

# Investment markets research – Economic note

13 May 2009

## 2009/10 Commonwealth Budget: Living with the aftershock!

### Overview and market implications:

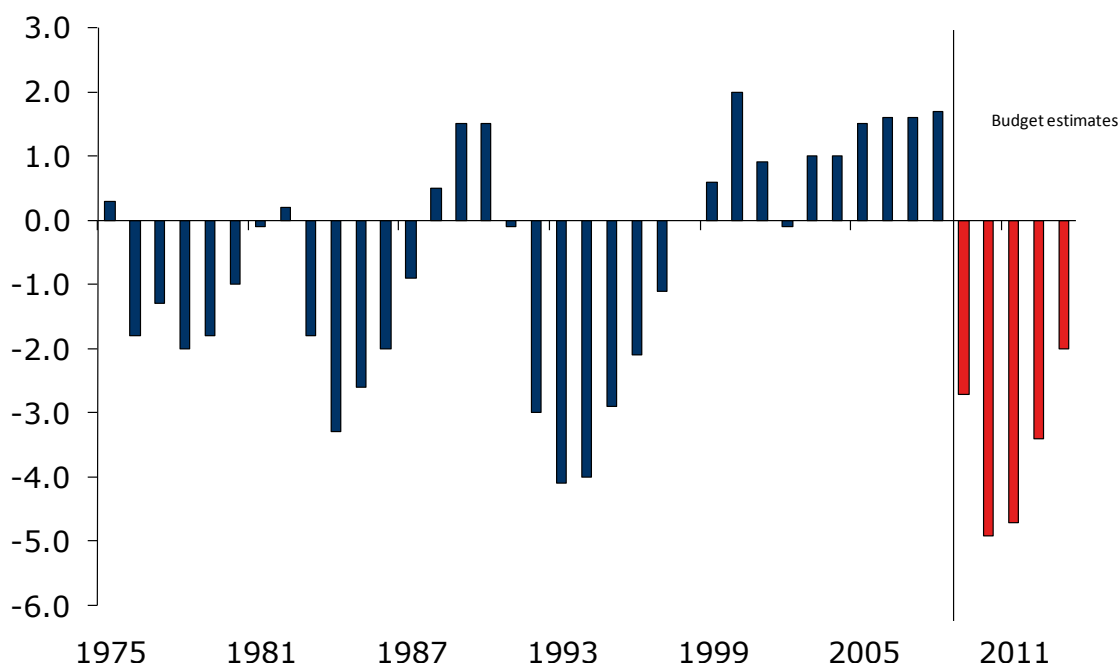
The 2009/10 Commonwealth Budget is expected to be in deficit by almost \$A58bn, or 4.9% of GDP. This is the largest deficit, both in \$A terms and as a share of GDP, in Australia's peace-time history. The 2008/09 budget is now expected to record a deficit of \$A32.1bn, 2.7% of GDP, well down from the May 2008 estimate of a surplus for the year of \$A21.7bn, or +1.8% of GDP. Furthermore, the Budget is expected to remain in deficit until 2015/16, implying seven years of deficit.

Of course, this difficult fiscal situation is a direct result of the global financial crisis and global recession, both in the sense of the impact on 'parameter changes' (i.e. the impact to revenue and outlays from slower economic growth) as well as the government's policy response.

In terms of the amount of fiscal stimulus applied to the economy for 2008/09, this stimulus amounts to a significant 4.4% points to GDP, with an extra 0.4% points added to the 2008/09 year in last night's Budget. For 2009/10 fiscal policy easing provides a further 2.2% points of stimulus, with an extra 1.0% point of this (or \$A12bn) being announced in the Budget. Another way to look at this is to note that since the May 2008 estimate, the budget position for 2009/10 has deteriorated by \$A77.3bn, i.e., from a previous estimate of \$A19.7bn surplus to a deficit of \$A57.6bn. Of this amount, \$A45.3bn is due directly to the weakening economy, with \$A32bn due to government policy initiatives.

The centre piece of the budget stimulus is a \$A22bn infrastructure spending plan, focusing on roads, rail, ports, education, health, clean energy and telecommunications. In addition, there is further fiscal stimulus for the consumer through increased pensions, two further rounds of income tax cuts (that were already legislated) and an extension of the First Home Owners Grant. To help pay for these outlays, however, the government has made changes to middle class welfare, health benefits, moving the pension age from 65 to 67 years, reduced tax breaks for superannuation and other changes. (See page 3 for details).

### Commonwealth budget surplus/deficit estimates



Source: Commonwealth Budget 2009/10

To finance these huge deficits, the government will need to issue significant levels of Commonwealth government securities (CGS), taking total CGS on issue from around \$A80bn today to just on \$A300bn by June 2013. This increased borrowing program will require around \$A60bn of Treasury bond issues in 2009/10, a massive increase from \$A35bn in 2008/09 and just \$A5bn per year for a number of years. The vast majority of these bonds are expected to be nominal bonds, with a new 2022 planned to be issued. The Budget leaves open, however, the option to begin re-issuing inflation index linked bonds in consultation with market participants. (See page 7 for details).

From an estimated net asset position of \$A44.8bn, 4.0% of GDP, as at June 2008, the Commonwealth government is now expected to have net assets of \$A4.7bn, or 0.4% of GDP, at June 2009. The government will then quickly move back into a net debt position, estimated at \$A53.7bn, 4.6% of GDP, at June 2010 and \$A188.2bn, 13.6% of GDP, at June 2013. The budget papers then indicate that net debt to GDP is expected to peak at 13.8% at June 2014, before declining back to 3.7% of GDP by June 2020.

While this is a significant deterioration in Australia's net debt position, it still places Australia in a vastly superior position to most other OECD nations. Indeed, budget papers note that "between now and the end of 2014, average net debt levels in major advanced economies are projected to increase to over 80% of GDP." (See page 8 for details). While the credit rating agencies have expressed some confidence that the 2009/10 Budget and projections for the outyears are consistent with an AAA credit rating, complacency should be avoided.

Overall, the Budget is unlikely to have a major impact on the sharemarket as a whole, given many of the leaks prior to the release. Over the medium-term, one of the key issues will be how to balance investor demand for shares against the large increase in government bond supply, which is likely to place upward pressure on yields. In addition, the economic growth forecasts provided for in 2011/12 and 2012/13 of 4.5%, if they happen, will be a positive for the sharemarket. Some individual sectors will be impacted more than others given the new initiatives and include: health, infrastructure, clean energy, retail and superannuation. (See page 9 for details).

For Australia, the Budget assumes recession in 2009/10 (with growth forecast at -0.5%), with a below-trend recovery in 2009/10 of 2.25%. This comes after flat growth in 2008/09. The largest detractors to growth in 2009/10 are forecast to be business investment and the reversal of the terms of trade to 2006/07 levels. The government expects dwelling investment and household consumption to lead the economy out of recession in 2010/11. Of more interest was Treasury's longer term economic forecasts, with the view that in 2011/12, the Australian economy will return to above trend growth of 4.5%. Much of this optimistic view is due to Australia's location in Asia and our strong trade linkages with China. (See page 9 for details).

In terms of the impact of the Budget on the Superannuation industry, our FirstTech colleagues have stated that "the budget includes a number of changes to taxation, superannuation and government pension benefits. These changes include reducing superannuation salary sacrifice concessions from 1 July 2009, progressively increasing the age pension age to 67, reducing the private health insurance rebate, extending the First Home Owners Boost, introducing paid parental leave and offering tax breaks for small business."

## Key policy initiatives:

The Treasurer announced a number of policy initiatives in the Budget, some old, some new. Apart from the introduction of income tax cuts announced in the previous Budget, new spending initiatives in infrastructure, pensions, paid parental leave; housing and education were also introduced. New initiatives were also announced to cut spending, particularly in healthcare and superannuation. Interestingly, changes that had been anticipated to alcohol tax did not eventuate, but are likely to form part of the Henry tax reviewed to be released late this year.

### Income tax changes

Tax changes announced in the 2008/09 budget will come into effect from July 1 2009. The key changes include:

- The 30% threshold will increase from \$A34,001 to \$A35,000.
- The 40% rate will fall to 38%. This rate applies on income between \$A80,001 and \$A180,000.
- The Low Income Tax Offset will increase from \$A1,200 to \$A1,350.

Further changes will be made from July 1, 2010. These include:

- The 30% threshold will increase from \$A35,001 to \$A36,000.
- The 38% rate will fall to 37%. This rate applies on income between \$A80,001 and \$A180,000.

### Infrastructure

The Budget outlines a total of \$A22bn in new infrastructure investment. The spending is broad-based and will apply to roads, rail, ports, a national broadband network, clean energy, education and health.

Highlights in the infrastructure spending include:

- Regional rail express, Victoria. Funding will build a 40km rail route from West Weribee to Melbourne. \$A3.225bn.
- Gawler and Noarlunga rail, SA. Funding will fund the electrification and modernising of a 43km rail line in Adelaide. \$A0.585bn.
- Hunter expressway. A new dual carriageway between the F3 and the New England Highway. \$A1.451bn.
- Ipswich Motorway. Additional works on the stretch between Gudna and Dinmore. \$A0.884bn.
- The N1 project. The project improves the freight route from Melbourne to Cairns with the construction of bypasses, three-laning, flood proofing etc. Specific projects will include the Kempsey bypass and duplication on the Bruce Highway. \$A8.1bn.
- Oakajee Port common user facilities. Facilities will increase the capacity of ports in the mid-west region. \$A0.339bn.
- National Broadband Network. The government will provide seed funding for the establishment of the network, further funding from debt finance. The roll out will begin in Tasmania. \$A4.7bn.
- Clean energy infrastructure. Includes money for carbon capture and storage demonstration projects, establishment of Renewables Australia to fund development, Solar Flagships for four solar projects with a capacity of 1,000 megawatts. \$A3.565bn.
- Education infrastructure. Considerable amounts of this building spend was announced in the previous budget. \$A2.285bn.
- Health and hospital infrastructure. Money for new and upgraded hospitals, improved cancer infrastructure in rural areas and improved research into disease prevention and health care. \$A3.172bn.

### Pensions

The Budget increases the single pension by \$A32.49 per week while the pension for couples has been increased by \$A10.14 per week. However, by 2017 the eligible age for the aged pension will increase from 65 to 67. Payments to carers were raised by the same amounts. The total cost of this scheme is \$A14.2bn.

### Paid parental leave

The Budget introduces paid parental leave. Primary caregivers will be paid the equivalent of the minimum wage of \$A554 per week over 18 weeks.

### First home-owners grant

The boost to the first home-owners grant has been fully extended to September 30 2009. For the period from October 1, 2009 to December 31, 2009 it will fall from \$A21,000 to \$A14,000 for new homes and from \$A14,000 to \$A10,500 for established home. Beyond January 1, 2009 the boost will end and the first home-owners grant will return to \$A7,000.

**Education**

The Budget allocates \$A491m up to 2013 to create 50,000 new university places in addition to an increase in spending for disadvantaged students of \$A437mn.

**Business investment**

The Budget increases the tax break for small businesses with turnovers of sub-\$A2 million turnover to 50% from 30%.

**Healthcare**

The Budget changes the Medicare levy surcharge with the levy to increase for singles earning more than \$A90,001 and \$A180,001 for families to 1.25% from 1.00% and to 1.5% for singles earning more than \$A120,001 and families earning more than \$240,001. The rebate on private health insurance will decrease from 30% to 20% for singles earning more than \$A75,000 and families earning more than \$A150,000. Medicare fee cuts to doctors will save the government \$A153.4m. Changes were also made to funding arrangements for radiology and pathology, with the funding of radiology services rising and the funding of pathology services falling as a result of efficiency savings in the sector.

**Superannuation**

The Budget saves \$A4.2bn by capping the amount that individuals can salary sacrifice into their superannuation at \$A50,000 for those over 50 years old and \$A25,000 for those under 50 years old.

## The Budget and the economy:

For Australia, the Budget assumes recession in 2009/10 (with growth forecast at -0.5%), with a below-trend recovery in 2009/10 of 2.25%. This comes after flat growth in 2008/09.

The largest detractors to growth in 2009/10 are forecast to be business investment and the reversal of the terms of trade to 2006/07 levels. The government expects dwelling investment and household consumption to lead the economy out of recession in 2010/11.

It is interesting to highlight the government's forecast of flat growth in 2008/09. Looking at the data released already, with September quarter 2008 GDP printing at +0.1%, and December quarter 2008 GDP at -0.5%, it appears the government is forecasting positive economic growth in both the remaining quarters of the 2008/09 financial year.

With the forecast for economic growth in 2009/10 at -0.5%, the government seems to be factoring in a recovery in economic growth before deteriorating later in 2009 and into 2010. This would be at odds with market consensus that economic conditions are at their worst right now before a recovery later in 2009.

Not surprising, the year-average forecasts provided by the government are the same published by the Reserve Bank of Australia (RBA) in its Statement on Monetary Policy released last week.

### Domestic economic forecasts

	Outcomes	Estimates	Forecasts	Forecasts
	2007/08	2008/09	2009/10	2010/11
<b>Gross Domestic Product (GDP) (%)</b>	+3.6	0.0	-0.5	+2.25
<b>Gross National Expenditure (GNE) (%)</b>	+5.5	+0.25	-1.25	+2.5
<b>Non-farm output (%)</b>	+3.6	-0.25	-0.50	+2.25
<b>Farm output (%)</b>	+4.5	+13.0	+1.00	0.00
<b>Net Exports (%)</b>	-1.9	+0.25	+0.75	-0.50
<b>Terms of Trade (%)</b>	+5.2	+8.75	-13.25	0.00
<b>Current Account Deficit % GDP</b>	-6.2	-3.0	-5.25	-5.75
<b>Business Investment (%)</b>	+14.2	+2.5	-18.5	+3.5
<b>Unemployment rate (%)</b>	+4.2	+6.0	+8.25	+8.50
<b>Consumer Price Index (%)</b>	+4.5	+1.75	+1.75	+1.50
<b>Wage Price Index (%)</b>	+4.1	+4.25	+3.25	+3.25

Source: Commonwealth Budget 2009/10

### Major economic parameters – long term perspective

Of more interest was Treasury's longer term economic forecasts, with the view that in 2011/12, the Australian economy will return to above trend growth of 4.5%. Much of this optimistic view is due to Australia's location in Asia and our strong trade linkages with China.

	Forecasts		Projections		
	2008/09	2009/10	2010/11	2011/12	2012/13
<b>Gross Domestic Product (GDP %)</b>	0.0	-0.5	+2.25	+4.5	+4.5
<b>Unemployment rate (%)</b>	+6.0	+8.25	+8.5	+7.5	+6.5
<b>CPI (%)</b>	+1.75	+1.75	+1.5	+2.0	+2.5

Source: Commonwealth Budget 2009/10

### International economic growth forecasts – vs IMF

On the global economy, the 2009/10 Commonwealth Budget assumes -1.5% in 2009, this is slightly more pessimistic than the International Monetary Fund (IMF) estimates of -1.3% in 2009. However in 2010, forecasts are more optimistic than the IMF with a recover to 2.25%, compared to IMF forecasts of 1.9%. Much of this difference is due to a faster recovery in Chinese economic growth.

	Actual	Treasury		IMF	
	2008	2009	2010	2009	2010
<b>US</b>	+1.1	-3.0	+0.25	-2.8	0.0
<b>China</b>	+9.0	+6.25	+8.0	+6.5	+7.5
<b>Europe</b>	+0.7	-4.0	0.0	-4.2	+0.5
<b>Japan</b>	-0.7	-6.0	0.5	-6.2	+0.5
<b>World</b>	+3.2	-1.5	+2.25	-1.3	+1.9

Source: Commonwealth Budget 2009/10, RBA & IMF

## Bond market implications:

Largely consistent with pre-Budget expectations, the 2009/10 budget will require a significant increase in the issuance of Commonwealth government securities (CGS), to pay for the deficit for the coming year, with further substantial debt issuance expected out to 2012/13. For 2009/10, the Budget anticipates total Treasury bond issuance of \$A60bn, pretty close to market expectations, but well up on the previous years.

In February 2009 the government revised its borrowing limit from \$A75bn to \$A200bn. It now looks likely, however, that this limit will be breached in 2010/11, with total CGS on issue likely to peak at around \$A300bn in 2012/13. The government will need, therefore, to go back to the Parliament for an increase in its borrowing limit to around \$A300bn.

### Some details

After issuing only \$A5.1bn of CGS (all benchmark bonds) in 2007/08, the government now expects to issue approximately \$A35bn in 2008/09, taking total CGS on issue to just under \$A112bn, with benchmark bonds (or "hot stock") accounting for an estimated \$A79bn of this.

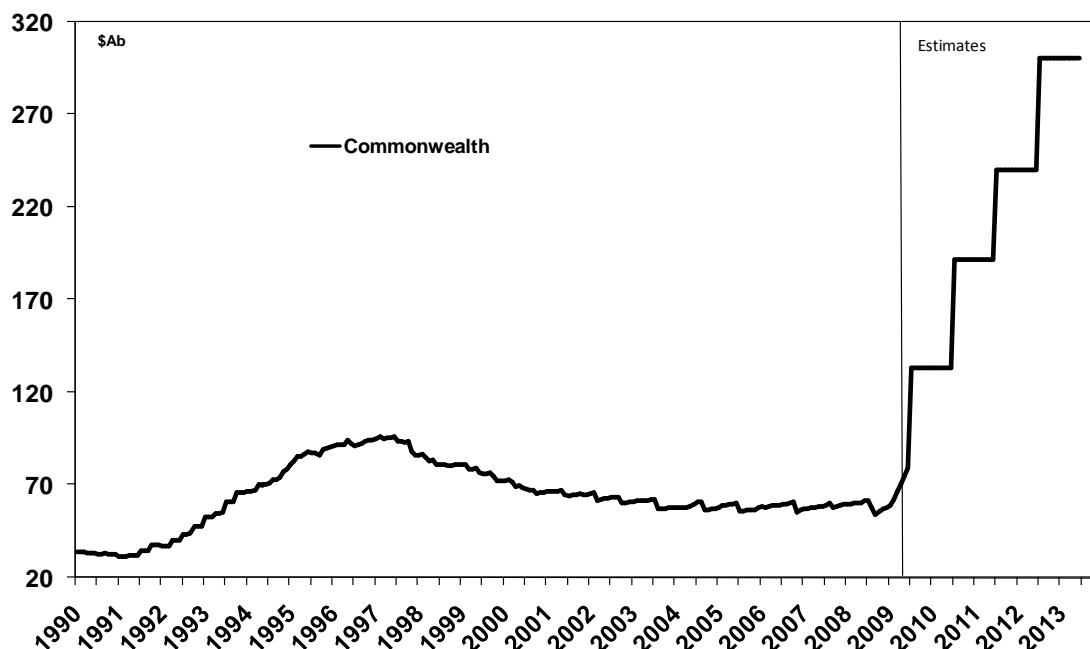
For 2009/10 the Australian Office of Financial Management (AOFM) will be required to issue a staggering \$A60bn in new debt. This will take total CGS on issue to just under \$A170bn, with an estimated \$A133bn of this accounted for by benchmark Treasury bond lines.

### Commonwealth government borrowing needs and debt issuance

\$Abn	2008/09	2009/10	2010/11	2011/12	2012/13
Headline cash deficit	35.9	59.8	58.9	48.5	25.1
Maturities	5.1	6.0	16.1	7.1	7.7
Total funding requirement	51.0	65.8	75.0	55.6	32.8
Bond issues	35.0	60.0	75.0	55.6	32.8
Total net bonds issued	29.9	54.0	58.9	48.5	25.1
"Hot stock" on issue	79.0	133.0	191.9	240.4	265.5
Total securities on issue	111.9	169.9	228.8	277.3	300.8*

Source: Commonwealth Treasury & Colonial First State \* numbers may not add due to rounding.

### Commonwealth securities on issue, actual and projected



Source: Commonwealth 2008/09 Budget

For the outyears, taking into account the ongoing large budget deficits and bond maturity profile, total CGS on issue is expected to grow to just over \$A300bn by June 2013. As noted above, this will require an \$A100bn increase in the government's current debt borrowing ceiling.

The Budget paper states that “the bulk of the issuance in 2009/10 will be into existing bond lines and will take account of the relative demand for lines of different maturities. At least one new Treasury bond line is planned to be issued in 2009/10. This is expected to be a Treasury bond maturing in 2022.”

The Budget also stated that the AOFM “will continue to explore the use of other financing instruments, such as Treasury indexed bonds, in consultation with market participants.”

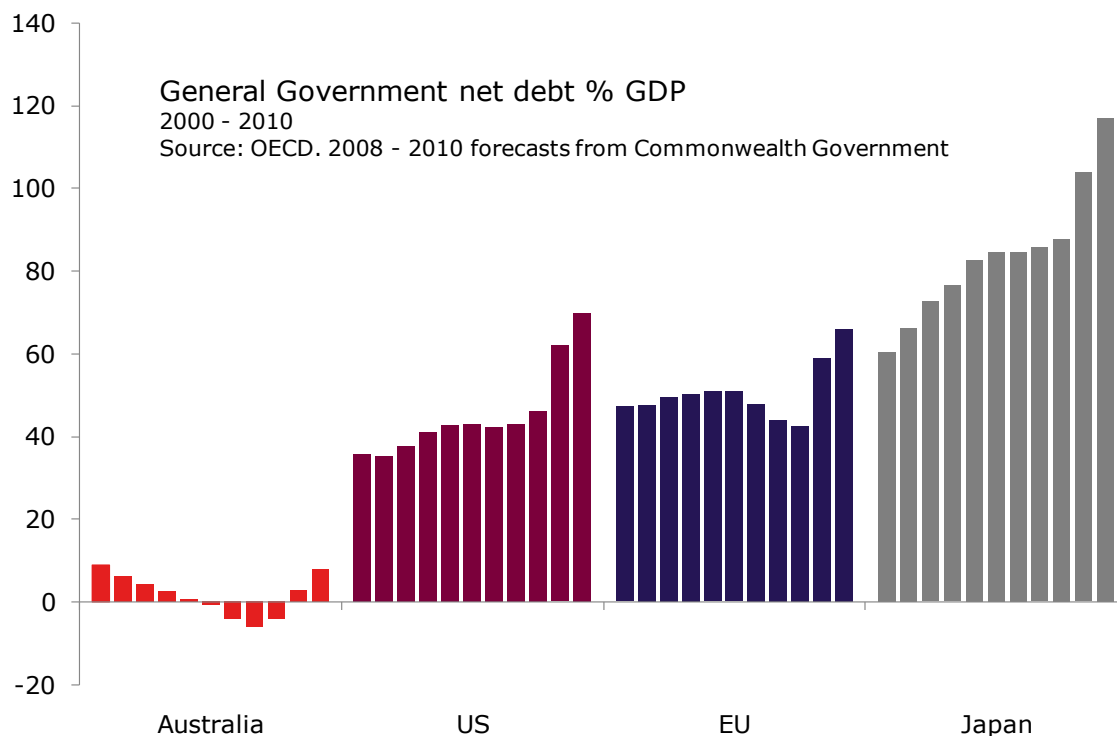
Today the AOFM has released a statement, detailing that the remainder of the 2008/09 bond selling program will include two tenders per week of up to \$A800m, into existing bond lines. For 2009/10 the bond selling program will include two tenders per week (for most weeks of the year), with total volumes of each tender to be in an \$A700m-\$A1bn range. As stated in the Budget, most of these issues will be into the current bond lines, but with a new 2022 bond to be issued “in the second half of the financial year.” Of note, the AOFM held a bond tender today of \$A700m 15 April 2012 bonds. These bonds saw a very high bid/cover ratio of 4.4 times, indicating solid demand.

The AOFM has also stated today that “consideration will be given to issuing longer-dated Treasury Bonds and resuming issuance of Treasury Indexed Bonds. The issuance of such bonds would assist portfolio management by widening the range of available debt instruments, diversifying risk and potentially tapping additional sources of investor demand.

“Issuance of longer-dated Treasury Bonds could also strengthen the overall functioning of Australian financial markets by providing pricing benchmarks for other long-dated instruments, such as public and private infrastructure bonds. Similarly, resumption of indexed bond issuance could assist in the debt financing of long-term infrastructure, since Treasury Indexed Bonds would serve as both a pricing benchmark and a risk management tool. Indexed financing can be attractive for those infrastructure projects whose revenues are linked to inflation. In addition, indexed instruments have advantages for investors with inflation-linked liabilities. The AOFM will consult market participants over coming weeks about issuance of longer-dated Treasury Bonds and Treasury Indexed Bonds.”

From an estimated net asset position of \$A44.8bn, 4.0% of GDP, as at June 2008, the Commonwealth government is now expected to have net assets of \$A4.7bn, or 0.4% of GDP, at June 2009. The government will then quickly move back into a net debt position, estimated at \$A53.7bn, 4.6% of GDP, at June 2010 and \$A188.2bn, 13.6% of GDP, at June 2013. The budget papers then indicate that net debt to GDP is expected to peak at 13.8% at June 2014, before declining back to 3.7% of GDP by June 2020.

While this is a significant deterioration in Australia’s net debt position, it still places Australia in a vastly superior position to most other OECD nations. Indeed, budget papers note that “between now and the end of 2014, average net debt levels in major advanced economies are projected to increase to over 80% of GDP.” While the credit rating agencies have expressed some confidence that the 2009/10 Budget and projections for the outyears are consistent with an AAA credit rating, complacency should be avoided



Source: Commonwealth Budget 2009/10

### **Commonwealth guarantee for the States**

The Treasurer has also used the Budget as an opportunity to fine-tune the proposed Commonwealth guarantee of State government bonds. Each State will now have 28 days after they start issuing new State debt with the Commonwealth guarantee to decide whether or not to guarantee existing lines of debt. These arrangements will also only take place once legislation is passed.

In addition, the Commonwealth guarantee can now be extended for bonds with a maturity up to 15 years, including for inflation linked securities. States will also have the ability to “buy back guaranteed securities and either warehouse them without extinguishing the guarantee or extinguish both the securities and the guarantee over them.”

## Equity market implications:

### Equity market and sectors of the economy likely to be impacted

Overall, the Budget is unlikely to have a major impact on the sharemarket as a whole, given many of the leaks prior to the release. Over the medium-term, one of the key issues will be how to balance investor demand for shares against the large increase in government bond supply, which is likely to place upward pressure on yields. In addition, the economic growth forecasts provided for in 2011/12 and 2012/13 of 4.5%, if they happen, will be a positive for the sharemarket.

Some individual sectors will be impacted more than others given the new initiatives and include:

#### Health Care

There were numerous changes to health care contained in the Budget. Changes to private health insurance rebates are not expected to largely impact the sector given the increases to the Medicare levy if higher income earners fail to hold private health insurance. The government anticipates retaining 99% of those people currently holding insurance. The move to make Medibank for profit could also have implications for further changes to the health insurance industry and further consolidation.

Other impacts on the sector centre on cuts to pathology funding (down 8.4% over the next four years) and an increase in the funding for radiology (a 10% price increase). Changes to bulk billing incentives may lessen the impact on both services. There is likely to be an impact on the listed health care stocks given a higher exposure to pathology sectors in Australia. Moves to make the sector more competitive could also be a negative as new entrants can now enter. However given Australia's ageing population the demand for health care is expected to remain strong over the long-term.

#### Infrastructure

The centre piece of the Budget was the \$A22bn infrastructure spending plan on transport, energy, education and health infrastructure. This is likely to boost the listed contractors and building material companies (especially given the extension to the First Home Owners Grant). However it is important to keep in mind that the large drop in private non-dwelling construction expected by the government over the coming two years is a negative for the sector. So while it is positive that public spending is taking over, some weakness might be expected from the pull back in investment in the resources sector.

#### Clean energy Infrastructure

One of the more interesting initiatives to come out of the Budget was the \$A3.5bn spending on clean energy infrastructure, a sector not focussed on up until now. Wind farms and other alternative energy producers could be a winner while companies involved in the construction of these initiatives should also benefit.

#### Retail

The increase in pension payments in September 2009 and the income tax cuts coming into effect on July 1 2009 is a mild positive for the retail sector. The anticipation is that some of the increase will be spent rather than saved, given those that are targeted. While there were no new cash handouts, the sector should be a partial winner as comfort levels in the community grow. Some changes to the Baby Bonus and Family Tax Benefit B for higher-income earners should not have a large impact on spending.

#### Superannuation industry

While there were some changes around the edge to superannuation, as widely anticipated, major changes will be held back, awaiting the release of the Henry Tax Review and Nick Sherry's review of superannuation to be released late this year.

The reduction of the cap on concessional super contributions and the transition cap and co-contributions for low-income earners are unlikely to have a large impact on net inflows into super balances. Higher income earners could bring forward inflows into super accounts of those looking to optimise taxes prior to 30 June 2009, similar to what happened prior to 30 June 2007. The maintenance of the 9% compulsory superannuation guarantee is key to the industry and the lift in the pension age from 65 to 67 over time will mean super balances are retained for longer.

## Budget details, 2009/10 and beyond

The underlying cash budget deficit for 2009/10 is \$A57.bn, the largest deficit on record and represents 4.9% of GDP. This compares to the previous largest deficit of 4.1% of GDP in 1992/93 and 3.3% in 1983/84, i.e. the last two recessions.

This underlying cash budget deficit represents a turnaround of \$A26bn from 2008/09 estimates and around \$A77bn from the original estimates of 2008/09 released in last year's budget. This indicates just how sharp and deep the downturn has been in the global and Australian economy. The turnaround in the deficit is split between policy changes (accounting for around \$A31bn) and parameter changes due to the economic downturn (accounting for around \$A45bn).

In 2009/10, Revenues are estimated to be \$A290.6bn, down from initial estimates contained in last year's budget of \$A319.5bn. The government has estimated that \$A210bn in revenue (mostly from less taxation revenue) will be lost over the forward years due to the global recession with a fall in company taxation revenue a large contributor.

Outlays: \$A338bn is estimated for 2009/10. This includes around \$15bn in new spending, mostly centred on infrastructure.

The government has also highlighted its path back to surplus strategy. The aim will be to bank increases in tax revenue that is naturally associated with an economic recovery and by limiting real growth in spending (at 2% pa). This should see the deficit more than halve by the final year of the forward estimates (2012/13) and return to surplus by 2015/16. It appears much of this is conditional on returning to the governments above trend growth forecast in 2011/12 of 4.5%. The return to surplus is therefore put at risk if the economic recovery is weaker than forecast.

Net debt deteriorated from an estimate of -\$A4.7bn in 2008/09 to \$A53.7bn in 2009/10. Interest expense is therefore expected to be \$A1.5bn in 2009/10 and rising to \$A7.6bn in 2012/13 or 0.6% of GDP.

\$Abn	2008/09	2008/09	2009/10	2010/11	2011/12	2012/13
	Original Est.	Budget Est.	Budget	Budget	Budget	Budget
Revenue	319.5	295.9	290.6	294.8	320.8	349.7
% GDP	25.9	24.7	24.7	24.1	24.7	25.2
Outlays	292.5	324.4	338.2	344.5	356.4	375.0
% GDP	23.8	27.1	28.7	28.2	27.4	27.0
Net operating balance	+27.0	-28.5	-47.6	-49.7	-35.6	-25.3
Underlying cash balance	+21.7	-32.1	-57.6	-57.1	-44.5	-28.2
% GDP	+1.8	-2.7	-4.9	-4.7	-3.4	-2.0
Headline cash balance	+23.6	-32.9	-53.1	-56.0	-41.8	-30.3
Net assets/debt	+45.0	-4.7	53.7	112.2	161.7	188.2
% GDP	+3.7	-0.4	4.6	9.2	12.4	13.6

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