1% in March 2009, but remain 3.2% lower than at the end of 2008. The S&P/ASX200 Index ended the month at 3,582 and is 33% lower than at this time last year.



Market Watch

Australian shares

The Australian share market rallied off its lows in March, registering its first positive return since August 2008 and its strongest monthly gain since April 1995. The All Ordinaries index rose 7.1% in March, but is still down 34.7% over the past 12 months.

A number of policy announcements in the US and UK, early signs of profitability returning to US banks and some signs of stabilisation in the weak economic data saw share markets rise in March.

These gains came after the All Ordinaries Index tested a new low on 6 March 2009, reaching 3,111 which is down 54.6% from its peak on 1 November 2007. With American International Group reporting a \$US61.7 billion quarterly loss, renewed concerns over the US financial sector led share markets lower. The functionality of the UK banking system was also called into question, with additional capital needed for some banks. Since the low on 6 March, the All Ordinaries Index rallied 13.5% to the end of month.

The announcement of the Public Private Investment Program (PPIP) unveiled by US Treasury Secretary Tim Geithner buoyed markets. The plan will use a combination of government and private money to purchase between \$US500 billion and \$US1 trillion in legacy (i.e. bad) loans and securities. The aim is to take the 'toxic assets' off bank balance sheets and find a market price for legacy loans by creating an investment fund to purchase these troubled assets. This should reduce uncertainty within the banking system and encourage confidence.

This helped the Australian Financials ex-Property sector rise 14.0% in March. The major banks rose, with ANZ Banking Group (+18.3%), Commonwealth Bank of Australia (+16.5%), Westpac Banking Corporation (+13.0%) and National Australia Bank (+12.4%) appreciating. Some signs of risk taking returned to the market, with Macquarie Group gaining 59.3%. The ban on covered short selling was extended until at least 31 May 2009.

Among the sectors, Industrials (+15.4%) was the best performer, offsetting recent falls, on hope that financing conditions were improving and as some businesses considered restructuring. Asciano Group (+104.5%), Macquarie Infrastructure Group (+42.7%) and United Group (+24.1%) were the better performers. The Materials sector (+9.4%) also had a strong month, assisted by gains in commodity prices and renewed investor interest in the sector. Healthcare (-8.2%) and Telecoms (-4.8%) both fell, as defensive sectors moved out of favour over the month.

Some hints of optimism therefore returned to share markets in March and while this has provided the market with hope, caution is needed. Economic data in Australia is likely to get worse over coming months, reflecting the force of the global recession. While the share market appears to have factored in much of the expected bad news, low confidence and risk aversion may take over and the share market could retreat again. Nevertheless, recent aggressive policy actions in the US and UK are positive and should make a difference over time and help the global economy recover in 2010.

The S&P/ASX 200 Accumulation index (which includes re-invested dividends) rose 8.0% in March to be down 29.5% over 12 months.

Global shares

The major global equity markets recovered in March, with major policy announcements in the US and UK and suggestions that some economic indicators were bottoming. Gains were particularly strong across parts of Asia and in the US, with European markets more muted.

The MSCI World index, a broad measure of global shares, rose 7.2% in \$US but was down 0.2% in \$A. The \$A rose 7.4% against the \$US in March. Over 12 months, global shares were down 44.0% in \$US terms and have fallen 26.1% in \$A terms.

US share markets rose during the month, despite predictions by Standard & Poor's that aggregate dividends by S&P 500 companies will fall 23% this year, the biggest decline since 1938. The Dow Jones Industrial Average was up 7.7%, the S&P 500 rose 8.5% and the NASDAQ was up 10.9%. The S&P 500 had its strongest monthly gain since October 2002. Since its bottom on 9th March, the index rallied 17.9% to the end of March.

Asian markets were stronger in March, despite some poor fourth-quarter economic growth figures. The Nikkei index rose 7.2%, while Hong Kong was up 6.0% and Singapore rose 6.6%. The Chinese share market rallied strongly (+22.6%) with signs government stimulus measures are working.

European markets moved higher, although less so than indices in the US. The European economy continues to work through very weak conditions, with the policy response muted compared to some other regions. Germany (+6.3%), France (+3.9%) and Italy (+2.6%) rose, while the FTSE 100 Index in the UK ended the month 2.5% higher.

Emerging markets were stronger in March, with the MSCI Emerging Markets price index up 14.2% in \$US and 6.3% in \$A. Russia rose strongly, up 24.3%, as the oil price rose 11.0%. Other markets to perform well included Czech Republic (+17.0%), Poland (+10.8%) and Hungary (+8.7%) after heavy falls the prior month over debt concerns.

Fixed interest

Policy makers continue to work overtime to support their financial system and encourage economic growth. In Australia, this took the form of the Commonwealth Government guaranteeing State government debt, both new and existing, for a fee and on a voluntary time-limited basis. This effectively changed the 20-year history of the States' semi-government bond market.

The move came as the semi-government bond market became increasingly dysfunctional following the guarantee of bank debt in November 2008 and the large amount of infrastructure development to be funded over coming years. Just prior to the announcement on 25 March, NSW State government bonds were trading at a spread over Commonwealth bonds of 1.41%. At the end of month the spread was 1.00% and compares to 0.63% 12 months ago as the market responded favourably to the announcement. Queensland semi spreads were 1.58% prior to the announcement, 1.07% at the end of the month and 0.60% 12 months ago. Queensland is also dealing with a downgrade to its credit rating from AAA to AA+.

With official interest rates already at their lowest possible levels, both the US and the UK introduced quantitative easing (QE) as a further tool to ease monetary policy. The Federal Reserve announced it would purchase up to \$US300 billion of long-term Treasury securities over the next six months. On the day of the announcement, US 10-year bond yields rallied from 3.01% to 2.53%, before ending the month at 2.66%. The Fed also increased planned purchases of mortgage debt and agency debt, totalling \$US1.45 trillion.

In the UK, the Bank of England plans to initially purchase £75 billion of government bonds. Markets were supportive, with 10-year bond yields declining from 3.39% before the announcement to 3.06% two days after, before finishing the month at 3.17%.

Globally, 10-year bond yields remain at low levels, with yields falling given the announcement of quantitative easing policies and despite expectations of an increase in bond supply as governments increase debt levels. In the US, 10-year bonds stand at 2.66%, in the UK at 3.17%, in Japan 1.35% and in Europe 2.99%.

At the end of March, 10-year Australian government bond yields stood at 4.42%, while domestic corporate bonds with credit ratings in the BBB- to BBB+ range had an average yield of 10.72%. This compares to 4.40% and 9.52% respectively at the end of February.

The UBSA Composite Bond index returned (-3.46%) in March for a 12-month return of 14.72%. The Reserve Bank of Australia (RBA) left interest rates on hold during the month. Markets are divided over the next move, with expectations moving towards another pause in April. The UBSA Bank Bill index returned 0.28% in the month and 6.69% over 12 months.

Listed property

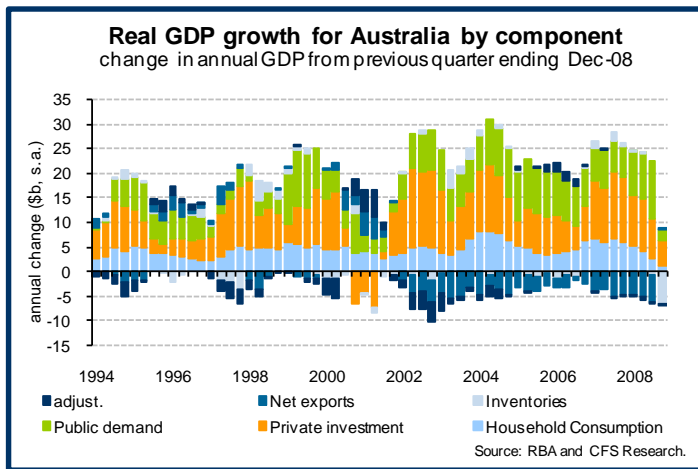
The listed property sector showed signs of stabilisation, finishing March broadly flat. The sector has fallen 57.6% over 12 months. Signs of optimism returned with renewed policy action to improve the functionality of credit markets and as several large US banks suggested they had returned to profitability in the early months of 2009.

While these signs of optimism are encouraging, the remainder of 2009 could be challenging for the sector as it deals with falling property prices, rising vacancy rates and financing issues. A number of REITs are expected to cut distributions in the coming months as a way to protect against challenging conditions ahead.

Global property markets improved in March, with major markets mixed. Asian markets rose while Europe underperformed. The UBS Global Investors Index (Net TR) \$A was down 3.6% in the month (returns were held back by the stronger \$A) to be 47.1% lower over 12 month.

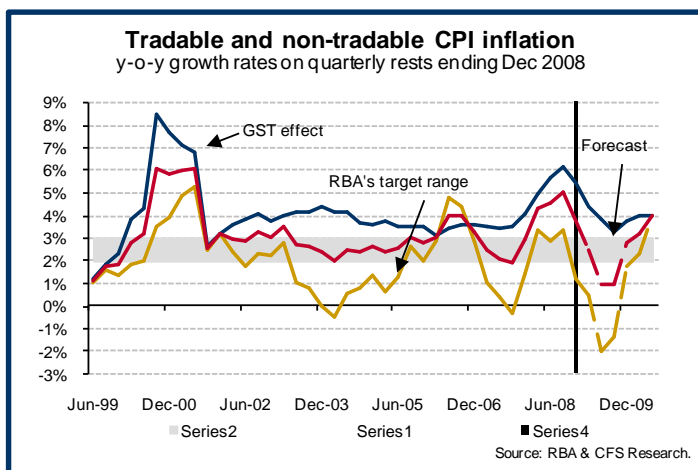
Key economic indicators

GDP growth



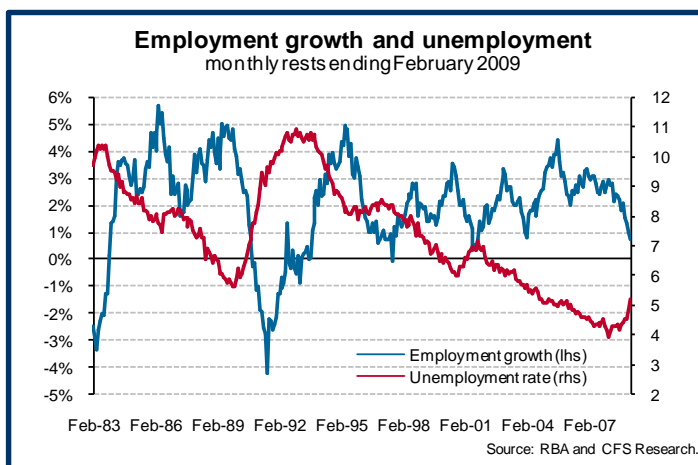
- The Australian economy contracted -0.5% in the December quarter of 2008. Growth for 2008 was just 0.3%, the lowest level since December 1991.
- Growth was limited to small contributions from household consumption, business investment and net exports. Falling inventories was the most substantial drag on demand.
- With IMF increasing the size of the contraction in global growth to -0.5% to -1.0%, the Australian economy will continue to be buffeted by contractionary forces over 2009.

Inflation



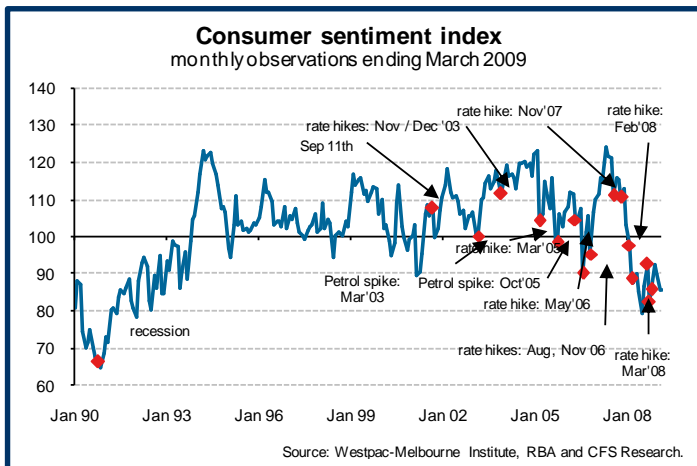
- In Q408, inflation fell 0.3% from the previous quarter but rose at an annual rate of 3.7%, still above the RBA's target zone of between 2-3%.
- CPI inflation is likely to fall considerably further in 2009, particularly as commodity prices remain at levels substantially lower than those seen in 2008.
- However, a key issue for the Australian economy over the longer term will be managing inflation from domestic sources. In 2008, domestic inflation rose aggressively due to supply bottlenecks and capacity constraints.

Labour market



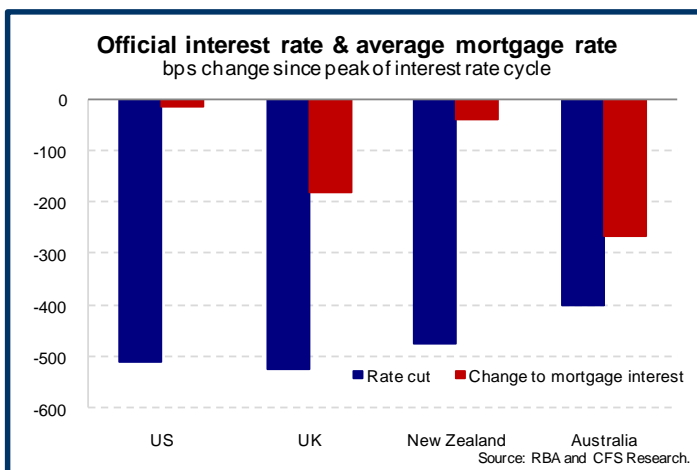
- Unemployment in Australia rose from 4.8% in January 2009 to 5.2% in February. The fall in employment in full-time workers of 52,000 was particularly dramatic.
- An important aspect of the current labour market is the rise in the participation rate, despite falling job opportunities due to older workers remaining in the labour force for longer due to falling super returns.
- We expect labour market weakness to persist and the unemployment rate to rise to 7% or beyond over 2009 and into 2010.

Consumer sentiment



- Consumer sentiment fell a further 0.2% in March 2009 from its level a month earlier and by 3.3% from a year earlier.
- Consumer sentiment seems to be stabilising at these very low levels as uncertainty over the Australian economy and labour market continues to weigh on households.
- Consumer sentiment should remain around these levels in 1H09 as stimulatory monetary and fiscal policy offset the weaker labour market.

Interest rates



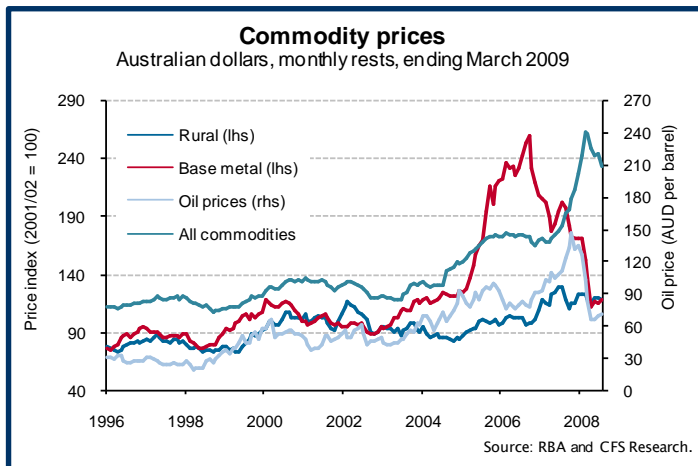
- The RBA decided to leave the official cash rate at 3.25% at its March meeting. While a shift in strategy from the RBA, after five consecutive interest rate cuts since September 2008, further policy easing is still expected in the months ahead.
- The RBA's monetary policy has been effective in lowering the interest costs of Australian households. According to the RBA, ongoing mortgage rates paid in Australia have fallen, on average, by nearly 300bps compared to just under 200bps in the UK and less than 15bps in the US, despite massive policy easing.
- While the RBA has signalled that interest rates are on hold for the time being, it will remain vigilant for signs of further deterioration in economic growth in 2009.

Retail sales



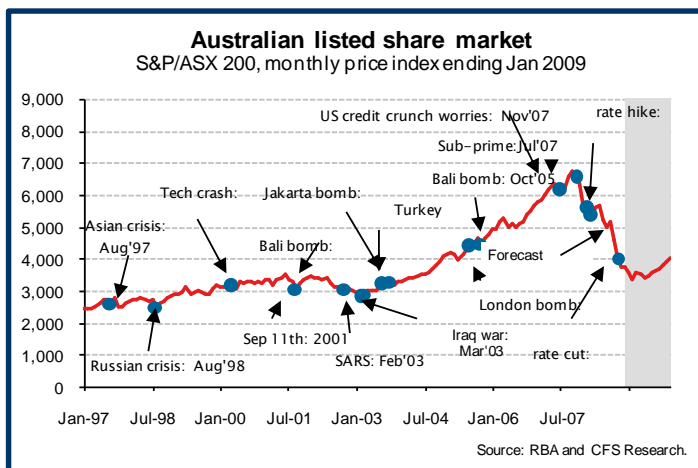
- Annual retail sales growth slowed in February after a dramatic rise in December 2008 and January 2009. Sales fell 2.0% in February from a month earlier as the impact of the fiscal stimulus waned.
- Further volatility in retail sales is expected over 2009 as further fiscal stimulus is delivered to households in combination with lower interest rates.
- A continued recovery in retail sales over 2H09 is dependent upon the labour market and the ability of monetary stimulus to gain broad-based traction within the economy.

Commodity prices



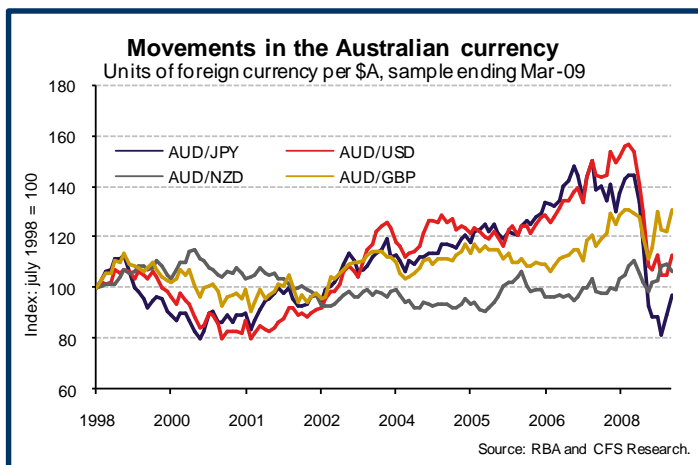
- Many commodity prices, particularly oil and base metals, have fallen precipitously in the past six months due to financial stress and the global slowdown in economic activity.
- The RBA's commodity price index, however, shows that prices have fallen 14% since their peak in 2008. This is generally due to the current contract prices for coal and iron ore, Australia's key export commodities and the weakness of the Australian dollar.
- It is expected that contract prices will be substantially lower for both iron ore and coal over 2009. These negotiations are currently beginning and will conclude by June.

Equity market



- The Australian stock market rose, on a monthly basis, for the first time since August 2008. The S&P/ASX 200 Index rose 7.1% over the month to finish at 3,582. On an annual basis, prices are down 33%.
- Factors contributing to the February 2009 performance include some signs of slower deterioration in the global economy and the positive reaction to government proposals for the US banking sector.
- A sustained recovery in equity prices over 2009 will be dependent on more stable earnings and a positive re-pricing of risk.

Exchange rate



- The Australian dollar remained volatile in March rising to US\$0.70 from US\$0.64 at the end of February 2009 as broader financial markets saw an improvement.
- The rise in the Australian dollar reflected less risk aversion, the RBA's new policy position and a small recovery in commodity prices.
- With further signs that the RBA is now on pause and improvement in commodity prices, the current favourable support for the currency should remain in place.

Economic perspective

Quantitative Easing: What is it, how does it work and will it come to Australia?

The United States and United Kingdom have recently announced the deployment of Quantitative Easing (QE). While nothing seems impossible in the current global environment, the chances of QE being needed in Australia remain very low. The Australian economy entered this global slowdown in relatively good shape and, despite the generally held view that we are now in recession, the local economy continues to outperform.

QE could be described as a further easing of monetary policy when interest rates are at or near zero. The central bank enters the market to buy government bonds to increase the supply of money available to be lent out to the economy, while also lowering interest rates across the yield curve. While the history of quantitative easing does not give a clear guide to its effectiveness, the move should be seen as an important part of the overall suite of policies being deployed around the world to help the global economy recover from the 'Great Recession' – and in that light they are welcome.

In essence, QE is designed to support the economy in two ways:

1. **Lowering interest rates.** By buying government bonds the central bank is attempting to lower the yield on these bonds. Given that government bond yields usually form the benchmark rate at which many other borrowing rates are set in the economy, this should act to lower the interest rate charged for other borrowers.
2. **Adding to the money supply.** By buying government bonds from banks, the central banks add to the supply of funds available to lend. The expectation then is that the banks will use this increased supply of money (credit) to lend out to the economy. In this way QE also acts to support a recovery of economic growth.

Two of the biggest criticisms of QE are that it doesn't work or that it will create unacceptable levels of inflation. The volume of lending undertaken in the economy is not only a function of the supply of credit, but also the demand. Just because banks have more money to lend, doesn't mean that there will be demand for these funds. Perhaps the most significant concern is that banks will not use their increased credit to lend to the economy, but just deposit the money with the central bank and earn interest. These concerns may be valid and they could dampen the effectiveness of QE policies. This is not a reason for the central banks not to engage in QE, rather it reinforces the view that QE should be seen as part of the central banks' and government's overall policy response to a significant period of economic underperformance and deflation concerns, along with restoring financial stability and aggressive fiscal policy easing.

The concern over QE creating inflation stems from the view that by sharply increasing the money supply, the increased demand created in the economy will raise prices. But this seems like a problem that most central banks would like to have in the current environment! Indeed, the economic reality is that we are in the middle of what the International Monetary Fund calls "The Great Recession" and the bigger risk to the global economy is deflation (or disinflation). It seems implausible that inflation could suddenly become a problem in an economic environment where demand, in countries as large as the US, Japan and the UK, has fallen to such an extent so as to necessitate an extraordinary level of monetary policy expansion.

Will QE be needed in Australia?

The short answer to this question is that it is highly unlikely, but in the current global economic environment nothing is impossible. The critical issue for Australia is that much would need to go wrong with the world from here, for Australia to be in the position where it would also have to deploy QE. Despite the weaker-than-expected -0.5%/qtr Q4 08 GDP result and the generally held view that Australia is in recession, the fact remains that the Australian economy continues to outperform most other major economies.

Indeed, it is highly significant that, at 3.25% for the current cash rate, the RBA has around 300bps of monetary policy easing to go before they would need to contemplate a move to QE. Related to this is the view that the monetary policy transmission mechanism is still working in Australia, with the strength of the local banking system meaning that almost all of the 400bps of monetary policy easing so far has been passed onto lower mortgage rates and that these lower rates are translating into increased housing finance demand, especially from first home buyers (with the obvious help from the government's increased first home buyers' scheme).

In addition to the traction being gained from the traditional source of monetary policy easing, the Australian economy is also being supported by a significant easing of fiscal policy. Once again, part of the reason for the success of the fiscal policy stimulus actions is likely to be the fact that Australia went into this economic downturn with a very strong fiscal position, allowing the government to act quickly and decisively and still end up with Budget deficit estimates and net debt estimates significantly smaller than other major OECD nations.

CFS Research contact details

Anthony De Francesco	Head of Research	adefrancesco@colonialfirststate.com.au	+612 9303 3598
James White	Investment Economist	jwhite@colonialfirststate.com.au	+612 9303 2645
Mary Culjak	Research Assistant	mculjak@colonialfirststate.com.au	+612 9303 3518

Investment markets research contact details

Stephen Halmarick	Head of Investment Markets Research	shalmarick@colonialfirststate.com.au	+612 9303 3030
Belinda Allen	Analyst	ballen@colonialfirststate.com.au	+612 9303 3110

For further informationcfsinstitutional@colonialfirststate.com.au**Head of Business Development, Australia and New Zealand**

Tony McFadyen +61 2 9303 2699

Institutional Account Management

Jeremy Edmonds +61 2 9303 2695

Daniel Bristow +61 2 9303 6311

Institutional Business Development

Peter Weldon +61 2 9303 6860

Matt Russell +61 2 9303 7024

Ali Karmali +61 2 9303 6070

Liz Krajewski +61 2 9303 2927

Helen Squadrito +61 2 9303 6142

Nadene Moore +61 3 8628 5615

Hugh O'Neill +61 2 9303 6116

Simon Good +61 3 8628 5681

Lucas Rooney +61 7 3328 5875

DISCLAIMER

Product Disclosure Statements (PDS) and Information Memoranda (IM) for the funds issued by Colonial First State Investments Limited ABN 98 002 348 352, Commonwealth Managed Investments Limited ABN 33 084 098 180, and CFS Managed Property Limited ABN 13 006 464 428 (collectively CFS) are available from Colonial First State Global Asset Management. Investors should consider the relevant PDS or IM before making an investment decision. Past performance should not be taken as an indication of future performance.

No part of this material may be reproduced or transmitted in any form or by any means without the prior written consent of CFS. This material contains or is based upon information that we believe to be accurate and reliable. While every effort has been made to ensure its accuracy we cannot offer any warranty that it contains no factual errors. We would like to be told of any such errors in order to correct them.

This material has been prepared for the general information of clients and professional associates of CFS. You should not rely on the contents. To the fullest extent allowed by law, CFS excludes all liability (whether arising in contract, from negligence or otherwise) in respect of all and each part of the material, including without limitation, any errors or omissions.

This material is intended only to provide a summary of the subject matter covered. It does not purport to be comprehensive or to render specific advice. It is not an offer document, and does not constitute a recommendation of any securities offered by CFS. No person should act on the basis of any matter contained in this material without obtaining specific professional advice.

Colonial First State Global Asset Management is the consolidated asset management division of the Commonwealth Bank of Australia ABN 48 123 123 124.

Copyright © (2009) Colonial First State Group Limited
All rights reserved.