

Economic review

14th May 2009

Monthly snapshot of the Australian economy

Important economic data released throughout April and early May 2009 has shown some improvement from the very weak data of 2H08.

- **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.
- **Interest rates:** The Reserve Bank of Australia (RBA) left the Official Cash Rate (OCR) on hold at 3.00% in May 2009. This followed a 25bps cut in the previous month.
- **Labour market:** The unemployment rate unexpectedly fell to 5.4% in April, after rising rapidly to 5.7% in March 2009. The unemployment rate is still up substantially from the low of 3.9% in February 2008.
- **Retail sales:** Annual growth in retail sales accelerated in March to 6.3%. The surprise monthly growth of 2.2% suggests households have pre-empted the second fiscal stimulus payment due to be paid in April and May.
- **Consumer sentiment:** Consumer sentiment rose in April to its highest level since March 2008, as fiscal and monetary stimulus improved the outlook for household finances.
- **Home approvals:** The positive impact of the boost to the first home owner's grant flowed through to housing construction with a monthly rise of 3.5% in dwelling approvals in March.
- **Stock market:** Equity prices rose 5.5% in April after a 7.1% rise in March 2009. The S&P/ASX200 Index ended the month at 3,780 and is 32% lower than at this time last year.



Economic perspective

The shape of an emerging recovery

The rapid deterioration in global financial markets during September and October 2008 contributed to a dramatic decline in economic activity. The decline was most dramatic amongst those economies with large exposure to trade. While Australia is relatively exposed to trade, its links to China meant the decline in activity to date has been less severe than other trade exposed economies. However, the scale of the decline in global production may allow an improvement in economic activity to occur more rapidly than would otherwise be the case.

The extreme scale of the decline in global economic activity in late 2008 and early 2009 has prompted some recovery in two ways. First, the sheer scale of decline means a recovery can occur more quickly than if the decline was more gradual. For instance, the decline in global industrial production has been more substantial than the decline in final demand, prompting a recovery in manufacturing. This has particularly been the case in China, as seen in PMI Manufacturing Survey in Figure 1. Second, the scale of decline has led to a very substantial attempt by authorities globally to provide stimulus to their respective economies. It now appears that these two factors are contributing to some improvement in economic activity, including in Australia.

An improvement in economic conditions was evident in the Australian data relating to March and April 2009. Strong activity in retail sales and the housing market reflected the positive impact of fiscal stimulus and substantial cuts to official interest rates, while there was also a surprising improvement in the labour market.

Retail sales rose 2.2% in March 2009 and were up 6.4% annually. Sales are expected to rise further in April as the largest part of the government's cash transfer is paid in this month.

Figure 1

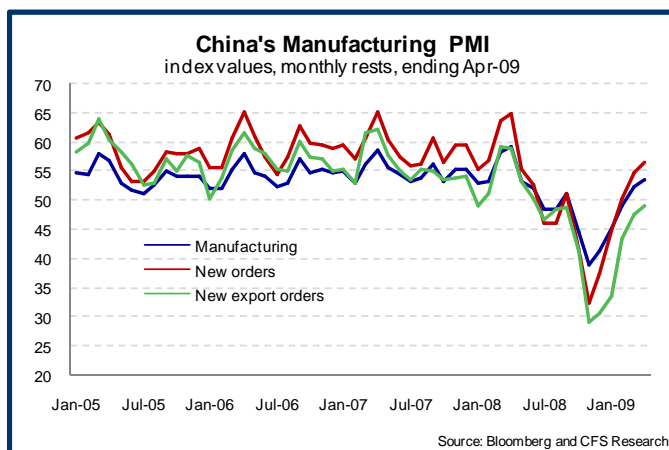
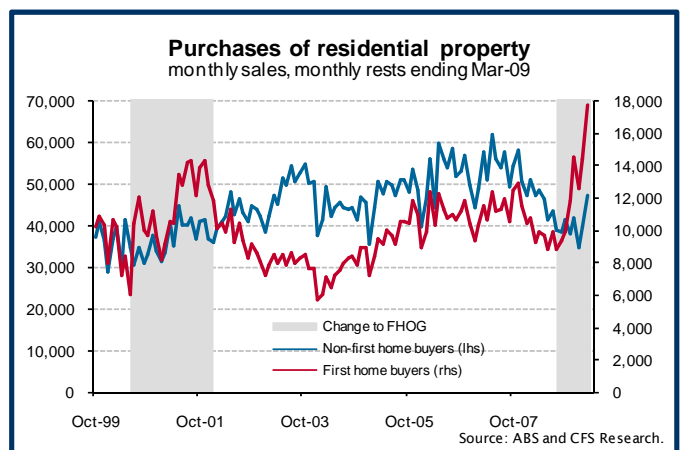


Figure 2



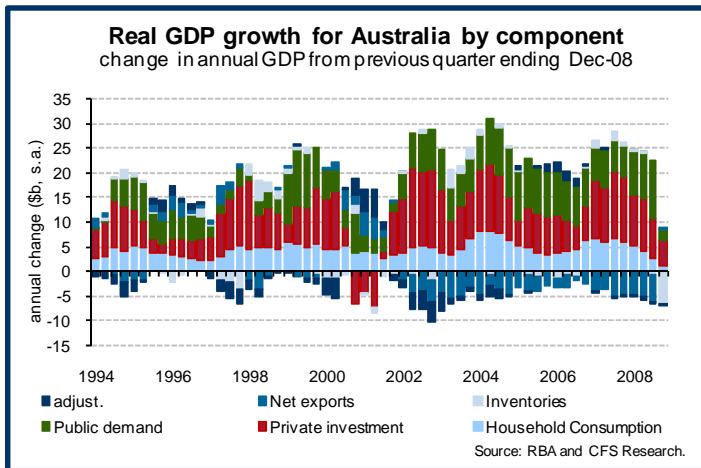
There were signs in March that the strong purchasing activity by first home-buyers was beginning to translate into greater construction activity with a 3.5% increase in new dwelling approvals from February to March. Housing finance also continued to rise; the monthly increase in owner-occupier finance was 4.9% and 13.9% for new dwellings. However, this data was not reflected in house prices. The weighted average price of houses in Australia fell -6.7% annually to March 2009, with the most substantial falls occurring in Perth (-10.1%) and Sydney (-7.3%).

The most surprising positive news came from labour statistics. Data showed that the unemployment rate fell from 5.7% in March to 5.4% in April and employment rose by 27,000 jobs, the largest jump in employment since October 2008. Questions were raised over the volatility and reliability of this data – but that is the case every month.

These data are positive in the context of the steep global deterioration of the past six months. However, the risks to a sustained recovery in 2009 are substantial. First, much of the positive impact from the initial fiscal stimulus will ease over 2H09, as cash transfers are consumed and the boost to the first home-owner's grant ends. Second, credit markets remain difficult to access, particularly for businesses and the extension of this process will hinder any recovery in business investment. Third, despite strong evidence of a recovery in the global economy, it remains vulnerable to further shocks, particularly within financial markets.

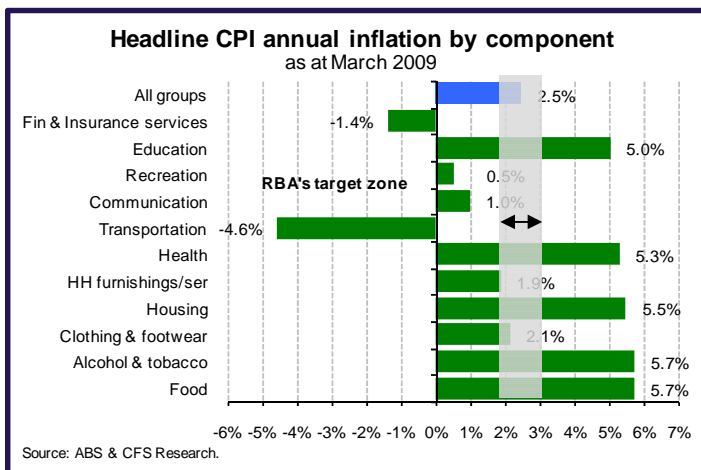
Key economic indicators

GDP growth



- The Australian economy slowed substantially over 2008, and contracted in the last quarter. This matched falls in global economic activity as the financial crisis impacted the real economy.
- The short-term outlook has improved slightly as exports remain strong and household spending benefits from the impact of fiscal and monetary stimuli.
- The IMF forecasts annual global growth to fall to -1.3% in 2009 and rise to 1.9% in 2010. US growth in the same periods is forecast to be -2.8% and 0.0% respectively.

Inflation



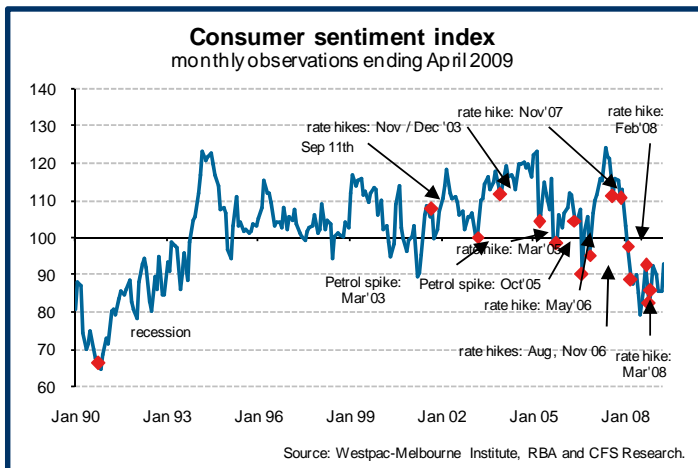
- In Q109 inflation fell to 2.5% (the middle of the RBA's target band) from 3.7% in the previous quarter. CPI has fallen rapidly from its peak of 5.0% in September 2008.
- The substantial fall in annual inflation has largely been driven by falling oil prices and interest rates. Domestic price pressures have remained high, despite falling growth.
- Further falls in inflation can be expected over 2009 as commodity prices and domestic demand remain weak. Inflation is likely to fall below the RBA's target band by 2H09.

Labour market



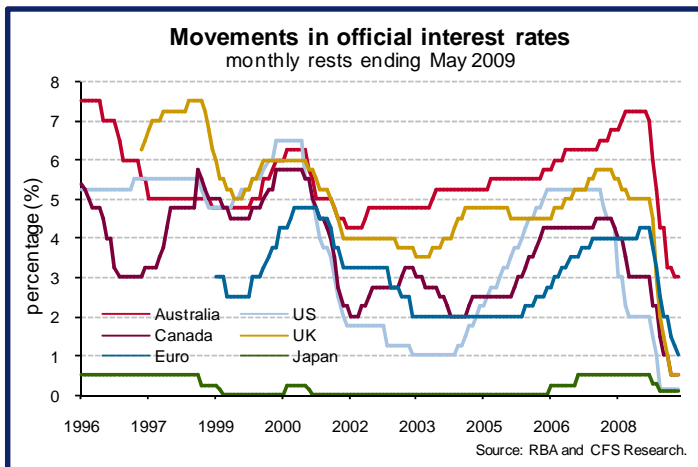
- Labour market conditions in Australia deteriorated rapidly over 2008 and into 2009. This was in line with global markets. Unemployment in the US and UK has soared to 8.9% and 6.7% respectively.
- Surprisingly, however, Australia's unemployment rate fell in April from 5.7% to 5.4% and over 27,000 jobs were created.
- Despite the positive result in April it is expected that labour market weakness will persist through 2009 and the unemployment rate is expected to peak at over 8%.

Consumer sentiment



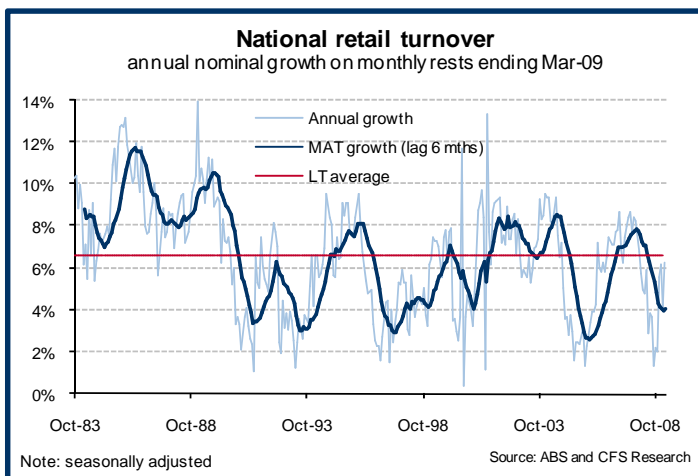
- Consumer sentiment rose 8.5% in April 2009 from its level a month earlier and is 6.1% higher for the year.
- The improvement in sentiment reflects a combination of factors including improved global economic and financial market performance, the payment of transfers to households and lower mortgage rates.
- Consumer sentiment should continue to stabilise in 2009 as stimulatory monetary and fiscal policy provides some buffer against rising unemployment.

Interest rates



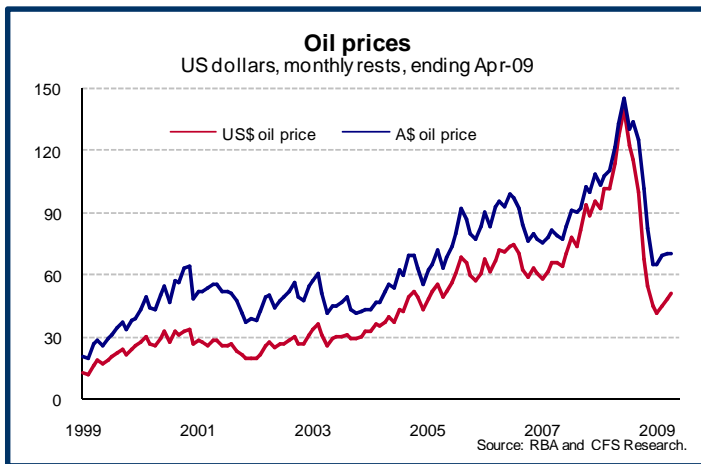
- The RBA decided to leave the OCR at 3.00% at its May meeting. This was the second pause since the shift to an easing policy began in September 2008.
- The RBA remains in a better position than many other central banks, with effective monetary policy and further scope to cut rates. Indeed, the US and UK have shifted their policy from rate cuts to “Quantitative Easing”, while interest rates are 1% or lower in Europe, Japan, and Canada.
- While the RBA has signalled that interest rates are on hold for the time being, it will remain vigilant for further deterioration in financial markets that may require further rate cuts.

Retail sales



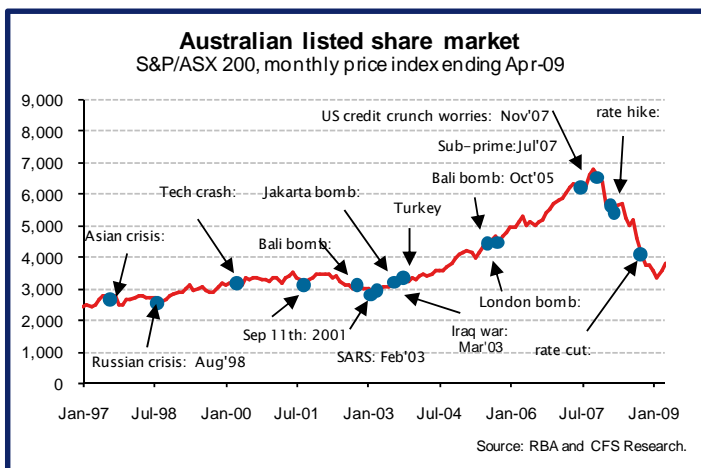
- Annual retail sales growth continued to rise strongly in March 2009. Sales rose 2.2% in the month and 6.3% annually.
- Key drivers of this shift have been the twin stimuli of substantially lower interest rates and discretionary payments to households.
- A continued recovery in retail sales over 1H09 is likely as households continue to benefit from stimulus and first time home-buyers furnish new homes. However, further weakness in the labour market may slow new spending in 2H09.

The oil price



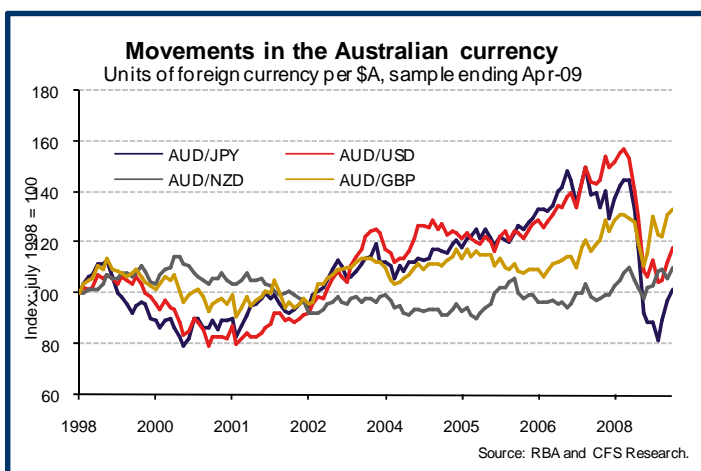
- Oil prices have declined substantially from their peak in the middle of 2008. Prices peaked in June 2008 at a high of US\$145 per barrel and have since fallen to US\$51 in April.
- One estimate suggests the decline in the oil price has provided a larger stimulus to the global economy than the discretionary stimulus packages proposed by the G-20 economies over the last six months.
- Oil prices have risen since their trough of US\$34.62 in February 2009. Given the anticipated recovery in demand accompanied by a fall in supply over the last six months, prices are unlikely to return to the recent lows.

Equity market



- The Australian stock market continued to rise in April 2009. The S&P/ASX 200 Index rose a further 5.5% over the month to finish at 3,780. On an annual basis, prices are still down 32%.
- Factors contributing to the rise over March and April include the perception that the global economy had reached bottom and that many stocks had become over-sold.
- Further rises in share prices are unlikely to emerge over the remainder of 1H09 as prices seem to have out-run the improvement in the global economy.

Exchange rate



- The Australian dollar rose further in April, finishing the month at US\$0.73 from US\$0.69 in March. The A\$ remains well above its recent lows of below US\$0.60.
- The rise in the dollar reflected increased appetite for risk over the month and an improvement in global commodity prices.
- Given the RBA's signal that monetary easing is now on pause. This should provide favourable support to the currency as domestic interest rates will remain high relative to other global economies.

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