Russell Investments

Russell Australian Market Barometer

Look-forward with the latest insights and valuations // November 2009

Including enhanced asset allocation strategic tilt recommendations

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Market outlook

- Global recovery in early stages. EPS rebound underway. Plenty of cash still on sidelines.
- Valuation extremes now largely unwound in risk assets. Value depends on continuing corporate profit recovery.
- Tilt towards corporate investment grade credit still in place.
- AUD close to a valuation extreme but no catalyst for a reversal at present.

Crisis… what crisis?

There is near universal agreement that the financial crisis is over and the global economic recovery is underway. Global sharemarkets have moved from pricing in a new Great Depression in March to now discounting a solid rebound in earnings per share (EPS) growth. The debate now is whether the global recovery will be self-sustaining and robust, or if the initial bounce in activity will give way to a sluggish, Japan-style, 'lost-decade' of growth.

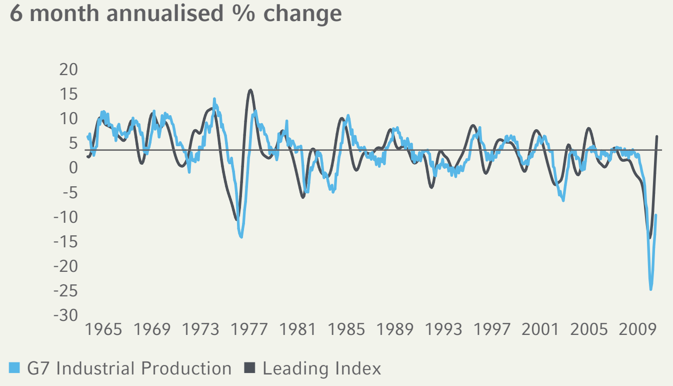
Not surprisingly, this debate is central to asset market values. An ongoing 'V' shaped recovery implies that sharemarkets still offer significant value, even after the 60% rebound since March. High trailing PE ratios are less of a concern as EPS will soon catch up with market pricing. The sluggish growth scenario, by contrast, means that high multiples imply genuine overvaluation. Shares have become over-exuberant and are and likely to correct once investors realise the lacklustre outlook for EPS growth.

"The debate now is whether the global recovery will be self-sustaining and robust, or if the initial bounce in activity will give way to a sluggish Japan-style 'lost decade' of growth."

Our view is balanced between these two extremes. The powerful forces of inventory restocking, pent-up consumer demand and ongoing policy stimulus are likely to see further upgrades to global economic growth forecasts. We are hitting the 'sweet spot' of the EPS cycle as labour cost cutting continues and pricing power and sales volumes slowly return. There is still plenty of cash sitting on the sidelines, meaning equity markets can continue to push higher before moving into outright expensive territory.

However, the strong bounce in activity from deeply depressed levels is likely to eventually give way to a more sombre assessment of the medium-term growth outlook. US households face a prolonged period of de-leveraging and bank balance sheet repair is likely to be an extended process. Banks are unlikely to expand lending anytime soon as they deal with the mountain of credit losses and try to maintain capital ratios. While the worst is largely over in terms of mortgage defaults and mark-to-market securities write-downs, the losses from commercial property lending are yet to peak.

EXHIBIT 1A **G-7 Industrial Production and Leading Index**



SOURCE: OECD

Predictions that the US will resemble Japan, however, seem too pessimistic. Japanese policy makers made many mistakes, but the biggest was the failure to prevent persistent deflation. Deflation makes consumers delay spending, squeezes profit margins and increases real interest rates. It prolongs the process of balance sheet repair as debt burdens increase in real terms but asset values stagnate. Banks are reluctant to lend when collateral values are under continual downward pressure.

US core inflation is trending lower and headline inflation is negative. Some investors fear that the US is headed towards entrenched deflation while others worry that money printing by the Fed risks a return to 1980s style high inflation. Moderate, but positive, inflation seems the most likely medium-term outcome. Earlier this year, the Federal Open Market Committee (FOMC) for the first time announced long-run projections for the desired rate of inflation. The majority of FOMC members indicated that 2% inflation was optimal. This is the closest the Fed has come to announcing a formal inflation target.

The US economy faces some strong headwinds in coming years from the after-effects of the crisis; unemployment is likely to decline only slowly. A Japan-style economic stagnation, however, seems unlikely.

Market outlook

(continued)

Australia: Optimism overdone?

Optimism continues to build on the outlook for the Australian economy. In May, the panel of forecasters surveyed by Consensus Economics predicted that Australian GDP would contract by 0.7% this year. The October survey upgraded the growth forecast to +0.8%. Not robust growth, but it marks Australia as the only OECD economy expected to expand this year. The Reserve Bank confirmed the positive outlook by lifting the cash rate at both the October and November board meetings by 25bp each time, taking the cash rate to 3.5%. Despite the rate rise, consumer confidence rose further to extremely optimistic levels in October (Exhibit 1B).

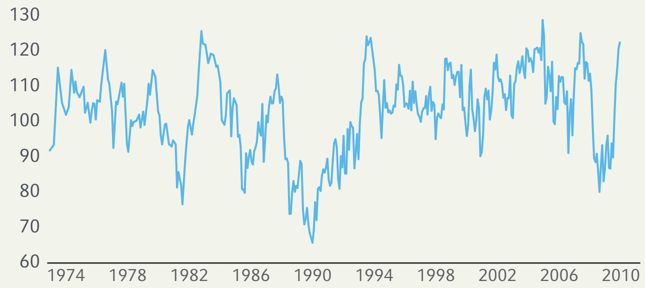
Australia's relatively strong economic performance reflects a combination of factors:

- A banking system that largely avoided the structured debt boom, maintained home lending standards and has had a relatively low level of asset write-downs.
- A housing market that largely held its value thanks to undersupply, only a small rise in unemployment, low mortgage rates and finance availability.
- RBA interest rate cuts that were quickly passed onto households via variable mortgage interest rates (the RBA estimates that the reduction in interest payments equalled five percent of disposable income).
- Payments to households as part of the fiscal stimulus measures that boosted disposable income by just under 3%.
- The depreciation in Australian dollar from 98¢ in July last year to 62¢ in March. This supported export incomes and helped firms competing with imports.
- Export resilience. Export volumes rose nearly 2% in the 2008/09 fiscal year. Thanks to the weaker AUD, the value of exports increased by 22%.

There is a danger that the current bullish international investor sentiment towards Australia is overdone. The combination of the stronger AUD, withdrawal of government payments to households and rising interest rates could see indicators such as retail spending soften in coming months.

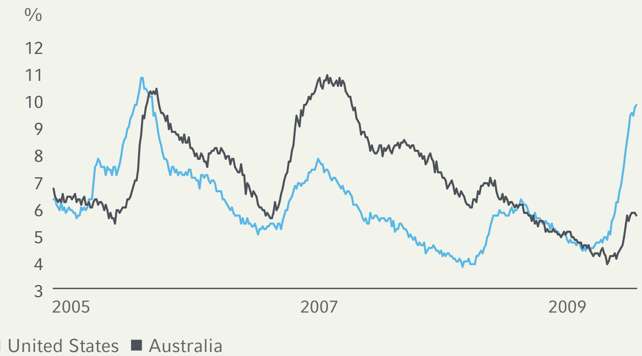
Australia's economy is in better structural shape than just about any other. However, there is less cyclical upside than for other economies and many of the factors that supported growth so far in 2009 are now unwinding.

EXHIBIT 1B **Australia: Consumer Confidence Index**



SOURCE: Westpac/Melbourne Institute

EXHIBIT 1C **Unemployment Rates**



SOURCE: ABS, BLS

Market outlook

(continued)

Asset class views – credit tilt continuing, AUD on the radar

The recovery trade has paid off handsomely over the past seven months with global shares up 60% and credit markets rallying strongly. The result is that the valuation case in favour of riskier assets is now much less clear-cut. The main rationale for staying long the recovery trade is that plenty of cash remains on the sidelines and the recovery in corporate profitability is still in the early stages.

"Cost cutting should soon be supplemented by rising sales volumes and eventually returning pricing power to drive strong EPS gains for a couple more quarters."

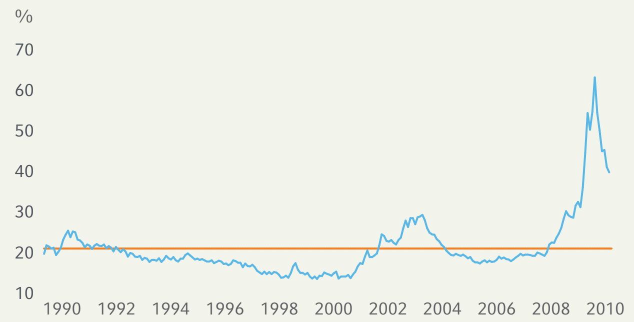
Exhibit 1D shows US money market fund assets as a percentage of the market capitalisation of the S&P 500. This rose to 60% in March at the height of the crisis. It has since declined to 40%, but is well above the long-term average of 20%. Many investors who panicked out of the market in March have yet to return. Not all will return, but the weight of money argument is strongly in favour of exposure to riskier assets.

One of our favourite indicators of the US profit cycle is the Conference Board's quarterly survey of CEO confidence. Around 100 CEOs are surveyed each quarter and as Exhibit 1E shows, the survey tends to lead annual growth in operating EPS by one to two quarters.

CEO confidence plunged to the lowest level in the 32-year history of the survey at the end of 2008. The 25 point rebound in the June quarter was the second largest in the survey's history and the eight-point gain in the September quarter proved that the June quarter was no statistical fluke. CEO confidence is now the highest since mid-2004 and signals a strong rebound in EPS over the next couple of reporting seasons. It's likely that we are heading into the 'sweet spot' for the EPS cycle. Even after the 37% rebound in the June quarter, S&P 500 operating EPS is still 43% below the 2007 peak. The June quarter gains were driven by aggressive cost cutting as firms aggressively shed labour. Cost cutting should soon be supplemented by rising sales volumes and eventually returning pricing power to drive strong EPS gains for a couple more quarters.

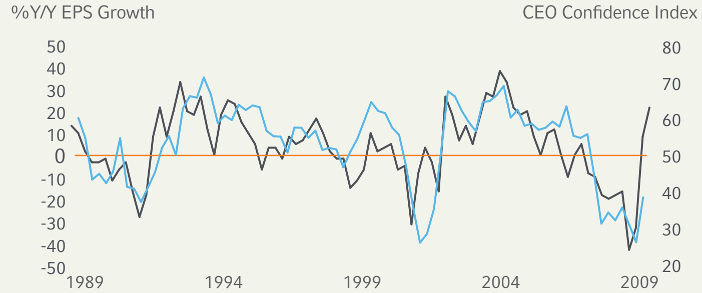
Our positive near-term view on the EPS cycle means that we continue to see value in global equity markets and recommend investors be at their long-run allocation. Those still underweight should continue to average back in.

EXHIBIT 1D **Ratio of Money Market Fund Assets to S&P 500 Market Cap**



SOURCE: Datastream, ICI

EXHIBIT 1E **CEO Confidence & S&P 500 Operating EPS**



■ 4th Quarter ended EPS Growth ■ CEO Confidence (advanced two quarters)

SOURCE: I/B/E/S, The Conference Board
Note: Q4 2008 operating EPS negative, so no percentage change

Market outlook
(continued)

The overweight position we recommended last quarter to global investment grade corporate credit is still in place. Spreads have narrowed over the past few months and credit is no longer at a valuation extreme. We set an exit target of 150bps for the Barclays Global Aggregate Corporate option adjusted spread when we initiated the recommendation in June. This spread currently stands at around 200bps and we expect it to trend lower amid improving liquidity and declining default probabilities.

The valuation opportunities in global and local REITs have now largely unwound and we are still neutral on Australian versus global shares.

The asset class that has come squarely onto the radar for our strategic tilting process is the Australian dollar. At over 90 US cents, it is pushing towards a valuation extreme. We think it is too early to cut currency hedges with global investors likely to be attracted by rising short term interest rates and there is no near-term catalyst for a currency reversal. The valuation 'elastic' is getting pulled tighter, however.

"The asset class that has come squarely onto the radar for our strategic tilting process is the Australian dollar."

Conclusion: Back the cyclical upswing, but beware of excess optimism

Our advice in the July Barometer was to focus on the strength of the cyclical global economic upswing and disregard for the time being concerns about the longer-term growth trend. This advice is still largely valid. The recovery from the worst global recession in over fifty years is in the early stages and has further to run. In particular, the rebound in corporate profitability has the potential to surprise expectations and there is plenty of cash still waiting to be reinvested. Equity markets do not yet seem to be pricing in an overly optimistic outlook, even after the 60% share price rebound since March.

The global recovery, however, is rapidly becoming a consensus view and the danger is that expectations will soon become over optimistic. We are not there yet, but this is the next risk to watch out for.

Strategic Tilting Views

Global Investment Grade Corporate Credit

❮Credit Government Bonds❯

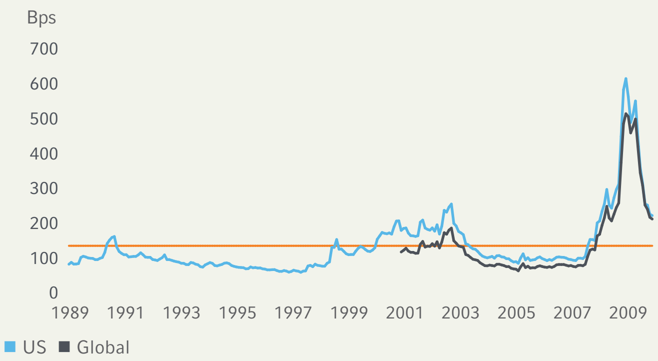
TILT

Medium Level tilt	Performance 7.52%

- **Low level tilt** initiated June 4.
- Upgraded to **medium level tilt** July 22.
- **Performance from June 4 to October 30:** The Barclays global corporate credit index has outperformed global government index by 7.52%.
- **Exit target:** 150bps for the Global Investment Grade Corporate option adjusted spread to global government yields.

Global Investment Grade Corporate Credit

EXHIBIT 2A **Investment Grade Corporate OAS**



SOURCE: Barclays

The strategic tilting process looks for asset classes that have moved to unsustainable extremes and then tries to identify whether the conditions for a return to 'normality' are in place. Credit markets spreads moved to an extreme after Bear Stearns ran into trouble in March 2008 and hit panic mode after the Lehman collapse in September.

> *"The final factor falling into place by late May for a credit tilt was the emergence of a positive supply/demand balance into the sector. "*

Exhibit 2A shows the spread between the yield on the Barclays investment grade corporate bond index and the sovereign index. 'OAS' stands for option adjusted spread. This adjusts for the embedded call option (they can be repaid early) in many corporate bonds. The spread also adjusts for the different duration of the corporate and government bond indices.

Our approach to strategic tilting follows two stages:

Stage 1: identify when an asset class has reached an unsustainable extreme.

Stage 2: identify when the conditions for mean reversion are in place.

Stage 1 has been satisfied since at least mid-2008. However, our stage 2 indicators signalled caution until early June. These indicators are:

- A decline in the VIX index of S&P500 implied volatility to within 1.5 standard deviations of its long-term average (implying the VIX needs to be below 33),
- Evidence of a broad based recovery in global business sentiment,
- Signs of returning investor confidence to the asset class.

There is a strong correlation between equity market volatility and credit spreads (note: the spread in the chart is not option adjusted). Holders of corporate debt have a payoff structure that provides limited upside (the promised interest payments are made and principal is returned) and significant downside (the company defaults). Rising volatility increases the downside risks for corporate bond investors (volatility means defaults are more likely) while doing little to improve upside return potential.

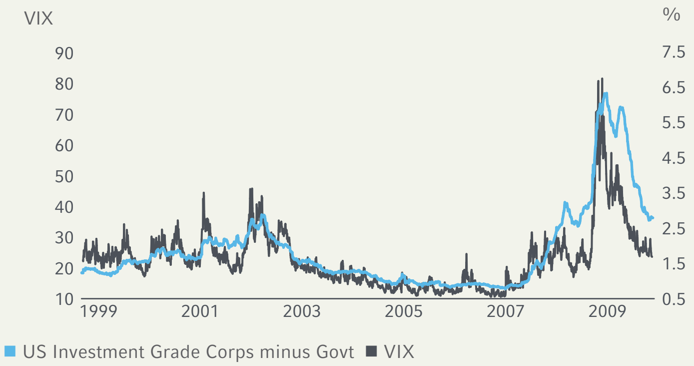
Measures of business sentiment help gauge the likelihood of rising defaults and are correlated with corporate profit outcomes. By late May, there was evidence that many indicators of global business sentiment had lifted from their lows. The ISM survey in the US had improved for five consecutive months. The new orders component of the index had risen past 50, into positive territory. The IFO survey in Europe was also showing signs of improvement.

The final factor falling into place by late May for a credit tilt was the emergence of a positive supply/demand balance into the sector. Our discussions with fixed income managers pointed to significant investor interest in increasing exposure to credit. The forced selling of credit positions by hedge funds seemed to have been exhausted, while many firms had managed to ease balance sheet pressures through successful equity raisings.

Strategic Tilting Views

(continued)

EXHIBIT 2B **Investment Grade Spread & VIX**



SOURCE: Barclays, Datastream

In early June, Russell's Australian strategic tilting group initiated a low-level tilt towards global investment grade credit. The spread at this time was 320bps. It was started as a low-level tilt because business confidence indictors, although improving, were mostly still in pessimistic territory.

By late July, the catalysts were in place to upgrade to a medium level tilt. US CEO confidence (as described in the main essay) had recovered to optimistic territory and the VIX was continuing to trend lower.

Where to from here?

Our target for ending the tilt is when the global corporate spread reaches 150bps – as at October 30, the spread was 196bps. The spread has averaged 125bps since 1989. The extra 25bps for our 'normal spread' target makes allowance for the likelihood that risk premiums will be permanently higher because of the crisis.

At just under 200 bps in late October, the spread is no longer at an extreme that would justify initiating a tilt. However, our strategic tilting process never proposed to exit a tilt when an asset class leaves an extreme.
Once a tilt has been initiated, the process is to continue the tilt until the exit target has been achieved or the catalysts that gave us confidence to enter the tilt are no longer in place. In the case of the credit tilt, that would require a significant reversal in business confidence and equity market volatility.

With measures of business confidence, such as the Conference Boards' CEO confidence index, still rising and the VIX index although higher, still under 33, we are comfortable holding onto the credit tilt.

Strategic Tilting Views

(continued)

Global shares versus fixed income

❮Global Sh. Fixed income❯

Recommendation: remain at strategic benchmark weight

Global shares versus fixed income

As of late-October, the MSCI Word share price index has risen 60% from its March lows. Clearly, global shares are no longer as cheap as they were seven months ago. Even so, they still offer reasonable value across a number of indicators. We do not recommend an overweight allocation to global shares. Shares look okay from a medium-term perspective and we recommend being at a benchmark allocation. However, valuations are not at the 'unsustainable extreme' required by our strategic tilting process.

One of the challenges in valuing equity markets is to assess the sustainable level of earning per share (EPS). Simple PE ratios can show markets as cheap when EPS is unsustainably high, and as expensive when EPS is cyclically low. The Shiller PE involves calculating a trend level of EPS by averaging the level of inflation adjusted EPS over the past 10-years.

"Clearly, global shares are no longer as cheap as they were seven months ago. Even so, they still offer reasonable value across a number of indicators. ."

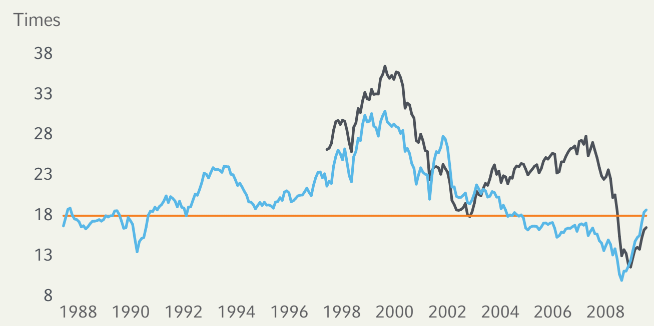
Exhibit 2C shows the trailing PE and the Shiller PE for the MSCI developed world index.

The trailing PE, at 18 times, is close to the long-term average. The Shiller PE, at 16 times, is below the average for the trailing PE and still below levels that prevailed prior to the Lehmann collapse last September.

The chart shows the level of inflation adjusted EPS. The 10-year average is the "E" from the Shiller PE ratio.

If the 10-year trend is the right measure of sustainable EPS, then global shares are cheap, but not extremely so. The bear case for shares is based on the view that EPS was artificially boosted by the rise in leverage during the boom, meaning shares are still relatively expensive. The case for shares being cheap relies on a significant proportion of the rise in EPS up to 2007 being due to structural factors. If so, the sustainable EPS is higher than the 10-year average suggests, making global shares good value. Our suspicion is that a proportion of the run-up in EPS was due to improved fundamentals and the underlying trend in EPS is higher than the 10-year average.

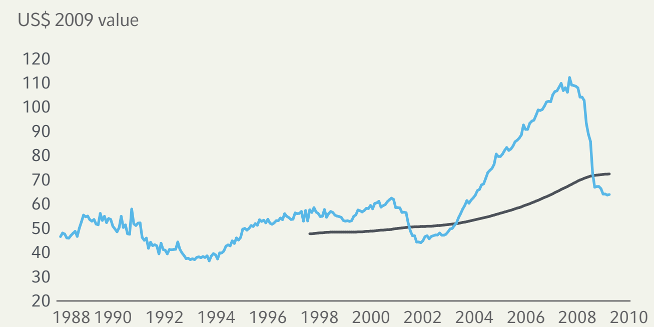
EXHIBIT 2C **PE Ratios: MSCI Developed World**



Trailing ■ Shiller PE ■ Average excluding Internet bubble (1998 - 2002)

SOURCE: I/B/E/S

EXHIBIT 2D **Real Trailing EPS: MSCI World**



Real Trailing EPS: MSCI World ■ 10 year average

SOURCE: I/B/E/S, Datastream, Russell calculations

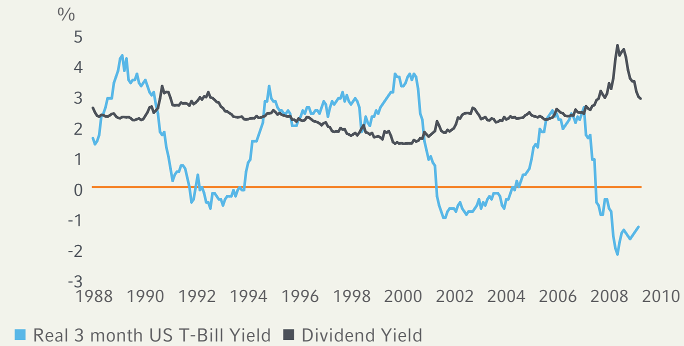
Price to book value (share price divided by the value of tangible assets less liabilities) remains one of the more bullish indicators for global shares. This ratio is still well below the average for the past twenty years.

Strategic Tilting Views
(continued)

EXHIBIT 2E **Price to Book Value: Global Shares**

SOURCE: Datastream, Factset

EXHIBIT 2F **MSCI World Dividend Yield versus Real US T-Bill Yield**



SOURCE: Datastream, Factset, Russell calculations

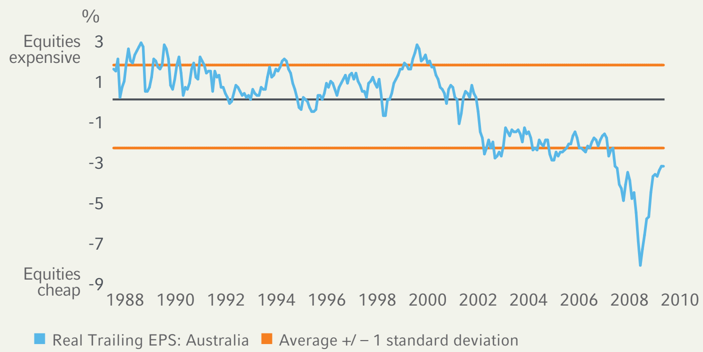
Price-to-earnings and price-to-book value are measures of *absolute* equity market valuation. These indicate that global shares while not a bargain, show reasonable value when compared to the past twenty years.

Measures of equity value *relative* to cash or bonds are more favourable. The chart compares the dividend yield on the MSCI World share index to the inflation adjusted US 3-month Treasury bill yield. Although the dividend yield has fallen to 2.9% from the November 2008 peak of 4.6%, it is still above the 10-year average of 2.4%. Compared to the post-inflation return from short-term interest rates, global shares look good value.

Global shares also look good value when compared to US 10-year government bond yields (we use US yields as a proxy for global yields). The earnings yield is the inverse of the forward PE ratio. The chart shows the 'Fed model'. Shares are expensive when the earnings yield is less than the bond yield and cheap when the earnings yield is above the bond yield.

Exhibit 2G shows that shares are still cheap relative to bonds. However, given the low level of US 10-year bond yields at 3.4%, it's probably more correct to say that government bonds are expensive rather than shares being cheap. The arguments for the direction of bond yields cut both ways. Yields can be kept low by the lack of US inflationary pressure as unemployment stays high and by the likelihood that Asian central banks will be large buyers of Treasuries to offset US$ weakness. Yields will come under upward pressure from the projected US$3 trillion increase in government debt over the next four years to finance the fiscal deficit and bailout schemes. Some of the apparent undervaluation of global shares disappears assuming a "normal" US bond yield of 5%

EXHIBIT 2G **US Bond Yield less Global Earnings Yield**



SOURCE: I/B/E/S, Datastream

Strategic Tilting Views
(continued)

In summary, global shares look:

- Fully valued on the trailing PE ratio,
- Reasonable value on the Shiller PE ratio,
- Reasonable value on the price to book value ratio,
- Cheap compared to real short term interest rates,
- Cheap compared to current US government bond yields and fairly valued compared to a more normal level for the long-term bond yield.

Our conclusion is that global shares have good long term value. We don't think that they are at the valuation extreme needed to trigger a strategic tilting position. We recommend being at your strategic benchmark weight.

Strategic Tilting Views
(continued)

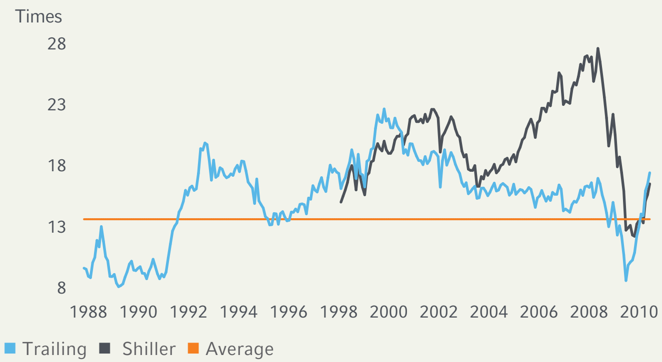
Australian shares versus fixed income

❮Australian Sh. Fixed income❯

Recommendation: remain at strategic benchmark weight

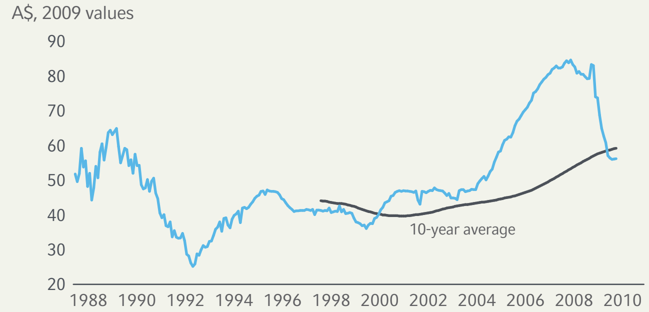
Australian shares versus fixed income

EXHIBIT 2H **PE ratios: Australia**



SOURCE: I/B/E/S, Datastream, Russell calculations

EXHIBIT 2I **Real Trailing EPS: Australia**



SOURCE: I/B/E/S, Datastream, Russell calculations

The valuation story for Australian shares is mixed. PE ratios have moved into expensive territory, but the market dividend yield is still above the long-term average and price to book value is relatively low. Australian shares look fully valued when compared to 10-year bond yields.

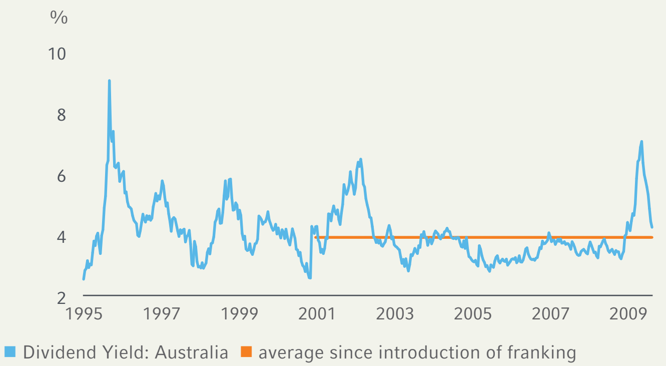
The trailing PE ratio, at nearly 18 times, is above the long term average of 14 times. The Shiller PE ratio, based the average of real EPS for the past ten years, has pushed up to 17 times.

The key to assessing the valuation of Australian shares is to estimate the underlying level of trend or sustainable EPS. An important question is how much of the run-up in EPS from 2003 to 2007 can be recaptured, and how much was due to cyclical forces and rising leverage. The 10-year average is the "E" from the Shiller PE ratio. EPS looks close to a cyclical low. If so, the 10-year average may be an overly conservative measure of the underling trend and Australian shares may not be as expensive as the Shiller PE suggests.

The dividend yield at 4.25% in October is still above the 3.9% average since the introduction of dividend imputation in 1987.

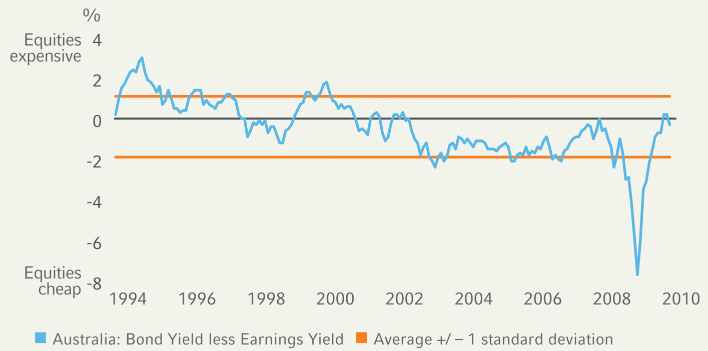
Strategic Tilting Views
(continued)

EXHIBIT 2J **Dividend Yield: Australia**



SOURCE: Datastream. ASX300 from Jan 1987, Datastream Index before 1987

EXHIBIT 2K **Australia: Bond Yield less Earnings Yield**



SOURCE: I/B/E/S, Datastream

The other point of caution on the Australia share market comes from the 'Fed-model' that compares the forward earnings yield on shares (the inverse of the PE ratio) with the yield on 10-year government bonds. Equities are expensive (or bonds are cheap) when the bond yield is above the shares yield. Shares are cheap (bonds expensive) when shares yield more than bonds. After signaling substantial undervaluation for Australian shares in late 2008, this model now suggests that local shares are fully valued.

Strategic Tilting Views
(continued)

Australian shares versus global shares

❮Australian Sh. Global Sh.❯

Recommendation:
benchmark allocation

Australian shares versus global shares

Australian shares are starting to push into expensive territory compared global shares. The forward PE ratio for the MSCI Australia share index is 10% higher than the MSCI World forward PE ratio. Through most of the 1990s, Australia's PE ratio was around 15% lower than the world PE ratio. This is because, relative to the world, Australia is overweight low PE ratio sectors like financials and resources, and underweight high PE ratio sectors such as information technology.

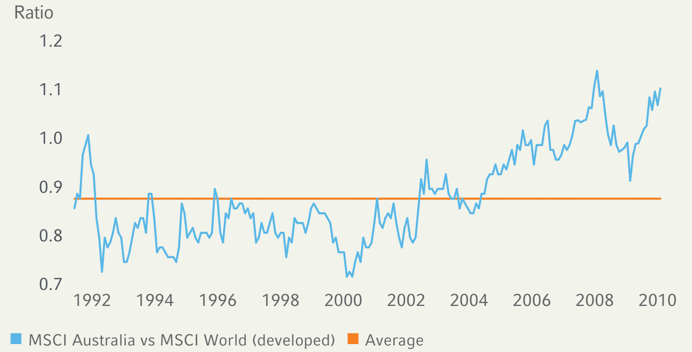
Some of Australia's premium rating disappears when allowance is made for the different sector weightings. Diversified resources have a 30% weighting in the local index compared to 14% in the global index. This sector is trading on a forward PE ratio of nearly 20 times.

Re-weighting the GICS sectors in the Australian market with global weights, gives the local market a PE ratio premium of around 8%; slightly expensive but not the extreme required to consider moving out of local shares and into global shares. It is still below the 25% premium on consistent weights that the Australian market traded on in late 2007.

One of the issues when considering the local market is the valuation of the diversified resources sector. The forward PE ratio for the sector is high, at nearly 20 times, but this is in part due to the collapse in EPS. EPS reached extraordinary levels in 2008 on the back of the China boom and commodity supercycle expectations. It is now back at 2005 levels and looks to be in the early stages of a recovery. However, EPS will have to rebound strongly to justify the sector's current lofty PE ratio.

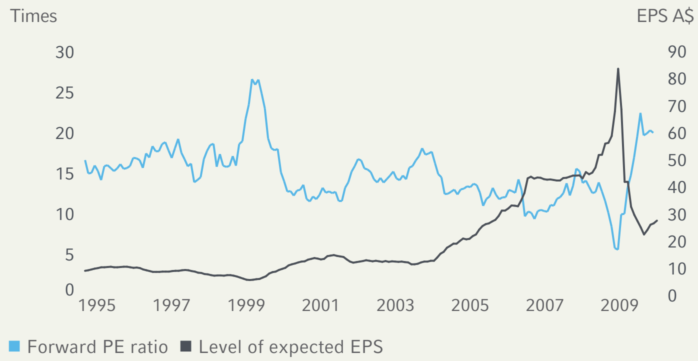
EXHIBIT 2L **Australian forward PE ratio relative to the World**

MSCI Australia vs MSCI World (developed)



SOURCE: I/B/E/S

EXHIBIT 2M **Diversified Resources**



SOURCE: I/B/E/S

Strategic Tilting Views

(continued)

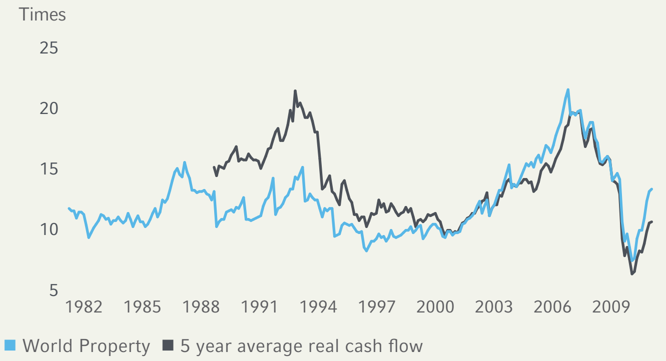
REITs versus Shares

❮REITs Shares❯

Recommendation:
benchmark allocation

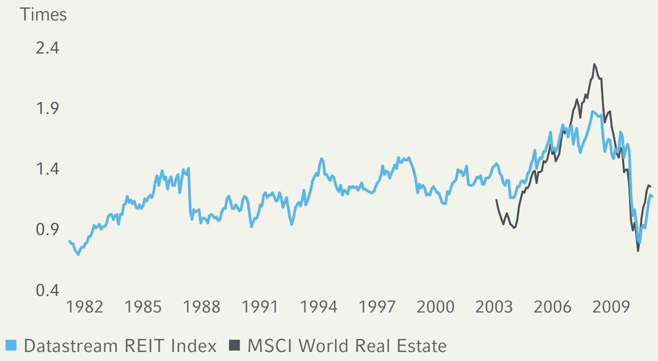
REITs versus shares

EXHIBIT 2N **Price to Cash Flow: World Property**



SOURCE: Datastream

EXHIBIT 2O **Price to Book Value: World Property**



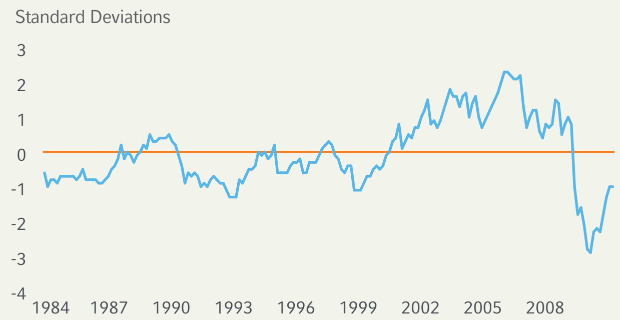
SOURCE: Datastream, Factset

Last quarter we identified Global REITs as a potential strategic tilting candidate. At the time, our composite value index placed the sector as around two standard deviations below fair value. However, concerns over the outlook for underlying property values in the US, refinancing issues and uncertainty about future earnings growth potential kept us from initiating a tilt. Our composite value index now places the sector as one-standard deviation below fair value and we no longer think REITs are at enough of a valuation extreme to justify a strategic tilt.

Our two preferred valuation metrics for global REITs are price to cash flow and price to book value.

Both show significant value for global REITs. We have combined both measures into a composite valuation index (CVI) by standardising the ratios (mean set to zero, standard deviation set to one) and equally weighting them into an index. The CVI suggests that global REITs are currently one standard deviation below fair-value.

EXHIBIT 2P **Global REITs Composite Value Index***



SOURCE: Russell Investment
*equally weighted Price to Book Value and Price to Cash Flow

Strategic Tilting Views

(continued)

Australian dollar currency hedge ratio

❮Unhedged Hedged❯

Recommendation: Strategic benchmark alloacation (potential tilting candidate)

Australian dollar currency hedge ratio

At around 90¢, the A$ is well above our purchasing power parity (PPP) estimate of 67¢. It is just over two standard deviations above PPP when the standard deviation is calculated over the period since the A$ was floated in late 1983. This, however, may not be the best measure of whether the A$ is at an extreme since the A$ has become more volatile in recent years . Using a rolling 10-year standard deviation, the two-standard deviation benchmark moves to 93¢ (one standard deviation equals 13¢).

In trade-weighted terms, the A$ is not at the extreme reached in July 2008. Last year's surge in the trade weighted index (TWI) was driven by declines in both the Yen and the US dollar. The Yen has appreciated by 16% against the US$ since last July, making the A$ less over-valued in trade-weighted terms.

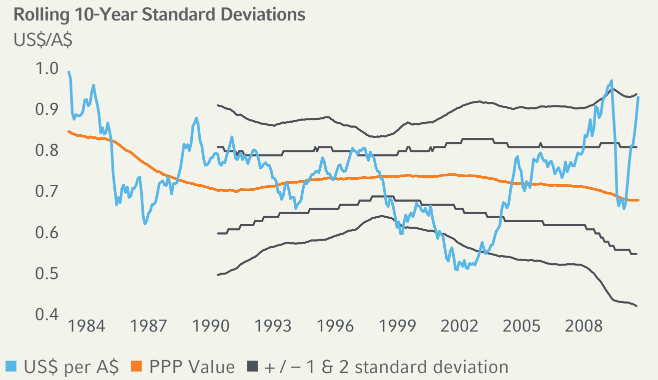
Our recommendation is that the currency hedge ratio should remain in line with the long-run strategic benchmark for the time being. Although the A$ is near a valuation extreme, the catalysts for a reversal are not yet in place. In particular, capital flows seeking the interest rate carry have the potential to keep the A$ at elevated levels.

At current levels, the upside for the A$ is limited relative to the potential downside and there is an argument for averaging down currency exposure. For the time being, however, there are few identifiable factors likely to trigger a sustained A$ downturn.

The most bullish factor for the A$ is the prospect of large inflows chasing the interest rate differential between Australia and other developed markets. The Wall St Journal summed it up well recently when concluding that Australia has "a stable currency, resurgent economy and elevated interest rates". This combination can make the carry trade look like a one-way bet.

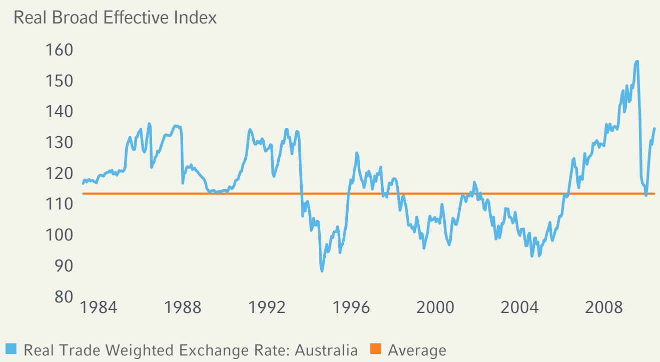
In general, the bullish A$ view is based on confidence that the global economic recovery will drive investor risk appetite and commodity price gains. The A$ is positively correlated with investor risk appetite and has risen in line with the recovery in the US share market.

EXHIBIT 2Q **US$ per A$ & PPP Value**



SOURCE: Russell Investment

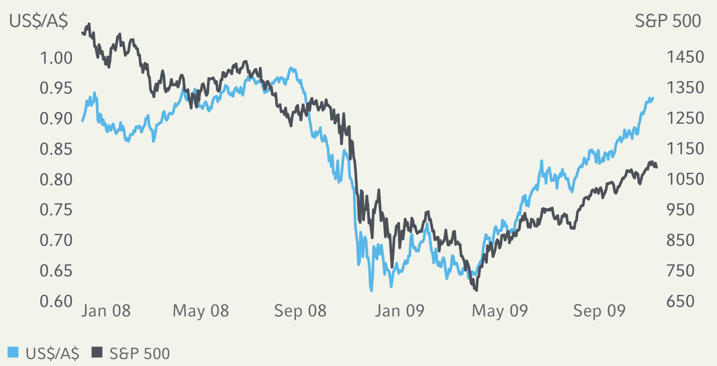
EXHIBIT 2R **Real Trade Weighted Exchange Rate: Australia**



SOURCE: JPMorgan

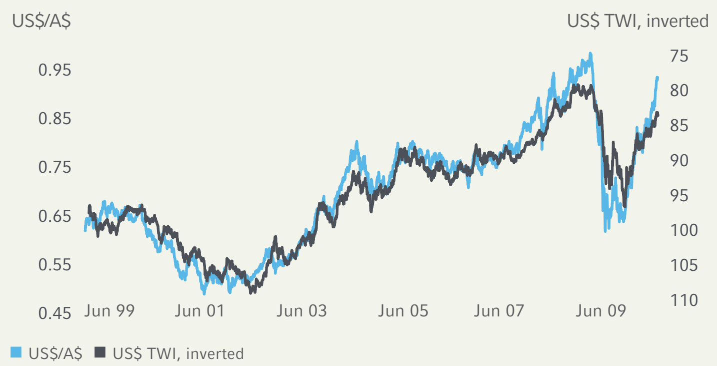
Strategic Tilting Views
(continued)

EXHIBIT 2S **US$ per A$ & S&P 500**



SOURCE: Datastream

EXHIBIT 2T **US$ per A$ versus inverted US$ TWI**



SOURCE: Datastream

The A$ should remain well supported while confidence in the global recovery persists.

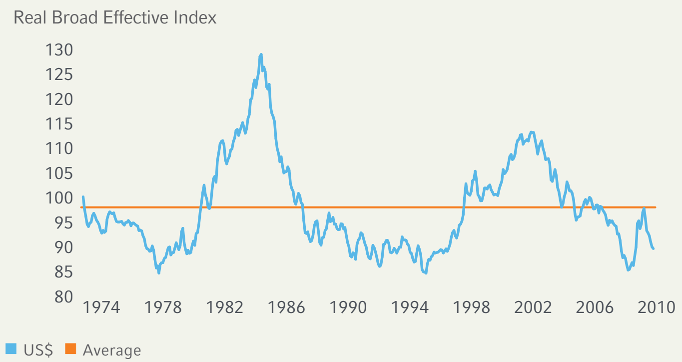
Scenarios for A$ weakness involve fears of a double dip downturn for the global economy, a run of surprisingly weak Australian economic data that revives monetary easing expectations, or a surprise appreciation by the US$.

There is a strong inverse correlation between the US$/A$ and the trade-weighted US$. The A$ weakness from July 2008 to March 2009 coincided with a 20% rise in the trade-weighted US$. The A$ rebound since March has occurred alongside a 13% fall in the US$ TWI.

This means that the outlook for the Australian dollar is closely linked to the direction of the US$.

The real trade-weighted US$ is now 8% below its long-term average. Previously, the US$ has needed to fall 12 to 13% below its long-term average before reversing. This suggests that the amount of potential further US$ weakness is becoming limited in relation to previous experience. However, the US$ is not yet at levels of undervaluation that have previously triggered a rebound.

EXHIBIT 2U **United States: Real Trade Weighted Dollar**



SOURCE: US Federal Reserve

Strategic Tilting Views

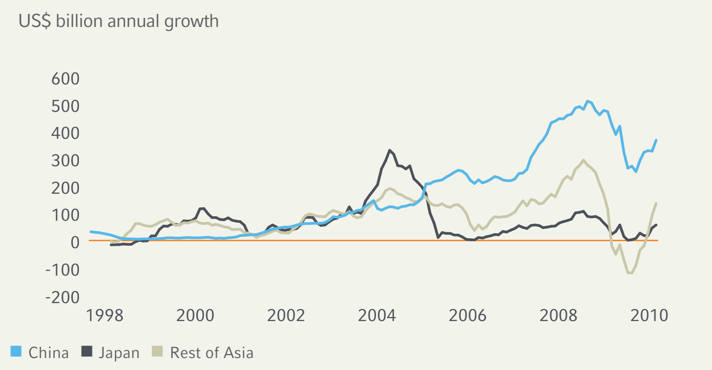
(continued)

The main scenario for a significantly stronger US$ involves a renewal of fears about the global economic outlook triggering US$ safe-haven purchases. Right now, global economic indicators are still in the rebound phase from the post-Lehman Brothers collapse. Russell's North American economist, Mike Dueker, warns that US economic indicators could disappoint through the first half of 2010. This could be the catalyst for a US$ rebound if fears of a double-dip recession cause investor risk aversion to rise.

The main factor likely to limit the extent of US$ weakness is the role of central banks across Asia (in particular the People's Bank of China) as US dollar buyers of last resort. US dollar weakness since March has put significant upward pressure on the currencies across Asia. Central banks have responded by stepping up their accumulation of foreign currency reserves, mainly through US$ purchases. China's reserves increased by US$320 billion from March to September. Central banks across the rest of Asia (ex Japan) increased reserves by US$175 billion over the same period.

The wildcard is the Bank of Japan. Its reserves have grown only modestly so far this year. The Yen has risen 10% against the US$ since April and Japan's economy is suffocating under resurgent deflation and export weakness. Government officials have repeatedly rejected currency intervention to push the Yen lower. This, however, may be their only policy option. The BOJ embarked on aggressive currency intervention in 2003 and 2004. A move by the BOJ to weaken the Yen alongside US$ purchases by other Asian central banks would put a floor under the US$ and limit the extent of further A$ gains.

EXHIBIT 2W **Asia: Accumulation of Official Reserves**



SOURCE: Datastream

Glossary of key investment terms

Earnings per share (EPS) –

Net profits divided by the number of shares on issue. This is the earnings figure used by most analysts.

Consensus expected EPS –

Sometimes referred to as forward EPS. These are forecasts for EPS based on a survey of sell-side analyst forecasts. Over 700 broking firms provide analyst estimates for around 45,000 publicly listed companies in 70 markets. They are often referred to as I/B/E/S estimates – an acronym for the Institutional Brokers' Estimate System. Earnings estimates are provided on a financial year basis and on a rolling 12-month ahead basis. The advantages of consensus expected EPS are that it is forward-looking and is a relatively clean measure of earnings. Analysts typically do not forecast abnormals and one-off events that can distort historic measures of EPS.

Forward price to earnings ratio (forward PE) –

Share price divided by the 12 month ahead consensus EPS forecast.

Shiller PE ratio –

Inflation adjusted share price index divided by the 10-year average of inflation adjusted EPS.

Price to book value –

Share price divided by the value of tangible assets less liabilities.

Price to cash flow –

Removes the effects of depreciation and other non cash factors from earnings.

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