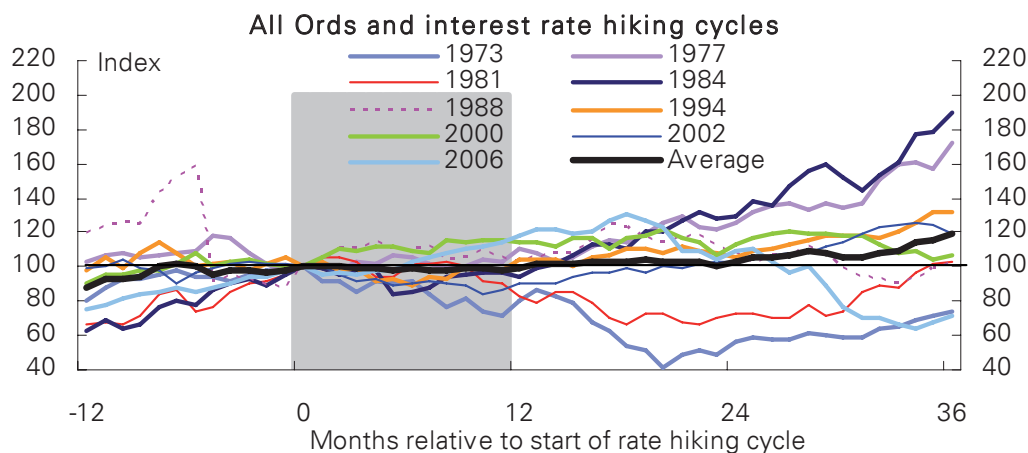


## Rising interest rates can be (initially) a positive signal for equities

Generally, higher interest rates have a negative impact on equity markets. The reasons are twofold:

1. lower company revenues (due to slower sales of cyclical industrials, a higher exchange rate impacting competitiveness/translation of profits, higher interest costs)
2. lower equity valuations (as a result of a higher discount rate incorporated into future cash flow discount models).

Initially however, rising interest rates can also signal an expected improvement in GDP, as is currently the case. As seen in the following chart, the Australian equity market has often risen when monetary policy has been tightened, particularly in periods when low accommodative levels are brought back to more neutral monetary settings. We are in the early stages of the Reserve Bank of Australia ('RBA') increasing rates from an unprecedented low level of 3% to a more neutral setting of 4.5 to 5%.



Historically, Australian monetary policy has been tightened in tandem or led by the US Federal Reserve monetary policy cycle. This time however, Australia is raising official cash rates well before the US, with the expectation that the US Federal Reserve will begin raising rates in 2H 2010. Until that time, there is an expectation that the US equity market will continue to improve, which in turn should continue to provide positive sentiment for the Australian economy, and the equity market in particular.

Risks remain that the RBA tightens cash rates too aggressively, 'knocking the wind' out of the economic recovery. All indications are that they are likely to take a moderate approach which leads us to believe that this risk remains low.

Even though there currently may appear to be some short term market consolidation, this has been expected given the strong rally we have experienced since March 2009. However, we believe that rising interest rates are a positive signal given the low levels from which they are rising and the moderate amounts in which they are likely to be raised into an improving domestic economic environment.