SEPTEMBER 2009 QUARTER ECONOMIC SUMMARY

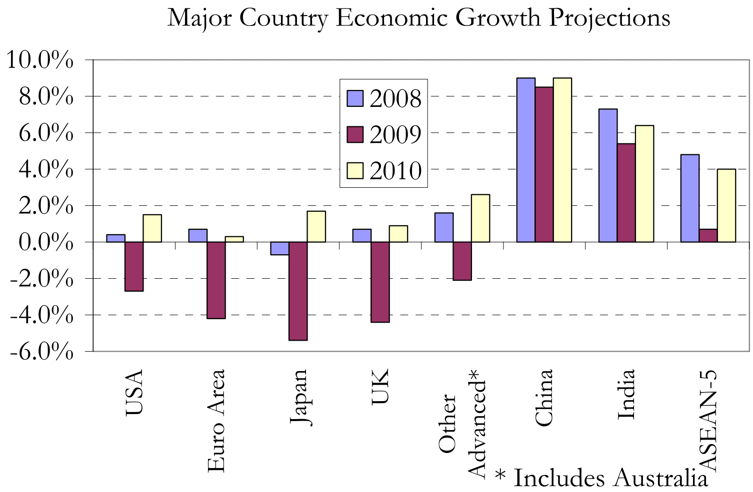
The September quarter saw a strong lift in share prices globally flow through to sharply improve business and consumer confidence.

Leading indicators for economic activity in many countries around the world rebounded exceptionally strongly (see chart, right, illustrating the Goldman Sachs Leading Indicator over rolling 3 month periods). The series of dramatic drops in central bank interest rates and sharply increased government spending globally appears to have had a strong impact.

You can see from careful scrutiny of the following chart that the strength of the rebound varies somewhat from country to country.

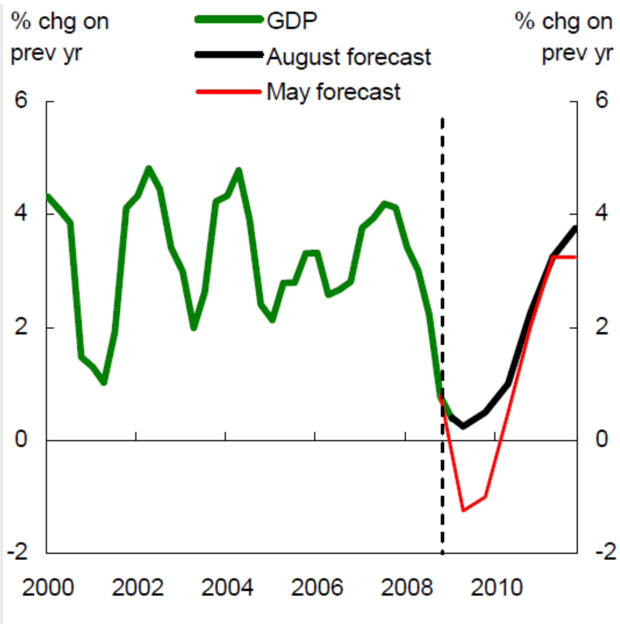
The IMF outlook for "advanced economies" is for a very slow recovery.

Within developing eco nomies, China and India continue to enjoy an exceptionally strong outlook, while ASEAN-5 (Indonesia, Malaysia, Philippines, Thailand and Vietnam) are expected to have an anaemic 2009 with significantly stronger growth from 2010.



The outlook for Other Advanced Economies (including Australia) has been sharply lifted by the IMF in the last couple of months.

Perhaps the most symbolic "turnaround" development came on 31 July, when the Australian financial markets' greatest pessimist, Economist Gerard Minack of Morgan Stanley, withdrew his prior view that Australia would more-or-less be sucked into a depression. He expressed admiration for the effectiveness of the Rudd government in averting an economic disaster. He also conceded the outlook for the Australian economy, while still with its challenges, no longer justified extreme concern.



In the first week of August, the commentary accompanying the RBA's monthly interest rate decision indicated the Reserve Bank too had become more optimistic. Its projections for Australian economic growth over 2009/10 have been lifted to now be marginally positive (see chart, left).

We still expect Australian household disposable income to consistently edge lower till June 2010. A significant proportion of the positive revisions to economic forecasts are driven by the business sector.

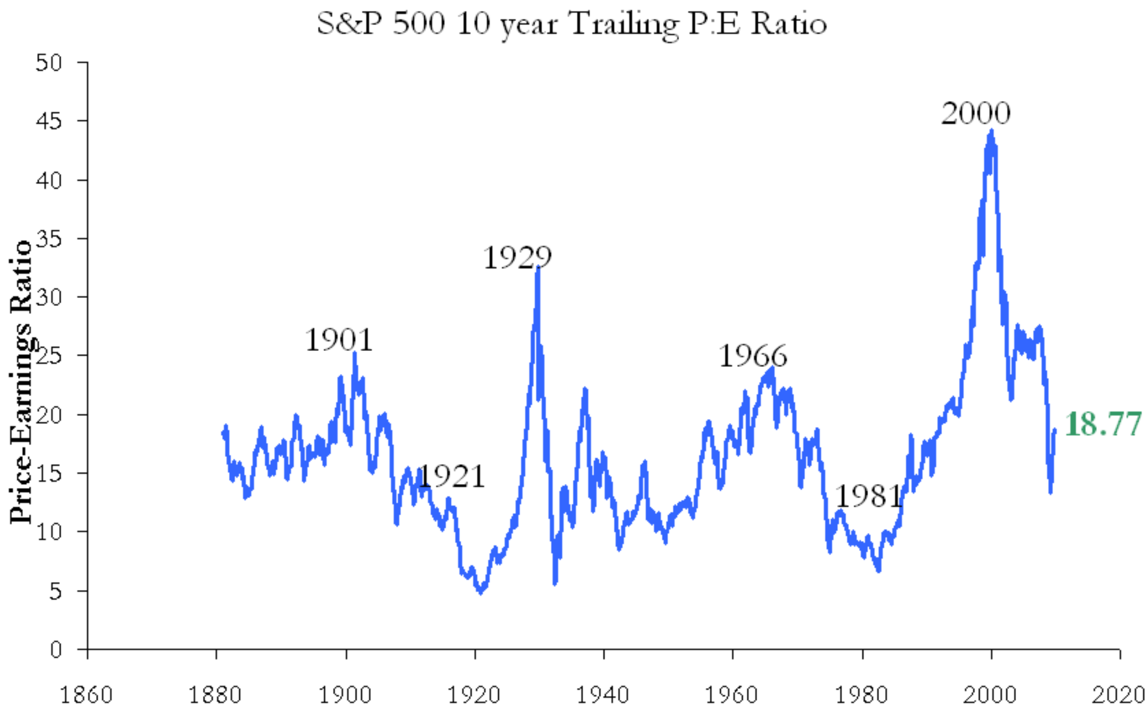
The rise in the All Ordinaries Accumulation Index for the quarter was the third-largest quarterly rise since 1970. We have not had such a strong return from the "All Ords" in 20 years.

We think the Australian share market as a whole is close to fairly valued relative to its underlying fundamentals. We could illustrate this using Australian share market data; however for consistency with some of our past communications and also to promote a very long term perspective, we show on the following page what we sometimes find is a more useful indicator of long term share market value.

The chart on the following page shows the ratio of share prices to companies' earnings per share, or "the price you are paying for every $1 of underlying company profits", the often quoted P:E ratio. It is shown going back to 1881 for the S&P 500, the most indicative measure for the key US share market.

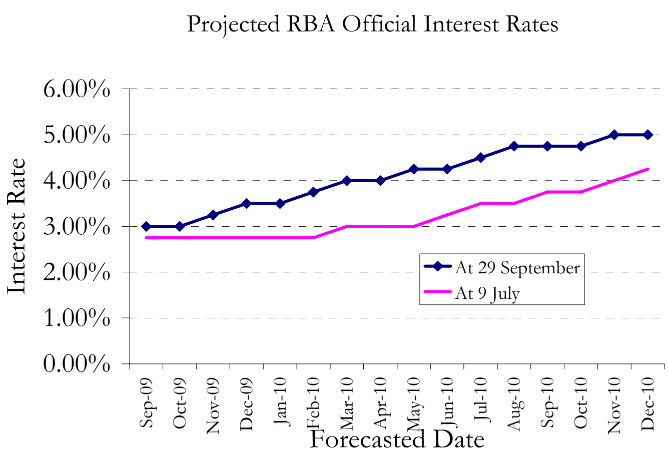
The "earnings per share" numbers in the chart are smoothed over 10 years. This is an attempt to show US share prices relative to rolling mid-cycle earnings per share. In other words – and this is the whole point of the chart – it is a rough gauge of the "price" of shares from the point of view of *long term* investors.

It shows that US share prices now are around the middle of the long term range, suggesting US share prices generally are broadly trading around their fair value. We again emphasise our view since late 2008/early 2009 that the days of prolonged share market declines are now probably behind us.



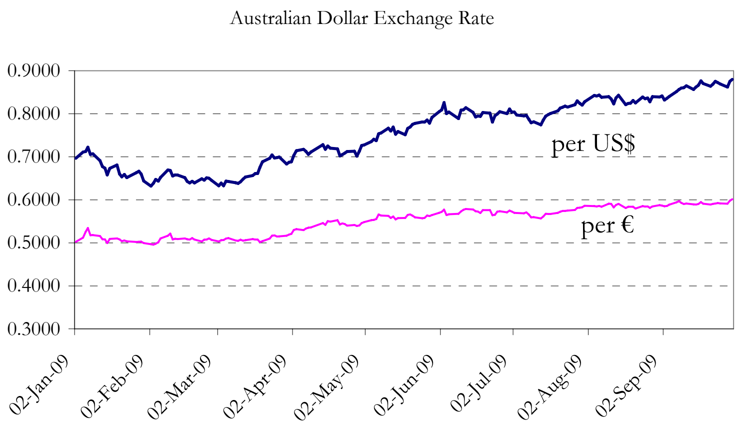
When reviewing the above, be careful to remember the P:E ratio is based on *trailing 10 year* earnings. In the press P:Es are frequently quoted using earnings which are forecast for the coming financial year for individual stocks. The two cannot be directly compared.

The recognition of the success of the government's spending in stabilising the economy saw a dramatic lift in *projected* RBA official cash rates over the coming years. At the beginning of the quarter in early July, the state of the economy was projected to weaken further, according to consensus. Official cash rates had been predicted to be 2.75% by September and to stay that way till March 2010.



But the economic data over the quarter was so surprisingly strong that projected official cash rates rose strongly across all horizons during the quarter (see chart, right). At the end of September, "RBA insiders", who warm up the market on the current RBA thinking, at writing were suggesting the RBA would lift rates by 0.25% on Melbourne Cup Day and by another 0.25% on 1 December. However, even they were further surprised by the strong ANZ job advertisement data released on 5 October, at its 6 October meeting the RBA lifted official interest rates to 3.25%. An extended series of rises in official interest rates is now expected over the next 15 or so months.

Higher projected Australian interest rates, all else being equal, attract large scale money market deposits, particularly from within offshore companies. To put money on deposit here and capture the higher interest earnings, those companies need to sell their home currency and buy Australian Dollars. This helps push up the Australian Dollar exchange rate. By 30 September, the Australian Dollar was buying US$0.88, up nearly 40% from its February lows of around US$0.63. You will note, however, that the US Dollar has been particularly weak over much of the year. The Australian Dollar's climb relative to the Euro, for example, has been a more modest 20%.



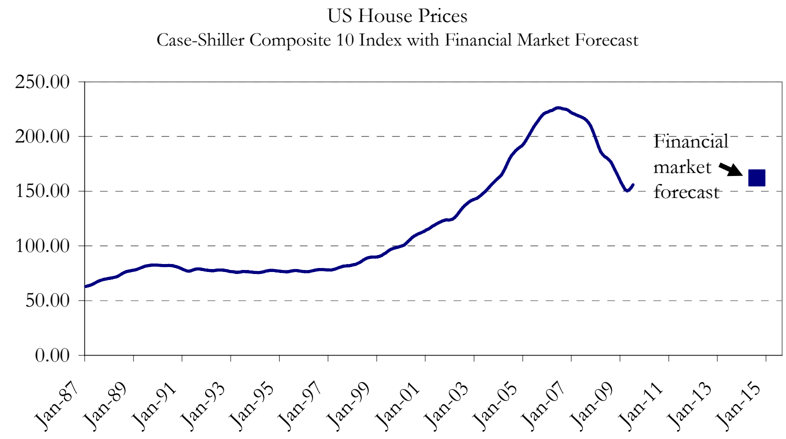
We had begun to note the surprising strength of the real economy in the last Quarterly Report. We suspect that the outlook will continue to improve for the Australian economy. We reason that, as last quarter, the major surprise element will be the flow-through effects of (recently) higher share prices. This helps job security, hours worked across the economy, and ultimately more general business and consumer confidence.

We expect comparatively weak growth from international economies. While the sharp share prices rises globally will assist in lifting growth a little, major developed economies will be coming off a low base. Companies like Cash Converters tell us they recently received 1,200 employment applications in England in response to a single job ad, while average annual rents on the High St for retail stores in the UK have fallen from GB£33,000 to GB£8,000. Unemployment is expected to remain comparatively high in most major developed economies for an extended period. *Under*employment is particularly high. Developed economy consumers remain quite indebted too, constraining their ability to loosen their purse strings.

There remain large and specific threats to the US economy.

You will recall that the global financial crisis began due to falls in the price of US houses. They have probably bottomed but are only expected to pick up very slowly. At writing, the implied house price appreciation over the next five years within the metropolitan areas of the largest 10 US cities is virtually zero (refer following chart). This implies a practically 0% US house price appreciation over the 10 years of 2004 to 2014.

A very high volume of US home mortgages remain on "honeymoon" rates. These honeymoon rates have recently commenced rolling over to more realistic rates (including a substantially higher interest rate premium to cover credit risk). The wave of such mortgages rolling over, however, does not diminish much till around 2013/14. As borrowers are likely to face higher mortgage repayments as the discounted rates rollover to more market-related rates, that may also act to help slow the US economic recovery.



US unemployment benefits lapse after a year. A high volume of workers retrenched in late 2008 will soon be desperate for an alternative social security safety net.

We continue to see much opportunity for careful, patient, contrarian investors to pick up quality investments that deliver strong returns *provided they remain focused on the long term*. We are rapidly seeing the investment potential of several of the most high-profile recovery stocks being realised.

In the event this continues further, we anticipate issuing portfolio trim and re-balance recommendations to you.

Property Performance Review

It has been a disappointing 15 months for property investments. Property investments have been hit by devaluations and, in the face of much tighter bank lending standards, pressures on property managers to cut income distributions to trim syndicate loan-to-valuation ratios. In isolated cases, syndicates may even seek fresh capital from investors.

Thankfully, however, from current indications our recommended investments have been less severely impacted than many. As a firm, we have comparatively few clients with material holdings in listed real estate investment trusts like Westfield, Stockland, General Property Trust and so on.

Financial Market Metrics

Interest Rate	% Yield as at 30.06.09	% Yield as at 30.09.09	Change in Rate over Quarter
Australian 90 Day Bill	3.20	3.38	0.18
Australian 10 Year Bond	5.52	5.44	-0.08
US 10 Year Bond	3.53	3.18	-0.35
US Federal Reserve Funds Rate	0-0.25	0.25	-

Commodity	US$ as at 30.06.09	US$ as at 30.09.09	% Movement over Quarter
Gold (Australian Bullion, US$/ounce)	940.85	1007.42	7.08
Oil (US$ per barrel, West Texas Intermediate)	69.31	70.61	1.88
Copper US$ per tn	5088	6136	20.60
Nickel US$ per tn	16494	17335	5.10
Aluminium US$ per tn	1662	1852	11.43

Currency	Rates as at 30.06.09	Rates as at 30.09.09	% Movement over Quarter
US dollar AU$/US$	0.8114	0.8801	8.47
Euro AU$/EUR	0.5751	0.6015	4.59
Pound sterling AU$/GBP	0.4872	0.5487	12.62
Yen AU$/JPY	77.76	78.82	1.36

Share Market Indices (Excluding Dividends)	Close as at 30.06.09	Close as at 30.09.09	% Movement over Quarter
S&P/ASX 200 (Australia)	3955	4743	19.92
S&P 500 (USA)	923	1057	14.52
FTSE 100 (UK)	4340	5133	18.27
DAX (Germany)	4905	5675	15.70
Nikkei 225 (Japan)	9958	10133	1.76
Hang Seng (China)	18379	20955	14.02