

Ausbil Dexia Limited Investment Markets

January 2010

Ausbil, a partnership of investment experience and financial strength

AUSBIL DEXIA LIMITED

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A Member of the Dexia Group

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Money does not perform. People do.



Ausbil Dexia Limited
Australia

International Economic Overview

Overview

January 2010 was a difficult month for markets despite economic and earnings data being mostly positive.

The December quarter 2009 US GDP data was in line with upgraded consensus estimates and the strong Chinese GDP outcome was a significant improvement on expectations of even three months ago. Three events, however, were of concern to the market; firstly, the Greek sovereign debt problem and its relationship to the Economic Monetary Union (EMU); secondly, the administrative tightening on domestic lending in China in the wake of strong growth data; and finally, unpredictable US policy and its broader ramifications beyond the proposed splitting of Commercial and Investment Banks.

Greece and the EMU

The crisis raised many questions that sceptics had always voiced about the Economic Union (EU) and the EMU. Greece is the EMU member, post the Irish fiscal tightening, that is in the most challenging position, but it is not alone. Spain and Portugal are at risk, and there are some big issues at stake. This dilemma goes to the heart of long term issues about the EMU, including whether countries will be prepared to give up some aspects of economic sovereignty. This is, of course, what many key German policymakers have wanted all along. The EMU challenge, however, needs to be kept in perspective. It might just be that we see a more imaginative replacement of the effectively now defunct Stability and Growth Pact which will place the EMU on firmer longer term foundations.

China

China has been a concern since the start of 2010 but it is a “positive” problem to have; that of needing to tighten financial conditions to slow the recovery. Where there were uncertainties that the 8 per cent growth target would be reached, now there is pessimism that the actual growth results of 10.7% will lead to excessive tightening.

History indicates that once Chinese GDP growth is outside an 8 to 10 per cent range, Chinese policy becomes active. That is now the situation. The concerns about unsustainable lending, property bubbles and inflation are reasonable but need to be seen in context of Chinese policymakers reacting quickly and firmly to maintain stable, strong growth. To date the tightening has been via domestic lending controls rather than interest rate adjustment. The authorities could still use market based mechanisms for future adjustment, such as an interest rate and exchange rate adjustment.

U.S. Regulatory Policies

Whilst there are sound reasons for splitting the commercial from the investment banking activities to manage the capital adequacy and risks, the timing is difficult. This is still a fragile time of recovery from a low point of virtual bank insolvency.

Whilst the Obama announcements on regulatory changes are designed to appeal to the electorate, there is a more substantial issue which will have much more broader ramifications. The continuing work of the banking regulators both within the US and internationally is designed to reduce risk by requiring substantial additional capital and by holding this capital in sovereign debt rather than other banks’ securities. Similarly, there will be additional requirements to ensure that there is acceptable matching of the term structure of long term loans and deposits.

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A lot depends on how these measures are defined and implemented. The overall effect will be to slow lending and aggregate growth, during a period in which strong growth is needed. The recent political agenda now provides a difficult overlay and the market is discounting heavily for the uncertainty.

Global Outlook

In its January update, the International Monetary Fund (IMF) improved its outlook for the global economy in 2010. Global GDP growth is now expected to reach 4% this year, a 0.8 percentage point upgrade from the October 2009 forecast. World GDP growth is also now expected to reach 4.3% in 2011, up marginally from the prior estimate of 4.2%.

Unsurprisingly, the IMF expects the recovery to be uneven. The advanced economies are forecast to expand 2.1% in 2010 and 2.4% in 2011, following a 3.2% contraction in 2009. At the same time, the emerging economies are expected to grow by 6.0% in 2010 and 6.3% in 2011, after recording a 2% expansion last year.

While economic activity is looking stronger, IMF forecasts suggest the inflation outlook remains benign. Consumer prices are expected to grow by 1.3% in the advanced economies this year, up slightly from their October estimate of 1.1% and below the long-term average level of around 2%. Prices in the emerging economies should rise by 6.2%, up from the October forecast of 4.9%, a sizeable upgrade but still below the pace recorded in recent years. Modest commodity price inflation expectations underpin these forecasts, with the IMF's baseline oil price forecast unchanged from October at US\$76 a barrel for 2010.

So while the recovery in the advanced economies, especially in the Euro area and UK, is projected to "be weak by historical standards", the strength of the forecast overall global growth rate is positive. The emerging economies, particularly China and India are expected to lead the global economic recovery and the prospect of a sluggish recovery in some of the advanced economies is not especially concerning.

Indeed, the IMF upgrades were announced on the same day as the release of the December quarter UK GDP figures, which showed barely positive growth in the quarter. Furthermore, the IMF's marginal upgrade to Spanish GDP growth for 2010 still leaves the economy contracting 0.6% this year. This highlights the point that the cyclical recovery in global demand conditions is in train even as some patches of weakness persist in the developed economies. The trade forecasts also make this clear, with global trade expected to expand 5.8% this year, and to improve to 6.3% in 2011, after contracting 12.3% in 2009.

The second important point from the IMF upgrades is that the revisions to the growth numbers so early into 2010 seem to attest the sustainability of the recovery. The major developed economies were in recession in the second half of 2009, and the fresh upgrades point to ongoing improvement. In large part, these numbers are due to policy stimulation. Extraordinary policy stimulus has been the major factor behind the rebound in real activity, and the policies are set to remain supportive.

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Monetary policy, for example remains supportive. While crisis lending measures are gradually being phased out, changes in interest rates continue to be pushed back to at least the June quarter 2010. The US Central Bank kept interest rates close to 0% in its January meeting and reiterated its commitment to keep borrowing costs on hold for “an extended period”. The Bank of England also made it clear that it is intent on looking through the recent rise in inflation figures to keep monetary settings extremely loose. Similarly, the Europe Central Bank (ECB) is expecting a modest economic recovery for Europe combined with low inflation. This suggests that holding interest rates at their current record of low of 1% would be an appropriate policy setting.

Fiscal settings are also highly expansionary. Indeed, the US Federal Budget deficit is expected to be US\$1.35 trillion this year. Though this is slightly smaller than the 2009 deficit, at 9.2% of GDP it is still the second-largest deficit since World War Two, on Congressional Budget Office estimates. We expect that the Recovery Act funds still to flow through, as well as new policy initiatives this year to help create jobs, should still give momentum to the US and global economic recovery.

Furthermore, US deficit reduction from 2011 is unlikely to be dramatic. Governments in Europe are also expected to be in no hurry to put through fiscal austerity measures in the near-term, taking comfort instead in slightly better public debt figures as growth recovers.

Very accommodative monetary policy settings are also driving other sources of stimulus. Record-low interest rates have helped to drive a marked depreciation in the US Dollar and Sterling. This, combined with the cyclical recovery in global demand conditions, has supported firm expansion in global trade. Furthermore, currency effects are transmitting easy monetary conditions to the emerging economies.

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United States

The US Federal Reserve Open Market Committee continued down the path set by the recent policy statements by upgrading its outlook and furthering plans to unwind credit easing. It has also continued to maintain the current range for the federal funds target rate and has repeated that conditions “are likely to warrant exceptionally low levels of federal funds rate for an extended period”. However, there was one dissent: Mr. Hoenig “believed that economic and financial conditions had changed sufficiently that the expectation of exceptionally low levels of federal funds rate for an extended period was no longer warranted”.

The upgraded outlook, the single vote to revoke the “extended period” and the continued planning to unwind credit easing are all important steps toward tightening, although the funds rate remains at emergency levels and the Federal Reserve’s balance sheet is near a peak.

The initial US GDP growth rate for the December quarter 2009 came in at 1.4% (or 5.7% annualised). There are a number of noteworthy points about the outcome: it is the strongest quarterly rate of growth since the September quarter 2003 and the first time year-ended growth has moved into positive territory since the September quarter 2008.

The strength in GDP in the quarter partly reflects a sharp reduction in the pace of de-stocking, which added 0.8 percentage points or 3.4 percentage points (annualized) to quarterly growth. Businesses have run inventories down to record lows over the recession and now simply cannot continue to reduce them much further. A rebuild is underway.

As a further indication of the underlying pulse in the economy, final sales of domestic product (which excludes changes in inventories), grew by 2.9% annualized in the quarter, up from 2.0% in the September quarter. While not as spectacular as the overall headline result, it confirms that a modest recovery is underway in the US economy.

One of the more encouraging aspects of the report was a lift in household consumption; this was the second consecutive quarter of solid growth and came despite the impact of the withdrawal of the ‘cash for clunkers’ fiscal incentive to stimulate car purchases.

Elsewhere, fixed investment grew for the first time since the June quarter 2007, supported by various fiscal incentives. Investment in equipment and software was particularly strong, growing 13.3% in the quarter underpinned by tax breaks. Residential investment increased by 5.7% in the quarter on the back of the first homebuyer tax credit. Partly offsetting this however was a 15.4% fall in non-residential structures investment.

Public demand continues to track well below its long-run average growth rate, presumably reflecting the impact of constraints on finances at all levels of government. Meanwhile, net exports contributed marginally to GDP growth in the quarter, with a strong rise in exports of 18.10% only partly offset by a more modest rise in imports of 10.5%.

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The current low level of stocks virtually guarantees that it will continue to exert a positive influence on growth through 2010. Investment in equipment and software will ease from the rate in the December quarter as the stimulus from fiscal measures recedes, while prospects for a turnaround in non-residential structures looks remote in the near term with low levels of resource utilisation, falling commercial property prices and uncertain demand weighing on the sector. In contrast, residential investment looks to have bottomed, with the previous surplus inventory now being managed and underlying population growth still providing a support.

Public finances at all levels of government remain severely impaired and pressure to rein in discretionary spending will likely see public demand continue to track below its long run average rate through 2010. Meanwhile, external demand will have a modest positive impact on growth through 2010 as solid growth in exports is offset by the impact of the recovering domestic economy on growth in imports.

The market is revising up its forecasts for US growth following the stronger than expected result in the December 2009 quarter. Current consensus for GDP growth on 2010 is around 2.5%. This is likely to continue to be revised up.

The latest reading on production indicators suggests that the US economy continued to expand at a solid pace in the December quarter of 2009. The automotive sector showed the best improvement, though gains were broad-based. Capacity utilisation rates also improved across most of the major categories, with total industrial capacity utilisation above 71% in late 2009. Though still below its long-run average level of around 80%, the current rate is nonetheless 3 percentage points above its June reading.

Furthermore, the Philadelphia Fed Survey points to increasingly firm manufacturing growth in the mid-Atlantic region. The headline business conditions index rose to 20.4 in December from 16.7 for November, now at its highest level since early 2005. Significantly, the employment sub index pushed up from 2.0 to 6.4, its best reading in two years.

With slack in the economy starting to diminish, producer prices have started to increase. A surge in energy costs drove the first year-on-year price gain in the Producer Price Index (PPI) since November 2008. Price pressures were widespread, with the core PPI increasing a firm 0.5% in the month.

At the consumer level, price growth has also returned. The CPI increased 1.8% year-on-year in November, from -0.2% year-on-year for October. With energy prices rising, monthly consumer price growth has also climbed higher in recent months. The recent core CPI was recorded at 1.7% year-on-year basis, 0.2% above its September quarter 2009 average level.

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New housing activity continued to improve; suggesting that a long-standing constraint to GDP growth has finally abated. Housing starts increased to an annualised rate of 574,000 in November, from a downwardly-revised 529,000 for October. Construction should also continue to improve in the coming months, with building permits lifting in November. Total permits improved from an annualised rate of 551,000 in October to 584,000, their highest level since November 2008.

Homebuilder sentiment finished the year on a slightly softer note, though is also holding well above the lows reached earlier in 2009. The ebb in sentiment should prove temporary, with the labour market improving and growing strength in the existing homes market likely to soon start pushing up the demand for new homes.

The Conference Board leading index suggests the US economy outlook continues to firm. Following a 0.3% gain in October, the index rose 0.9% in November, its eighth consecutive rise. The index is now slightly higher than its most recent peak in July 2007. With the coincident index also up 0.2% in the month, activity looks to be on track.

United Kingdom

The UK emerged from recession, but only on the most pedantic, technical definition (0.1% for the December quarter is equivalent to a rounding error). The headline GDP growth of 0.1% was disappointing, but the detail of the data gives rise to more fundamental concerns, principally the stagnation in key areas of the private sector. The distribution sector growth in the December quarter was probably influenced by expenditure having been brought forward ahead of the January VAT increase. The UK will continue with its de facto zero percent policy rates, now applicable for almost a year. Also to continue is the £200bn of quantitative easing, the fiscal deficit heading for 12% of GDP and a competitively-valued currency. The outlook for 2010 is for an improvement; however, it will be a modest growth outlook.

Japan

Standard and Poors Ratings (S&P) revised to negative from stable its outlook on the 'AA' long-term rating on Japan. S&P cautioned that the Japanese government's diminishing economic policy flexibility may lead to a downgrade unless measures can be taken to stem fiscal and deflationary pressures. "At a forecasted 100% of GDP at fiscal year end March 31, 2010, Japan's net general government debt burden is among the highest for rated sovereigns. Moreover, the policies of the new Democratic Party of Japan (DPJ) government point to a slower pace of fiscal consolidation than we had previously expected", noted S & P. Combined with other social policies that are not likely to raise medium-term trend growth and with persistent deflationary pressures, S&P forecast that Japan's net general government debt to GDP will peak at 115% of GDP over the next several years.

There are a number of positives, including the country's strong net external asset position, the Yen's status as a reserve currency, the financial system's resiliency throughout the recent global recession, and the economy's diversification. The biggest problem is the continued deflation, where prices continue to fall, making consumers wary of current purchases and making saving attractive. Significant structural changes are still required for the economy.

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Europe

A credibility shortfall is intensifying concerns about the difficult fiscal adjustments ahead in Europe. This was particularly evident in Greece last quarter when the new government revised up the estimate of the 2009 deficit from 6% of GDP to 12.7% of GDP. Portugal revised up its estimate of last year's deficit from 8% of GDP to 9.3%, and Spain revised up its estimate from 9.5% to 11.4%. Given the scale of the fiscal adjustments needed, these revisions make the resolution all the more difficult.

Against this backdrop, there are serious concerns regarding the political commitment to deficit reduction. For Greece, where the fiscal deficit has averaged 7.7% of GDP since 1980, investors doubt whether the government is committed to making the hard decisions needed to stabilize the debt to GDP ratio. In Portugal, the 2010 budget contains only a modest fiscal tightening, which is somewhat surprising in the current environment in which financial market pressure is intense. The lack of a more assertive response in Portugal suggests that there are limits on what the minority government can achieve.

Euro policymakers are indicating that Greece cannot be ejected from the Euro area and that it will not be allowed to default, and that the IMF will not be invited to provide outside discipline. Hence, it will be regional pressure that will be needed to produce the desired result. The region's poor track record on ensuring fiscal discipline would risk turning any temporary support packages into a de facto fiscal transfer.

The data on Euro area economic activity has shown some improvement. The large upward revision to German manufacturing orders in November, from an initial estimate of 0.2% for the month to 2.8%, suggests much stronger momentum in German industry than previously thought. The 2.1% monthly gain in French consumption of manufactured goods in December suggests that total consumption spending in France may have increased by around 5% in the December quarter of last year. Importantly, this increase reflects more than just the boost to car sales from the French car scrappage scheme, and provides some upside improvement to the French GDP outlook.

German employment rose in December, vacancies rose in January, and the rise in unemployment in January was modest given the adverse weather. Unemployment in the Euro area is also rising by smaller amounts. The Euro area composite sentiment indicator is now only 5 points below its long-run average, having already risen 25 points since the trough last March, while the German IFO business survey is now back in line with its historical average.

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China

Chinese GDP expanded by 10.7 per cent over the year to the December quarter, up from 9.1 per cent (revised) in the September quarter.

Overall, the December quarter outcome was stronger than expected. The pace of household spending appears to have moderated slightly and real retail sales increased by 2¼ per cent compared with growth of more than 4 per cent in the previous two quarters. Despite this slowdown, the outlook for consumption remains strong. Household sentiment about current and future income improved over the second half of the year and authorities have indicated their commitment to supporting household spending in 2010.

Investment was the predominant source of growth in 2009. However, partial fixed asset investment data indicates that the pace of capital expenditure slowed in the second half of the year and contracted in the December quarter. Both state owned and private investment fell. This may reflect waning fiscal stimulus, with the package more front loaded than had been expected.

On the other hand, business sector conditions remain very robust with all surveys improving noticeably in the December quarter. Profits increased sharply in the three months to November and are higher than prior to the global financial crisis. Moreover, widening profit margins suggest overcapacity is not currently widespread (although fears of future overcapacity maybe prevalent).

Inventories seem likely to have contributed to GDP growth in recent quarters, following large subtractions in 2008 and early 2009. The Purchasing Managers Index shows an increasing net balance of firms now restocking while inventory levels for sectors where data is available has also risen for the past three quarters.

Trade flows have recovered rapidly in the second half of 2009. Net exports are likely to have contributed to GDP growth in recent quarters, although the exact magnitude is difficult to estimate due to data limitations.

Housing prices have continued to climb higher, though there are signs of regional disparity. Monthly growth in the 70-cities house price measure has accelerated in the past three months and is currently appreciating at an annualised pace of around 20 per cent. So far, the house price escalation is not geographically widespread. Only 14 cities out of the 70 survey had increases greater than the overall index, indicating a high degree of skewness. This reflects that some cities have experienced significantly large price increases.

Nevertheless, authorities have become clearly more concerned about the housing markets and have introduced a number of policy measures to contain activity. In general, policies have aimed to restrict new credit for second homes or speculative purposes. This is being implemented through greater scrutiny of lending, credit rationing and higher down payment ratios on land purchases. There has been an increased supply of low-cost housing. The State council has committed to building 1.8 million low rent homes and 1.3 million low-priced houses in 2009.

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Australia

The Reserve Bank of Australia (RBA) left rates on hold at 3.75% at its February meeting. This unchanged policy was unexpected, with the markets factoring in a 25 point move.

The pause is a clear reminder that the RBA remains conscious of the international backdrop. Jitters in European economies and concerns over Greece's financial fiscal position were considerations. China's policy tightening was mentioned. The extent of concern demonstrates that global market sentiment remains fragile. Other concerns on the domestic front noted in the statement were the increases in borrowing rates faced by households and businesses over recent months. These probably played a bigger role in the RBA's thinking than widely appreciated. Given recent elevated uncertainty in financial markets they also provided the RBA with sufficient caution to undertake the current pause.

House prices are on an upswing, with the residential construction activity thus far unlikely to meet the surging demands from strong population growth. Business and consumer confidence are at a very high levels, despite three consecutive rate increases. The unemployment rate has clearly peaked, and at 5.5% is closer to relatively full employment at the beginning of an upswing than at any time over the past few decades. Skills shortages are already rating a mention as various industries seek to lock in suitable workers for upcoming projects over the course of the year. Underlying inflation continues to remain elevated and, with growth indicators pointing to stronger than forecast activity, prices are likely to moderate only modestly over the year.

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New Zealand

The Reserve Bank of New Zealand (RBNZ) left the cash rate on hold at 2.5%, as expected. In addition, the RBNZ confirmed that the outlook for the economy continues to evolve in line with its December Monetary Policy Statement projections. The RBNZ maintained its expectation to increase rates around the middle of 2010.

The statement itself was very similar to the December statement, with the RBNZ being very cautious not to upset the markets with this announcement.

The RBNZ noted that global activity continues to recover, pushing NZ commodity prices higher. The NZ economy continues to recover, with the RBNZ acknowledging a pickup in consumer spending. Nonetheless, households remain cautious and credit growth is subdued. Business investment remains weak.

With the economic recovery starting to gain traction, the RBNZ will want to return policy settings closer to a 'neutral' level of somewhere close to 5%. The RBNZ has a large gap to close, with 250 basis points of tightening. However, relatively small increases in the cash rate are likely to have a surprisingly powerful effect on lending rates and household behaviour.

In the post financial crisis environment, the economy is now more sensitive to interest rate increases. In part, this can be attributed to a relatively steep normal-shaped yield curve. Borrowers have become more attracted to shorter-term interest rates, with a notable change in borrower preference to floating or fixed terms of just 6 months. This dynamic will be helpful for the RBNZ as it reduces the lag between cash rate increases and higher effective interest rates.

The sensitivity to high debt levels has been amplified by lower income growth and ongoing concerns for job security. These factors increase the potency of interest rate increases.

Retail sales were up strongly in November, rising 0.8% for the month compared to market expectations of a 0.5% rise. Importantly, the gains were consistent across the board, with core retail sales (ex auto) also rising by a very solid 0.8% for the month. This follows a recent string of improvements in core retail activity, which has risen by 2.7% in the past four months, consistent with the recent upturn in consumer confidence.

This improvement in both consumer and housing market conditions will have a significant bearing on policymaker actions further down the track, with tightening expected by the middle of 2010.

Fixed Interest

Performance and Outlook

The debt market delivered a strong positive return of 1.48 % over the course of January 2010. Performance for the 12 months was more modest however, at 0.3% as measured by the UBSA Government Bond index.

Ten year bonds opened the month at 5.64 % and closed at 5.38 %. Three year bonds opened at 4.66% and closed at 4.51%. The cash rate was kept stable at 3.75% as there was no January 2010 RBA meeting. The rate was left unchanged at the early February RBA meeting. All bond maturities are providing a positive yield curve. The Bill curve is anticipating rate increases over the next 4 months.

The Government Bond market strengthened as the equity markets weakened. This was a broad based international movement as riskier assets retreated due to a series of factors. The credit market retreated in major markets with the move to safe, sovereign assets; however, the monthly credit returns in the domestic market remained attractive.

The bond markets spent most of January rallying as the offshore events dominated the domestic market. The second half of January had seen concerns about a possible Greek sovereign default and investors sought safe havens causing US and Australian Government bonds to rally.

Strong domestic data did manage to cause small sell-offs in the Australian bond markets. Retail sales grew at 1.4% (month on month in November) and the unemployment rate fell to 5.5% in December. There was also strong building approval data and a high underlying CPI. These interludes were always short-lived, however, and the general rallying tone was dominant.

Australian 3 year bond futures rallied 21 basis points over January while the 10 year rallied 32 basis points. The slope of the curve flattened by 11 basis points over the month as a noticeable flattening in the early part of the month was later partially reversed.

The strong Australian rally was mostly only keeping pace with the US. The spread between Australian and US 10 year bonds narrowed slightly over the month but has continued to range trade between approximately 180 basis points and 200 basis points.

The Government bond program recommenced new issuance tenders on January 13 after a short pause for the festive season. Issuance then returned to normal patterns with A\$3.6bn of fixed rate bonds and A\$300m of indexed bonds issued in January. All tenders were well supported (in a rallying market) with the minor exception of the tender held on January 27, the morning of the CPI release – which was more about the timing than anything else.

On January 21, Queensland Treasury Corporation QTC issued a new bond, the Nov-14, without the aid of a Commonwealth Government guarantee, the first by an issuer that had previously used guarantees. The new line was launched with A\$4bn of initial issuance which made up the vast bulk of QTC's issuance of \$4.3bn (to 24 January).

Currency

The US Dollar lifted over January. Both risk aversion and improved US economic data played a role in the USD's rise over the month. In trade-weighted terms, the USD appreciated 2.1% over the month. However, on an intra month basis, the movement was volatile. The USD weakened early in the month following the December non-farm payrolls report. The larger-than-expected drop (-85k) in the December figures weighed on sentiment, and the USD dropped as markets pushed out the beginning of the Federal Reserve's rate rise cycle. The USD remained at these lower levels until mid-month because economic data, including retail sales, proved patchy.

The USD turned sharply later in the month as markets sold the Euro on concerns for Greece's sovereign outlook. European economic data further revealed a slowing in the Euro-zone economic recovery, and, by contrast, the US economic data continued to improve.

The USD regained ground into month end as the Federal Reserve 27 January meeting gave the markets a more positive commentary on the US economy. Adding to the improved outlook for the US economy were the stronger-than-expected December quarter GDP results which revealed the strongest quarterly growth rate in six years.

The Australian Dollar (AUD) had a mixed performance over January. The AUD fell 1.5% against the strengthening USD and dipped 4.4% against the Japanese Yen. However, in trade-weighted terms, the AUD gained 0.3% in January. During the month, the AUD touched a 25-year high of 0.5794 against the Pound and against the Euro it touched 0.6485, its highest rate since November 2007.

Australian Equities

The Australian equity market reported a 6.2% decline in January. Increasing concerns around the regulatory environment in the USA combined with higher than expected inflation risks emerging in China were the major drivers. Investors were also increasingly focusing on the upcoming February domestic reporting season with various companies taking the opportunity to address market expectations. There were both positive surprises, including upgrades from Commonwealth Bank and Computershare, and negative ones, such as a downgrade from Worley Parsons. Sales figures from Woolworths were seen as disappointing and raised questions over the strength and competitiveness of retail conditions.

Economic data retained a positive bias underpinned by strong data on employment, retail sales and building approvals. Inflation data surprised on the upside with the core rate outside the RBA's 2-3% target band, increasing the pressure on the Government to reign in its spending and for the RBA to continue its monetary policy tightening phase. After reaching a high of 93.2¢ the AUD retreated back below 90¢ finishing the month at 89.0¢.

In commodities, base metals (CRB Index -3.2%) and spot oil (TWI -8.2%) lost ground due to the potential shift in Chinese macro policy and a firmer US dollar. Spot gold (-2.1%) also succumbed to profit taking as the stronger US dollar weighed on sentiment.

The Resources sector (-9.4%) underperformed Industrials (-4.8%), as commodity prices reacted to the potential shift in Chinese policy and the firmer US dollar. The smaller companies, represented by the S&P/ASX Small Ordinaries (-7.4%), underperformed the large cap stocks (-5.9%), represented by the S&P/ASX 50 Leaders Index.

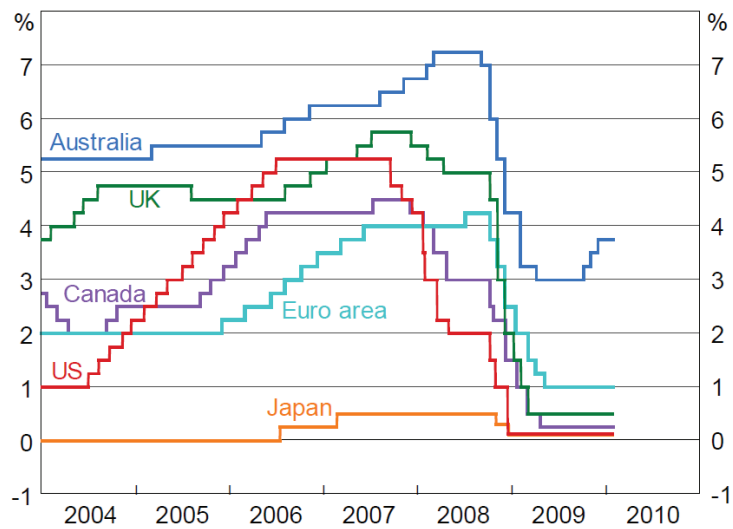
At a sector level, Information Technology (-1.1%), AREITs (-3.0%) and Telecommunications (-3.1%), were the best performing sectors with the major stock contributors being Computershare (+1.4%), Westfield Group (+0.8%), CFS Retail Property Trust (-1.6%) and Telstra (-2.6%).

Energy (-9.8%), Metals and Mining (-9.2%) and Materials (-9.0%), were the worst performing sectors over the period. At a stock level the major moves were recorded by Woodside (-10.3%), Oil Search (-14.2%), BHP (-8.6%), Rio Tinto (-9.2%) and Boral (-10.4%).

Profit reporting season and earnings expectations

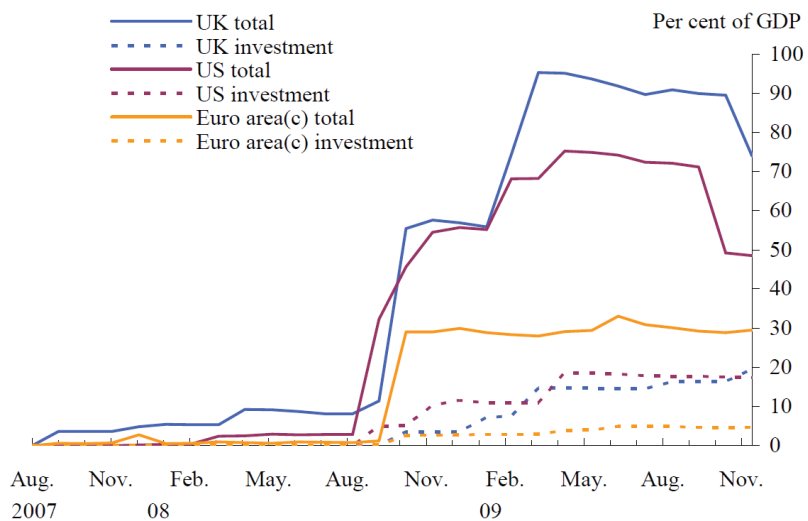
After the Australian equity market rose 37% in the 2009 calendar year, the market has begun the 2010 calendar year with a negative return in January. Investment sentiment has been volatile as investors digest the release of global macro economic data and try to interpret what impact the removal of global government fiscal (Chart 2) and monetary (Chart 1) stimulatory measures may have on economic growth and corporate earnings. The major moves are summarised in the following charts:

Chart 1: Major Countries' Policy Interest Rates



Source: RBA, Central Banks

Chart 2: Public sector interventions during the financial crisis



Sources: Bank of England, BIS, Board of Governors of the Federal Reserve System, ECB, FDIC, HM Treasury, IMF World Economic Outlook (October 2009), US Treasury and Bank calculations.

(a) End-of-month data expressed as percentages of 2007 nominal GDP.

(b) Scale of interventions = potential size of packages when announced

(c) Original euro area 11 countries plus ECB interventions.

Australian Equities

Even though the major developed economies are showing clear signs of improvement, growth needs to trend higher in a sustained manner. More recently, China's government introduced measures to reduce lending and control economic growth. This should be seen within the context of low double digit growth being reduced to sustainable high single digit growth, as per the country's officially enunciated "5 year plan" objectives.

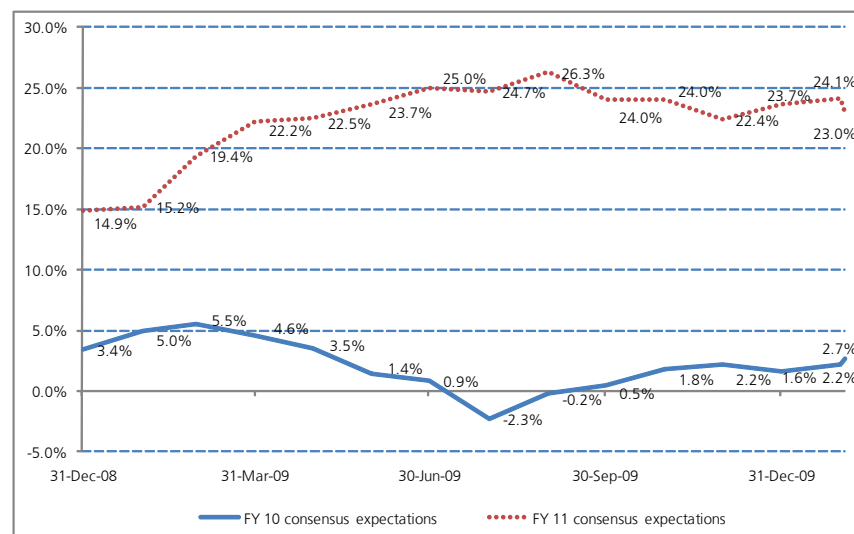
From a market valuation perspective, the Australian equity market has historically traded on a forward P/E multiple of ~14.5x. Within this context, Table 1 below suggests that the Australian equity market currently represents reasonable value at a PE multiple of 12.5x for the 2011 FY forecast. Additionally, Chart 3 illustrates the improvement in earnings trend for the market. Ausbil considers the 2010 FY earnings growth forecast of +2.7% to be conservative and we would expect to see this growth rate trend to increase over coming months. As a result, we feel that the prospect of improving earnings will also be supportive of current valuations.

Table 1

As at 02 February 2010	PE FY 2010(E)	PE FY 2011(E)	EPS Growth FY 2010(E)%	EPS Growth FY 2011(E)%
Market	15.3x	12.5x	+2.7	+23.0
Banks	13.5x	11.0x	+12.7	+23.4
REITS	13.0x	12.6x	-30.1	+3.3
Industrials	15.2x	13.1x	-5.5	+15.5
Resources	19.3x	13.4x	+21.3	+44.2

Source: Ausbil calculation based on consensus broker earnings forecasts.

Chart 3: EPS Growth

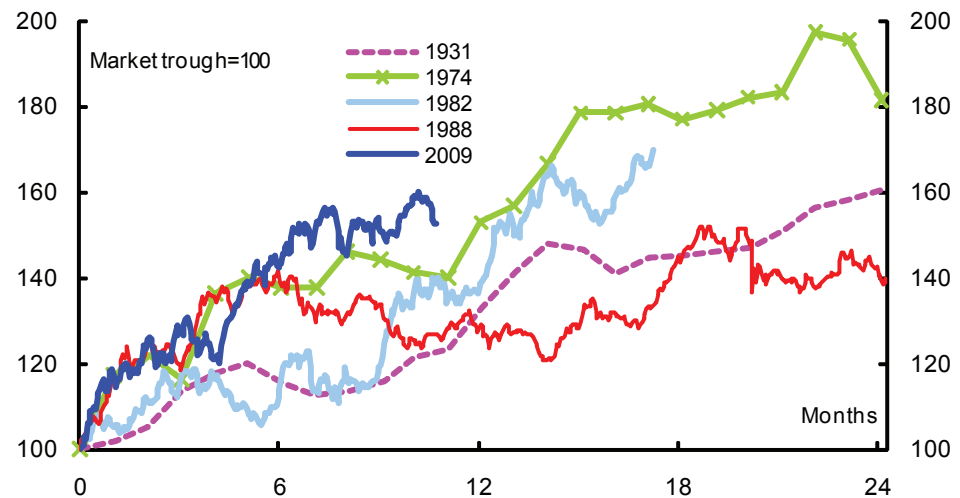


Source: Ausbil calculation based on consensus broker earnings forecasts.

Australian Equities

Sharemarkets rarely recover in a straight line. As illustrated in Chart 4, history has shown that the market will 'correct' during a market recovery from a trough. This usually occurs during periods when investors wait for earnings to support prices.

Chart 4: Recovery from largest falls in the Australian equity market



Source: IRESS, Wren Research, ASX, Deutsche Bank

Obviously, the 2010 February profit reporting season will be an important milestone for Australian equity market investors. In our view, we believe that the Transport, Construction Materials, Diversified Metals & Mining, Banks, Media, Retail and General Insurance sectors may surprise the market with better than expected earnings results. However, we also believe that there will be greater dispersion in earnings results within sectors and therefore stock selection will also be an important factor. There is a risk that earnings do not meet expectations, however we believe this risk is low and as a result retain Portfolio settings consistent with an anticipation of earnings recovery.