



Russell Market Review

Your analysis of recent economic events and market movements // January 2009

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Snapshot

- At least 19 economies entered into recession
- Equities and commodities continued to decline heavily
- Defensive market sectors outperformed

Quick overview

Flight to safety continues amid market volatility and worries over global recession.

During the December quarter, the global economic meltdown continued with recessions declared in at least 19 countries and unprecedented levels of volatility in global equity markets. Declining global growth led to commodities and commodity stocks being sold off heavily, and had a flow-on effect on the Australian dollar which declined significantly during the quarter.

The Australian equity market had its fifth consecutive negative quarter (-18.5%), with high levels of investor risk aversion resulting in defensive sectors such as gold and healthcare outperforming the broader market.

“While there are undoubtedly risks ahead, it is important to remember that a recovery from the current market conditions will eventuate... investors need to ensure that their portfolios are well diversified and consistent with their long term objectives.”

International equity markets also reflected investors' pessimism with the MSCI World Index down 11.5% in A\$ terms.

Globally, central banks continued monetary easing policies with the US, UK, Europe and Australia all reducing rates to combat the economic slowdown.

While there are undoubtedly risks ahead, it is important to remember that a recovery from the current market conditions will eventuate. To ensure that investors are well placed to take advantage of opportunities as they arise, investors need to ensure that their portfolios are well diversified and consistent with their long term objectives.

Snapshot

- Central banks slashed interest rates to revive stagnating economies
- Governments announced unprecedented stimulus packages

Global interest rates and fiscal stimulus packages

The global economy continued to deteriorate significantly during the December quarter after the bankruptcy of Lehman Brothers in September 2008 and as job losses mounted in the US, UK and Europe. These and other events led the International Monetary Fund to predict the first global recession (less than 3% GDP growth) since the Second World War. Corporates and consumers began to deleverage, retail sales across the globe fell and a number of iconic high street names were forced out of business or into administration (i.e. Woolworths UK, Hardy Amies).

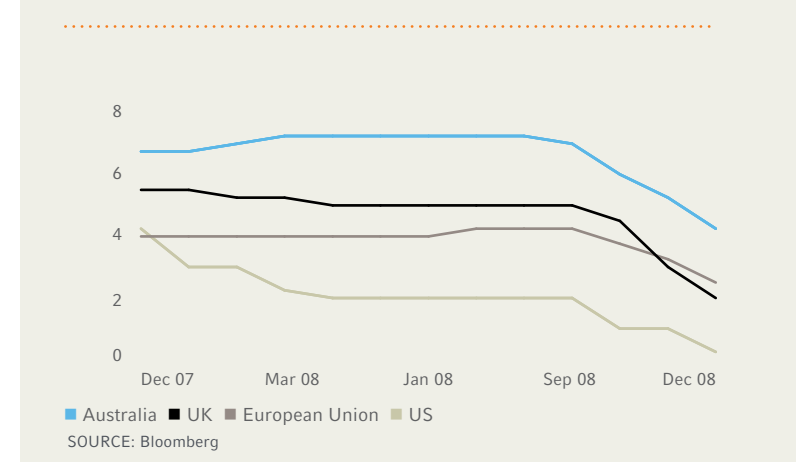
To counter stalling/ stagnating economies and in order to revive bank lending to consumers and businesses, central banks globally slashed interest rates while governments announced enormous fiscal packages to create jobs and encourage spending.

The US Federal Reserve cut its target Fed Funds rate from 2.0% at the start of October to a range of 0 – 0.25% and embarked on a quantitative easing program. Concurrently, President Elect Barack Obama announced a US\$775 billion economic recovery plan to create three million jobs in the next two years.

The Bank of England and the European Central Bank cut their interest rates from 5.0% and 4.25%, to 2.0% and 2.5% respectively to combat the slowdown. In addition to this aggressive easing of rates, the UK government assisted the recapitalisation of its domestic banking system and announced a stimulus package of US\$430 billion. The European Union also announced a fiscal stimulus package of EUR250 billion.

As their major trading partners faced increasing economic difficulties, China sought to stabilise its GDP growth which is expected to fall significantly in 2009/10. The People's Bank of China cut the one year loan rate by 1.35% over the quarter to 5.31%, while the Chinese government announced a stimulus package of US\$586 billion over two years to ensure the economy did not experience a sharper slowdown.

EXHIBIT A Global interest rates



As economic data and commodity prices deteriorated, the Reserve Bank of Australia (RBA) implemented its most aggressive rate cuts ever by taking the policy rate to 4.25%, that is 2.75% below the level at the start of the quarter. Seven years of rising rates had been reversed in a matter of months. The Rudd government reacted to the unfolding global and domestic crisis with a number of measures such as the AU\$10.4 billion pre-Christmas package to seniors and low income earners.

Snapshot

- **A\$ falls to a low of US\$0.61 over the quarter**
- **US\$ strengthened as investors flocked to US Treasuries**

Currencies

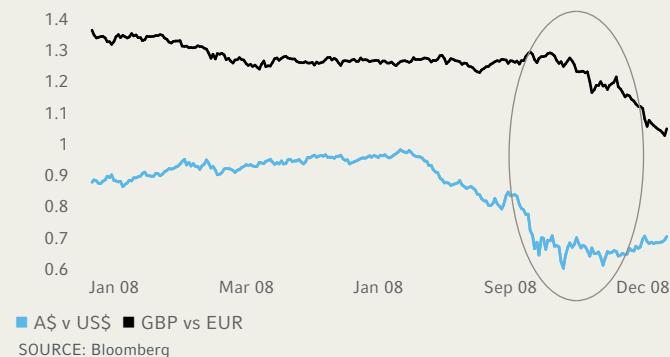
The chorus of A\$/US\$ 'parity' calls in the third quarter of 2008 muted into a deafening silence as the A\$ went into freefall during October and November. Declining by 13.4% for the December quarter, the A\$ touched a low of US\$0.61 before the RBA intervened in foreign exchange markets to steady the A\$'s decline. The fall was triggered by a combination of factors, including the declining global risk appetite, the narrowing of interest rate differentials as the RBA cut rates aggressively and slumping commodity prices.

The A\$'s precipitous decline from its high of US\$0.98 reminded many of its status as a commodity currency.

Despite the large fall against the US\$ and in trade weighted terms (-12.3%), the A\$'s performance against other major currencies was mixed. It fell by 25.0% against the Japanese Yen (JPY), 16.3% versus the Swiss Franc (CHF), and 11.6% against the Euro, rose 8.1% versus the Pound Sterling (GBP) and 2.1% against the Canadian dollar (CAD) and was broadly unchanged versus the New Zealand dollar (NZ\$). As the credit crisis continued to unfold and risk aversion reached epic proportions, the US\$ rallied strongly against all currencies other than the JPY, on the back of a flight to safety as investors purchased US Treasuries.

The December quarter saw the GBP fall heavily against the US\$, but also versus the EUR. The 18% decline against the EUR was sparked by mounting concerns over the soundness of the UK financial system and the contracting UK economy vis-à-vis the European Union. These concerns spurred a sharp rally in the EUR with the 15 nation currency almost reaching parity with the GBP in late December, however many analysts believe that the GBP's fall is overdone. As negative data emerges from the European Union showing a slowdown in GDP growth, particularly in Germany, France and Spain, the GBP could strengthen in 2009.

EXHIBIT B Currency pair movements



Snapshot

- Oil price reached a five year low of US\$33
- Commodity prices continued to fall sharply

Commodities

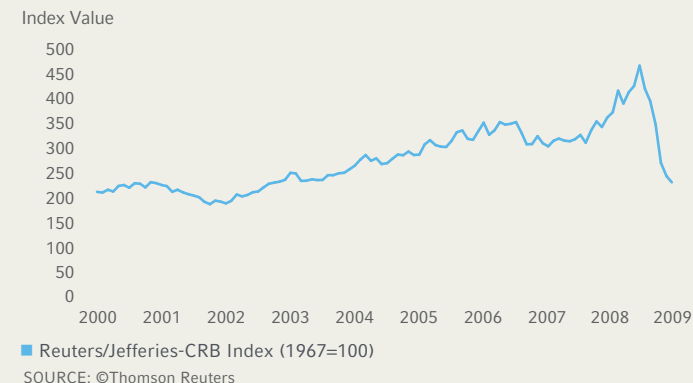
As global growth slumped during the December quarter and as predictions for 2009 grew more dire, commodities and commodity stocks were sold off heavily. Fears mounted over a significant drop in demand by BRIC countries (Brazil, Russia, India and China), particularly China, and the extent of the slowdown in the US, Japan and the European Union.

As recessionary conditions became more apparent, with at least 19 countries having declared a recession to the end of December 2008, the entire commodities complex plunged. The most notable decline was that of oil. Having reached a peak of over US\$147 a barrel in July 2008, and despite a succession of OPEC oil production cuts, the price collapsed 61% over the quarter, reaching a five year low of US\$33 a barrel in December with fears over deteriorating global demand and surplus inventories. For consumers, this resulted in the average price per litre for petrol falling to under A\$1 for the first time since 2004.

The December quarter also saw copper fall 54.8%, nickel 31.4% and aluminium 39.2%. These falls and the anticipation of significant reductions in future contract prices led to substantial share price declines for many Australian resource companies. Smaller miners which ran higher cost projects and were shut out of credit and equity markets were particularly affected, with share price declines of 80% not uncommon. Large miners were also impacted heavily, with BHP Billiton deciding to withdraw the 3.4 for 1 take-over offer for Rio Tinto largely due to the falling levels of global demand for commodities and the credit crisis. Rio's share price fell from a high of A\$157.45 to a low of A\$29.91 on news of the withdrawal, but recovered to approximately A\$40 by quarter end. Rio's management flagged asset sales and staff redundancies to strengthen the balance sheet and reduce debt levels that had increased markedly after Rio's take-over of Alcan.

Another example of listed commodity stocks falling heavily was OzMinerals, which was formed when Oxiana and Zinifex merged in 2008. OzMinerals was suspended from trading in December 2008 with its share price falling to A\$0.52, 88% down from its high, as it sought to refinance a number of loans. As at early January 2009 OzMinerals was still suspended from trading on the Australian Stock Exchange.

EXHIBIT C Commodity price index



Snapshot

- Investors favoured capital security over yield
- Credit spreads reached all time highs during the year

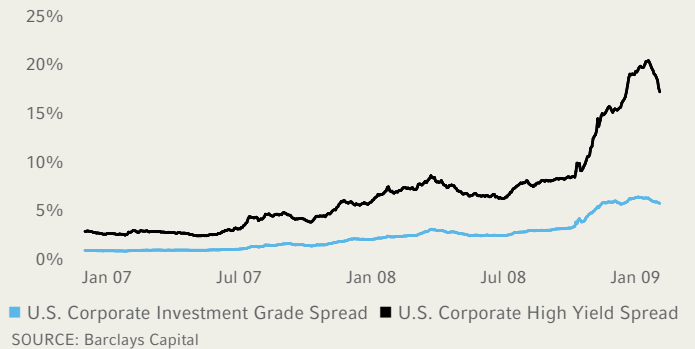
Credit spreads

In the wake of the Lehman bankruptcy, the market re-priced risk to a level the investment community hasn't seen since the Great Depression. Spreads on all forms of bonds touched what some analysts referred to as 100-year highs. With the global economic outlook deteriorating and deleveraging continuing, spreads marked a number of all time highs during the year.

There are similarities or rhythms to the way markets function throughout history. During the Great Depression, US Treasury bills had negative yields as investors were more concerned about the capital security of their money than the rate of return earned. This also occurred in mid-October, with credit and liquidity all but disappearing during an epic global deleveraging that left market participants fleeing from every asset class other than the relative safe havens of US Treasuries and the Japanese Yen.

The perfect storm of an unfolding financial crisis, mixed and tentative policy, an inflating and subsequently unwinding commodity bubble and the massive, systemic deleveraging, brought about a complete collapse in confidence and trust. However, with global central banks taking over a multitude of facilitative roles central to the functioning of the financial system, trillions of dollars have been injected to encourage activity between lenders and credit-worthy borrowers. The reluctance to lend remains, but there are several early signs of an improvement with some spread compression and the stabilising/rebounding of growth oriented currencies. Credit markets have loosened considerably, a natural and crucial first step in the rebuilding process. While the global financial system has sustained considerable damage, it has also withstood the consolidation of many of its weakest constituents, and is receiving the complete support of central banks and governments globally which are acting with unprecedented swiftness and coordination.

EXHIBIT D US credit spreads



Corporate bonds posted horrific results in September and October. Investment grade corporate bonds were down 6.6% and 5.8% respectively. Martin Fridson, a luminary in the high yield market, pointed out that if high yield returns were normally distributed, the 8% loss experienced in September would only happen once every 27,777 years. With a -16% return in October, it's difficult to even fathom the probability of this happening independently, let alone having two of the worst months in history back to back.

Snapshot

- Australian shares fell 18.5%
- Defensive sectors held up best
- Highly geared property trusts fell as much as 90%

Australian shares

The Australian share market recorded a loss of 18.5% during a quarter of unprecedented volatility as the credit crisis prompted sharp price declines. Global policy makers and central banks undertook extraordinary measures to curb the fallout, however this did not prevent the US, the European Union and Japanese economies from officially entering recession.

In Australia the Reserve Bank introduced aggressive monetary policy easing, cutting interest rates by a total 2.75% to 4.25% over the quarter, while in December the Federal government also announced spending measures of A\$10.4 billion to boost economic activity.

Investor confidence was heavily undermined leading to strong risk aversion. Consequently defensive sectors, such as gold (13.3%), healthcare (-0.3%), food beverage & tobacco (-4.2%), utilities (-5.3%) and telecommunications (-8.7%), outperformed the broader market. In contrast, cyclical sectors and those marked by higher debt levels suffered with property trusts (-33.2%) and real estate developers (-41.7%) sold down heavily on refinancing concerns. Individual property trust losses in the order of 90% for the year were not uncommon.

The banks sector (-20.0%) had a difficult quarter however the major Australian banks' financial position is widely accepted as being stronger than that of their international counterparts.

As demand for resources fell due to the global economic slowdown, so did prices within the metals and mining ex gold sector (-22.3%). Oil reached a 5-year low during the quarter and the energy sector declined (20.7%). Companies which support the resources industry were also severely sold down, for example, the world's biggest drilling provider Boart Longyear (-82.1%) and mining services companies Bradken (-68.5%) and Emeco Holdings (-64.4%).

EXHIBIT E Australian shares performance

Periods to 31 December 2008



Snapshot

- International shares declined by 11.5% in A\$ terms
- Telecommunications, healthcare and utilities fared best
- A\$ hedged returns weaker than unhedged as A\$ fell

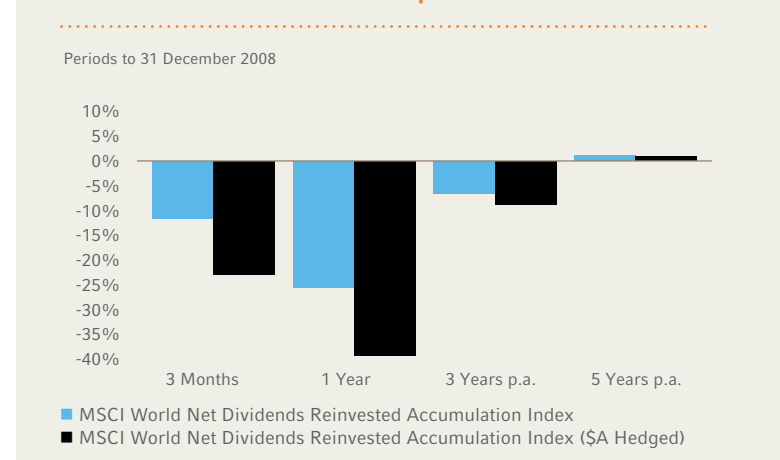
International shares

During the fourth quarter of 2008 international markets, as measured by the MSCI World Index, continued to reflect extreme pessimism on the part of investors. The Index declined by 11.5% for the quarter in A\$ terms (-22.7% in hedged terms), which resulted in a loss of almost 25% for the year.

Economic activity and data across the globe worsened dramatically. The US, Japan and the European Union all officially announced that their respective economies were in recession. While the UK, where GDP declined 0.5% for the third quarter, did not officially announce it was in a recession, policy makers conceded the likelihood of recession towards the end of the fourth quarter. Even the fast-growing emerging market economies, such as China, were not immune from the concurrent recessions affecting developed countries, with China significantly reducing its outlook for economic growth rates into 2009.

As a result of the deteriorating global economic scenario, domestic governments became increasingly involved in lending support to languishing economies. The US Federal Reserve, the Bank of England, the European Central Bank and the RBA all dramatically cut key rates during the quarter. In addition, governments in developed and emerging countries announced fiscal policies to stimulate economic activity. Developed countries announced broad rescue packages, including capital injections, guarantees, and loans for the financial sector in particular. The breadth and scope of monetary/fiscal policy action and other governmental intervention around the world was unprecedented.

EXHIBIT F International shares performance



The performance of the sectors resembled trends established in the third quarter, where more defensive sectors offered investors a relative safe-haven. The telecommunications (-1.1%), healthcare (-10.6%), and utilities (-9.1%) sectors were the top performing sectors for the quarter in local currency terms. Three of the more cyclically sensitive sectors, financials, materials and consumer discretionary, underperformed the MSCI World Index for the period. The financials sector, down 32.5% in local currency terms for the quarter, continued to face pressure as solvency concerns remained at the forefront of investor anxiety. The materials sector, down 24.8% in local currency terms, continued to sell-off on reduced demand from global economies in decline, and the consumer discretionary sector, down 23.9% (in local currency), suffered from reduced consumer sentiment and spending.

Snapshot

- Global property fell 35.7% in A\$ hedged terms
- Asian property outperformed other regions
- US dividend yields rose to 7.6%

International property

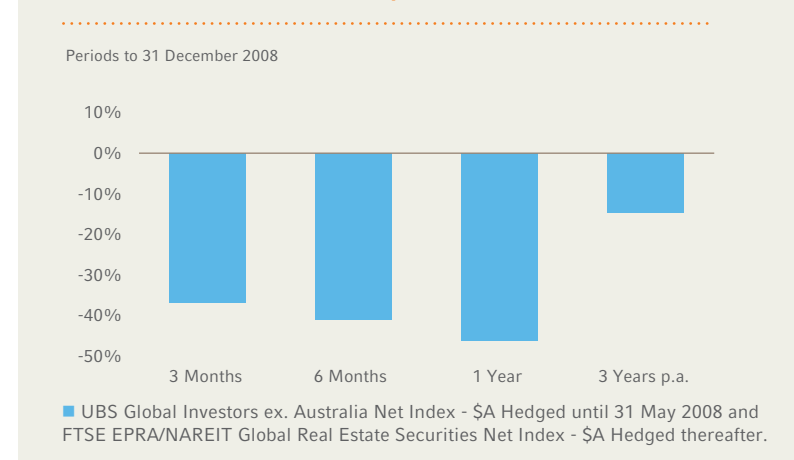
The global property securities market delivered a -35.7% return for the quarter, as measured by the FTSE EPRA/NAREIT Global Real Estate Index - \$A hedged, underperforming the global equity market by 13.0% on a hedged basis. Regionally, in local currency terms, Asia (-18.4%) led the index, followed by Continental Europe (-26.0%), the UK (-34.3%), Australia (-34.5%) and North America (-39.2%).

Asia's outperformance was led by Hong Kong (-9.6%), while Singapore (-19.6%) and Japan (-24.5%) fell behind the broader index in local currency terms. Chinese development companies listed in Hong Kong were supported by central bank lending rate cuts. The Japanese office rental market came under pressure from the combined effect of higher vacancy rates in central Tokyo and decreasing average rents. There was a large spread between the top and bottom performers in the Australian REIT market, indicating the emphasis on companies with well capitalised balance sheets versus those that face debt, refinancing or covenant issues.

With the exception of Sweden (-9.1%), most of the major real estate securities markets in Europe underperformed relative to the broader index. European property markets started to show signs of weakness, putting pressure on Germany (-20.0%), France (-25.3%) and the Netherlands (-27.0%). Macro-economic conditions continued to weigh heavily on UK share prices.

In North America, the real estate securities market in Canada (-32.2%) and the US (-39.7%) finished behind the broader index in local currency terms. Mirroring the early 1990s, which recorded the last severe economic slowdown, dividend yields reached elevated levels and ended the year at approximately 7.6%. In December there was a clear shift away from defensive strategies as investors grew somewhat more confident that lenders were now more willing to extend loans and renegotiate terms.

EXHIBIT G Global real estate performance



Snapshot

- Australian bonds were well supported
- Government bond yields fell considerably
- Corporate bonds underperformed government issues

Australian bonds

The Australian bond market had a spectacular December quarter returning 6.3%, outperforming both international bonds and the cash market at 4.8% and 1.7%, respectively

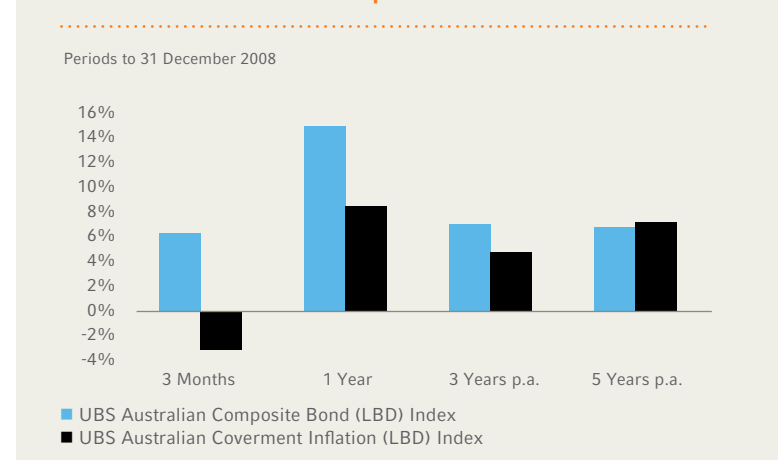
Sentiment in fixed interest markets both globally and in Australia was dominated by the credit crisis and worsening economic outlook. In response, governments and central banks stepped in to curb the fallout. The US government implemented its biggest suite of market initiatives, most notably the US\$700 billion Troubled Asset Relief Program in October. Additionally, the US Fed Funds rate was cut to an unprecedented range of 0% to 0.25% with the Federal Reserve commenting that “weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time”. The Bank of England cut rates to 2.0%, a 70-year low, and indicated further monetary easing was likely.

In Australia, the RBA decreased the official cash rate aggressively over the quarter by a total of 2.75% to 4.25%. Bank bill yields fell sharply on this news, as the magnitude of the easing exceeded market expectations.

Domestic government bond yields fell sharply across the board but particularly for shorter maturities. Australian 3-year bond yields fell by 1.9% to 3.2%, whereas 10-year bond yields decreased by 1.4% to 4.0% during the quarter.

Corporate bonds underperformed government issues, and within the credit market higher rated securities fared relatively better than sub-investment grade and lower rated credits. Semi-government paper underperformed short term credit by 0.2% in December as demand turned to the new issue of government guaranteed bank debt on terms more favourable than the market had expected.

EXHIBIT H Australian bond performance



Snapshot

- International bonds returned 4.8% in A\$ hedged terms
- US Treasuries traded at a negative yield
- Credit spreads rose to record levels

International bonds

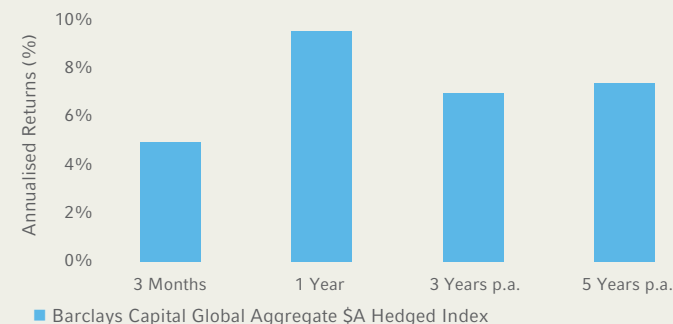
The international bond market returned 4.8% in A\$ hedged terms over the quarter as the global financial crisis led investors to seek safer assets. The flight to safety stoked demand for government securities to such a degree that yields fell to record levels. Risk aversion was so extreme that US Treasuries traded at a negative yield during the quarter.

Governments intervened decisively in an effort to alleviate the crisis, first flooding markets with liquidity to lessen funding constraints, and later by taking substantial direct stakes in banks to keep the financial system afloat. However, interbank lending rates remained exorbitant as banks remained reluctant to lend to each other, while credit markets froze as liquidity constraints forced institutions to reduce leverage. Fund redemptions also accelerated, with forced sales sending credit spreads to record levels, nearly doubling for asset sectors such as high yield, emerging market debt, and certain types of asset-backed securities.

As the threat of inflation collapsed, policymakers were able to cut rates aggressively across the globe, leading to additional yield declines. The Bank of England was forced to reduce interest rates by 3.0% to 2.0%, while in Europe the more hawkish European Central Bank cut by 1.75% to 2.5%. In the US, rates were cut from 2.0% to a range of 0 – 0.25%, effectively zero, and the US Federal Reserve has focused its attention on 'quantitative easing' in an effort to boost the economy. Japan's central bank cut rates to 0.1%, while that country's government delivered a record budget of US\$979.2 billion for 2009 as it looked to inject new life into a faltering economy.

EXHIBIT I International bonds performance

Periods to 31 December 2008



Snapshot

- Emerging markets fell 18.0% in A\$ terms
- Energy and materials again hardest hit
- South Africa and China held up best in local currency terms

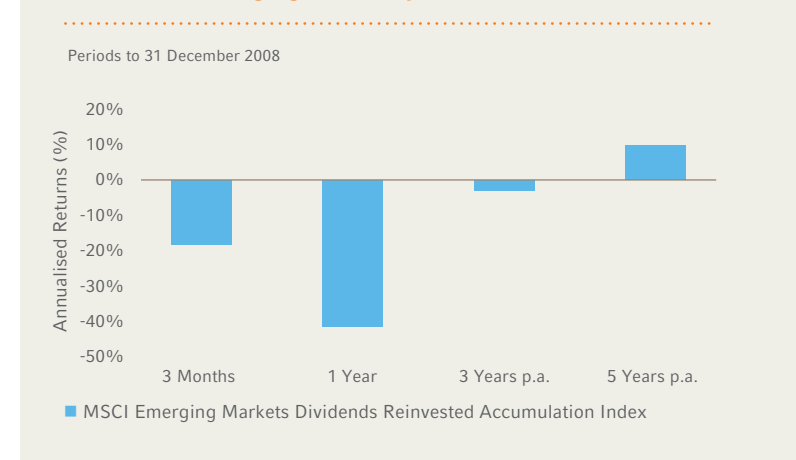
Emerging markets

The MSCI Emerging Markets Index declined by 18.0% in A\$ terms over the quarter.

Stocks fell sharply early on, as the fallout from the financial crisis and the looming global recession weighed heavily on sentiment, driving the Index to one of its worst months ever in October. Despite concerted central bank intervention on interest rates and the announcement of rescue packages for troubled financial institutions across the globe, the downward trend continued on evidence of a sharp cooling in China's economy and the confirmation of the European Union's first recession. The sell-off occurred across all sectors, with energy and materials hit particularly hard as the global economic slump cut demand for commodities. Russia endured a difficult period as the country's currency came under intense pressure as falling oil prices threatened to wipe out the country's current account surplus. Russian stocks were sold off heavily on political and economic concerns.

In local currency terms, the top performers for the quarter were South Africa (-6.6%), China (-10.9%) and Mexico (-11.8%). The laggards were Pakistan (-49.8%) that put a floor under its stockmarket which led to several days of no activity, Russia (-49.0%) which experienced a flight of capital and Hungary (-40.8%) which applied for and received IMF assistance.

EXHIBIT J Emerging markets performance



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 abnormalities 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.

Price to Earnings Growth Ratio (PEG)

Forward PE ratio divided by the one-year-ahead consensus expected EPS growth rate. This ratio attempts to determine the value of a market per unit of earnings growth. A low PEG ratio means the market is attractively priced for its expected earnings growth.

Purchasing Power Parity (PPP)

The theoretical long term equilibrium exchange rate between two currencies. It is based on an assumption of efficient markets and on the purchasing power of the currency for a defined basket of goods in each currency.

LPTs

Listed property trusts.

REITs

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