

Colonial First State Global Asset Management

An overview of the Australian economy: The outlook for 2009

Presentation to GAM

James White

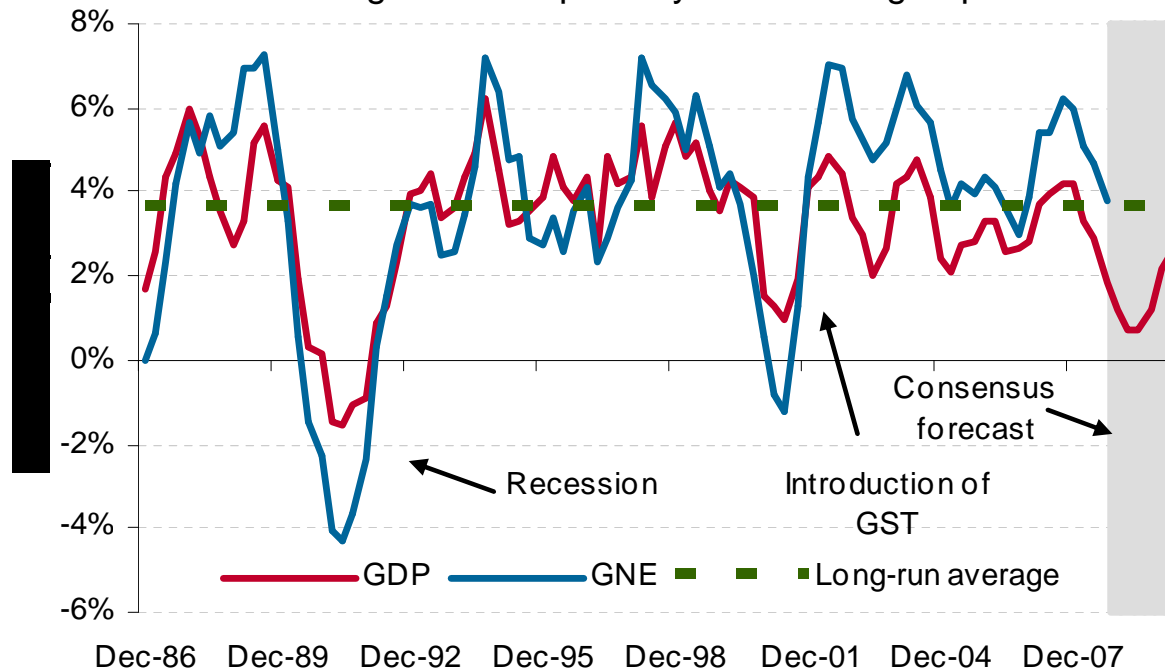
Research

21st January 2009

Australian economic activity

- rapid slowdown with emerging recovery in 2H09

Australian real macroeconomic activity
annual growth on quarterly rests ending Sep 2008



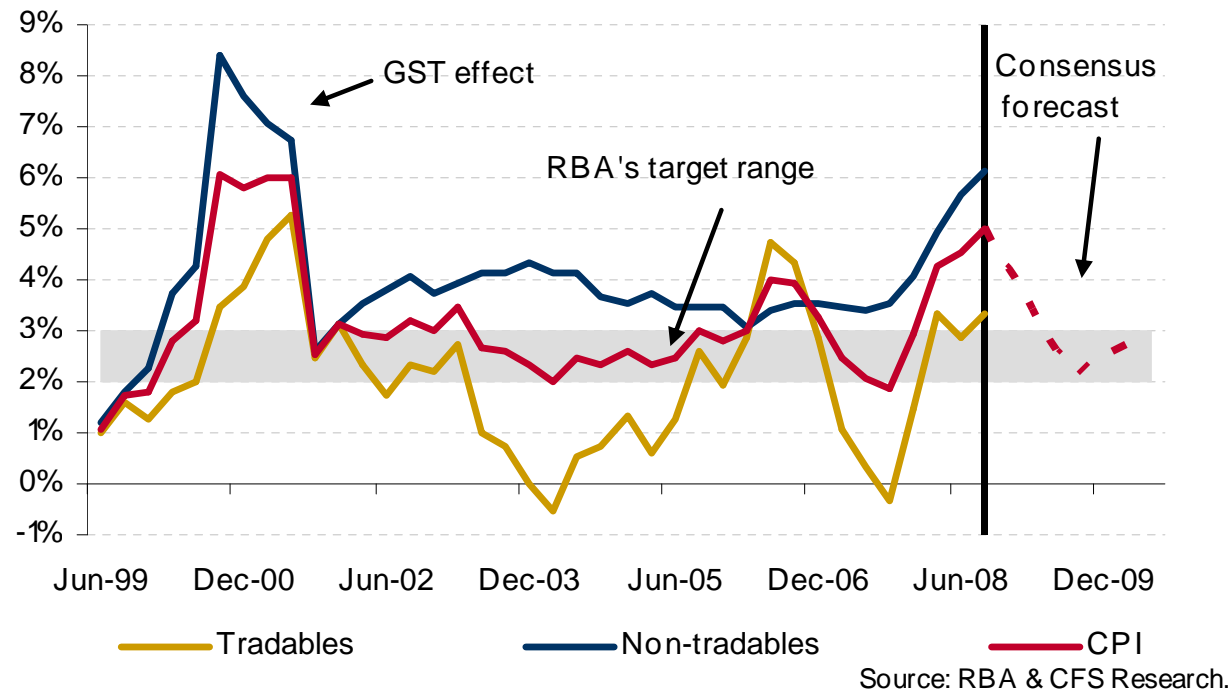
Source: RBA and CFS Research.

- Annual growth in economic activity fell dramatically in the third quarter of 2008. Growth was just 0.1% for the quarter and 1.9% annually.
- Growth's slowed as household financial stress rose.
- 2 ➤ CONSENSUS FORECAST: 2.5% (2.6% for CBA) for CY2008, 1.1% (1.9% for CBA) CY2009.

Inflationary pressures

- inflation has shifted to disinflation

Tradable and non-tradable CPI inflation
y-o-y growth rates on quarterly rests ending Sep 2008



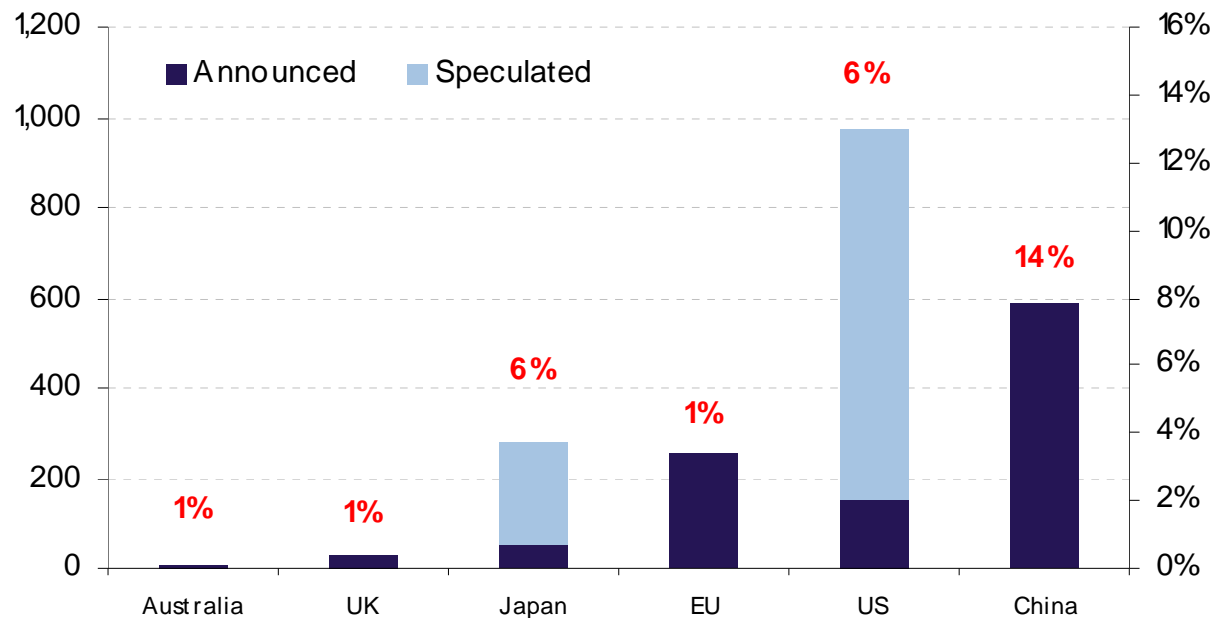
- Inflation reached 5.0% in Sep-08 reflecting substantial growth in domestic supply constraints.
- With easing commodity prices and slower demand the peak in CPI inflation is likely to have peaked.
- 3 ➤ CONSENSUS FORECAST: CPI inflation to ease to 2.5% end of CY2009; in line with CBA estimates.

Global fiscal stimulus

- a source of new demand and risk

Proposed and Announced Fiscal Packages

US\$ bn and share of 2008 GDP, as at January 2009

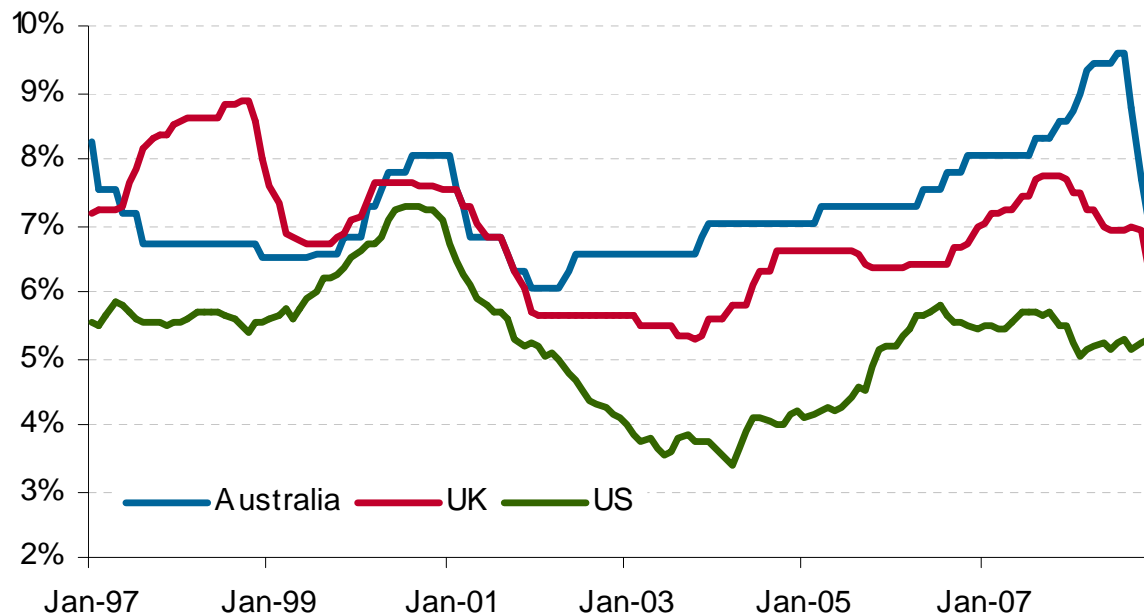


Source: CBA Economics, CFS Research

- Fiscal stimulus is essential to ensure that waning demand in the private sector is replaced by demand from the public sector.
- The proposed packages are substantial but also put significant strain on government balance sheets in the US, EU, UK and Japan, but not China and Australia.
- So there is a limit to how far governments can support further demand.

Mortgage market rates - households to enjoy greater savings

Indicator rates: standard variable mortgages
interest rate, monthly rests ending December 2009



Source: RBA, Bank of England, Freddi Mac and CFS Research.

- Central banks around the world have cut interest rates to improve liquidity and provide support for the eventual recovery
- In Australia the policy has been substantially more effective than it has been in other economies, particularly the US and UK
- 5 ➤ The RBA is likely to start to slow its easing policy in the first quarter of 2009 as it considers the impact it has had on demand

The labour market

- key source of demand destruction

Trends in the unemployment

share of labour force, monthly rests ending December 2008



Source: ABS, BEA, ONS, Eurostat, JP Morgan and CFS Research

Australia's unemployment rate

monthly rests ending December 2009



Source: ABS and CFS Research

- Unemployment is ticking upwards to 4.5% and employment growth has slowed to 1.3% annual growth in December 2008.
- This model predicts substantial falls in employment in financial services, property and business services and mining and measures the likely spill-over effect of these jobs on other industries in the economy. CFS forecast 5.8%, with 6.8% the upper limit and 5.1% the lower limit.
- FORECAST:

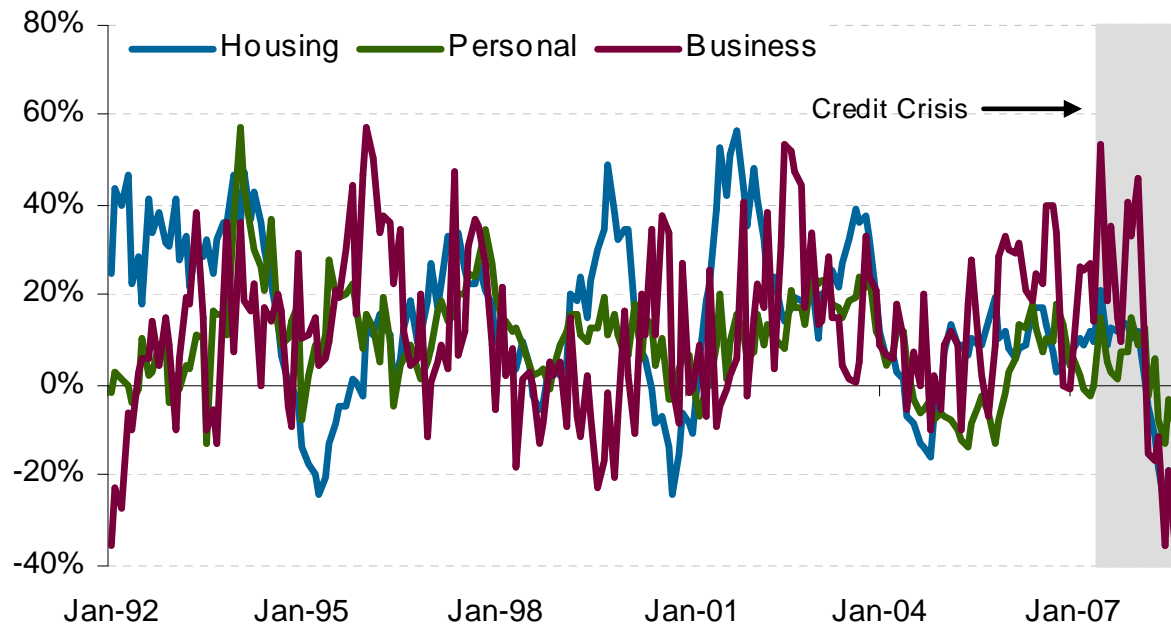
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- CBA: Unemployment to rise to 5.4% by end of CY2009.
- CONSENSUS: 5.7% unemployment rate by end of CY2009.

Lending

- further element of demand destruction

New lending commitments by sector
annual change on monthly rests, ending Oct 2008



Source: RBA and CFS Research.

- New lending commitments are down across the three sectors on an annual basis:
 - commercial lending has collapsed due to the credit market and uncertainty over the economic outlook
 - household de-leveraging and the weakness in auto-finance explains personal lending
 - there is a glimmer of hope in the residential figures, particularly in first home-buyers

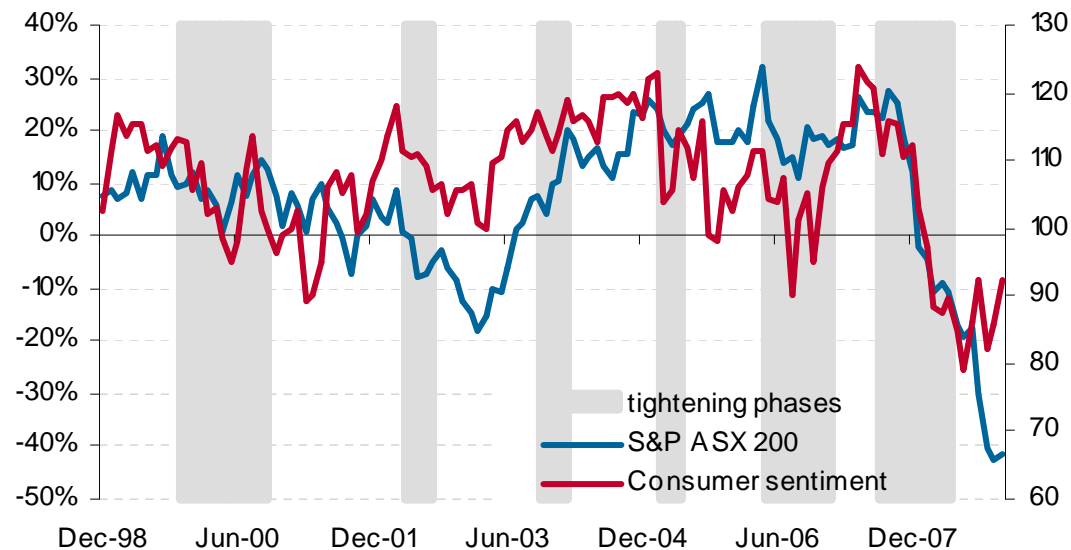
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- Anecdotally, banks have become keener to lend though focused on housing, government and infrastructure

Consumer sentiment

- interest rates and asset price decline

Consumer sentiment and the S&P ASX 200
index and y-o-y change, monthly rests ending Dec-08

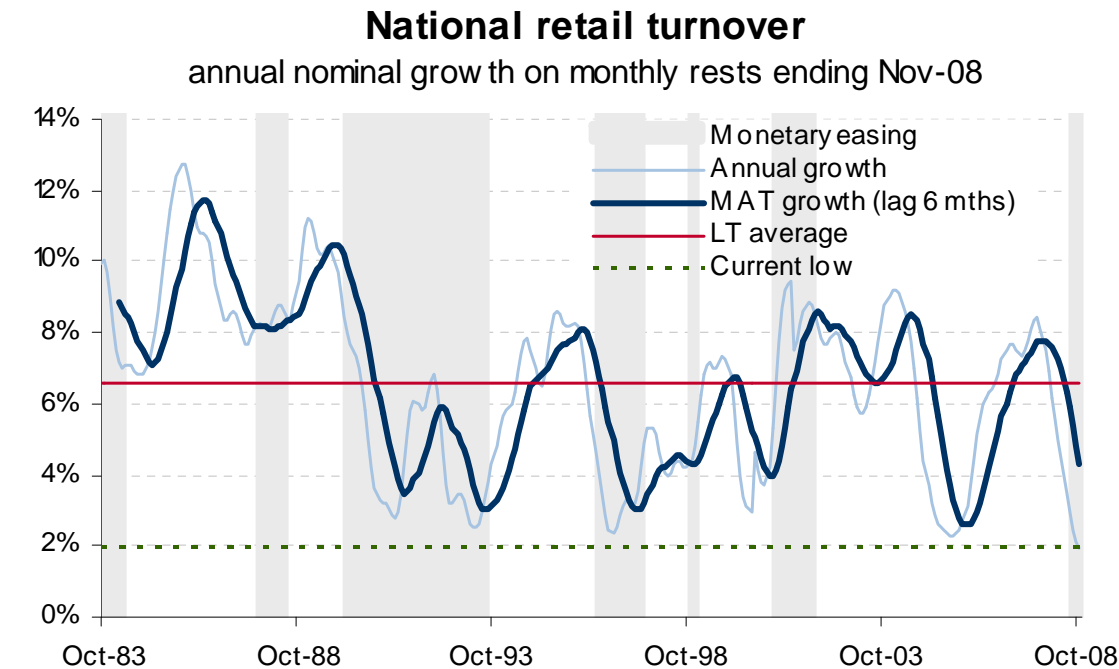


Source: Westpac-Melbourne Institute, RBA and CFS Research.

- Consumer sentiment rebounded slightly in December, reflecting greater stability and the changes to household balance sheets.
- With improved fundamentals, the recovery will come with an improvement in sentiment.
- 8 ➤ FORECAST: the weak labour market outlook will continue to weigh on sentiment but household cash flow has been transformed in the last six months

Retail sales activity

- data reflects RBA downturn and uncertainty



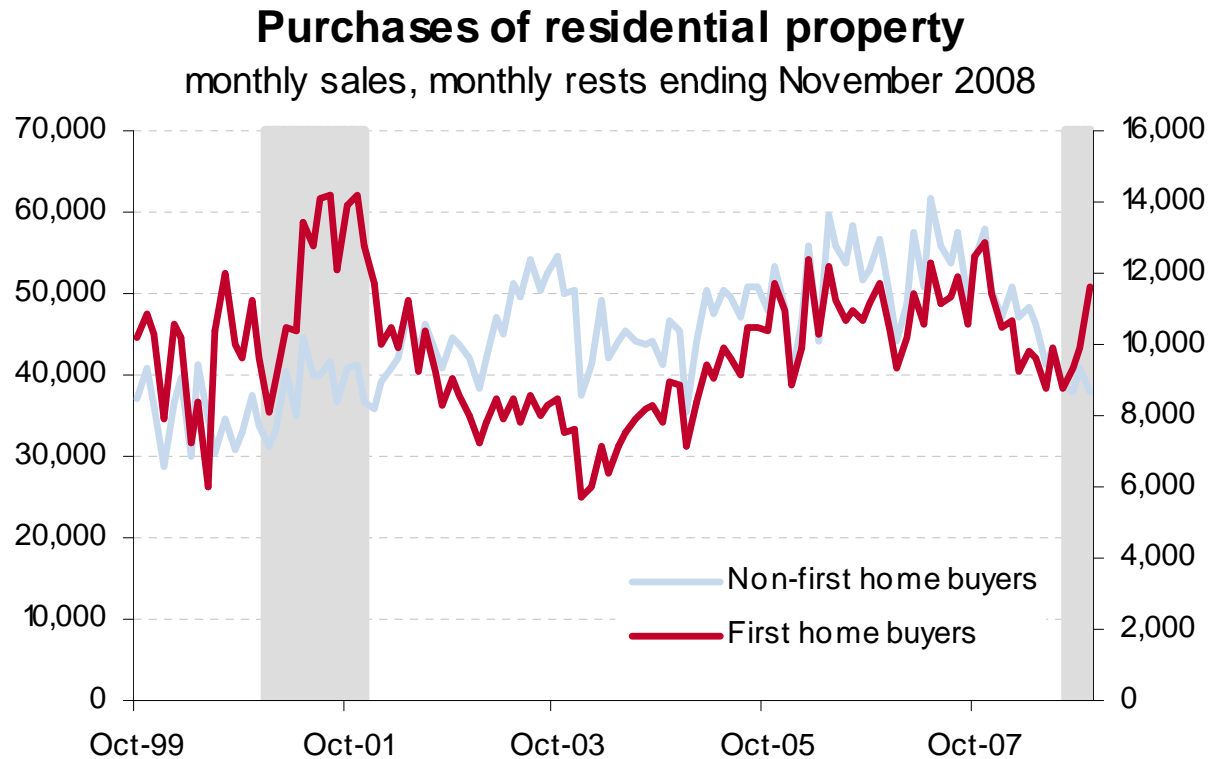
Note: seasonally adjusted series.

Source: ABS and CFS Research

- Retail sales continue to reflect the RBA downturn and the uncertainty that reached its peak in Oct-08.
- Retail sales in Oct-08 were 0.2% higher than in Sep-08 and just 2.0% on an annual basis.
- FORECAST: A combination of easing price pressures, lower interest rates and fiscal stimulus provide the basis for a cyclical improvement in retail sales, though sentiment is weak.

Residential market

- divergent activity trends in the market

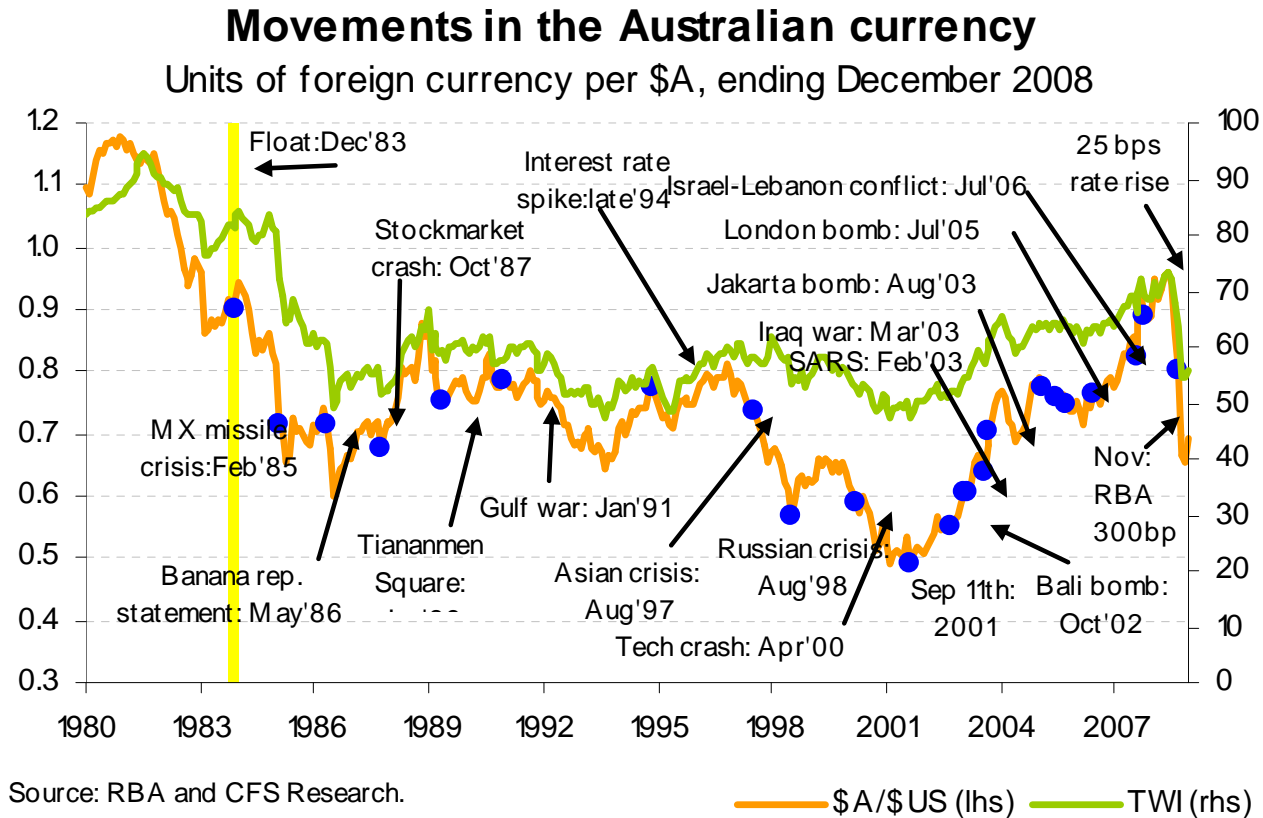


- Residential housing will be at the forefront of any recovery in domestic demand:
 - fiscal and monetary incentives
 - significant under-supply of housing

- 10 ➤ Activity, particularly amongst new home-buyers, will rise in the sector before any substantial price rises. There is evidence that sales are increasing amongst first home buyers with the number of properties sold up 32% between Jun-08 and Nov-08.

Australian dollar outlook

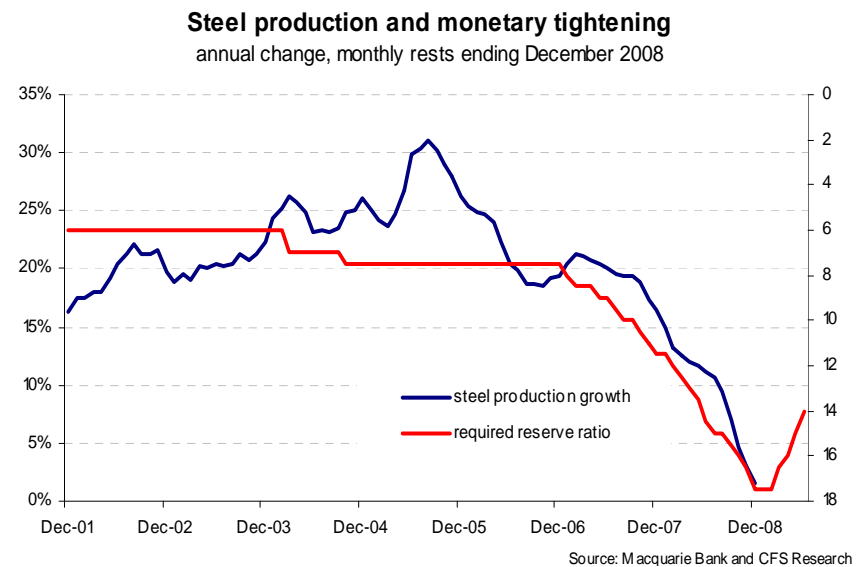
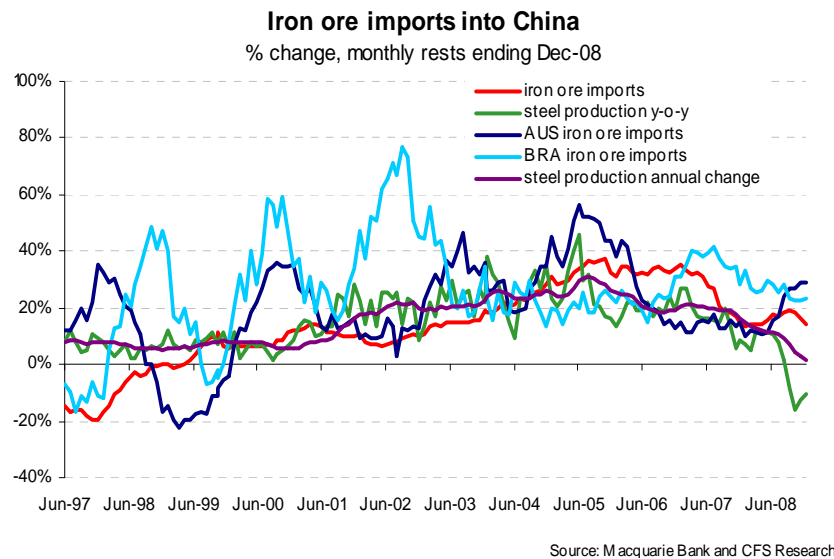
- supports export sector growth



- The AUD fell sharply in 2008 before stabilising between US\$0.65 and \$US0.70 in December.
- The weakness has been associated with the strength of demand for US treasury bills, outlook for global growth and weak commodity prices.
- FORECAST: Any recovery in risk-taking in asset markets will strongly favour the A\$. \$US0.85 (US\$0.78 CBA) for CY2009.

Iron ore market

- April negotiations are crucial for mining sector

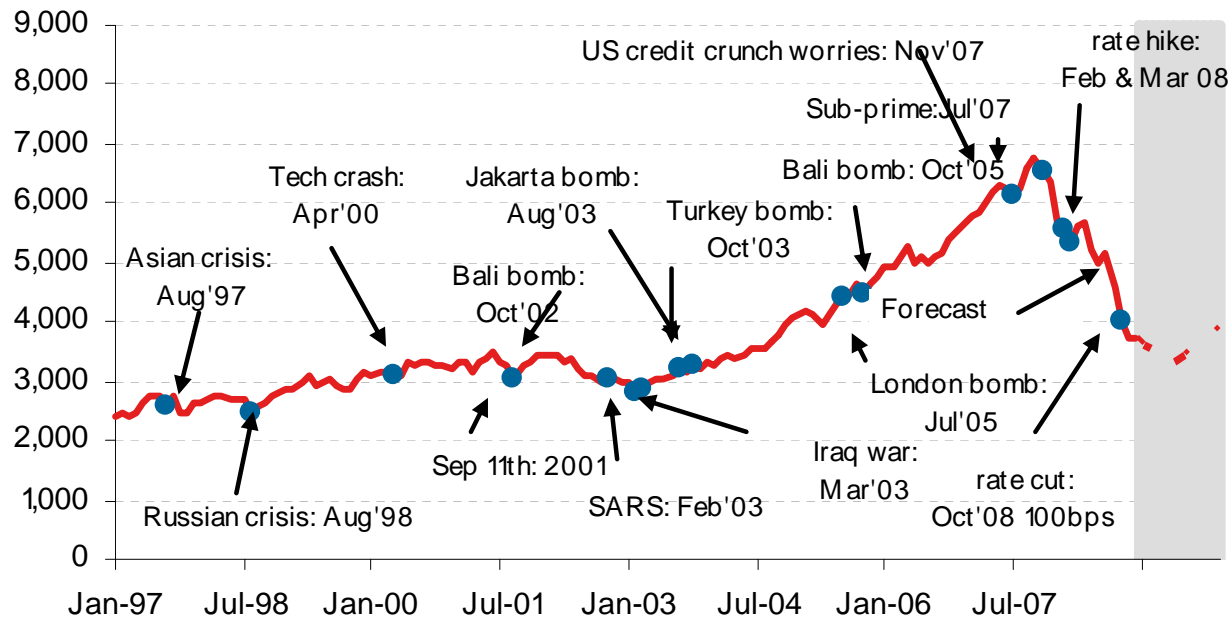


- This year's iron ore contract negotiations will be of enormous importance to Australia's economy and as a guide to the state of China's economy.
- Chinese steel production has shrunk in recent months, yet Australia's iron ore exports have grown at a rate of 29%, the fastest growth since 2006.
- As China's monetary tightening policy ends, and fiscal stimulus begins, a recovery in steel demand can be expected over 2009.

Listed markets

- further downside before a recovery

Australian listed share market
S&P/ASX 200, monthly price index ending Dec 2008



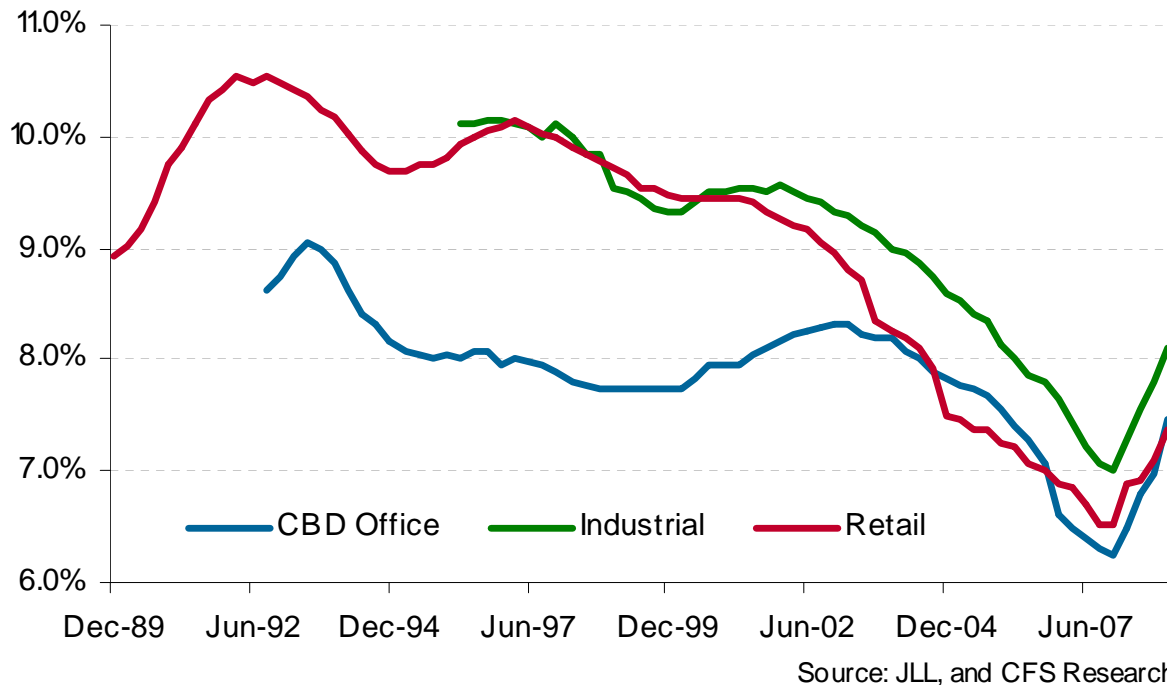
Source: RBA and CFS Research.

- The collapse in equity prices over 2008 (52.3%) has devastated the superannuation accounts of many Australians.
- While a recovery makes sense, weak sentiment and turmoil in global markets means a period of stability in 1H09 is necessary before any sustained recovery.
- Key events include bank dividends and commodity prices.

Real asset markets

- less likely to see any recovery this year

Real estate prime investment yields
average yield across each core real estate sector



- ➔ The outlook for real asset markets is more problematic:
 - there may be catalysts to support positive space market fundamentals
 - but who are going to be the big buyers and why would they buy

Summary remarks

- Economic activity in Australia will remain weak over 1H09. The primary driver of this slowdown is demand destruction due to:
 - uncertainty
 - unemployment

- A recovery in demand is expected in 2H09 due to a combination of demand creation through fiscal and monetary stimulus and restored certainty and confidence

- There are **four key factors** that will determine the strength and timing of the recovery in economic activity, the labour market and retail sales:
 - a signal that monetary easing has ended, providing certainty about medium to long term rates
 - first quarter unemployment rate at or below 5%
 - first home-buyer purchases average at least 11-13k per month
 - a reduction of less than 20% in the iron ore contract price for 2009/10

- The key risks to the economy:
 - the return of inflationary pressures, both external and internal
 - the prolonged downturn in G3 economies

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