

2011/12 Australian budget: Good times, bad times

Economic research note

11 May 2011

- The 2011/12 Commonwealth budget reinforces an aggressive tightening of fiscal policy. This will help the economy continue to adjust to structural change, working with tighter monetary policy.
- The economic forecasts that the budget is based on look credible, with slower growth in the near-term and above trend growth in the year ahead.
- The larger near-term budget deficits imply a higher level of net government debt and more bond issuance. This must be seen in an international context, where Australia's government debt level remains very low.
- The re-commitment by the government to maintaining a deep and liquid government bond market is a welcome development.
- For the equity market there is little in the way of specific points of impact, but with the macro-economic settings generally seen as a positive.

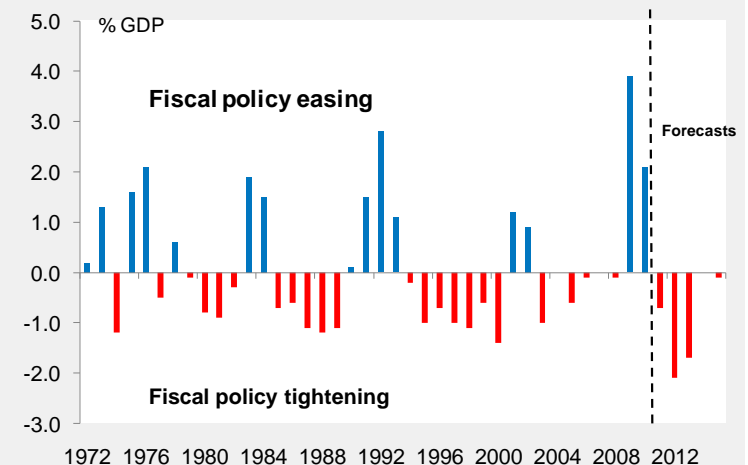
Overview and market implications:

The 2011/12 Commonwealth budget represents a tightening of fiscal policy of 2.1%/pts of GDP over the year. Indeed, from a deficit of \$A54.75bn, 4.3% of GDP in 2009/10 to a projected surplus of \$A3.5bn, 0.2%, in 2012/13, fiscal policy will be tightened by 4.5%/pts of GDP. However, it must be remembered that this aggressive fiscal policy tightening follows on from the GFC-related fiscal policy easing of a massive 6%/pts of GDP over 2008/09 and 2009/10.

For 2011/12 the budget deficit is estimated at \$A22.6bn, or 1.5% of GDP, down from the 2009/10 deficit of \$A49.4bn, 3.6% of GDP. These budget deficit estimates are far higher than the previous forecasts of \$A12.3bn, 0.8% of GDP for 2011/12 and \$A41.5bn, 3.0%, in 2010/11, with most of this deterioration due to the cost of the natural disasters and lower-than-expected revenue collections.

Over 2011/12 the tightening of fiscal policy will come via an array of 'savings' worth \$A22bn over 4 years, including changes to family payments, cuts in defence spending, the introduction of the flood levy, tighter concessions around private health insurance, changes to tertiary education fee discounts, changes to FBT concessions for vehicles and general efficiency savings across the public sector. This will be partly offset by increased spending measures worth \$A19bn on skills and training, workforce participation policies, and infrastructure and health spending, especially in the regional areas (not a surprise given the political realities).

Fiscal policy impulse



Source: Commonwealth Treasury and CFSGAM



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Over the medium-term the ongoing tightening of fiscal policy will come from limiting real growth in spending to an average of around 1% per year and allowing increases in revenue from the growing economy to flow through to the bottom-line. The finding of further savings to pay for new spending measures, including the cost of recovery from the natural disasters of this year will also assist.

For an economy that is undergoing structural change as a result of the dramatic shift higher in Australia's terms of trade (the ratio of export prices to import prices) the tightening in fiscal policy that is now underway will provide a necessary boost to national savings.

In the budget the Treasury has taken the effort, once again, to include a major research piece on the impact of structural change within the economy. In the research piece (Statement 4: Opportunities and challenges of an economy in transition) the Treasury has stated that "to maximise the opportunities that will flow from the continued rise of Asia, Australia needs to continue to change and innovate – as it has done in the past. We need policy settings and institutions that harness the talents of our people and allow them to make the most productive use of those talents and respond to a changing world."

It is important to note that this tightening in fiscal policy will work in conjunction with tighter monetary policy, not as a complete replacement. The latest RBA "Statement on Monetary Policy" made it clear that upside risks to inflation are building that will require higher interest rates over H2 2011 and likely into 2012.

This combination of policy initiatives will likely keep those sectors of the economy that are softer, ie. households, consumers and non-resource exporters, on their weaker path, allowing room for the terms of trade related resources capex and export boom to continue. In addition, the economy will need to continue to support the necessary increase in infrastructure spending (road, rail, ports, utilities etc) that is required in a number of key cities (ie. Sydney) and regional centres, as well the rebuilding process that is underway in many regions of the economy after this year's severe weather events.

A key part of the budget that will also assist the economy through its structural change is the focus on the labour force, with a number of policy initiatives to increase participation in the workforce and increase productivity through better skills training.

In addition, the budget focuses on infrastructure, providing more funding for Infrastructure Australia that would help develop a deeper pipeline of priority infrastructure projects. In addition, a number of new initiatives will be developed to encourage greater private sector investment in national priority infrastructure projects. This should work in conjunction with the workplace initiatives and could see productivity levels rise in Australia after many years of a trend downward.

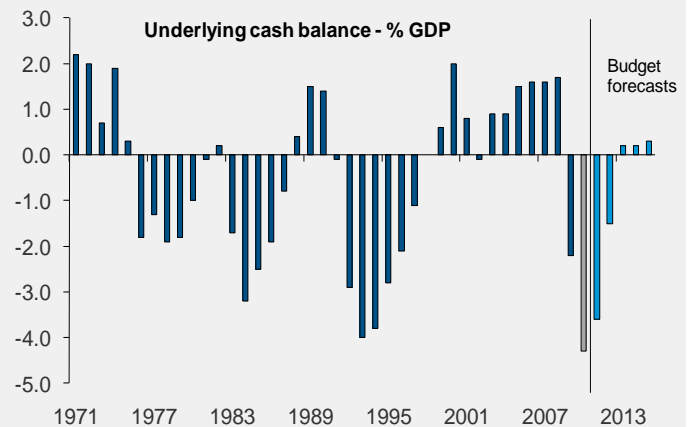
Some details

The 2011/12 budget deficit (underlying cash balance) of \$A22.6bn or 1.5% of GDP is significantly higher than the previous estimate for the coming year of \$A12.3bn, 0.8%, but is a much better outcome than the latest 2010/11 estimated deficit of \$A49.4bn, 3.6% of GDP (previously estimated at \$A41.5bn, 3.0%).

For 2011/12, the deterioration in the budget deficit from the previous estimate of \$A12.3bn to \$A22.6bn, comes from \$A2.6bn in policy decisions and \$A7.8bn in changes to 'parameters', especially \$A5.6bn in lower-than-expected revenue.

In the years ahead, the Commonwealth continues to expect the budget to return to surplus in 2012/13, with the surplus for that year now expected at \$A3.5bn, 0.2% of GDP, up marginally from the previous estimate of \$A3.1bn, 0.2%. For 2013/14 the surplus is a little higher at \$A3.7bn, 0.2% of GDP, and then to \$A5.8bn, 0.3%, in 2014/15. The chart below shows the expected path back to surplus.

Commonwealth budget surplus/deficit estimates



Source: Commonwealth Treasury

Over the forecast period, revenue is expected to grow from 21.9% of GDP in 2010/11 to 23.2% in 2011/12 and then up to 24.0% in 2014/15. Over the same period outlays are forecast to decline to 23.5% of GDP in 2014/15, from 24.5% in 2011/12 and 25.2% in 2010/11.

Australia's fiscal position continues to stand-out against its OECD peers, especially given the fiscal woes so evident in Europe and the US. The 2011/12 budget should be seen, therefore, by investors, both domestic and international, as a positive sign of Australia's relative economic strength.

In terms of the economic forecasts supporting the budget, we see these as credible and largely consistent with the view expressed by the RBA and financial market participants. Economic growth is set to accelerate to 4.0% in 2011/12, up from a revised 2.25% in 2010/11, before moving back to 3.75% in 2012/13.

The main sources of growth in 2011/12 are expected to be a 16%/yr surge in private business investment and 3.5%/yr growth in household consumption. After a 19.25% surge in 2010/11, the terms of trade are forecast to be all-but unchanged in 2011/12.

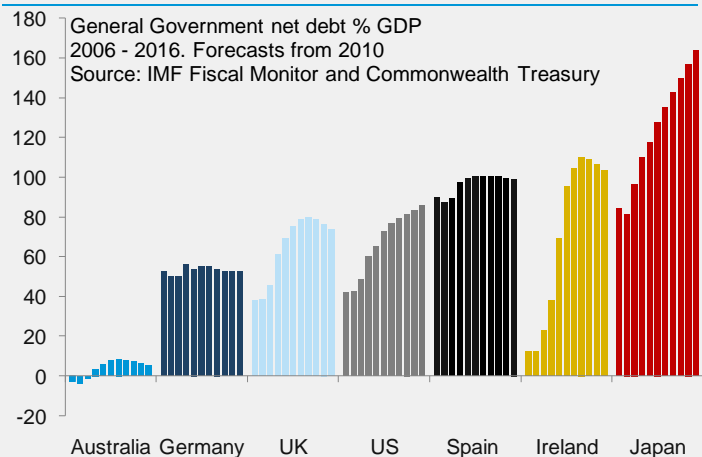
The budget forecasts headline inflation of 2.75% in 2011/12, down from 3.25% in 2010/11, before returning to 3%, ie the top of the RBA's 2%-3% target range, in 2012/13.

While employment growth is expected to ease back to 1.75% in 2011/12 and 2012/13, the unemployment rate is forecast to edge down to 4.75% by June 2012 and then to 4.5% by June 2013.

The higher-than-expected budget deficits for 2010/11 and 2011/12 will see net debt peak at a higher level than previously expected.

General government net debt is now expected to peak at \$A106.6bn, 7.2% of GDP as at June 2012, up from the previous estimate of a peak of \$A94.4bn, 6.4%. By 30 June 2015 net debt is expected to have declined to \$A100.9bn or 5.8% of GDP. This is obviously well down on the estimated levels of 80%-100%+ for a number of major OECD nations.

General governed net debt: Australia vs OECD nations



Source: Commonwealth Treasury, IMF Fiscal Monitor April 2011

The budget notes that net issuance of Commonwealth government securities (CGS) in 2011/12 will total \$A33bn. This will include \$A53bn in bond issuance (\$A51bn in nominal bonds and \$A2bn in inflation-indexed bonds), less \$A14bn in maturities and \$A6bn run-down in T-notes on issue.

Significantly, the budget has come out strongly in re-committing the government to maintaining a 'liquid and efficient' CGS market, with the size of the market going forward to be around 12%-14% of GDP (ie. approx. \$A200bn in the years ahead).

The maintenance of a deep CGS market will be important to maintain both the 3-year and 10-year futures contract, but will also be essential to help Australian banks meet new international banking regulatory requirements.

Importantly, the budget also commits the government to retaining a 'liquid' inflation-linked bond market and will target issuance of ILBs at around 10%-15% of the total size of the CGS market. In addition, the CGS yield curve will be lengthened 'incrementally' with the yield curve planned to be extended to 15 years over the next two years.

As budget surpluses build in the years ahead the government will need to turn its mind to what policy options present themselves. The government is likely to want to reduce net government debt as a first option, but, as stated, will also continue with the policy of maintaining a liquid and efficient CGS market. In this context the development of a Sovereign Wealth Fund (SWF) for Australia or further allocation to the Future Fund will need to be considered as a way of ensuring the long-term benefits of the resources boom are secured.

For equity markets, the implications are limited with other issues such as the strength of the Australian economic data, the path of the Australian dollar, offshore events and the two-speed global economy still dominating. For more analysis on the impact see the section "Equity market implications" below.

Key policy initiatives:

The Federal Government has committed to \$A22 billion in savings initiatives and new spending of \$A19 billion over the forward estimates. There were few new announcements in the budget and no surprise announcements.

Key policy initiatives in the 2011/12 budget, some of which have been announced previously, were:

Workforce Participation

- The real centre piece of the budget is the “Building Australia’s Future Workforce” package.
- A total of \$A3 bn has been committed to new skills initiatives over 6 years and will include \$A558mn National Workforce Development Fund to respond to the most critical skills needs facing Australian industry and is expected to create 130,000 high quality training places. With unemployment already back below 5%, increasing the supply and quality of the workforce is of critical importance to the economy.
- The other focus of this program will be on boosting workforce participation. This includes bringing forward to Low Income Tax Offset to provide more immediate return to work and phasing out the Dependent Spouse Offset for taxpayers born on or after 1 July 1971.
- This compliments previous measures by the government, including the lift in the child care rebate to 50%. Participation measures are also aimed at young people, single parents, people with disability and the very long term unemployed.

Infrastructure

- The government has shifted tack in relation to infrastructure and is expecting assistance from the private sector for the large amount of infrastructure work needed in the Australian economy.
- Tax impediments will be removed to provide greater private sector investment with greater certainty.
- A National Infrastructure Construction Schedule will be established listing large infrastructure works at all levels of government. This will be managed by expanding the powers of Infrastructure Australia, assisted by additional funding of 40%.
- There is a new \$A6bn allocation to the Regional Infrastructure Fund over the eleven years to 2020/21, \$A434mn has been committed to specific projects already in Queensland and \$A480mn in WA. This is in return for the introduction of the Mineral Resources Rent Tax.

Health

- The Government, in what is expected to be one of the initiatives which will have Parliament wide support is committing \$A2.2bn over five years to mental health with a focus on early detection and suicide prevention.
- An additional \$A16.4bn in funding for public hospitals under changes to the National Health Reform Agreement between the Federal and State governments. The Federal Government is lifting its share of funding of efficient growth from 45% to 50% in 2017/18.

- There will be an additional \$A1.8bn for regional hospitals and health services. There will also be \$740mn over 5 years for diagnostic imaging services and new medicines.

Education

- Introduction of reward payments for great teachers in 2014 and an increase in funding for children with disabilities.

Welfare

- There are a number of changes to the welfare system, particularly middle class welfare with both new spending initiatives and spending cuts.
- Some key initiatives include lifting Family Tax Payment Part A for dependent 16 to 19 year olds in full time secondary study, improving the Low Income Tax Offset, enhancing the Education Tax Refund and changing the payment options for family payments and child care rebates.

Small business and manufacturing

- Small business will be able to claim up to \$A5000 as an immediate deduction for motor vehicles from the 2012/13 year and also changes will be made to Pay As You Go instalments for 2011/12 to improve cash flow.
- The manufacturing sector is due to receive \$A34.4mn to help secure projects although given the challenging operating environment this sector faces due to the strength in the Australian dollar it does seem a token gesture.

Tax reform

- Much of the spending cuts (totalling \$A22bn over the forward years) have been called tax reform and include changing the car fringe benefits scheme to include a single tax rate to reduce incentives to travel more kilometres. This is expected to save \$A954mn.
- Other key savings will be met through pausing indexation of some family payments, phasing out the Dependent Spouse Tax Offset and the Entrepreneurs Tax Offset (around \$A2bn saving)
- There are also changes to the tax of Trust Income for children, expected to save \$A755mn.

Migration

- A further 16,300 skilled migrants will be allowed, although funnelled into regional areas where skills shortages have been identified.

Financial services industry

- The anticipated extension of a tax break for foreign investors conducting business through local fund managers has been agreed to. This follows on from the Johnson report on “Australia as a Financial Centre” released early in 2010.

Natural Disasters

- A total of \$A6.6bn is to be provided for natural disaster recovery. The flood levy will contribute \$1.7bn of this amount.

Other key savings initiatives include defence spending and efficiency (\$A2.5bn over 4 years), and an 'efficiency dividend' of \$A1bn.

One key policy initiative remains missing from this list and that is, of course, the government's policy on the pricing of carbon. Details of this major economic reform are not likely to be presented until later in the year (after the Greens take control of the Senate on 1 July). At this time the government will likely be required to restate their budget estimates, including revenue, outlays and economic forecasts.

The government has committed to the carbon tax being relatively revenue neutral with "every cent raised from the carbon price to assist households, support jobs in the most affect areas and to encourage the transition to a clean energy future". Around 50% of the tax revenue will be funnelled to households.

Key policy initiatives from last year still have not been legislated and include; reduction in corporate tax rate to 28% from 30%; increase in superannuation guarantee from 9% to 12%; the cut in interest withholding tax paid by banks; increase in the super guarantee age to 75 from 70; higher super contribution limits for those aged 50+ with less than 500k and the super tax rebate for low income earners. Like the carbon tax, these are expected to be introduced from July 2011 onwards when the Federal Labour government has control of the Senate in conjunction with the Greens.

The Budget and the economy:

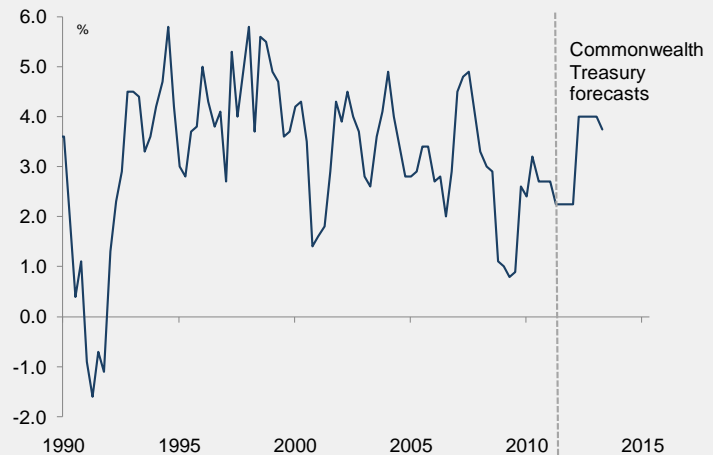
The 2011/12 Budget has altered the official view on the economic outlook quite significantly. The forecasts overall are credible and what is generally believed by financial markets and the RBA.

The profile of growth in the first-half of 2011 has been significantly impacted by natural disasters and are expected to detract 0.75% points from economic growth in 2010/11. When combined with weakness in consumer spending, economic growth is now forecast to be 1% point lower than expected in MYEFO. Effectively this growth downgrade explains a large proportion of the higher budget deficit outcome.

Economic growth is expected to be just 2.25% in 2010/11 before accelerating sharply to 4.0% in 2011/12 and slowing to 3.75% in 2012/13. This growth profile is underpinned by the large mining capex work to take place in response to elevated commodity prices.

It is interesting to note that the RBA is slightly more optimistic than the Federal government, forecasting growth of 4.25% through 2011/12, potentially reflecting the different path of interest rates between the two parties.

Australian economic growth – actual and forecasts



Source: ABS and Commonwealth Treasury

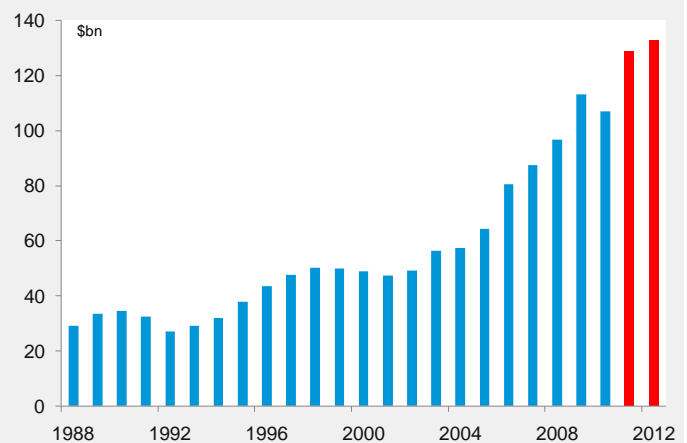
The Federal government clearly outlines the "patchwork" nature of the Australian economy due to consumer caution and the strong Australian dollar hurting tourism and manufacturing.

Business investment is expected to experience strong growth in 2011/12 (+16%) and 2012/13 (+14.5%) and largely underpins the optimistic growth outlook for the Australian economy. It also highlights one of the risks if projects are delayed due capacity constraints.

This business investment is expected to be concentrated in engineering, construction, machinery and equipment investment. The forecast increase in capex is being driven by the LNG sector with support also from iron ore and coal.

Non-residential investment is expected to remain weak, though not enough to prevent the Federal government to expect business investment to reach a 50-year high as a share of GDP by the end of 2012/13.

Australian private sector capex – actual and forecasts



Source: ABS

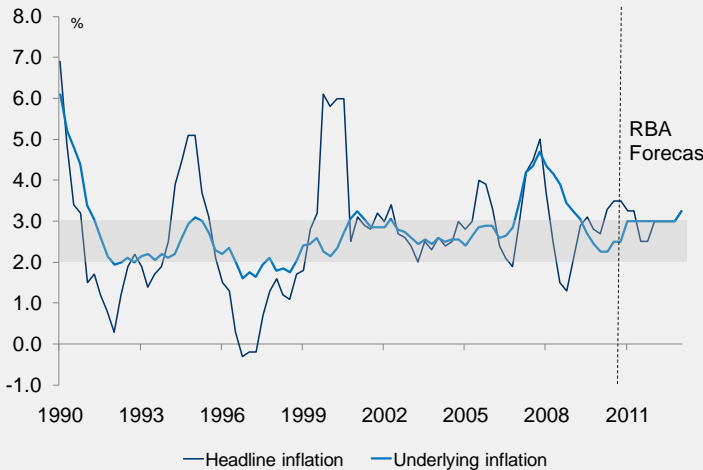
Inflation is expected to increase to 3.25% in 2010/11 from 3.1% in 2009/10 due to the impact of floods and Cyclone Yasi on food prices. Given low capacity constraints, inflation is expected to remain at higher levels of 2.75% in 2011/12 and 3.0% in 2012/13, despite the offsetting forces of the high Australian dollar (which is forecast to stay at these levels over the forecast horizon) and the withdrawal of monetary and fiscal stimulus.

The Federal government does seem concerned over the future makeup of inflation, one which we would agree with. The main driver of inflation over the past decade has been non-tradable inflation such as health, education and utilities. These pricing pressures are not going away and even are expected to accelerate over coming years due to underinvestment in these sectors and capacity constraints.

However in the future inflation pressures are expected to come from the tradables sector with more import price inflation (or less deflation) expected due to improvements in the global economy and especially as emerging markets add to global manufacturing costs and demand for food and other consumables.

Clearly inflation continues to be a large issue for the global economy, especially Australia's near neighbours in the Asian region. This does highlight a key risk for the medium term outlook for inflation in Australia with a cooling of inflation pressures in Asia predicated on changes to monetary policy and more flexible currencies. It does highlight that inflation and hedging inflation risks globally will continue to develop as theme to watch.

Australian inflation – actual and forecasts



Source: ABS and RBA

The unemployment rate is expected to continue to fall to 4.75% in June 2012 and 4.5% in June 2013 (slightly ahead of RBA expectations by December 2013). Employment growth is expected to slow over coming years after the fast pace experienced to date post the GFC.

Wages growth is expected to hold at 4% in 2011/12 before accelerating slightly to 4.25% in 2012/13. The Federal government does make the point that this masks significant divergence in wages growth between sectors. Resource exposed industries are expected to record faster wages growth with many anecdotal stories already being heard coming out of the resources sector.

Wages growth will be a key issue for the RBA over coming years, especially if there are high profile settlements with unions in the public sector. What could temper this is both Federal and State governments tightening the belt to move back towards surplus over coming years.

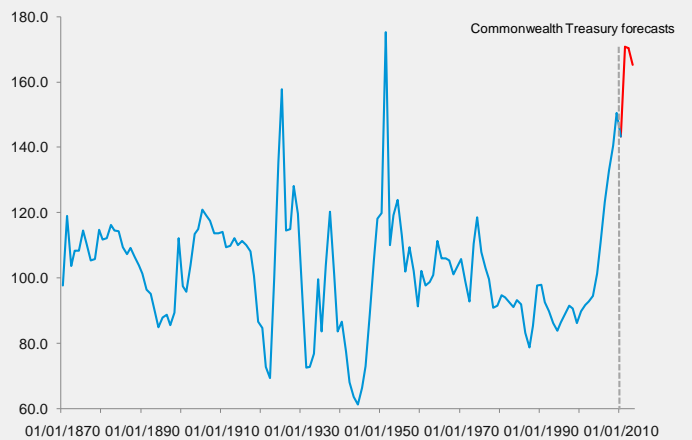
Over the medium-term, the budget projects the terms of trade to decline as global supply of iron ore and coal increases. There does seem a concern that an elevated terms of trade does pose additional risks to the Australian economy on two fronts.

Firstly the elevated terms of trade does pose additional strains on other sectors and does increase the uncertainty in budget forecasts given both the demand overlay through the re-emergence of China and India and the supply element of securing enough resources to undertake the projected mining capex. The other risk is that Australia is now much more leveraged to the commodity price cycle and the Asian economic cycle and could make swings in the terms of trade and economic growth much more volatile.

Economic projections in the budget does assume the Australian economy will remain at full capacity over the projection period to 2014/15, with economic growth of 3%. Beyond this time, it is not until 2017/18 when the economy is expected to slow to 2.75% due to ageing population.

Over the next 15 years the Federal government is assuming a 20% fall in the terms of trade, back to around 2006/07 levels (ie still at an elevated level compared to average levels). A technical assumption has now been included for the Australian dollar forecast to move in line with the long term historical relationship with the terms of trade. This implies a 0.9% per annum fall in the Australian dollar over the projection period. What this does say is that given the terms of trade is expected to terminate at around 2006/07 levels, the Australian dollar should remain at elevated levels and at a higher average rate than what we have seen post the 1983 float.

Australia's terms of trade – actual and forecast



Source: RBA and Commonwealth Treasury

On the global economy, economic growth is expected of 4.25% in 2011 and 4.5% in 2012. The two-speed global economy is expected to converge slightly as growth in emerging economies moderates and recoveries in developed economies gain pace. Downside risks are significant and well known in financial markets. These centre on inflation pressures in developing economies, fiscal consolidation pressures in many advanced economies, European sovereign debt problems, rising oil prices and weakness in financial sector balance sheets.

One area of potential upside for the global economy is improvements in sentiment and the subsequent lift in investment that could be undertaken due to the large amount of liquidity sitting idle in the US (no doubt due to the quantitative easing program by the Federal Reserve).

Domestic economic forecasts

	Actual 2009/10	Estimate 2010/11	Forecast 2011/12	Forecast 2012/13
GDP %yr	2.3	2.25	4.0	3.75
GNE %yr	2.4	3.25	4.75	4.25
Net exports % cont.	0.1	-1.0	-1.0	-0.75
Terms of trade %/yr	-4.4	19.25	-0.25	-3.0
Current acc. deficit % GDP	-4.1	-2.0	-4.0	-5.25
Business investment %yr	-4.9	4.25	16.0	14.5
Unemployment rate % at June	5.2	5.0	4.75	4.5
CPI %yr	3.1	3.25	2.75	3.0
Wages %yr	3.0	4.0	4.0	4.25

Source: Commonwealth Treasury.

Bond market implications and debt selling task:

In addition to the details in the budget, the AOFM has this morning issued a statement detailing their borrowing expectations for the remainder of 2010/11 and 2011/12.

For 2011/12 the budget expects net issuance of Commonwealth government securities (CGS) of \$A33bn, down from a revised \$A47bn for 2010/11.

This net \$A33bn increase in CGS on issue is clearly higher than the \$A22.6bn deficit expected in 2011/12. This extra \$A10bn or so can be accounted for by \$A2.7bn borrowings that will be applied to the government’s capital injection to the NBN Co, an increase in Australia’s financial contribution to the IMF of \$A1.8bn and planned increases in the government’s holding of financial assets, most especially RMBS.

For 2010/11 to-date the AOFM has issued \$A45.6bn in nominal bonds, with a further \$A10bn planned for the remainder of the year. A new 2023 bond is planned to be issued prior to the end of this financial year.

The AOFM expects to issue \$A51bn in nominal bonds in 2011/12, implying a net increase in nominal bonds on issue of \$A37bn, taking the face value of nominal bonds on issue to around \$A198bn as at June 2012.

Nominal bond tenders are expected to continue be held each Wednesday and Friday through 2011/12, with each tender to range in size from \$A500m-\$A1.2bn. Issuance in 2011/12 is expected to include one or two new mid-curve Treasury bonds. The AOFM also intends to extend the maturity of the yield curve over the next two years with a 15 year bond to be issued either in 2011/12 or 2012/13.

After issuing \$A2.5bn in inflation indexed bonds (ILBs) in 2010/11, the AOFM expects issuance of ILBs in 2011/12 of \$A2bn, taking the total on issue to \$A13.9bn. As noted above, the government has committed to maintaining a ‘liquid’ ILB market of around 10%-15% of total CGS on issue. This commitment is to be applauded.

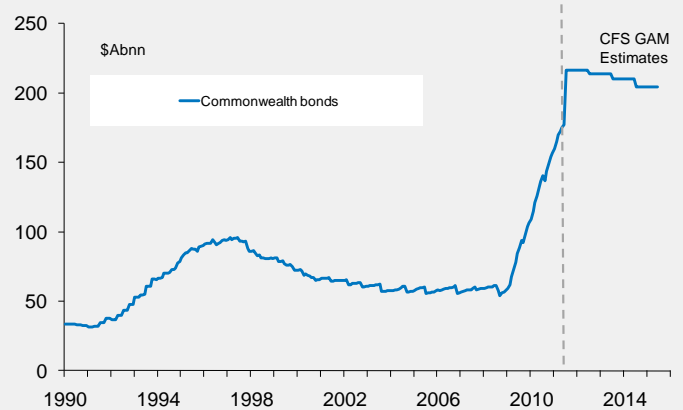
No new lines of ILBs are expected to be issued in 2011/12, with tenders of \$A200m to take place each month, except for December and January.

We now estimate that total bonds on issue (including both nominal and inflation-indexed) will be around

\$A216bn as at June 2012, up from an estimated \$A177bn at June 2011. Total bonds on issuance is expected to peak at 30 June 2012 and edge down to around \$A204bn by June 2015 – the chart below shows details.

As noted above, the government’s re-commitment to maintain a deep and liquid CGS market is welcome news. Events through the GFC clearly demonstrated the significant benefits to the Australian markets and economy more generally of having a ‘liquid and efficient’ CGS market. Based on this experience and given the increase in demand for CGS that is likely to flow from new regulations to the global banking system, the government has stated that it will look to maintain the CGS market at around 12%-14% of GDP (ie. around \$A200bn) over time.

Commonwealth securities on issue, actual and projected



Source: Commonwealth Treasury and CFS GAM Investment Markets Research.

Equity market implications:

The 2011/12 budget is unlikely to have any significant implications for the Australian equity market. The economic outlook is supportive, however this must be balanced against the fiscal tightening that will take place over the next two years.

The budget is unlikely to change the current theme in the Australian economy of strength in the resources sector and weakness in retail, manufacturing and tourism. The elevated nature of the Australian dollar is expected to still deter foreign investors while domestic investors remain cautious due to the economic outlook, rising labour and material costs and policy headwinds.

A key focus for the equity market over coming years will be the introduction of new government policies (which were not detailed in the budget) including the NBN, carbon tax and MRRT. The ability of the government to pass significant pieces of legislation including health insurance reform and the carbon tax does present some risk to the outlook and does overlay political risk to the equity market, one issue that has been raised by foreign investors.

In terms of sector implications within the equity market, as always the health care sector will be impacted at the margin due to changes in mental health, pathology and radiology funding.

The changes to infrastructure spending and funding model could see additional work take place, benefiting contractors. This obviously would be dependent on the ability to attract workers and the cost of doing so. The competition for labour and raw materials is expected to continue due to the mining boom, the increase in skilled migration and the new workforce participation measures hopefully could see labour supply increase and ease wages pressure at the margin.

The retail sector could also be impacted through the transfer of some income from higher-income households to lower-income households. This may impact on discretionary retailers, although any impact is likely to be small. The retail sector continues to be significantly impacted by consumer caution and with falls in house prices in Q1 2011, the introduction of the flood levy on 1 July 2011, volatile equity markets and talk of higher interest rates, significant headwinds remain for the retail sector.

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