

Client Economic and Market Update May 2010

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Markets and Economics

- Economic and market news this month was dominated by the European Debt Crisis.
- High government debt levels in some European countries, and concerns in financial markets over the ability of these countries to service these debts, has resulted in increased volatility in global markets. The crisis began with concerns over spiralling Government debt levels in Greece, with the European Union and the International Monetary Fund having to step in with a rescue package totalling 750 billion Euros to stabilise markets.
- This action initially calmed investor nerves, before the crisis spread to other countries such as Spain and Portugal. Markets fear these and other European countries have unsustainable Government debt levels which will require measures such as a freeze on pensions, wage cuts and higher taxes, potentially depressing already weak economic growth and leading to a deep European recession.
- Unfortunately, fear over a crisis overshadowed otherwise positive economic news in the US and Australia. The latest data in the US points to solid company profits, strengthening economic growth and a pick up in consumer demand. Unemployment, though still just under 10%, has stopped rising.

Markets and Economics

- The Australian economy continues to grow, with the RBA forecasting growth of 3.25% in 2010. However, being an open economy, Australia is not immune to any negative economic impacts from the rest of the world.
- We continue to believe that Emerging Markets, particularly in Asia, will lead a global economic recovery. Many of these economies have been able to unwind stimulus packages without a major detrimental impact on their economies.
- It is important to note, however, that if this growth in emerging markets, is not well managed then the possibility of 'price bubbles' forming is real. The most concerning of these is in the Chinese residential market.
- Your advisor will continue to monitor market events as they unfold, however, we firmly believe that despite current market instability, the economic fundamentals for investing over the longer term (+ 3 years) remain strong. In particular, we believe that Australia is the preferred investment option when compared to other markets.

Asset Class Update

Cash

- The Reserve Bank of Australia (RBA) increased the cash rate by another 0.25% to 4.50% in May. This is the 6th rate hike since October 2009.
- The RBA's comments show that the main reason for the increase was due to a sharp increases in commodity prices which are likely to boost wages and therefore put pressure on inflation.
- Given the recent uncertainty around the European Debt Crisis and that it could worsen, the RBA's commentary also indicates that it may pause following the latest rate hike, with "monetary policy well placed for the present".
- With a potential slowdown or pause in rate rises, our key message remains unchanged, that is:
 - Although further rate rises will assist clients holding cash for income, over the longer term better opportunities exist in the other asset classes. Dollar cost averaging remains the preferred method of investing in these other asset classes.

Asset Class Update Cont'd

Fixed Interest

- As a result of market uncertainty in April, investors sought the relative safety of investing in government bonds of countries whose perceived economic performance is strong (for example, the US, Australia and Germany).
- This was at the expense of riskier Government bonds in countries as Greece and Spain, where prices fell sharply given concerns over their ability to manage their debt levels.
- Corporate issued bonds did not fair too badly, with the premium (yield) paid to investors for holding riskier bonds, falling during the month.
- Therefore we believe that in the current market environment, preference should be made for those fund managers that focus on high quality Sovereign and Corporate debt.
- Our view is that investors should maintain a neutral position in Fixed Interest.

Asset Class Update Cont'd

Property

- Returns for Global and Australian Listed Property were solid in April, rising 3.9% and 4.2% respectively.
- The outlook for Australian listed property has improved, supported by a strong domestic economy. However, the yields offered by listed property stocks are not yet attractive enough for investors relative to the RBA's cash rate and the 10-year Government bond yield.
- The concern for listed global property is that stock prices have risen too quickly and ahead of restructuring efforts required in the sector. Evidence of this restructuring, as well as other sectoral issues, and in light of a patchy economic recovery will need to be addressed for recent strong returns to be sustainable.
- Our position continues to be that the most appropriate way of gaining access to property is via Australian equity managers who invest, on a very selective basis, in property stocks.



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Asset Class Update Cont'd

Australian Equities

- Australian shares followed the general direction of most share markets in April, falling 1.3%.
- Most sectors fell for the month, with Health Care the worst performer, falling 6.9%. Telecommunications however was a standout, rising 5.6%.
- Smaller companies performance was relatively stronger in April, recording a flat return and outperforming the larger company stocks.
- The performance of the share market, however, overshadowed positive economic and market news:
 - A forecast GDP growth rate of 3.25% in 2010, by the Reserve Bank
 - More attractive valuations for Australian shares as a result of improved company profits and recent share price falls
 - A pick up in takeover activity since February 2010 (with a total of around \$25 billion deals announced) as companies with low debt levels and large cash balances look for opportunities
- 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 Equities

- Global share market losses in April were concentrated in Europe, where the index was down 5.3% on the back of the European Debt Crisis, with investors withdrawing from the Euro as well as European shares.
- By comparison the US S&P 500 Index was up 1.9%, whilst the Japanese market was largely flat at 0.3%. In Emerging Markets, Chinese shares fell 7.7%, largely due to measures by the Chinese central bank to slow down consumer demand.
- As we have continued to highlight, volatility remains a current feature and is likely to increase and test investors' nerves. In light of this, we are increasingly focusing our efforts on monitoring the performance of both developed and emerging economies.
- Our **key message** is to continue to overweight global equities, with a focus on emerging economies over the long term.

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