

MARCH 2009 QUARTER ECONOMIC SUMMARY

Themes for Quarter:

The quarter opened with financial markets already in an exceptionally grim mood. Market sentiment blackened further over January and February until, by its nadir on 10th March, share prices were forecasting the next Depression.

Relief finally arrived when the US Treasury announced a new plan to introduce private sector capital to help rescue troubled US banks and, around the same time, the US and UK central banks began to increase their money supplies. As banks are responsible for the lending at the heart of modern economies, the plan to repair US bank balance sheets offered massive potential relief. The move to increase money supplies in the USA and UK should ultimately help reduce the indebtedness of consumers and businesses.

These developments proved enough to spark a sharp rally in financial markets. Within three weeks, share prices in many major developed markets, including Australia, jumped between 15 - 20%.

Australian economic growth is now slowing rapidly. It is virtually certain Australia will experience at least two quarters of negative growth. Moreover projections of a rebound are very soft. Early signs, however, are already showing that it will arrive in the form of new household formation on the back of the First Home Owners' Grant.

It is equally clear that the cash flow squeeze within the business sector is continuing and that financial institutions have tightened their lending criteria. Institutions are now rationing credit to those with the highest creditworthiness, presenting a major challenge to others.

From a long term perspective, current share prices present investors with the opportunity to top up their holdings at highly attractive prices. Sentiment simply does not get much worse. We are encouraging those of our clients with low allocations of their portfolios invested in Australian shares to progressively increase their weighting.

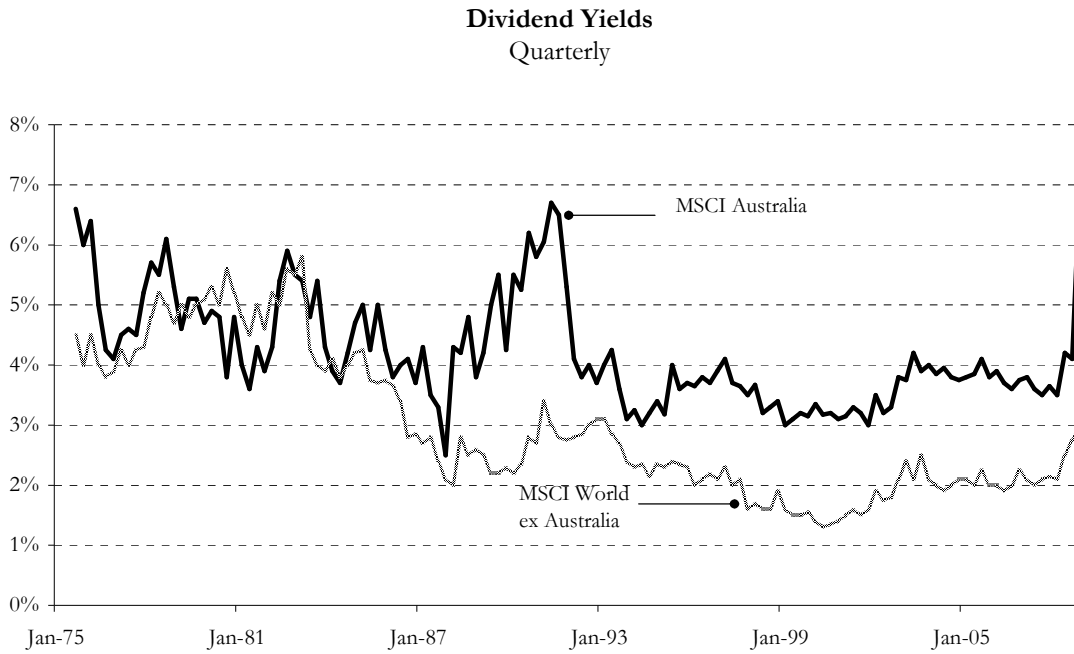
We are beginning to see isolated examples of distressed selling of commercial property. Prime commercial property in major CBDs is likely to be marked down over the next few quarters, and we will be reviewing opportunities to take advantage of pricing weakness over the coming months.

We believe prices on government bonds, bank-backed bonds and the most highly rated corporate bonds are close to their highs and we will be urging clients to trim those investments over the course of this calendar year.

Exceptionally Grim Mood

Share prices continued to fall so sharply over the first 2¼ months of the quarter. Share prices fell so low by early March that trailing dividend yields jumped to yields not seen since before 1973. The dividend yield for the MSCI Australia Index (which approximates the

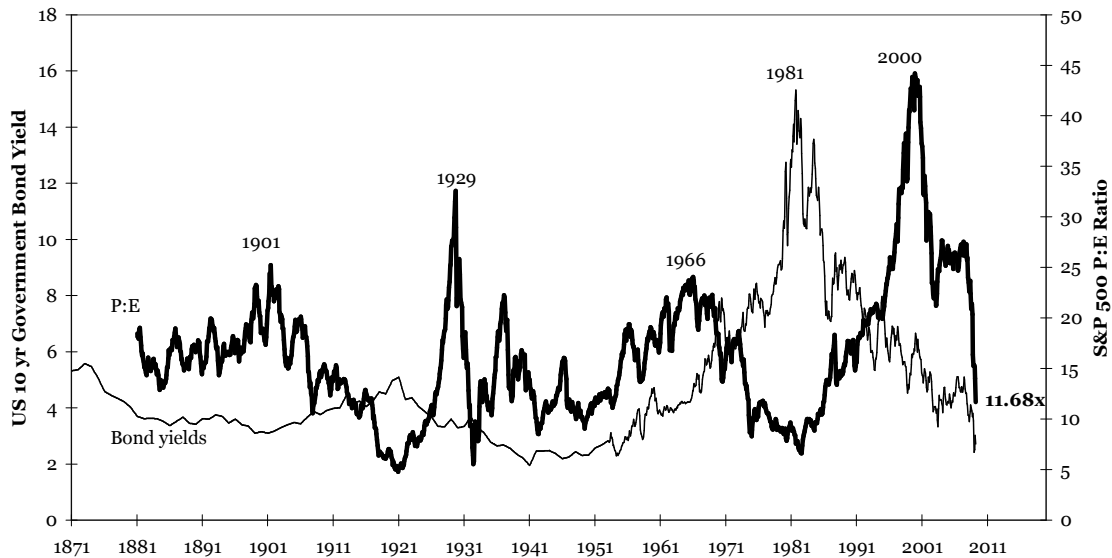
Top 50), is shown in the graph below together with the dividend yield on the world's largest listed companies offshore.



Within mid-sized and smaller companies, dividends yields have shot up higher still. In early March the historic dividend yield, grossed up for franking credits, exceeded our projected long term average short-term deposit rate of 5%pa, by *3% or more* for close to 50% of the Top 500 listed Australian companies.

The US S&P 500 index declined more than Australian share price indexes. At the market bottom in early March, the P:E relative to trailing 10 year earnings fell to below 11.7x. This was a level only seen a few times since the beginning of the data for that index in 1881, as can be gauged from the following chart:

S&P 500 Price:Earnings Ratio relative to trailing 10 year EPS,
 US 10 yr Government Bond Yield,
 to 9th March 2009 market low

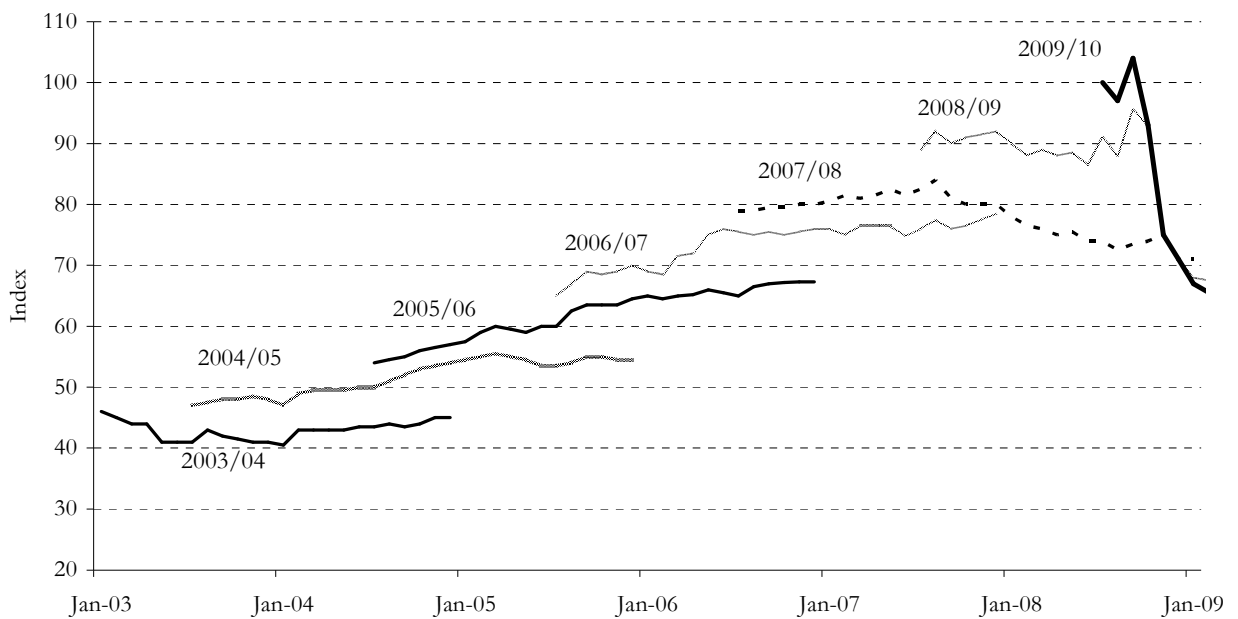


As bad as this looks for the March trough, it actually reflects *worse* share investor sentiment than it might appear at first flush. On most of the other few occasions in which the P:E had fallen to similar levels over the last 150 years, US longer term interest rates had been somewhat higher. In other words, in those other periods, share prices were low but so were bond prices. So *everything* then looked cheap (relative to short-term deposits).

The fact investors are now prepared to pay very high prices for long term US government bonds while, at the same time, US share prices are so low is symptomatic of the *most extreme* levels of risk aversion. Prices within financial markets now clearly endorse 2008 comments of the former Federal Reserve chairman, Alan Greenspan, in which he said the US housing market was to face a once in a century downturn.

As can be seen from the following chart, which shows broker-analyst Earnings Per Share (EPS) forecasts for the stocks underlying the MSCI Australia Index, EPS forecasts for the FY2010 have fallen by an exceptionally large 35%:

Forecast Earnings Per Share
MSCI Australia (Approximates "Top 50" on the ASX)

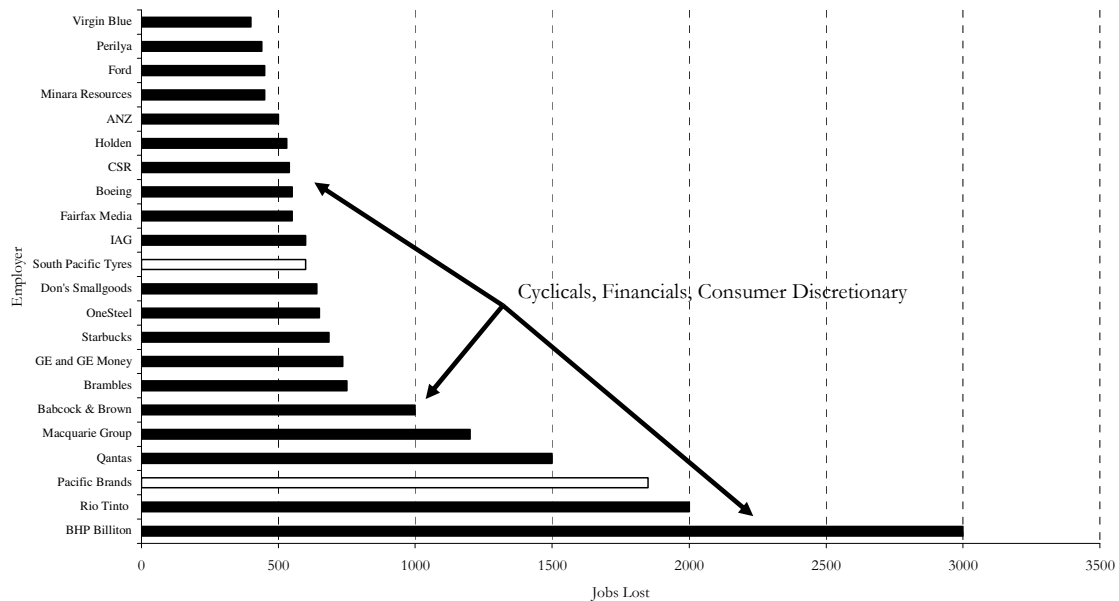


A disproportionately high proportion of the negative revisions was visited upon cyclicals and financials.

The counterpart data for forecast EPS for the US S&P 500 index is even more extreme.

A theme of the quarter was job cuts, particularly within cyclicals, financials and consumer discretionary companies. This is illustrated below:

Major Australian Job Losses since June 2008



Relief

The two main catalysts for the sharp relief rally from 10th March were:

- the plan to re-capitalise troubled US banks by introducing government-private sector investment partnerships, and
- clear indications the USA and the UK would increase their money supplies and thereby help reduce the real indebtedness of US and UK consumers and businesses.

Fixing US bank balance sheets may sound a remote issue for Australian investors, but it is a vital step in restoring US consumer and business confidence, and ultimately US economic and global growth. The fact we can today regard it as vital to the success of our individual portfolios simply shows how dramatically this truly global crisis has shrunk the world.

The move to increase money supplies in the USA and UK is expected to lift final demand. It is also expected to inch US and UK inflation higher. Over time, this should help deflate the real value of consumers' and businesses' pre-existing debt. As that begins to happen, it should engender further confidence and stimulate demand.

Neither of the above measures will *necessarily* work. The relief rally has been based more on the combination of the extreme longer term value on offer within share and bond markets and the hope that the measures *might* at least be partially successful.

We note that historically, there have been some extremely costly and very vivid policy errors arising from where countries materially boosted their money supply. We expect governments and regulators will be somewhat nervous about the consequences of these more extreme measures, and remain alert to any early indications of misfires.

US authorities also announced major US banks would be required to stress test their balance sheets to two economic scenarios specified by the Federal Reserve. These would comprise a base case scenario and an adverse scenario. The base case foreshadows that US economic growth re-emerges in 2009/10. The adverse scenario imagines US economic growth does not turn materially positive till 2010/11 (see table below). A sobering thought for those tempted to invest all their excess cash and bonds into the share market now!

US Bank Stress Test Assumptions					
Metric	Current	Baseline Case		Adverse Case	
		2009	2010	2009	2010
GDP	-6.3%*	-2.0%	2.1%	-3.3%	0.5%
Unemployment (Yr Average)	8.5%	8.4%	8.8%	8.9%	10.3%
Home-price declines	-19%	-14%	-4%	-22%	-7%

* 2008 4th quarter real GDP

This stress test would permit the US central bank to pre-identify the most at-risk banks and the degree to which they were likely to need fresh capital. This was amongst the most well-considered, forward-looking and thorough regulatory measures taken since before the March 2008 collapse of Bear Stearns. It was one of the first signs that the US Federal Reserve was finally beginning to think ahead and develop its battle strategy.

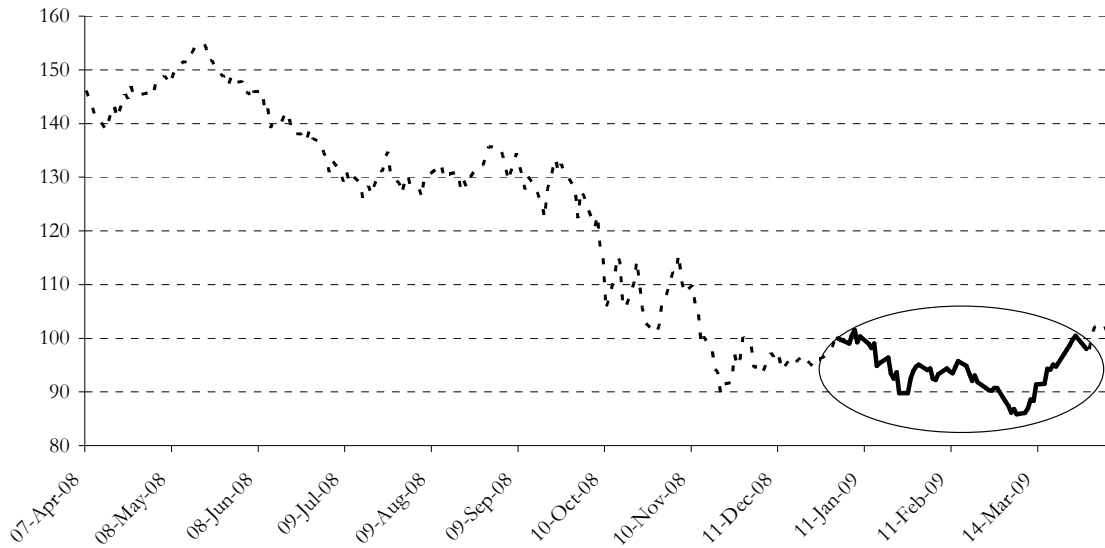
Finally and less concretely, there was also growing hope that the very intensity of the massive downdraft in financial markets globally would put greater pressure on the G-20 in its early April meeting to achieve more meaningful measures to help lift global economic growth.

Sharp Rally

Australian share prices began their c.15% rebound from their lows on 10th March. Share prices of the most stressed financials and cyclical benefitted most.

Over the full quarter, the ASX 200 ended down 4.1%, while the result after making allowance for dividends was -1.98% (illustrated in the chart below):

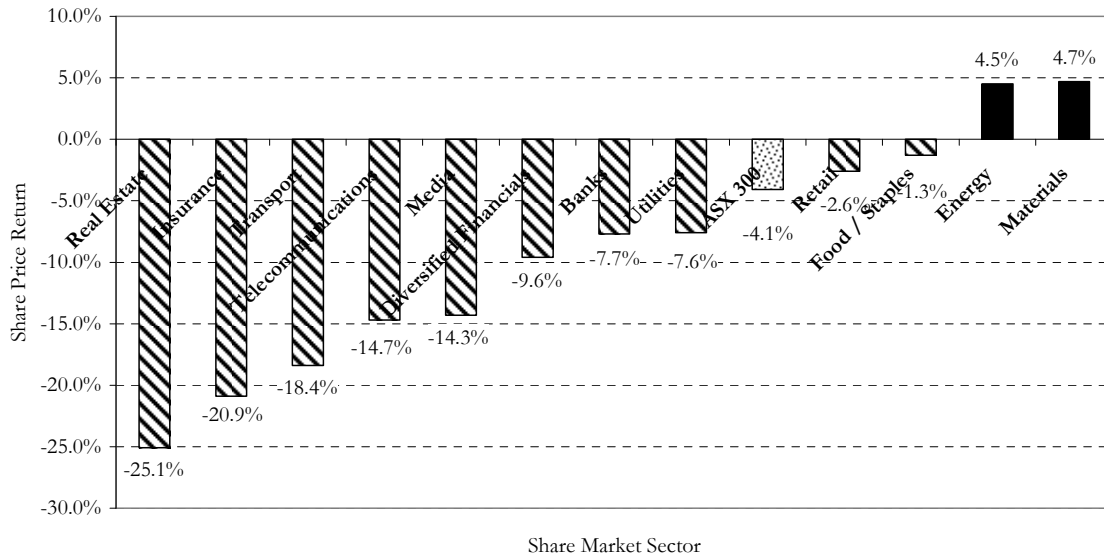
ASX 200 Accumulation Index
 April 2008 - April 2009
 31 Dec 2008 = 100



Energy and Materials stocks actually finished the quarter over 4% higher (see following chart).

Worst impacted over the quarter were A-REIT's (Australian Real Estate Investment Trusts), insurance, transport and media stocks.

Share Price Returns
 for the Quarter ending March 2009



That completed six successive negative quarters for the Australian share market.

The All Ordinaries Index has never had seven successive negative quarters since 1938. While that is little comfort, we suggest it does illustrate that the probability of a continuation of negative quarterly returns from here is low.

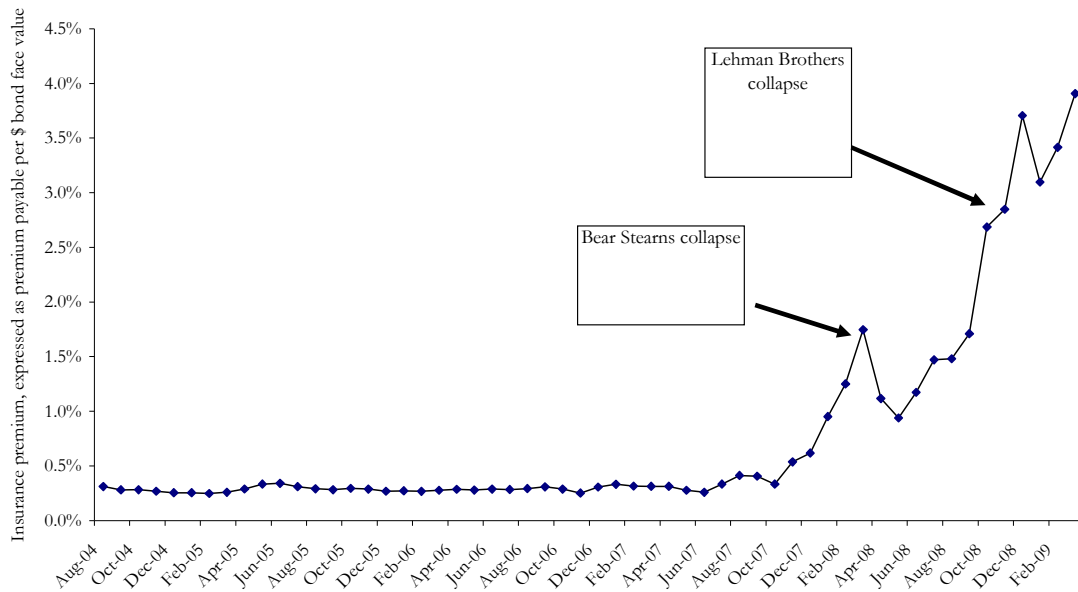
There were few major direct property transactions. The building and construction industry super fund, c+bus, took an interest in the landmark Dexus office tower under construction on the corner of Bent and Bligh Streets, in the Sydney CBD. There were also strong indications that AMP's Statutory Fund #1, which backs its capital guaranteed obligations, will sell Adelaide's "Black Stump", 25 Grenfell St, on a very sharply increased capitalisation rate.

Jones Lang LaSalle research estimates that there is presently \$28 billion in commercial property for sale across Australia. With Financial Services expected to be the most sharply contracting industry in 2009 and Sydney being particularly heavily exposed to financial services, we expect to see substantial weakness in Sydney commercial property prices.

Bond investors holding stock issued by the Australian government, semi-governments and the very highest grade corporates continued to benefit from the extreme risk aversion in financial markets. The price of these investments managed to largely maintain their high prices, edging only slightly lower as yields started to climb.

Investors in corporate bonds issued by more typical investment grade corporates continued to see the market treat those bonds with disdain. As markets are progressively projecting the recession to be longer, they are attaching a higher probability to corporate default and to more significant losses for bondholders. This is reflected in the continuing increase in the cost of insuring moderately high quality corporate bonds against default (see following chart).

Cost of Insuring Australian Corporate Bonds from Default



This will be the background for up-coming bank P.R. department releases saying their cost of funding continues to increase and they thus are unable to fully pass on further interest rate cuts to variable mortgage borrowers.

Interest Rate	% Yield as at 31.12.08	% Yield as at 31.03.09	Change in Rate over Quarter
Australian 90 Day Bill	4.075	3.12	-0.96%
Australian 10 Year Bond	3.985	4.41	+0.43%
US 10 Year Bond	2.2123	2.6647	+0.45%
US: Federal Reserve Funds Rate	0.25	0 to 0.25	0

Currency	Rates as at 31.12.08	Rates as at 31.03.09	% Movement over Quarter
US dollar AUD/USD	0.6928	0.6873	-0.79%
Euro AUD/EUR	0.4919	0.5190	+5.51%
Pound sterling AUD/GBP	0.4796	0.4804	+0.17%
Yen AUD/JPY	62.57	67.48	+7.8%

Commodity	Price in US\$ as at 31.12.08	Price in US\$ as at 31.03.09	% Movement over Quarter
Gold (Australian Bullion, USD/ounce)	884.30	922.60	+4.33%
Oil (USD per barrel, West Texas Intermediate)	39.25	49.67	+26.55%
Copper US cents per tn	3041	4003	+31.64%
Nickel US cents per tn	11609	9755	-15.97%
Aluminium US cents per tn	1507	1355	-10.09%

Equity market movements during the quarter:

Index: Equity Markets	Close as at 31.12.08	Close as at 31.03.09	% Movement over Quarter
S&P ASX 200	3722	3582	-3.76%
S&P 500 (USA)	903	797	-11.64%
FTSE 100 (UK)	4434	3926	-11.45%
DAX (Germany)	4810	4084	-15.08%
Nikkei 225 (Japan)	8859	8109	-8.46%
Hang Seng (China)	14387	13576	-5.64%

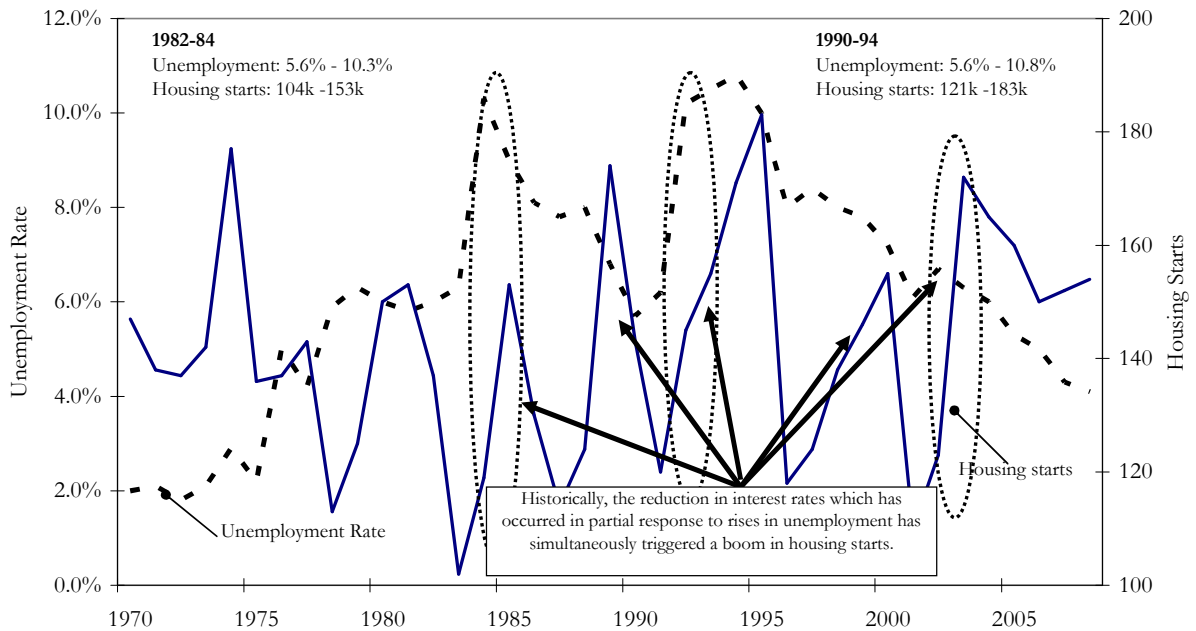
Australian Economic Growth

Both the Australian government and the Reserve Bank have attempted to counter the collapse in final demand with more expansionary policies. At writing, for example, tax payers who earned up to \$100,000 in the 2007/08 tax year were anticipating receiving up to \$900 from the ATO. On 4th February, the RBA cut the official interest rate a further 1% to 3.25% (this was followed by the 0.25% interest rate cut announced as this update was going to press, to bring the official interest rate to 3.00%).

There is evidence of a strong uptake in the First Home Owners' Grant. Leading indicators such as visitation at the HomeWorld display in Western Sydney (which is visited by an estimated 80% of intending Sydney home builders) has continued at high levels.

Note that historically, jumps in housing starts have tended to coincide with increases in unemployment, and not lag them as intuition would tend to suggest (see following chart). Home builders have historically been more sensitive to interest rate cuts than the lagged rebounds in business and consumer confidence.

Housing Starts ('000s) versus Unemployment



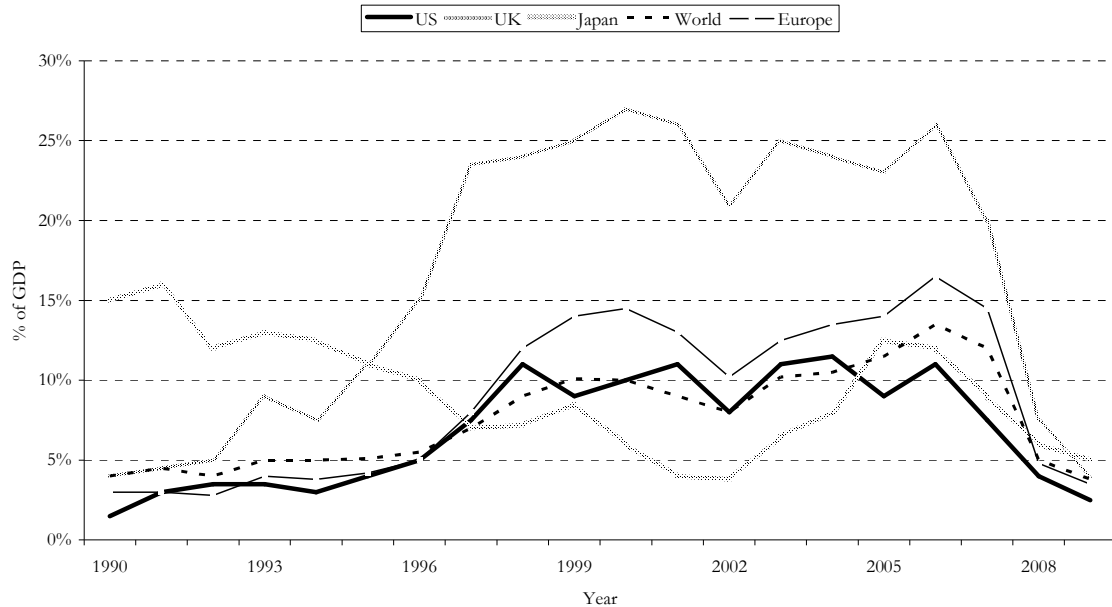
Housing prices have generally been steady, although sharper falls have occurred among the more expensive suburbs in the capital cities.

Reflecting this, in the most recent months, property sales have been overwhelmingly concentrated in the cheapest 20% of properties.

Finally, again linking the local economic outlook to the international, we note the massive decline in the market value of major international banking groups in the last few quarters (see following chart). In most cases, major banks internationally have lost in the order of 80% of their share market value. In many cases, this value destruction represents a very material loss of wealth when measured relative to country GDP.

Economy-wide net savings in the developed economies is typically only a couple of per cent of GDP. It is easy to infer that with significantly increasing bank capital being required as a minimum by regulators, it will likely take between 5 and 10 years before major banking groups internationally have fully and comfortably re-capitalised themselves. The conclusion is loans will be rationed to only the most credit-worthy for a very extended period of time.

International Banking Industry Market Capitalisation, by Country



The struggling Australian economy highlights the significance of the following recent developments:

1. The massive losses within the banking sector globally are so large that, from the perspective of the USA, UK and major continental European governments, many will probably remain undercapitalised for more than five years.
2. With the disappearance or crippling of a range of massive financial institutions associated with lending to less credit worthy borrowers and the global capital shortage, remaining financial institutions will ration credit towards more credit-worthy borrowers. That will mean that lower-grade borrowers will struggle to obtain credit.
3. Historically, global portfolio diversification has helped investors reduce the volatility of returns within their portfolio, and in part that was due to the de-synchronised economic cycles in different countries. The move to more global governance of financial regulation will increase the tendency of global financial markets to move in tandem, *reducing* the diversification benefit to be obtained through global diversification. We anticipate pro-active top-down portfolio management will therefore prove of increased importance *for the foreseeable future*.
4. Wide readers of the financial press will be aware that, following the exceptionally strong financial market returns between 1980 and 2007 relative to 1900 to 2007, commentators have been remarking that “investors will have to expect lower returns”. Now that it has happened, share investors can put the experience largely behind them. We don’t hold the same hope yet for bond investors or commercial property investors. Grosvenor has responded by materially increasing the selectivity it is applying in order to recommend investments within each asset class. As a result,

you can expect to see more diverse investment recommendations over the coming quarters.

Simplified, our current economic outlook for Australia is:

- **5% chance of Great Depression II.** This would entail outcomes such as 10%+ unemployment for a period of three or more years, no resuscitation of business confidence or business investment, negligible economic growth in major trading global partners, deflation or disinflation (say, an inflation rate of below 1%pa for a rolling three year period) and real official cash rates of 1%pa or less. While this is not a highly likely scenario at this point, it could come about from a string of major policy errors on the part of international governments and regulators. We submit that 5% is nonetheless an exceptionally high probability (relatively speaking) given that the scenario is so adverse.
- **10% chance of prolonged, very weak growth.** That would include an unemployment rate in the range of 8% to 10% for three years, only minor pockets of resuscitation in business and consumer confidence, continued strong propensity for consumers to save an abnormally high proportion of their incomes, low inflation (say, 1% to 2% inflation) for 18 months with a marginal increase above this after that point, real official cash rates averaging around 2%pa.
- **80% chance of initial moderate recession, slowly developing into moderate economic growth from early 2010.** This base case assumes Chinese and US economic growth pick up noticeably around late 2009. In such a scenario, we could expect to see unemployment peak between 8% and 11%, but more quickly decline to average closer to between 6% and 8% over three years. This case is consistent with major governments and international regulators successfully co-ordinating to restore the capacity of systematically important financial institutions to recycle savings into loans. It is consistent with share markets generally rallying (albeit not at the rate of 20% per every three weeks) from here, and government and similarly highly-rated bonds falling in price from around this point.

This base case is also consistent with sharp spikes up in the price of energy (oil, gas, coal, uranium, electricity) emerging in the coming quarters.

We believe that key institutions globally are faced with incentives and constraints that make this broad outcome highly likely. That is the major reason why we attach such a high probability to it.

Flowing from the “moderate recession, slowly blossoming recovery” theme, it is easy to see that balance sheet strength will likely remain of heightened importance.

- **>4% chance of a rapidly fading recession giving way to a moderately strong economic rebound.** A “V-shaped” rebound is possible but not particularly likely, as this would require a very significant return of both consumer and business

confidence. We don't see that confidence rebound as likely due to continue labour retrenchment pressure and reduced access to finance for all but the most creditworthy borrowers.

- **<1% chance of recessionary fears quickly receding and being replaced with a strong growth bounce.** Practically all the institutional factors that drive such recoveries are now absent. For example, nearly all major lenders to lower grade borrowers have been wiped out, have been brought to their knees, or have put their loan books into run-off mode. If this scenario was to begin to materialise, it would most likely be quickly choked off by extreme energy price spikes and sharp increases in official interest rates globally.

We are now increasing clients' recommended investment in Australian shares from historic lows towards more neutral longer term settings over the course of a year or so.

Taking the above scenarios together with the compelling long term valuations on the share market, we hope clients will appreciate why we will be increasing portfolio allocations to selected shares, and property investment, cautiously.

We have reallocated resources within our investment team in the last four months to place sharper focus on the tougher environment likely to surround us for several years. This refocus is turning up a wide range of sometimes-less-obvious opportunities. We look forward to discussing these with you over the coming months.

Market and Sector Earnings Per Share (EPS) Growth % p.a. year on year			
	FY2008A	FY2009E	FY2010E
All Companies	-1.4	-18.9	-1.5
Banks	-1.2	-18.8	6.5
Property Trusts	0.2	-23.0	-16.0
Resources	0.3	-25.6	-12.6
All other companies (excluding Resources, Property Trusts and Banks).	-3.6	-11.2	5.8

Source: Macquarie Research

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