Ausbil Dexia Limited Investment Markets

September 2010

Ausbil, a partnership of investment experience and financial strength

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Money does not perform. People do.

Ausbil Dexia Limited
Australia

International Economic Overview

Overview

We continue to note sustained but uneven global growth, led by strong emerging market growth. The US and Europe are producing more modest, but positive recoveries.

In the US, the small gain in the June quarter GDP (1.6% annualised) reflected strong growth in final domestic demand (4.0%), especially in business investment (up 17.6%), but an even sharper surge in imports, and hence a marked deterioration in net trade. Thus, while US domestic demand grew, the main beneficiaries were businesses outside the US.

In Japan, the June quarter growth has already been revised up - fitting the regular pattern of upward revisions to growth seen over recent years. In both the US and Japan, we expect growth in the second half of 2010 will be similar on average to the June quarter pace. For Europe, GDP growth is likely to slow from the very strong June quarter, but should stay positive.

Industrial production growth has slowed in advanced and developing economies alike, with the slowdown particularly pronounced in Asia - a policy response to the rapid rebound of the previous 18 months. Output across emerging Asia is already 20.5% above pre-Lehman peaks, while the rest of the world is still down 8.3%. Just as China contributed to the regional recovery in 2009, it is now an important part of the slowdown in trade and output growth. Some of this reflects the inventory cycle, but policy is also having an effect through a clampdown on energy-intensive industries and the administrative squeeze on real estate. The effectiveness of the latter squeeze already seems to be fading.

Slower growth presents less of a problem for Asia compared to developed economies. The recovery in output has been largely driven by internal demand within the Asian region and the Asia policy-makers are able to use a range of orthodox policy tools to combat any excessive slowdown in growth. This improves the predictability of outcomes in Asia compared to the major developed economies.

International Economic Overview

United States

Federal Reserve policymakers left the door open to further Quantitative Easing (QE) in their latest meeting. The Committee voted to keep interest rates near 0% for "an extended period" and decided to maintain its existing policy of reinvesting principal repayments from mortgage securities into bonds. While the Committee acknowledged the softer domestic demand and inflation conditions in recent months, the trends were not enough to drive more policy support for now.

Notably, the statement did show the policy makers discomfort that the current level of inflation is too low. This suggests that any further signs of economic weakness will hold the door open to more policy support later in the year.

Leading indicators remain consistent with ongoing, but soft growth in the second half of 2010. The Conference Board Leading Index rose 0.3% in August for its second consecutive gain. Easy monetary conditions, capital spending and some improvement in average weekly hours and housing activity lifted the index. This takes the annualised growth rate to 4.1%, in line with its 4.2% rate in July, which suggests the June quarter downshift in activity growth is levelling out.

Capital expenditure should be important in keeping the recovery on track. Orders for non-defence capital goods (ex aircraft) - a proxy for business investment - gained 4.1% in August. This is the third increase in the last four months. Shipments and unfilled orders for these goods continued to rise. With new orders up nearly 15% year on year, this points to firm gains in equipment and software investment in the September quarter and another solid contribution to GDP from non-residential investment.

Residential construction started to steady in August, following its post tax credit plunge in recent months. Housing starts lifted to an annualised pace of 598,000 from a downwardly revised 541,000 in July. Activity remains weak but small improvements are evident for both the single family and multi-family segments.

A meaningful recovery continues to look some distance off. Building permits ticked higher in August, to an annualised rate of 569,000. This is below the pace of starts, pointing to sluggish housing activity into the December quarter of 2010. Furthermore, multi-family units drove the increase. Single-family permits fell in fifth month in a row. These are the largest component of the market, highlighting that the improvement is not yet broad-based.

The market for existing homes continues to have bearing on the pace of the housing recovery. Existing homes sales improved from an annualised rate of 3.84m for July to 4.13m in August, still well below the average pace of around 4.75m over the past 18 months. Existing home inventories remain elevated at 11.6 months' supply.

International Economic Overview

United Kingdom

The historical economic data continues to show decent growth, but investors are highly nervous about the economy's ability to withstand the upcoming fiscal tightening. As expected, June quarter GDP growth was revised up from 1.1% for the quarter to 1.2% with rapid growth in exports and consumer spending. Early evidence hints that growth slowed to about 0.5%-0.6% but such a pace is not weak in the context of other developed economies.

Private savings are now extremely high – especially in the corporate sector – and surveys suggest that firms are now looking to expand investment and employment. Monetary policy remains very loose, and UK banks now appear well-capitalised. At the same time, the low pound is giving a powerful and persistent boot to exports, which now are growing at the fastest pace since 1980.

Inflation is likely to remain sticky, reflecting sizeable cost pressures from the low Pound and the VAT increase. We expect CPI inflation to stay above the 2% target for 2010, 2011 and probably in 2012 as well. Nevertheless, the Monetary Policy Committee will keep rates ultra-low for a while unless long-term inflation expectations accelerate. The fiscal deficit continues to fall gently, and Consensus forecasts expect this to continue. With fiscal tightening as well, we expect that the deficit will fall from £145bn in 09/10 to about £130bn in 10/11 and then falling below £100bn in 2011/12.

The UK's Sovereign Credit Rating was reaffirmed at AAA stable by Moody's. They assume that the fiscal consolation plan will stay on target, which it has to date. Also the latest Bank of England Minutes revealed an 8-1 vote to keep policy unchanged in September, and signalled that they were moving closer towards more asset purchases - that is - more quantitative easing.

Japan

The government has announced additional stimulus measures in early September. Consumer spending is now likely to be highly volatile, with the prospective expiration of subsidies for the purchase of cars and home appliances. These measures will make the assessment of the underlying economy difficult, however the general trend of the economy is for slower growth. Exports are slowing due to slow developed market growth and the strong Yen, whilst private capital expenditure is positive due to the strong rebound in corporate profits.

The government intervened in the FX markets, and the Yen/USD has stabilized around Y85/USD for now. The Bank of Japan (BoJ) has provided additional liquidity. If upward pressures on the Yen rekindle as we expect, the political pressure on the BoJ to take additional easing measures will likely intensify.

The impasse in economic policies appears unlikely to unravel in the near future. The basic thrust of economic policies will remain largely the same under the new Kan Administration. Importantly, the policy decision-making will be extremely difficult as the ruling coalition falls short of the absolute majority in the upper House of Parliament.

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Europe

There remains a large divergence between the growth rates of the European Union (EU) member countries. Some euro area countries (e.g. Spain, Greece) are likely to show a contraction in GDP while others (such as Germany) will probably slow from the decent growth rate of the June quarter. Available information on the 2011 budget proposals suggest a broad-based fiscal tightening in the euro area by around ¾-1% on average. With the outlook for nominal GDP growth of around 3½% next year (up from around 2% this year), we expect a reduction in the deficit-to-GDP ratio to below 5% next year. Noting the much larger fiscal tightening in the strained periphery countries, adverse fiscal risks in those countries remain much larger than in the core countries - mainly stemming from the short term link between fiscal tightening and weaker economic activity. Hence, pressure on periphery sovereign bond markets should remain.

The European Central Bank (ECB) kept its main non-standard policy measures in place, by extending the full allotment procedure for all open market operations and expanding its asset purchases under the securities markets program.

After the surge in the June quarter, (which was overstated by temporary, mainly weather-related, factors) most sentiment indicators for German GDP in July/August still suggest decent GDP growth in the September quarter. We expect that domestic demand will keep the recovery going, supported by ongoing export expansion. With support from decent income growth – reflecting job gains and modestly accelerating wages – we expect that in 2011 private consumption will increase by about 1.75%. This would be the fastest pace since 2001. According to the government's budget proposal, fiscal policy will tighten by around ½% of GDP next year. Hence, the headwinds from fiscal policy are modest and the country is likely to continue to benefit from its competitiveness.

Business indicators signal ongoing modest expansion of the French economy. After the deterioration in consumer sentiment earlier in the year, consumers turned somewhat more optimistic in August. Comments by government officials suggest a tightening in fiscal policy in 2011 of around 0.9% of GDP. After a likely reduction of the deficit in 2010, this should help to meet the government deficit target of 6.0% of GDP next year – despite its too-optimistic growth forecast. After the likely implementation of the controversial pension reform, we do not expect far reaching reforms or additional substantial fiscal tightening before the 2012 presidential election.

International Economic Overview

China

With the European sovereign crisis, the slowdown in US recovery and rising trade tensions, many were surprised by the resilience in China's exports, which still grew 34% for the year to August. New demand in Asia and Latin America supported growth. While we do not expect the advanced economies to fall back into recession, final demand growth there should still be tepid. Thus, we expect the long-awaited slowdown in China's exports to materialise in the coming months.

Output, investment and consumption have all been stronger than expected. Food prices rose strongly in the past few months. Prices rose the fastest for rice (12%) and vegetables (19%), crops most affected by the spring droughts and the summer floods, in addition to a generally poor harvest. Through the sharp ascent was disturbing, the impact of natural disasters is temporary, especially if other prices are stable. Inflation so far is unlikely to trigger rate increases, which would restrain the entire economy.

Economic activity regained speed in August, against the direction of policy. Industrial output growth accelerated, with heavy industries taking the lead. Power consumption growth also picked up. Property sales rebounded and prices rose with it, even before the typically strong sales season of Sept-Oct. These are signs that domestic tightening and external slowdown had not been as severe as advertised. We expect tougher execution of policies related to property market and energy conservation.

With economic activity still growing quickly and monetary policy still loose relative to the needs for economic growth, the outlook for inflation in the medium term will not remain benign. Adding fuel to this are the expectations of higher wages and the still unresolved property market imbalances.

As US-China tensions mount, China's policymakers may be more inclined to increase imports, rather than make other more difficult reforms such as strongly appreciating the currency. This could both give orders to American merchants and reduce China's surplus, even if temporarily.

The currency appreciated by nearly 2% in September, compared to 0.3% in the first two months of the de-pegging. The timing of appreciation fits into the US political calendar. Though opportunistic, this at least shows that Chinese leaders are responsive to external political pressure. Thus, with US mid-term elections and G20 meetings in November, it is very likely that the currency appreciation could continue in the coming few months. Afterwards, however, the revaluation is likely to return to a more subdued pace, as the global economy and China's exports are no longer in rapid expansion. We still see 3-4% annual appreciation as the norm for the next two years or so.

International Economic Overview

Australia

We continue to expect real GDP growth of around 3½% in 2010, rising to 4¾% in 2011. This outlook is underpinned by the terms of trade reaching their highest level since the middle of last century. In the near term, growth should be driven by household demand and inventory rebuilding, but next year and beyond business investment and exports should expand. In particular, investment in new gas projects, net of the associated increase in imports, alone could boost GDP directly by around 1% in 2011-12. Added to this will be significant investment in iron ore and associated port and rail infrastructure. The indirect effects of this investment on employment, incomes and confidence should boost growth further. There are two-way risks to this outlook, but the recent fall in the unemployment rate to 5.1% suggests the balance of risks is to the upside. As a result, we anticipate 25bp rate rises on a regular basis to the point where domestic demand is actively constrained.

In its quarterly report on Australian Commodities, the Australian Bureau of Agriculture and Resource Economics (ABARE) revised up its estimates for Australian commodity export revenue in Financial Year (FY) 2010-11 to $211.7bn from $167.5bn in FY09-10 and the old high of $194.1bn in FY08-09. If the ABARE forecasts are right, commodity export revenue would represent a very robust 15½% of current nominal GDP and the expected fiscal year change in export revenue ($44bn) adds 3½% to nominal GDP.

The ABARE highlights include:
Agriculture: There are upgraded prospects for winter and summer crops, with the highest water storage levels in Murray-Darling since 2002.

Thermal coal: there is increased reliance on imports by China and India. World thermal coal trade is expected to rise +5% in 2011 from +3% in 2010 Domestic thermal coal production is expected to shift from -2% in 2009-10 to +15% in 2010-11. This is due to the increase in the number of coal projects expected to commence production this year and the expanded port capacity.

Steel Making: Global steel consumption growth is projected to ease from 9% in 2010 to 5% in 2011. In China, ABARE notes "the development of western provinces, the construction of road and rail infrastructure and increasing urbanisation will continue to underpin relatively strong growth in steel consumption." Nevertheless, ABARE assumes that Chinese steel consumption growth eases from +9% in 2010 to +5% in 2011.

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Iron Ore: Despite a slower rate of steel demand growth, Chinese iron ore imports are expected to shift from -2% in 2010 (617Mt) to +10% (677Mt) in 2011 as less demand is met from local production. Australia and Brazil are expected to capture more market share in 2011 as Indian exports of iron ore are expected to be unchanged as higher production will be directed toward meeting increased domestic demand.

Metallurgical Coal: Exports from the Gladstone and Dalrymple Bay ports were affected by above average rainfall in the March quarter, and further disruptions are expected in the September quarter as a result of scheduled maintenance shutdowns. For 2010 as a whole, Australia's exports are forecast to increase by 20% to 162Mt. In 2011, Australia's exports are forecast to increase by a further 4% to 169Mt, reflecting planned expansions to production capacity and an assumed return to average seasonal conditions.

Gold: In 2011, the world gold price is forecast to again average around US$1200 an ounce. In 2009-10, Australia's gold export shipments fell by 22%. In 2010-11, gold export volumes are forecast to rise 18%, reflecting the forecast growth in domestic gold production and higher demand for jewellery in regional markets.

Fixed Interest

Performance and Outlook

The debt market delivered a strong negative return of (0.99%) over the course of September 2010. Performance for the 12 months was 7.26% as measured by the UBSA Government Bond index.

Ten year bonds opened the month at 4.76 % and closed at 4.96 %. Three year bonds opened at 4.24% and closed at 4.75%. The cash rate has, again, been kept stable at 4.50% for a number of months. The market was anticipating a tightening at the early October meeting but the RBA held rates unchanged. The associated commentary was hawkish for the future direction of rates.

The domestic bond market is being strongly influenced by international bond movements, particularly the US and Europe. The curve sold off with the improved international equity markets.

The Bond market does not offer value in this economy, with the strong rate of growth and a relatively high underlying rate of inflation. The positive aspect is that it is clear that the Central Bank has these risks under control. Nevertheless, a continued risk of a sell off remains for the local bond market.

The credit market also weakened, due primarily to the weaker underlying yield.

We continue to expect US Treasury yields to drift lower. This is based on the macro-economic outlook, which calls for growth to remain tepid and for inflation to stay low, and thus for the Federal Reserve to be on hold for an extended period of time and continue to purchase bonds on its own balance sheet. In such an environment, interest rates will likely trade in a range. Additionally, we expect the Federal Reserve to embark on a further quantitative easing program following the November 2-3 meeting. In addition, potential future foreign exchange intervention by Japanese policymakers to stem declines the rise in the Yen represents a further upside risk to demand. This is due to the Bank of Japan potentially purchasing Treasuries with the US dollars it has exchanged. Against that, however, the risk of heavy bond supply and the eventual recovery in the US economy keep us neutral on US yield levels.

Since their last increase on May 4, the RBA has maintained a clear tightening bias, warning that inflation pressures were likely to build again in 2011. They remained on hold in recent months to see how the global outlook resolved and to see how the economy has reacted to the tightening to date. While Australian yields rose as the RBA firmed their tightening bias, yields in US fell as the Federal Reserve moved a step closer to quantitative easing.

We had been looking for higher yields in Australia and for part of September the market moved in this direction. Our bias remains to sell rallies for the market RBA forecast is still under-priced – the market has been generally pricing 50 basis points of RBA hikes over the next year. In our view, the RBA will be more hawkish.

Anything with a positive yield will be well bid in an environment where the Federal Reserve has been emphasising that interest rates in the US are going to be low for a very long time. This means that yields along the maturity spectrum as well lower rated corporates can go to low levels. The combination of Federal Reserve stimulatory action and RBA rate increases means that the Australian Government yield curve will probably invert.

The Australian-US 10 year bond spread is very wide but likely to stay there. The Aus-US year spread pushed to +250bps. Even so, a new round of Federal Reserve quantitative easing would send US 10 year Treasury yields lower and Australian-US spreads wider.

Foreign Exchange

The Australian Dollar (AUD) was the best-performing major economy currency in the September quarter, rallying around 8.3% in trade-weighted terms and around 13.4% against the US Dollar. This was due to uncertainty associated with the European sovereign risk blow-up and bank funding difficulties while US economic data relieved concerns about a double dip recession. Over this time frame, Australian commodity base metals export prices rose over 17% (in USD terms) amid sustained demand from China.

We expect the Australian Dollar to continue to outperform. The AUD will be volatile until the extent of the developed economies growth downshift becomes clear, but should gain as world growth picks up again in 2011. The RBA tightening cycle is the most advanced in the major economies, but a tight labour market and high underlying inflation is rekindling the RBA's hawkish instincts.

The Emerging Markets Asian expansion is still moderating to a more sustainable pace, but will continue to provide medium-term support to the AUD, steadily boosting export volumes and the prices of Australia's bulk commodity exports. As a result, robust profits will continue to attract capital and underpin Australia's resource-sector investment boom, putting pressure on capacity, wages, and inflation. The AUD/USD is rising to break parity and then slipping toward end-2011 as the US economy shows signs of recovery and the Federal Reserve begins implementing policy normalization which will have a positive impact on the US Dollar.

Australian Equities

The Australian equity market closed the month 4.8% higher. Macro news flow improved investor confidence with pronouncements from the Basel Committee on its revised capital requirements for banks, macro data from the US and Europe and clear signs that China's economy was stabilising all contributing to a more positive outlook for global markets. Domestically, the resolution of the Federal election combined with strong domestic macro data improved investor sentiment.

Merger and acquisition activity slowed, with NAB withdrawing its revised bid for AXA Asia-Pacific after objections from the ACCC. Following the end of reporting season, corporate news flow also slowed, with Macquarie Group's profit warning being one of the few noteworthy events to report.

Economic data flow remained strong during September. Q2 GDP showed growth of 1.2% quarter on quarter. The RBA left interest rates unchanged although it remains hawkish, while employment trends remain strong with Australia now close to full employment at 5.1% and falling. The AUD gained strongly against the USD (+8.6%), Euro (+0.9%), pound sterling (+6.0%) and the Yen (+7.7%).

In commodities, the CRB Index gained 8.6% over the month. Most commodities reported positive returns during the period with spot oil (+11.2%), LME spot copper (+8.5%), aluminium (+13.2%) and the precious metals index up 10.0%. Spot gold (+6.4%) reported its largest monthly gain since November 2009 and achieved record highs when measured in US dollars.

The Resources sector (+7.0%) outperformed Industrials (+3.8%), as oil, gold and base metals prices rose over the month. The smaller companies, represented by the S&P/ASX Small Ordinaries (+9.1%), outperformed the large cap stocks (4.3%), represented by the S&P/ASX 50 Leaders Index.

At a sector level, Metals and Mining (+8.4%) Materials (+7.6%), and Industrials (+7.6%), were the best performing sectors with the major stock performers being Rio Tinto (+9.5%), BHP Billiton (+6.3%), Sims Metal Management (+6.3%) and Downer EDI (+23.6%).

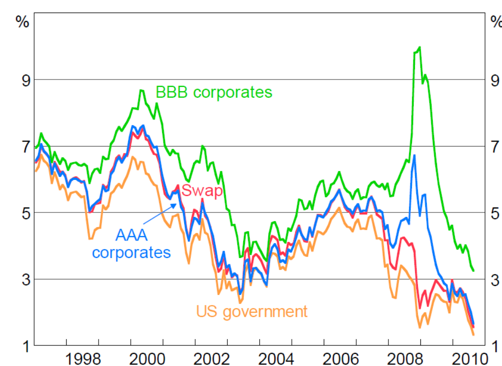
The defensive sectors; Telecommunications (-4.5%), AREITs (-0.9%) and Healthcare (+2.3%) were the worst performing sectors over the period. The major underperforming stocks were TPG Telecom (-13.2%), Telstra (-4.7%), Charter Hall Retail (-3.5%), Commonwealth Property Office Fund (-2.6%) and CSL Ltd (+0.3%).

Quality corporates able to invest for the future

In the face of tepid growth and low inflation in their respective economies, central banks around the developed world are focused on nurturing a nascent recovery. Having drastically reduced interest rates in response to the Global Financial Crisis, the prospects are for official interest rates to remain low and stimulatory for an extended period of time.

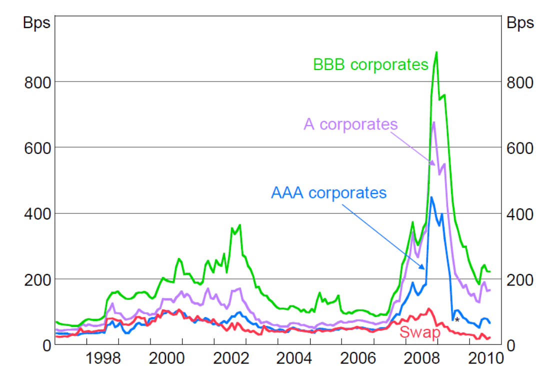
Furthermore, as highlighted below left, using the US corporate market as an example, corporate bond spreads have also reverted to a more 'normal' level. The effect this is having is that those US corporates who are able to access debt markets are able to borrow at multi-decade lows (as highlighted to the right).

US Corporate Bond Yields (3-5 years)
Monthly



Source: Bloomberg

US Corporate Bond Spreads (3-5 years)
To US government bonds, monthly



Source: Bloomberg *Option adjustment by Merrill Lynch (June/July 2009)

These low levels of interest rates are providing high quality corporate borrowers with the opportunity to fund long term investments, or hoard debt capital at opportunistic levels to take advantage of future growth opportunities. And as highlighted in the table below, there has been no shortage of quality corporates taking advantage.

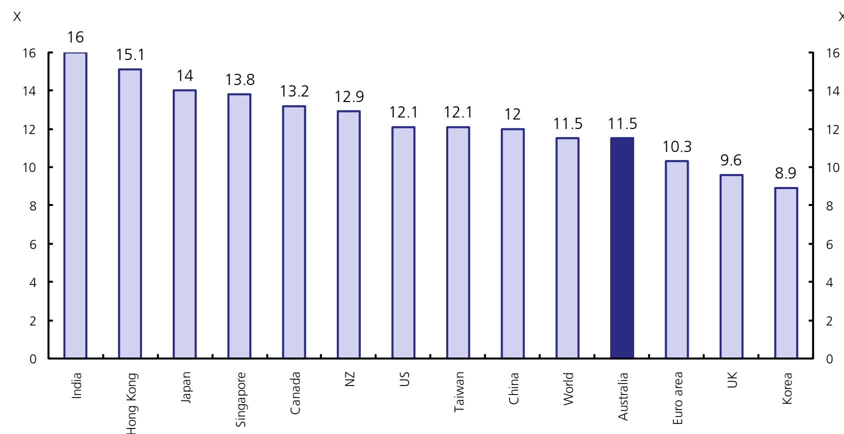
Recent US Corporate Bond Deals

Company	Rating	Size (USDm)	Term (years)	Yield %	Comment
McDonalds	A	450	10	3.5	-
		300	30	4.875	
IBM	A+	1,500	3	1	Record low yield for a 3 year corporate bond
Johnson & Johnson	AAA	550	10	2.95	-
		550	30	4.5	Equal record low yield for a 30 year corporate bond
Norfolk Southern	BBB+	250	100	6	First offering of 100 year debt since 2005
Southern California Edison	A	500	30	4.5	Equal record low yield for a 30 year corporate bond

Source: industry commentary, July/August 2010

Australian Equities

One option available to corporates is to grow earnings by acquisition, which coupled with low current equity market valuations should spur a renewal of takeover activity. In theory, the US$550m of 30 year debt raised by Johnson and Johnson (J&J) at 4.5% equates to an earnings yield of 22 times (with the after tax interest cost even lower). Any acquisition made with that debt where the acquired company is on a P/E of 22x or less would deliver value for shareholders. In the context of global market P/E's of 10-15x (as highlighted below), debt funded acquisitions are an attractive prospect for many companies.



Source: Datastream, IBES, MSCI, Deutsche Bank
Market PE ratio on 12m forward consensus earnings

Alternatively, this 'cheap' funding could be used to reinvest and grow earnings organically. An example may be to enter new markets (such as emerging economies), or invest in new research & development projects.

In summary, low global interest rates are providing corporates with a rare opportunity to acquire 'cheap' money. When you combine this low cost of capital with low global equity market valuations, corporates have two options available to them to increase earnings growth. In this environment, we believe acquisitions are a conservative option and therefore it would not surprise us to see an increased in the level of merger and acquisition activity globally, including Australia over the course of the coming period.