Client Economic and Market Update February 2010

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Markets and Economics
Looking for Opportunities whilst being Cautious

Global

- A recovery in global growth remains the key theme for developed economies, even though growth remains weak in some cases. Growth as a whole for the world economy is now expected to reach around 4% in each of the next couple of years.

- However, the recovery in the developed economies is likely to remain subdued for some time. This contrasts with the developing economies where stronger growth is expected.

- Although the outlook for the world economy as a whole has improved, what impact the removal of Government fiscal stimulus packages around the world will have remains a concern. A sustainable recovery will need to be supported by a strong pick-up in private demand which so far has not materialised.

- Investor sentiment remains generally positive, however, occasional shocks have seen investors look to the security of cash and bonds. These shocks have been associated with concerns over fiscal stimulus and the creditworthiness of some governments rather than the creditworthiness of financial institutions, as was the case in 2008 and much of 2009.

Markets and Economics Continued

- Whilst conditions have undoubtedly improved since early 2009, it’s important to remember that economic conditions in many developed economies, especially in Europe and USA , remain extremely fragile.

- These economies continue to face many underlying issues, such as overly-indebted consumers/home-owners. As such, we continue to be optimistic on a longer-term basis, but remain cautious over the shorter-term.

Australia

- In Australia, signs of economic recovery continue to show, with a surprising fall in the December unemployment rate to 5.5%, going against expectations.

- The impact of economic stimulus and continued demand for our exports (especially demand for resources from China) have helped ward off a significant rise in unemployment experienced by virtually all other developed economies such as the US and in Europe.

Asset Class Update

Cash

Against most expectations, the Reserve Bank of Australia (RBA) did not raise interest rates in February, leaving the official cash rate keep unchanged at 3.75% . The RBA gave the following reasons for its decision:

- Inflation has moderated as a result of less pressure from wages growth, weaker domestic demand and a higher $A;
- Interest rates are no longer at very low levels; and
- Little information to hand as to the effect of the most recent interest rate rises on economic activity

However ,the RBA also added that in its pursuit of controlling inflation, it is prepared to raise interest rates if economic conditions strengthen as expected.

A rising interest rate environment will benefit clients holding cash-based investments (e.g. savings accounts and term deposits). However as a long-term investment , we believe better opportunities are available in other asset classes (e.g. shares).

Asset Class Update Cont'd

Fixed Interest

- Global bond prices moved higher in January, as investors moved out of shares and into the relative safety of bonds, particularly Government and high quality bonds. This shift in sentiment was a result of concerns over the Government-debt crisis in Greece and potentially other European countries.

- As bond prices rose higher, this saw US and European bond yields fall (bond yields move in the opposite direction to bond prices) markedly.

- Despite the release of strong domestic employment and building approvals data, Australian bond prices were also driven higher on the back of global market sentiment, causing bond yields to fall

- Though investors showed a preference for higher quality bonds during the month, the shift from shares to bonds saw most fixed income security prices rise across the quality spectrum.

- Our view is that investors should maintain a neutral position in Fixed Interest.

Asset Class Update Cont'd

Property

- As with the rest of the share market, listed property also suffered a fall in January as investors moved away from listed-share investments.

- In Australia, the property sector fell 3%, whilst overseas listed property recorded a 3.9% drop.

- Despite a setback in performance in January, we believe that the sector has benefited from financial restructuring and increased transparency, which are likely to make listed property once again a viable investment option. We note the following evidence to support this view :
  - Debt levels in the sector have fallen to about 30% (the lowest levels seen since 2002);
  - Valuations have stabilised, following large writedowns in the sector ; and
  - No capital raising activity during January, signalling that the need to raise capital has decreased

- We still, however, retain our cautious view on this sector and will continue to monitor ongoing restructuring.

- We believe that the most appropriate way of gaining access to property investments is through Australian share funds that take selective positions in property stocks.

Asset Class Update Cont'd

Australian Shares

- Early gains by Australian shares in the New Year soon reversed on the back of concerns over global market events:
    - Decision by Chinese authorities to tighten lending growth to curb inflation, and the negative impact this could have on economic growth;
    - Measures announced by the Obama Administration in the US to give regulators the power to limi the size of the nation's largest banks and the scope of their risk taking activities; and
    - Sovereign debt issues in Greece and other European economies.

- These concerns pushed the Australian share market down 6.2% for the month, erasing the gains that had been achieved since September 09.

- A positive that has come out of January's decline, is that combined with what has been a reasonably positive company profit reporting season so far, the valuation of Australian shares has now fallen to historical averages. Had the market continued to rally, the market's valuation would have risen to unsustainable highs.

- Our key message is unchanged - we believe investing in quality Australian companies is an appropriate long-term investment strategy.

Asset Class Update Cont'd

International Shares

- Major share markets were in positive territory for most of January, until concerns over sovereign debt issues in Europe saw these markets sell off. This caused the main international shares index (MSCI World ex-Aust) fall 2.9% in January.

- Sector performance was mixed. In the US Finance sector for example, whilst those institutions focused on investment banking have performed well, banks with a focus on retail operations continue to suffer. This performance difference within the Finance sector has seen stocks such as Goldman Sachs and JP Morgan outperform Bank of America and Citigroup.

- Emerging share markets followed movements in major developed markets. Chinese shares, however, struggled on the back of the decision by Chinese authorities to tighten lending standards by financial institutions. This move is designed to control any blowout in inflation. We will continue to monitor these developments closely.

- We maintain our view that Emerging Markets will underpin global growth and should be a focus in investing in global share markets.