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The September Quarter

Concerns about a widespread financial crisis arising from the sub-prime issue sent shockwaves through global financial markets in July and August. Notwithstanding the resultant volatility, the Australian market posted a 5.7% gain over the quarter and whilst most international markets also posted gains in their local currencies (albeit mostly small), the MSCI fell by 1.8% in AUD terms over the same period. With the US economy slowing, the ability of the Asian economies/consumer to take up the resultant “growth slack” will be critical to the performance of Australian and global markets over the remainder of 2007.

Global Economy

There is little doubt that the risks in the world’s largest economy, the **United States**, have increased following the fallout from the sub-prime crisis. The US housing market has continued to decline and, coupled with tighter credit conditions, this is likely to impact significantly on US consumers and their capacity to spend. On a positive note, inflation pressures in the US have clearly moderated (and should continue to do so given the weakness in domestic demand) which provides latitude for the Federal Reserve to ease rates further. Corporate balance sheets remain relatively healthy and US equities still represent good value (14 time P/E ratio for the S&P500). Quality large cap stocks exposed to global growth and with access to credit are likely to outperform.

Whilst **European** growth has slowed, valuations remain compelling, with the region as a whole trading on a 12 times P/E ratio. In the **UK**, despite the sub-prime issues and flow-through effects on the banking sector, the economy remains strong, although inflationary pressures are persisting.

In Asia, the Bank of **Japan** left interest rates unchanged at 0.5% throughout the quarter – this despite an expectation that the regulators would move to raise rates. This decision not to move rates was primarily due to concern over the sub-prime issue and an anticipated flattening of growth resulting from the slowing of the US economy. **China** on the other hand grew by11.9%over the year to June, which was the highest level in twelve years. Against this growth backdrop, inflation risks remain high and we may well see further interest rate rises in China over coming quarters.

Domestic Economy

With the domestic economy running at close to full strength (evidenced by tight labor markets and high capacity utilization rates) risks to inflation remain on the upside. In August the Reserve Bank of Australia moved to raise interest rates by 25 basis points to 6.5%. The diminished outlook for US economic growth (and thus the flow on effects to Australian growth) has helped to alleviate some of the immediate inflationary pressures.

Australian corporate balance sheets are, in general, healthy and cashed up and should be able to withstand tightening credit conditions in the near term. The S&P/ASX300 index returned 5.7% over the last 3 months, impressively shaking off an interest rate rise and rebounding strongly following the August market sell-off. Despite stretched valuations, investors sort the relative safety of listed property trusts during the sub-prime crisis and this saw LPTs return a surprising 5.2% for the quarter.

OUTLOOK

Australian Shares

Whilst a strong domestic economy has resulted in the share market finishing in positive territory for another quarter, this has not been without some extreme volatility. Australia will continue to be affected by events around the globe and there is still uncertainty as to the level of the slowdown in the US. Considering that 63% of Australia's exports are to the Asian region, a key issue for the Australian economy and share market will be whether the developing markets of Asia can withstand a US slowdown. Australia's resources sector, which has contributed to the share market's strong gains, is also largely dependent on the Asian growth story. We expect Asian economic growth to slow but still remain robust.

The broader share market, having recovered its earlier losses in the quarter, is currently trading at a forward P/E of 17 times (based on consensus estimates). We believe that market pricing is not cheap but neither is it overly expensive, assuming growth expectations are met. Unemployment is at record lows, households are enjoying rising wealth, and company profits remain strong, as evidenced by the most recent reporting season. Against this positive backdrop is the risk of further interest rate rises due to rising inflation, and the uncertainty surrounding the strength of the US economy. Increased share market volatility is expected both here and abroad until these risks have abated and a clearer picture can be painted for a recovery in the US.

We are still comfortable maintaining a **neutral** weighting on Australian shares, with an overweight allocation to resources (even after recent price rises, the sector still represents good long term value) and financials.

Global Shares

Whilst tightening in credit markets has somewhat clouded the global economic outlook, forecasts remain positive, with the IMF predicting growth of 5.2% in 2008. This is despite a deteriorating economic outlook in the US and again illustrates the growing significance of China, India and other emerging markets like Latin America to global prosperity. The decisive action of the US Federal Reserve over the quarter in lowering cash rates by 50bps, significantly boosted investor confidence and averted what could have been a (more) significant sell-off in markets. However, the Fed's intervention has now created a strong expectation of further rate falls. If a further rate reduction is not forthcoming at the end of this month, it is likely that equity markets will fall.

Given the prevailing expectation of solid global growth (even after allowing for a softening in the US) a number of research houses have moved to an overweight view on global equities. However, given the uncertainty about the US and, to a lesser extent, Japan and having regard to likely price volatility (exacerbated by further currency fluctuations) we retain a **neutral** view on global equities.

(Note that with the AUD trading at historic highs and outside one standard deviation relative to long-run averages, this implies greater upside in the performance of unhedged (international) managed fund portfolios in the medium term)

Listed Property

Both domestic and global property has been subjected to volatility caused by the negative sentiment relating to the sub-prime issue. Australian LPT yields remain low, with the FY08 yield expected to be around 5.7% - this compares to a 90 day bank bill rate of 6.8% and a 10 year bond rate of 6.2%. We are likely to see further corporate and private equity activity in the domestic LPT market, however this is not expected to generate capital growth in the sector. In the absence of capital growth in the foreseeable future, together with the relatively unattractive yield we are **underweight** domestic listed property.

The outlook is more positive on the global property front, with the Asian markets likely to outpace other global real estate sectors. We see returns in Global REITs being in excess of 12% and hence have a more positive view on global real estate.

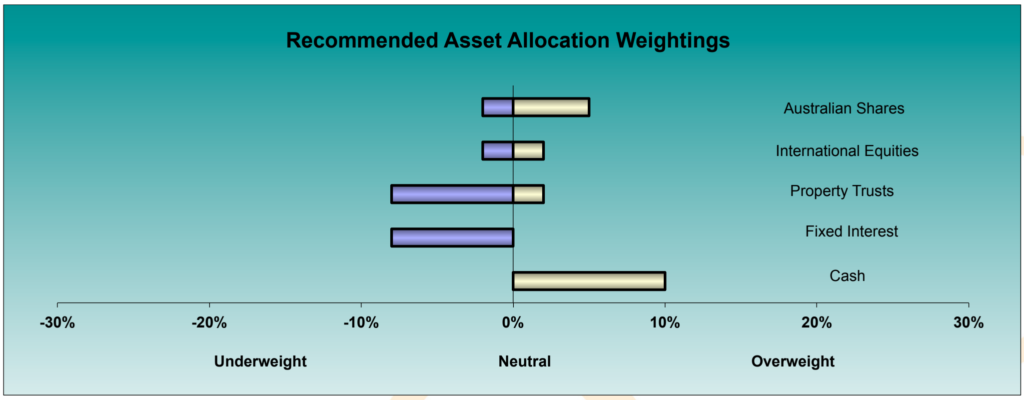
Fixed Interest

The domestic yield curve remains inverted and investors are not being rewarded for adding any duration to their portfolios. The risk to global interest rates remains on the upside and there still appears to be volatility in credit markets. We see little value in fixed interest over the short to medium term and we remain **underweight** fixed interest.

Cash

Cash represents the residual of our views on the other asset classes and as such, we continue to have a **slight overweight** position on cash, particularly in the short term.

A summary of our views on asset allocations follows:



Key Risks

The recent rally in equity markets has resulted in stocks being overbought on a momentum basis and this does leave us vulnerable to correction from a number of potential sources:

- **Oil prices** currently sit at record highs and with the prospect of increased tensions in the middle east, together with demand pressures as we move into the northern hemisphere winter, prices could well push even higher adding further to inflationary concerns. In Australia, the September quarter CPI data is due out on 24 October and any tick-up in the underlying number could see the RBA move quickly to raise domestic interest rates again.

- The **US economy** currently presents a number of challenges:
    - The **housing market** continues to be soft. Building activity is slowing further and prices are pushing lower.
    - There is the potential for a second wave of fall-out from the **sub-prime** issue. Losses from sub-prime investment (both direct and indirect) are still washing through the system and there is the likelihood of further mortgage defaults as newly funded loans roll-off initial honeymoon arrangements.
    - A further reduction in **cash rates** has already been factored in to equity market prices. If the Fed does not reduce rates at the end of this month, equity markets will move lower.
    - We have just entered the **reporting season** for US companies and the quality of profit results, together with the sentiment contained in outlook statements will impact the market in the short term.
- Whilst there is some speculation that a change of government after the 24 November **election** may present risks here in Australia, the reality is that it will be business as usual for the Australian economy and equity markets.

Regards

Andrew & Stephen