

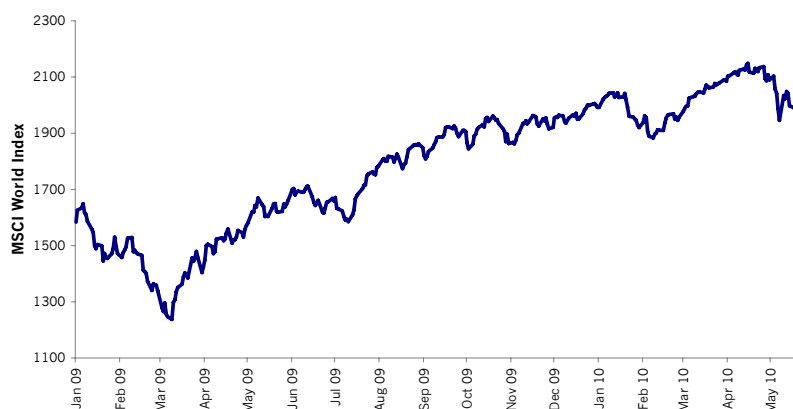
update on markets and events in Europe

The annual investment outlook in January 2010 highlighted that a key issue in the period ahead is how the huge amount of government stimulus would be unwound. Recent concern that Greece could default on its debt sent shock waves through global share markets, while worries about China and a new mining tax unsettled Australian investors. In this *newsnote*, ipac's Chief Investment Officer, Jeff Rogers, answers the questions on the minds of investors.

What has happened?

Share markets have fallen heavily since mid-April. We have seen double digit declines in most markets including Australia, with Europe hardest hit. Commodity prices and the Australian dollar have also declined sharply.

The chart opposite represents the recent fall. The MSCI World Index covers the major share markets. This index remains well ahead of its low in March 2009.



source: Datastream, MSCI World Index (net dividends reinvested) in local currency. Data to 25 May 2010

Were there any safe harbours in the storm?

High quality bonds have been favoured in an environment of heightened risk aversion and increased market volatility. At the start of the year we noted that exposure to bonds would be beneficial if economies and share markets stumbled. This has been the case. The benefit of diversification is also evident in our international share allocations where we maintain a 50% exposure to foreign currency that has cushioned some of the falls.

Why has the problem occurred in Europe?

To address the Global Financial Crisis of 2007-09, governments took on significant debt from the private sector and provided massive stimulus to support demand. Of critical concern for investors was how this debt would be unwound with governments expected to articulate credible medium term deficit reduction strategies. The problem was amplified in Europe where some countries, like Greece, entered the crisis in weak fiscal shape.

Even so, issues in Greece surprised investment markets. Fiscal mismanagement and misrepresentation of the size of its public sector debt deeply unsettled markets. Investors feared exposure to the default of Greek debt would weaken the capital base of European banks, reducing their ability to lend domestically and to Asia. There was also concern that the debt problem would undermine economic, political and social stability in Europe.

The issues in Greece have dominated the headlines. Why couldn't the problems be solved more quickly?

Given Greece's poor financial track record and the level of distrust, there was a reluctance to lend more money to Greece. Normally, a country which has lost competitiveness can respond by depreciating its currency. This mechanism provides breathing space to implement the necessary economic and political adjustments while also stimulating exports. This option was not available to Greece as a member of the Euro.

What has been done?

Central banks and governments are determined to prevent a repeat of the banking failures of the GFC. The IMF and the European Union co-ordinated a €750b liquidity support program that included emergency funding for Greece. This program is also accessible by any other Eurozone member state should it be required. Greece has had to tighten fiscal policy and establish a medium term plan to improve its finances.

Nevertheless, markets have questioned whether enough has been done to prevent Greece from defaulting on its debt. They are also querying the potential impact of fiscal consolidation measures on the European growth outlook. This uncertainty continues to unsettle markets.

What about the other nations with large fiscal deficits?

The situation in Greece has awakened concerns across the other parts of Europe, the United Kingdom and the United States. Importantly, countries with their own monetary policies and exchange rates, like the UK and the US, are in a better position to deal with their large deficits as they have more policy levers.

While the Europe debt crisis is not pleasant, it has brought forward government policy measures to address fiscal deficits in the key economies, which is good for the medium term outlook.

Why has the Australian equity market fallen so much given our strong economy and good debt position?

Australia's economic fortunes are closely linked with those of Asia. China has been tightening its economic policies to address fears of an asset price bubble in some of its property market. These measures potentially impact on China's growth prospects and consequently commodity demand. Less commodity demand reduces commodity prices. Falling commodity prices have a negative impact on the revenue of resource companies that make up a large component of the Australian share market. While it is not clear that China is aiming to slow growth substantially, markets are fearful of the risk. The introduction of the 'super profits tax' on mining companies added to the negative sentiment towards the Resources sector.

That said, the outlook for companies remains positive. Australian companies are generating good cash flow helped by significant cost cutting in recent years. There are signs that revenue is on the rise helped by a strong economy both domestically and in the region. This is good news for medium term returns.

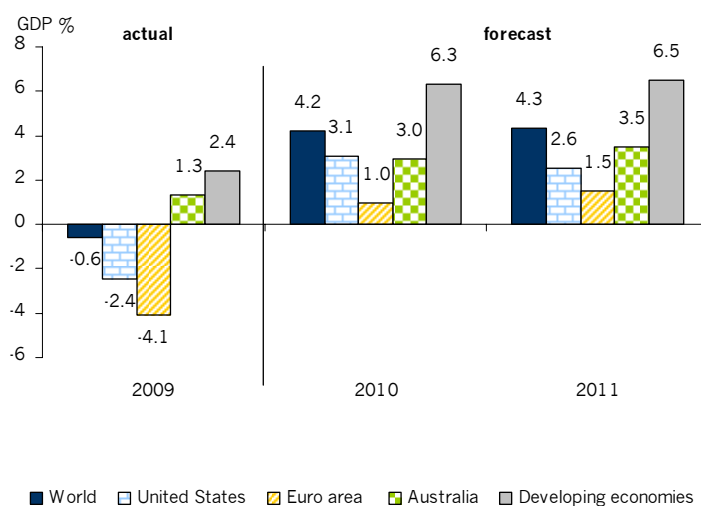
Why has the Australian dollar fallen so heavily?

The Australian dollar responds to news on commodity prices and to the appeal of Australian cash rates compared to the US cash rate (known as the carry trade). The crisis in Europe has made investors more fearful so they have de-risked their positions – selling high yielding Australian currency to buy back low yielding home currencies such as the US dollar. In addition, commodity prices have fallen on the expectation of lower demand from China and Europe. This has impacted negatively on the Australian dollar.

Has our outlook changed?

Investment markets offer attractive return prospects from current price levels. Signs of improved economic growth in the US have been largely overlooked. The chart opposite highlights the turnaround while emerging economies continue to power ahead.

While share markets are currently focused on issues in Europe and China, below the surface companies are doing better as the operating environment improves. For the next 18 months we are likely to see bouts of fear associated with global debt concerns followed by periods of optimism driven by the positive outlook for corporate profitability.



source: IMF; World Economic Outlook. Data as at April 2010

How are the Classic portfolios placed?

We believe over the medium term, sharemarkets will recognise corporate performance and prospects, benefiting our portfolios. The recent turmoil reinforces how important it is to be well diversified. Our portfolios provide exposure to a range of asset classes and strategies with different economic drivers. Our active managers are well placed to identify quality investment opportunities that are currently selling at discount prices.