

QUARTERLY MARKET UPDATE

An overview of investment markets to 30 June 2008

Volatile equity markets, record oil prices and high inflation – investors should remain disciplined and diversified to come out on top.

Extremely volatile equity markets were again the hallmark of the 2008 June quarter. Global and domestic equity markets staged a relief rally from mid-March to mid-May after the collapse and subsequent bail-out of Bear Stearns, the fifth largest US Investment Bank, by JPMorgan and the US Federal Reserve. However, record oil prices, multi-decade high inflation in emerging and developed countries, renewed US recession fears and the sub-prime credit crunch continuing to erode company balance sheets caused large declines in June.

The Australian equity market returned -1.7% for the quarter. International equity markets unhedged were down 6.5%, while emerging markets, affected by global growth concerns, fell 5.6%.

International property securities resumed their 2007 decline, falling 8.6%, while the battered Australian listed property trust sector fell another 15.8% after falling 19.1% in the first quarter. Fixed income markets were not immune from the market volatility and international bonds fell 0.6% while Australian bonds gained 0.4%.

The past eight months have been amongst the most volatile of the last 20 years and have led many asset classes to post negative returns on an annual basis. Nonetheless, investors should be reminded that equity market corrections are a natural part of being a long term investor. History tells us that, although the outlook can appear bleak after periods of market declines, these periods have often provided good opportunities for strong long term returns. The investment tenets of remaining disciplined and diversified are key to emerging strongly from the current market malaise.

Selected market indicators report for periods ended 30 June 2008 (% pa)

	3 mths	1 yr	3 yrs	5 yrs	10 yrs
Australian shares					
S&P/ASX 300 (All Ords before 1/4/2000)	-1.7	-13.7	11.4	16.2	11.2
S&P/ASX 200 (All Ords before 1/4/2000)	-1.8	-13.4	11.4	16.2	11.2
S&P/ASX Small Ordinaries	-4.6	-20.5	13.0	18.4	10.8
Overseas shares – in local currency (hedged)					
MSCI World ex Aust (nd LC)	-1.0	-15.7	5.6	9.2	2.6
Overseas shares – unhedged in A\$					
MSCI World ex Aust (nd A\$)	-6.6	-21.3	0.6	4.0	-0.5
MSCI World Small Caps (nd A\$)	-5.8	-26.6	-0.9	7.0	na
Property					
S&P/ASX 200 A-REIT [^]	-15.5	-36.3	-1.8	5.5	8.4
S&P/ASX 300 A-REIT ^{^^}	-15.8	-37.7	-2.4	5.2	8.3
Mercer Unlisted Property	1.8	14.7	17.0	15.2	12.8
Australian fixed interest & cash					
UBSA Composite Bond All Maturities	0.4	4.4	3.9	4.4	5.5
UBSA 90 Day Bank Bill	2.0	7.3	6.5	6.1	5.7
Overseas fixed interest					
Citigroup WGBI Hedged	-1.1	8.7	5.0	6.1	7.0
Lehman Bros Global Aggregate HDG AUD	-0.6	7.9	4.9	6.1	7.0
Currency					
US\$/A\$	5.1	13.1	8.0	7.4	4.5
Reserve Bank A\$ TWI	6.5	6.5	4.4	4.3	2.4
Inflation & wages					
CPI (June qtr 2008)	1.5	4.5	3.5	3.1	3.1
Full-time adult AWOTE (Feb qtr 2008)	1.5	4.7	4.2	4.6	4.5

Table data source: Mercer Manager Performance Analytics. There may be minor differences between figures in the table and in the text due to rounding.

[^] Formerly S&P/ASX 200 Property Trust Accumulation index.

^{^^} Formerly S&P/ASX 300 Property Trust Accumulation index.

Australian shares

The Australian share market opened strongly in April, however, by mid May weak investor sentiment resurfaced amid increasing oil prices, poor US economic data and intensifying credit crunch concerns over another bout of bad-debts for financial firms and mortgage foreclosures in the US. This curtailed the equity markets performance for the quarter with the ASX 300 posting a weak return of -1.7%.

The market was dominated by sectoral dispersion during the quarter, where energy (+34.3%) and resources (+12.0%) significantly outperformed, whilst property (-15.8%), financials (-8.6%) and consumer discretionary (-21.4%) weakened further. As such, the relatively flat performance for the quarter masked some very volatile sector returns.

Record high oil, iron ore and coal prices were a key catalyst for sectoral dispersion, with energy stocks, such as Woodside Petroleum (+23.9%), Origin Energy (+76.0%) surging.

Conversely, local banks and financials mirrored their global counterparts, beleaguered by widening credit spreads, further bad-debt woes and weakening earnings. Furthermore, despite receiving some respite in early April, the sell down of highly geared financials continued to weaken various stocks, notably Babcock & Brown (-49.1%).

Softening local economic data, including slowing credit growth, retail sales and housing approvals weakened cyclical sectors such as retailing and media, where David Jones (-20.5%), Harvey Norman (-19.5%) and NewsCorp (-19.8%) joined the laggards of the market.

International shares

Uncertainty continued to roil global equity markets during the second quarter as signs of a market recovery early in the quarter dissipated, handing equity markets the worst June performance since the Great Depression. Global equity markets, as measured by the MSCI World Index, were down 6.5% in Australian dollar terms for the second quarter.

Though the outlook remains uncertain, US economic activity continues to expand modestly, helped by the \$165 billion worth of consumer rebate checks which were mailed out to US taxpayers during the quarter.

Oil and gas prices continue to weigh on consumers as crude oil prices reached above \$140 a barrel for the first time. These strong prices boosted the global

energy sector with the MSCI World Index Energy Sector gaining 12.9% in AUD terms.

The financial services sector continued to lag the broader markets with the MSCI World Index Financials Sector down 16.6% in AUD terms with investors wary of further write-downs by banks and brokerages.

From a regional perspective, Europe was the worst performer within the developed markets with the MSCI France and Germany Index declining 8.6% and 7.7%, respectively, in AUD terms, as a strong Euro combined with slowing global growth reduced profit expectations for many European companies. Returns in the Pacific region led the developed nations as the MSCI Japan Index yielded 9.1% in local currency terms.

The MSCI US Index declined 2.2% in USD terms as the US outlook remains uncertain with labour markets continuing to struggle, particularly in the financials sector.

Listed property

The LPT sector suffered a weak and highly volatile second quarter, declining 15.8%. Despite the sector having a positive start – posting a return of 4.2% in April – May and June saw a repeat of themes which drove negative returns in the last quarter, with a resurgence of risk aversion amid growing uncertainty as to whether the credit maelstrom, which previously rocked the sector, would resurface.

Returns in the sector were largely driven by gearing levels, uncertainty surrounding property values and the ability of trusts to refinance maturing debt. Centro Properties Group (CNP, -18.3%) was further hampered by class actions alleging misleading and deceptive conduct. Mirvac Group (-24.5%) fell sharply after writing off its indirect investment in the Lane Cove Tunnel. The primary objective in the property trust sector during the quarter was to continue reducing debt and gearing levels either through asset sales, capital raisings or cutting distributions/dividends.

CNP is divesting assets in order to repay at least 50% of its \$A4.2b in debt by mid-December 2008. ABP (Abacus Property Group) (-10.7%) is offering a discounted distribution reinvestment plan (DRP) of 1% in a bid to raise funds as the availability of capital in the markets dries up. Other trusts following this trend include Becton Property, Mirvac, and Bunnings Warehouse Property Trust.

Australian bonds

The Australian bond market returned 0.4% for the quarter, ahead of the -0.6% in international bonds but below bank bills which advanced 2%.

The US Federal Reserve's actions in March to open the discount window to broker/dealers and orchestrating the buyout of Bear Stearns buoyed sentiment and resulted in improved liquidity in markets at the start of the second quarter. However, the increase in the oil price and growing concerns about inflation resulted in a re-evaluation of short term interest rates, particularly in the UK and Europe. Global bond yields shifted higher as markets reassessed monetary policy as the potential for central banks to ease policy to combat slowing growth was questioned. In Australia, yields also moved higher with the 10 year Government yield ending the quarter at 6.45% (vs 6.04% at the start). The RBA left rates unchanged over the quarter and there are signs that the higher rates are impacting on consumer credit and activity. Consumer spending has been slower but the outlook for inflation is uncertain.

Credit markets improved with spreads narrowing in April and May. There was some reversal in June as fears that more financial institutions may be in trouble rippled through the market.

International bonds

The Lehman Brothers Global Index declined 2.9% in US dollar terms and 0.6% in Australian dollar hedged terms during the quarter. Yields rose during the period on inflation concerns and hawkish comments on monetary policy by central banks. As the European Central Bank maintained its focus on inflation, expectations of a rate hike were greater in the Euro-zone than in the US, where the economic slowdown is presently more severe. As a consequence, yields rose slightly more in the Euro-zone than in the US, which had a negative impact on the US dollar towards the end of June.

Corporate bonds recovered some of the ground lost during a difficult first quarter of the year and outperformed US treasuries. However, concerns that the liquidity problems at some of the world's biggest financial institutions might not yet have concluded, and the downgrading of monoline insurers by the major rating agencies, weighed on investor sentiment and led corporate bonds to give back some of the gains made during April and May.

Despite June's under performance, high yield outperformed emerging market debt and US treasuries significantly.

Inflation

The June 2008 quarter saw global inflation concerns, described by the Bank of International Settlements as a "clear and present threat" to the world economy, become front page news around the world. With the price of oil and many soft commodities (rice, corn and soybeans) reaching record levels, inflation hit multi-decade highs in Australia, the European Union, Asia, and eastern European countries. A number of central banks raised interest rates in an effort to curb inflationary expectations. Many emerging market countries are experiencing double digit inflation with Vietnam at 25% and India over 11% while China's inflation measure rose to 7.7%. Higher soft commodity prices combined with shortages has caused strikes, protests and even riots in parts of Asia.

In Australia the CPI rose to 4.2% in the year to March 2008, its highest level since 1996, excluding the GST spike in the year 2000. The RBA has the current cash rate at 7.25% and refrained from increasing rates further in the June quarter as it waits for data to confirm slower domestic demand and consumption in the face of significantly higher petrol prices and borrowing costs. The RBA faces significant challenges going forward as it tries to maintain its CPI target of between 2-3%. In the face of external cost pressures now feeding into the Australian economy, there are fears of the spectre of a 70's style stagflation.

Source: Russell Investments, Russell Market Review July 2008

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