

Economic review

9th February 2009

Monthly snapshot of the Australian economy

Key economic data released throughout January and early February 2009 have continued to reflect the weakness in Australian and global demand over 2H08.

- **Inflation:** The Consumer Price Index (CPI) fell 0.3% in the final quarter of 2008 and the annual rate of inflation slowed to 3.7% from 5.0%. Inflation should fall to at least 2.5% by mid-year. The disinflation environment enables the Reserve Bank of Australia (RBA) to pursue further cuts to interest rates.
- **Interest rates:** The Reserve Bank of Australia (RBA) cut the Official Cash Rate (OCR) by 100bps to 3.25% in February 2009. This is the fifth cut in this easing cycle. The OCR has now fallen 400bps from August 2008.
- **Fiscal stimulus:** The government has proposed a second fiscal stimulus package (of \$42 billion or 3.9% of GDP) that includes cash payments to individuals, investment in schools and environmental improvements for housing.
- **Labour market:** In December 2008 annual employment growth was 1.3%. The unemployment rate has risen from 3.9% in February 2008 to 4.5% and is set to rise towards 6.0% over 2009.
- **Retail sales:** Annual growth in retail sales rose dramatically from 2.1% in November, rising to 5.6% in December 2008. Sales can be expected to remain strong over 1H09 as fiscal and monetary stimuli boost incomes.
- **Consumer sentiment:** Consumer sentiment fell 2.2% in January 2009 from its level a month earlier and 12.8% for the year.
- **Stock market:** Equity prices declined a further 5.0% in January 2009, while the S&P ASX 200 reached 3,333, its lowest level since 2004.



Economic perspective

The actions of the Australian government and the RBA have provided households and businesses with a significant stimulus designed to cushion the economy from the impact of the effects of the global financial crisis.

The stimulus, both fiscal and monetary, is considerable. A number of countries have announced large fiscal stimulus packages to support easing monetary policy; including China's US\$550 billion and the proposed US\$852 billion in the US. While Australia's is small in absolute terms, it is the third largest, behind China and Italy, relative to GDP. This is highlighted in Figure 1.

The monetary stimulus is even larger. The predominance of variable rate mortgages and better functioning lending markets in Australia mean cuts to the OCR have more substantially lowered the debt servicing costs of households relative to other markets. Effective mortgage rates for Australian households have fallen 200bps, compared to approximately 115bps in the UK and 15bps in the US.

Australia is now exposed to a substantial stimulus from government cash handouts and investment spending, as well as lower interest rates. The RBA acknowledged this in its statement which accompanied the most recent decision to change interest rates, and the February Statement on Monetary Policy: "*The combination of expansionary monetary and fiscal policies now in place will help to cushion the Australian economy from the contractionary forces coming from abroad.*" This suggests further stimulus, both fiscal and monetary, is unlikely unless the economy worsens further in 2H09.

The primary purpose of the twin stimuli is to pre-emptively avoid recession and limit the likely rise in the unemployment rate. They are aimed at sustaining domestic demand until such time as external demand and financial market conditions improve. Furthermore, it should preserve jobs in vulnerable areas such as retail and wholesale trade and construction by promoting activity in these sectors.

Figure 1

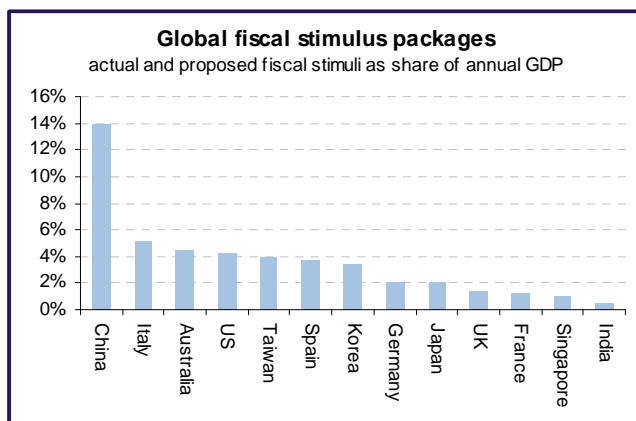
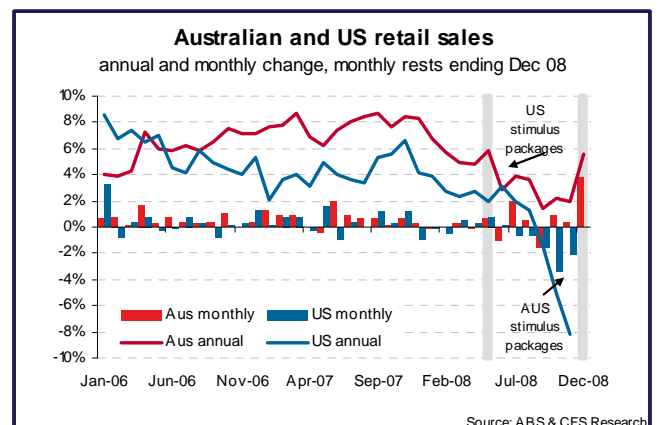


Figure 2



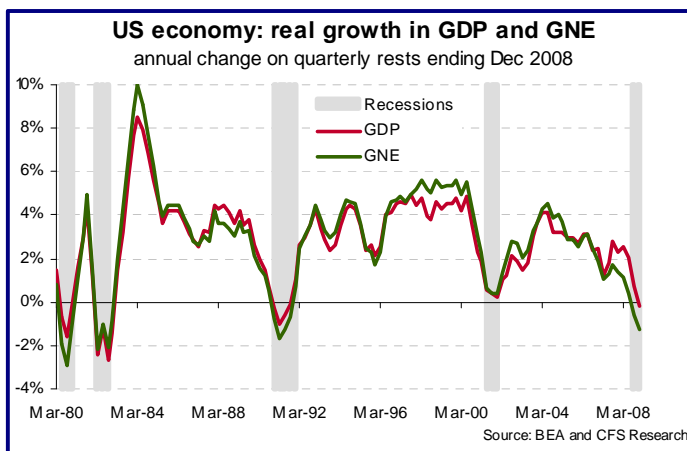
The twin stimuli seem to have already had some success in supporting the key retail and construction sectors.

Retail sales jumped 3.8% on a seasonally adjusted basis between November and December. This was a larger positive reaction than occurred after a similar stimulus in the United States. In May 2008, US households received similar cash payments (approximately 1% of GDP) to those received by Australian households in December. However, US retail sales in May rose just 0.8% from April 2008 and there was no further positive impact. US retail sales fell -8.2% in the year to November 2008. This is shown in Figure 2. While the initial response in Australia has been positive, further growth is required to reinforce the positive start.

The Australian Federal Government's package contains some medium term risk. It creates a burden of repayment on future generations which may require higher taxes and/or market interest rates. The stimulus does little to expressly address the medium term issues Australia faces, particularly, strong domestic inflationary trends (domestically generated inflation is still 5.4%). With the International Monetary Fund forecasting a return to growth in Asia over 2H09 and 1H10, the current weakness in commodity prices, particularly oil, is unlikely to persist, meaning the price pressures of 2007 and 2008 will return and give rise to higher interest rates over 2010 as the economy seeks to recover.

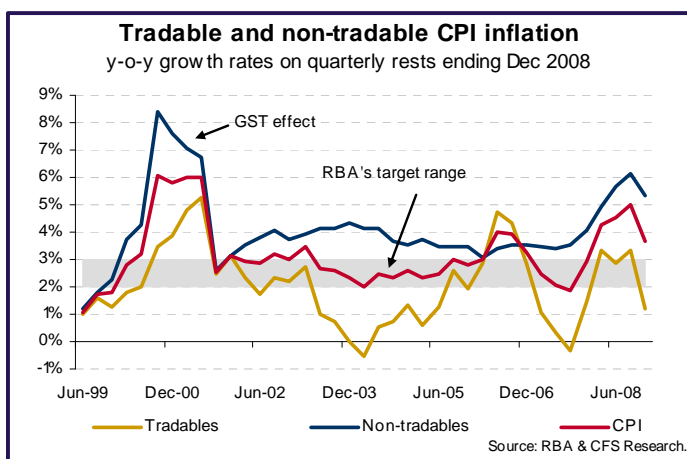
Key economic indicators

GDP growth



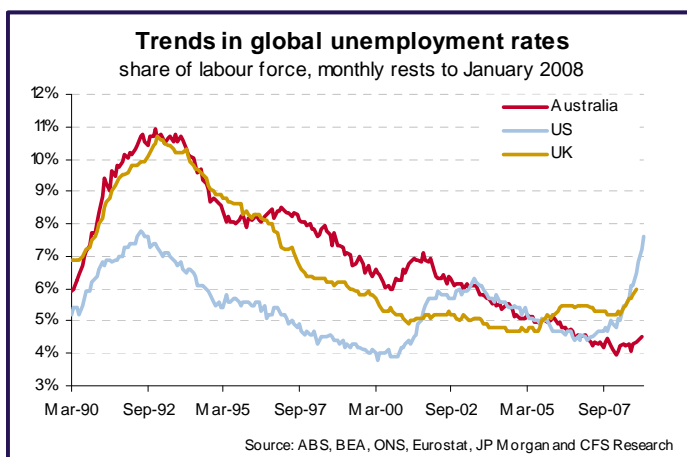
- The US economy has endured two consecutive quarters of negative growth. The economy shrank 0.2% during the course of 2008, with growth decelerating rapidly in the final two quarters.
- The short-term outlook for growth remains bleak as financial markets remain volatile and the labour market continues to worsen.
- The IMF forecasts annual global growth to slow to just 0.5% in 2009 and rise to 3.0% in 2010. US growth in the same periods is forecast to be -1.6% and 1.6% respectively.

Inflation



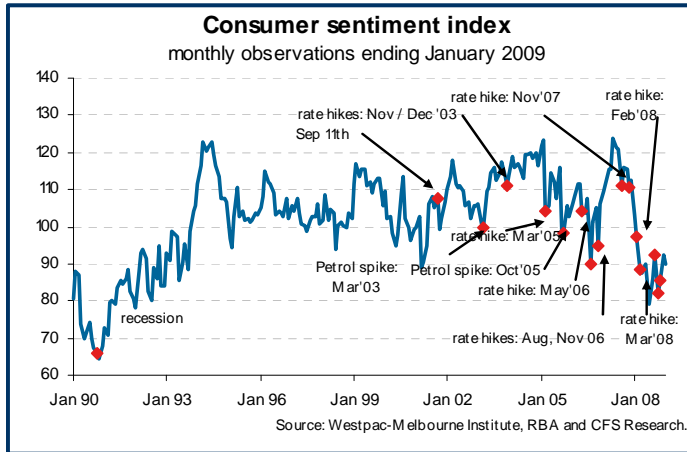
- In Q408 inflation fell 0.3% from the previous quarter but rose at an annual rate of 3.7%; still above the RBA's target zone of between 2-3%.
- The drivers of previously high inflation have started to ease including commodity prices and excess demand due to recent market turmoil and the slowing global economy.
- With commodity prices remaining below the highs of 2008 and slower domestic demand, inflation is expected to fall within the RBA's target zone in 2009.

Labour market



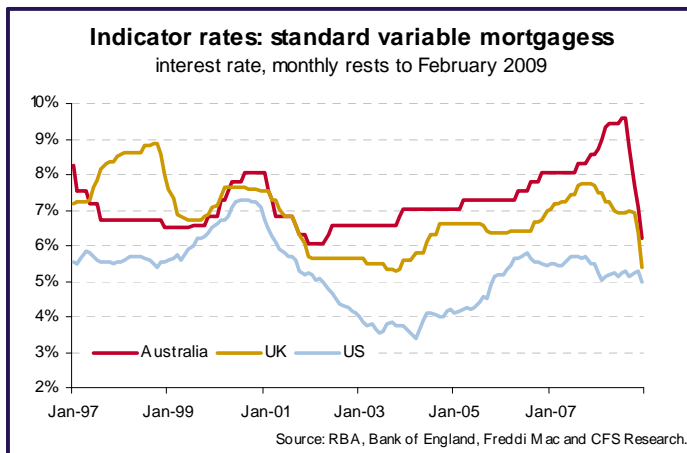
- Labour market conditions across the world have deteriorated rapidly over 2008. In the US and UK, unemployment rates have soared to 7.6% and 6.1% respectively.
- The Australian labour market is unlikely to deteriorate to such an extent over 2009, though it will soften.
- We expect labour market weakness to persist and the unemployment rate to rise towards 6% by the end of 2009.

Consumer sentiment



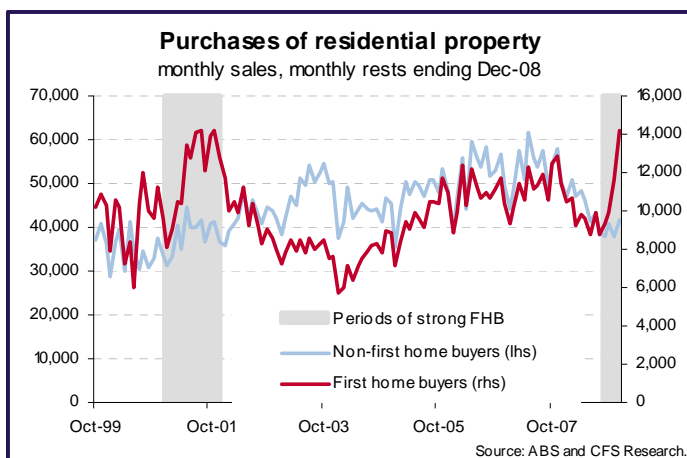
- Consumer sentiment fell 2.2% in January 2009 from its level a month earlier and 12.8% for the year.
- The recent fall in sentiment has been driven by the expectation that uncertainty over the Australian economy and labour market will persist over 1H09.
- Consumer sentiment should stabilise in 2009 as stimulatory monetary and fiscal policy provides a buffer against rising unemployment.

Interest rates



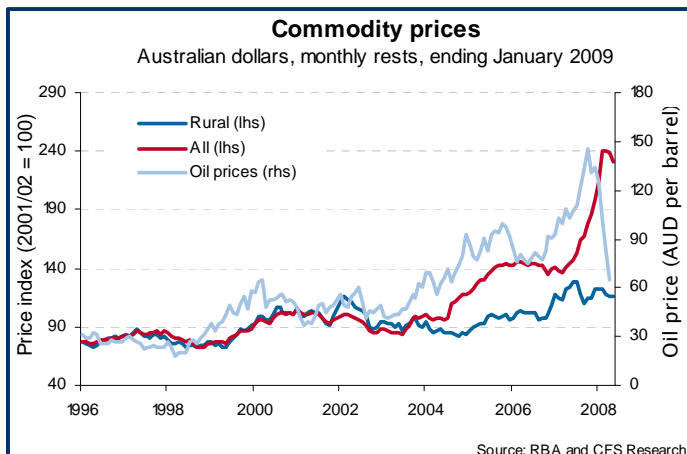
- RBA monetary policy shifted further in February 2009 as the OCR was cut by 100bps to 3.25%. This shift reflected the RBA's belief that interest rate cuts will provide support to domestic demand.
- The RBA's rate cuts have been more effective, relative to the cuts of other central banks, in easing the burden of mortgage payments on households.
- The RBA seems to have signalled that interest rate cuts are now less likely and that it will now focus on the strength of the recovery in demand and the outlook for prices.

Housing purchases



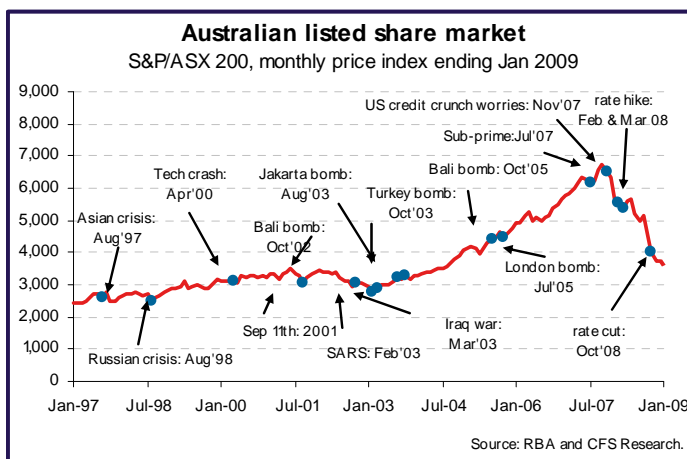
- The residential housing market suffered under high interest rates and rising household costs. Sales of homes, both new and established, slumped dramatically over 2007 and 2008.
- However, there has been a dramatic recovery in first home-buyer sales as a result of falling interest rates and the government's first home-buyer grant though the upper end of the market remains weak.
- A sustained recovery in home sales to first time buyers would create the conditions for a more broad-based recovery in residential housing activity in 2010.

Commodity prices



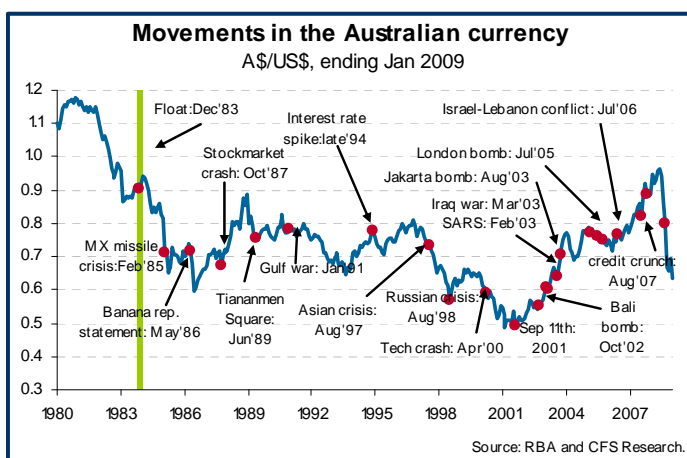
- Global financial stress and the slowdown in global economic activity resulted in commodity prices falling precipitously in the past six months.
- The RBA's commodity price index shows that in 2008 Australia's commodities have fallen 12.3% since their peak in US\$ terms and 4.0% in A\$ terms.
- The ability of China to recover its economic growth path is essential to a recovery in commodity prices over 2009, particularly if global demand remains weak.

Equity market



- The Australian stock market continued to fall in January 2009. The S&P/ASX 200 fell 5.0% over the month to finish at 3,540 a level last seen in 2004. This follows a fall of 41.3% in 2008.
- Factors contributing to the January performance include continued worsening in the global economy and particularly the US and China.
- The S&P/ASX 200 is likely to stabilise in 2009.

Exchange rate



- The Australian dollar remained volatile in January falling from US\$0.70 towards its most recent lows. It ended January at US\$0.63 as broader financial markets expected further volatility in economic data.
- The fall in the dollar continued to reflect a flight from risky assets, the RBA's rate cuts, increased country risk and a large fall in commodity prices.
- However, the RBA's signal that monetary easing is now on pause should provide favourable support to the currency as domestic interest rates will remain high relative to other global economies.

CFS Research has a global reach and the expertise to tailor research to your needs.**Contact details**

Anthony De Francesco	Head of Research	+612 9303 3598
James White	Investment Economist	+612 9303 2645
Mary Culjak	Research Assistant	+612 9303 3518

For further information**cfsinstitutional@colonialfirststate.com.au****Head of Business Development, Australia and New Zealand**

Tony McFadyen +61 2 9303 2699

Institutional Account Management

Jeremy Edmonds +61 2 9303 2695

Daniel Bristow +61 2 9303 6311

Institutional Business Development

Peter Weldon +61 2 9303 6860

Matt Russell +61 2 9303 7024

Ali Karmali +61 2 9303 6070

Liz Krajewski +61 2 9303 2927

Helen Squadrito +61 2 9303 6142

Nadene Moore +61 3 8628 5615

Hugh O'Neill +61 2 9303 6116

Simon Good +61 3 8628 5681

Lucas Rooney +61 7 3328 5875

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