



QUARTERLY MARKET OUTLOOK – June 2010

Global Economic Conditions

Global Economic Conditions

- [Australia](#)
- [United States](#)
- [Europe](#)
- [Japan](#)
- [Emerging Markets](#)

Investment Sectors

- [Australian Shares](#)
- [International Shares](#)
- [Property Securities](#)
- [Fixed Interest](#)
- [Stock Market Indices](#)

The Australian economy remains the envy of the rest of the developed world. Australia's December 2009 quarter GDP came in at 0.9%, marking the fourth quarter in a row of positive growth. It looks like more good times ahead. Rising Asian demand for Australian resources, at significantly higher prices, will fuel economic growth over 2010 and beyond.

The US economy is on the mend, recording an annualised GDP growth rate of 5.6% in the December 2009 quarter. However, private inventory investment was the biggest contributor to GDP growth, this does not represent a sustainable growth driver. The more important US personal consumption figure was up, but a 9.7% unemployment rate will continue to create difficulties for the US.

Economic recovery in Europe stalled in the final quarter of 2009. The second revision for December 2009 quarter GDP growth was flat in the 16 countries Euro zone. GDP in the wider 27 country European Union (EU27) increased by 0.1%. The long term effort required to reduce budget deficits combined with unemployment rates around 10% will see Europe continue to lag the rest of the world in economic recovery.

The situation is finally improving for the UK. The UK economy expanded at an upwardly revised 0.4% in the fourth quarter of 2009. This was the result of improved figures from the services, construction and agricultural sectors.

A changing of the guards is set to occur in Asia in 2010. While Japan grapples with slow economic growth combined with deflation, China continues to power ahead. China's economic growth surged at an annualised rate of 11.9% in first quarter of 2010, after rising 8.7% in 2009. This dwarfs the mere 3.8% annualised growth for Japan in the December 2009 quarter. The Japanese economy is recovering, but largely due to a revival in exports to China and other growing economies.

If China meets its consensus growth forecast of 9.5% in 2010, it will overtake Japan as the world's second largest economy. This historic event will mark the beginning of a new era in global economics. Enter the dragon.



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Australia



Australia's economic performance during the GFC was so good that it was the first developed country to begin the process of unwinding monetary stimulus, back in October 2009. The most recent GDP figures released from the Australian Bureau of Statistics (ABS) provide continuing evidence of a healthy domestic economy.

Australia's December 2009 quarter GDP came in at 0.9% – an increase on the September quarter reading of 0.3%. This marks the fourth quarter in a row of positive growth in Australia. Only one quarter of negative growth (Q4 2008) has been recorded in Australia over the past two years. During this period, the majority of other western economies were reporting large negative quarterly GDP numbers and were officially in recession.

This positive GDP outcome provides evidence of an economy returning to a healthy growth scenario, with monetary policy consequently returning to a more normal setting. The RBA's positive view of the Australian economy has been clearly displayed in its monetary policy decisions. Following three consecutive 0.25% rate rises in the December quarter, March and April also saw consecutive 0.25% rises. The cash rate now stands at 4.25% and is expected to be around 5% by the end of 2010.

Looking at the various contributions to GDP for the December quarter, machinery & equipment (0.8%), government capital expenditure (0.6%), household consumption (0.4%) and exports (0.3%) were the key drivers. Increased private capital expenditure on machinery & equipment was largely due to the stimulus boost provided by tax breaks, resulting in a considerable rise in business investment. Government spending was again a major contributor to the positive quarterly result. Public capital spending contributed 0.6 % points to GDP and government consumption added a further 0.3%. The winding back of government spending over 2010 and 2011 will need to be closely monitored to ensure private sector activity replaces government stimulus as a sustainable driver of economic activity.

The December quarter import and export figures don't accurately reflect Australia's terms of trade for the March quarter. In the most recent figures,

the January balance of goods and services saw a deficit of \$1.2 billion, up from a downwardly revised deficit of \$2.2 billion in December. This was the smallest trade deficit since June 2009, when it was \$376 million. A major contributor to the fall in imports was a \$666 million drop in fuel and lubricants. Exports rose by 1.0%, mainly due to an increase of \$239 million in metals ores and minerals. Australia's commodity exports were boosted in 2009 when China engaged in a high level of commodity hoarding to take advantage of low prices.

Increased global economic growth is expected to further support demand for commodities in the June quarter. The pricing environment has also improved. For example, iron ore producers are currently negotiating short term price contracts instead of annual prices with Asian steel makers. Analysts believe this could result in up to a 90% increase in contract prices for 2010.

In comparison with the US and Europe where unemployment remains around the 10% level, Australia's employment situation is strong. Following six months of drops, the Australian unemployment rate in February rose by 0.1% and remained steady at 5.3% in March. The ABS reported the number of people employed increased by 19,600 people, seasonally adjusted, in March. The slight rise in employment was driven by a rise in full-time employment, although this was offset by a fall in part-time employment.

The economic outlook for Australia in the coming quarter is one of continued moderate growth. There are still several risks to the domestic economy that need to be considered. Firstly, Australia is highly dependent on global commodity markets. Any price drops would have a negative impact both on domestic growth and on the trade situation. Secondly, Australia is increasingly dependent on the economic growth of China. While the outlook for China is strong, it is also not without risk. The key risk being Chinese government policies designed to stem inflation, leading to a sharp drop in economic growth. Finally, the current tightening of monetary policy in Australia, if excessive, could also strain economic growth at an undesirable level.

June 2010 Quarterly Market Outlook as at March 2010

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United States



Economic recovery is gaining traction in the US. Although revised down from earlier estimates, the US recorded for an annualised GDP growth rate of 5.6% in the December 2009 quarter. The US economy is expanding at its fastest rate in six years with the growth rate comparing well with the 2.2% growth rate achieved in the September quarter. The increase in fourth quarter GDP reflected positive contributions from private inventory investment, exports, personal consumption and non-residential fixed investment. The major detractor was a rise in imports.

The key driver in a strong US growth rate last quarter was not consumer spending, but businesses allowing their stockpiles to shrink at a slower rate than they had been previously. This change in inventories added 3.8% to the growth rate in the final quarter of 2009. Private businesses decreased inventories by US \$19.7 billion in the December quarter, following decreases of US \$139.2 billion in the September quarter. While these inventory changes alone cannot sustain growth for an extended period, many economists are hoping that once businesses become more confident about the recovery, they will increase production to refill their inventories.

While positive, the all important US consumer spending figures remained weak. Consumer spending grew at an annualised pace of 1.6% in the fourth quarter, after an increase of 2.8% in the third quarter. This was an improvement on estimates from early in the quarter, particularly considering the end of the "cash-for-clunkers" program which had helped stimulate auto spending. However, after previous US recessions, consumer spending was a much larger driver of economic recovery. Recent data has been more promising, with spending increasing 0.3% in February after rising 0.4% in January. Spending normally accounts for about 70% of US economic activity and will become vital to sustained recovery when government stimulus and the lift from inventories fades.

Business spending is improving with non-residential fixed investment increasing 5.3% in the December quarter, in contrast to a decrease of 5.9% in the preceding quarter. The most promising gain was in equipment and software,

which increased 19.0%, compared with an increase of 1.5% in the previous quarter.

The US balance of trade continues to improve. Real exports of goods and services increased 22.8% in the fourth quarter, compared with an increase of 17.8% in the third quarter. Real imports increased 15.8%, compared with an increase of 21.3% in the previous quarter.

In the most recent US employment figures, the US unemployment rate held steady in February at 9.7%. Employers cut fewer jobs than expected, according to official data, adding to hopes that the worst of the downturn in the world's largest economy is over. The data from the US labour department showed that 36,000 jobs were cut in February. This was a stronger result than most economists had been expecting. Unemployment at close to 10% will remain a major headwind to US economic recovery. The White House has conceded that the jobless rate is still "unacceptably high". There is an obvious relationship between unemployment and the critical growth driver of consumer spending.

It was more of the same from the Federal Open Market Committee (FOMC). While acknowledging that recovery is underway, the benchmark interest rate is set to stay low for an "extended period." The FOMC continue to maintain a target range for the federal funds rate at 0 to 0.25%. Expectations are for tightening to be brought forward from September 2010 to June 2010, with the Fed fund rate still expected to be less than 1.0% in a year's time.

Overall the US economy has shown a significant improvement over the March quarter. Recovery is clearly in progress. The June quarter will present a new set of obstacles. Fiscal stimulus is being unwound and a gradual increase in interest rates is now on the horizon. The Federal Reserve will stop buying US mortgage debt and this may present issues for the housing market. The recent business inventory reduction does not reflect an ongoing structural improvement in the economy and consumers will need to sustain growth. High unemployment remains a persistent headwind in this regard.

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Europe



The recent economic recovery staged by Europe ground to a halt in the final quarter of 2009. Output stagnated in Germany and contracted once again in Italy. The second revision for December 2009 quarter GDP growth was flat in the 16 countries that use the Euro. GDP in the wider 27 country European Union (EU27) increased by 0.1%. In the third quarter of 2009, growth rates were 0.4% in the euro area and 0.3% in the EU27.

This downward revision was unexpected and highlights how fragile economic recovery in Europe really is. The EU only emerged from recession in third quarter of 2009. The figures should confirm market expectations that the European Central Bank (ECB) will keep its key interest rate on hold at the current record low of 1.0%, for the remainder of the year. The ECB previously cited concerns that Europe's recovery is showing signs of losing momentum. But the ECB does not want to keep rates too low for too long. Rate hikes are now expected in early 2011.

The sovereign debt crisis remains an issue for Europe. While the EU has bailed out Greece, fiscal consolidation requirements will continue to hamper regional growth. The GDP figures showed that Greece contracted by 0.8% in the fourth quarter, while Ireland, enacting deep budget cuts of its own, saw output fall by 2.3%. A European Commission's assessment of various fiscal consolidation plans highlighted that most countries have assumed unrealistically high growth levels. This means that countries will either miss their targeted deficit reduction by 2013 or require additional fiscal tightening. This is not limited to countries with the biggest fiscal problems. Larger economies, such as France, will also need to intensify fiscal tightening to meet the required deficit reduction.

The regional heavyweights of Germany, France and Italy dominate Euro zone GDP performance. France managed to post strong 0.6% quarterly growth, Germany was flat whilst Italy contracted by 0.3%. France has weathered the global economic crisis much better than any other country in the region. While pausing in late 2009, Germany is likely to continue along the path of economic recovery. A rebound in inventories,

private consumption and manufacturing production all point to an increase in GDP at the beginning of this year. Over 2010, substantial fiscal easing should stimulate domestic demand, while a recovery in exports should continue to drive growth.

The situation is finally improving for the UK. The UK economy expanded an upwardly revised 0.4% in the fourth quarter of 2009. This confirms the economy exited recession with some momentum in the last few months of 2009. On an annualised basis, the economy contracted 3.1% in the fourth quarter from the same period a year earlier. This was an improvement on previous estimate of a 3.3% decline. For 2009 as a whole, the economy contracted 4.9%. Consensus forecasts for UK 2010 growth now stand at 1.1%.

The upward revision in the final estimate was driven by improved figures from the services, construction and agricultural sectors. The fourth quarter output in the services industry was 0.5% higher, while the production industry expanded 0.4%. The construction sector fell 0.9% but was up on the 1.0% decline previously estimated. Household expenditure was up 0.4%, while government spending rose 1.0%. A UK Treasury spokesman provided a cautious view on the figures. "While it is welcome to see an upward revision, recent data in the EU and elsewhere has highlighted that there are still risks and uncertainties to this recovery and there is no room for complacency."

Economic recovery is underway in Europe but the region still lags most of the developed world and Asia. High unemployment is an ongoing concern. Euro zone unemployment hit 10.0% in February for the first time since the euro currency was launched. Poor fiscal discipline in the years preceding the global financial crisis have made it comparatively difficult for European officials to react. The structural problems created by excessive spending now require a sustained long term effort to reduce budget deficits. The need to return historically low interest rates to more normal levels will provide further difficulties for the European recovery.

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Japan



Japan's economic woes of the 1990s appear to have come back to haunt it. After experiencing a deep recession in 2009, Japan is now in the undesirable position of having very slow economic growth combined with deflation. But the Japanese economy does appear to be on the mend. The government's monetary and fiscal stimulus were successful in restoring growth. More importantly, a revival in exports to China and other growing economies helped drag the Japanese economy out of recession.

Japan's economy grew 0.9% in the December 2009 quarter. This figure was revised down from the preliminary estimate of 1.1%, but was slightly better than September quarter GDP of 0.3%. The downgrade was the result of capital spending rising less than initially reported and private inventories detracting from growth. On an annualised basis, the Japanese economy expanded 3.8% compared with an initial reading of 4.6% and a median market forecast of 4.1%.

The results indicate that Japan continues to benefit from global government stimulus measures, which have improved global trade and encouraged Japanese households to increase spending. Domestic demand contributed 0.4% to growth, down from an initial estimate of 0.6%.

The contribution from external demand was unchanged at 0.5% although this is expected to pickup when the March 2010 quarter GDP data is released. Signs of a recovery in the export sector continue, with the latest figures showing Japanese exports rising 45% in February, compared with the same month a year ago.

Exports to Asia, which comprise more than half of Japan's total exports, rose more than 55% over the same period. Car shipments to the US more than doubled. How much of this export growth will continue to affect household spending remains to be seen, with Japanese companies continuing to cut personnel costs.

Deflation remains an ongoing issue within the Japanese economy. The GDP deflator, a key inflation indicator in Japan, came in at -2.8% for the December quarter. This was the biggest negative reading on record. The deflator is used to adjust data in nominal GDP to reflect overall price levels. Excess economic capacity coupled with an outright fall in labour costs, should continue to exert downward pressure on inflation, which will probably stay negative well into 2011.

Japan's unemployment rate held steady in February at 4.9%, after declines in the preceding three months. The number of employed persons in February was 61.85 million, a decrease of 800 thousand or 1.3% from the previous year.

Although there have been some signs of modest improvement, the Japanese economy is still a subject of great uncertainty. While manufacturing and exports have improved, the recovery needs to show signs that it has spread to consumers, who are facing declining wages and high rates of unemployment. Concern exists that the recovery may weaken as the support from stimulus packages fades, both within Japan and around the globe, and the impact of deflation becomes greater. The yen's strength, although recently weakening modestly, remains a threat to the sustainability of a recovery.

The Japanese government is likely to upgrade its economic assessment in the June quarter, while warning of ongoing deflation. Export growth in China will remain the key growth driver. The problem Japan faces is deflation - companies and consumers may delay spending on the expectation that goods will become even cheaper. Borrowing may also contract as real interest rates are higher than nominal rates.

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Asia (ex-Japan)



Developing Asia's major economies continue to follow China's lead, driving the overall global recovery. 2009 was a difficult year, but China's government managed to keep the economy growing. This was despite a significant downturn in export orders, which led to the dismissal of over 20 million workers. Strong monetary and fiscal stimulus maintained growth in domestic demand. Exports have since recovered, allowing China's economic growth to surge to 11.9% in the first quarter of 2010, after rising 8.7% in 2009. It is set to expand even faster in 2010, with consensus forecast growth of 9.5%. This would see China overtake Japan as the world's second largest economy before the year is through.

China's remarkable success in negating the impact of the global economic crisis is now creating problems. China is facing the combined effects of inflation, asset price bubbles, excess industrial capacity and poor relations with trading partners. China's recent growth was also heavily dependant on exports, which cannot continue to grow at their recent pace. Chinese government policy needs to shift to improving domestic demand.

Chinese exports should retain strong momentum in the coming quarter. The Purchasing Managers' Index (PMI) for China's manufacturing sector stood at 55.1% in March, up 3.1% from the February. The PMI measures the manufacturing sector's performance. A reading above 50% indicates economic expansion, while one below 50% indicates contraction. March was the 13th straight month that the index was above 50%, although it has moderated from its December 2009 peak. It is yet to be seen whether this growth can continue, as the strong rebound in exports is unsustainable. Uncertainties still remain on the demand side, particularly from the US.

Asset price bubbles, particularly in relation to property prices, remain a concern. Chinese property developers remain extremely cautious, holding on to cash and land. Investors are discounting the risks of policy tightening in China, where efforts to curb credit growth haven't yet led to a collapse in property demand. China's key issue in dealing with inflation, asset price

bubbles, and trade relations is the value of its currency. Maintaining a fixed exchange rate requires China to sell Renminbi in order to keep it from rising in value. In doing this, they are increasing money supply and fueling inflation and asset price bubbles. Chinese officials had hinted at a possible currency revaluation, but strangely, the US ignored this and demanded China do so. Now currency revaluation is off the table, as China do not wish to be seen as bowing to US pressure. Several of China's subsidies and tax rebates that promote its own exports and discourage imports are another driver of China-US tensions.

While often overshadowed by news about China, the Indian economy continues to post a healthy recovery from a very modest slowdown. India's economy grew 7.9% in the September quarter. December quarter data has not yet been released, but India's finance ministry have forecast economic growth of between 8.25 to 8.75% in 2010, before accelerating to over 9% the year after. This reflects rising demand for Indian's exports due to the global economic recovery. Domestic demand is also strengthening as business investment increase and high levels of confidence ensue. Consumer spending is also accelerating. The Indian economy is recovering faster than expected and has resulted in India's central bank raising its key short term interest rates by 0.25% to 3.5% in March.

These results have been mirrored in the smaller regional economies. The Singaporean Government recently released a statement predicting its economy will expand 9% this year, up from the previous forecast of 6.5%. The statement claims that GDP jumped an annualised 32.1% in the first quarter of 2010, up from the previous three months contraction of 2.8%. Korea's central bank forecasts growth of around 5.2% this year, with first quarter growth coming in at 1.6%.

Strong growth in Asia continues to underpin the global recovery. While the world has clearly split into two tranches of growth, there is still a strong interdependence between them. Faltering growth and demand from developed world customers will prevent export growth continuing in the emerging economies. Throughout the region, government policy decisions needs to focus on bolstering domestic demand.

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INVESTMENT SECTORS

Australian Shares



After sharp falls in January, the All Ordinaries Accumulation Index (including dividends) regained ground to return 1.5% for the March Quarter. This follows a modest gain in the December 2009 quarter of 3.7%. The Australian sharemarket has returned 44.0% in the past 12 months. After wild swings in prices over the previous five quarters (both up and down), volatility in equity markets has subsided; at least for now. Despite having to digest the possibility of sovereign debt default in Greece and potential Chinese policy tightening, the mood in the Australian market remained largely positive. This was aided by relatively strong results in the earnings reporting season, on the back of strong cost control.

Industrial stocks slightly outperformed resources over the March quarter. The S&P/ASX 300 Industrials Accumulation Index rose 1.3% for the quarter, compared with a 1.1% in the S&P/ASX 300 Resources Accumulation Index. The result masks an underlying trend of resource stocks returning to favour. Over March, resources returned 9.2% compared to 3.4% from industrials. Industrials are still ahead on an annual basis, returning 43.9% versus 37.4% for resources.

There is plenty of evidence that confidence has returned to corporate Australia. Chinese growth continues to fuel demand for resources and pump money into the Australian economy. Recent iron ore negotiations saw a move from a contract pricing regime more in favour of spot pricing, which nearly doubled the price. Oil prices rose 4.5% over the March quarter, on a West Texas basis, while coal pricing remains buoyant. Rising demand combined with rising prices bodes extremely well for Australia's economy. A strong rise in LNG developments and increased capital expenditure in mining and energy will provide significant support to the economy over the coming years.

Corporate activity, which was notably absent when prices were low, is fast returning to these areas. Arrow Energy (20.9%) agreed to an takeover offer from Shell and PetroChina while Macarthur Coal

(25.6%) rose sharply on the back of an approach from Peabody Energy. The first of April saw Australia's largest gold producers Newcrest announce a \$9.2 billion takeover offer of the second largest gold producer, Lihir Gold. The offer was subsequently rejected.

Looking at the various industry sectors over the quarter, information technology (7.1%) and healthcare (3.3%) outperformed. The information technology sector rose strongly in the March quarter, taking returns up around 70.0% since the start of 2009. Information technology was by far the strongest performing sector in the Australian market this quarter. During a difficult period, the sector displayed a highly desirable combination of defensive qualities and solid organic growth. Within the healthcare sector, another typically defensive play, profit results were largely positive. Cochlear (5.5%), CSL (12.2%), Ansell (11.1%) and Ramsay Healthcare (27.8%) all produced sound results and favourable outlook statements.

Telecommunications (-12.8%) and REITs (-3.3%) lay at the weaker end of the spectrum. The telecommunications sector result is basically the result of the incumbent carrier, Telstra (-12.8%). In a painful process, investors in Telstra have had to watch governments and regulators hand revenue over to competitors which invest minimal amounts in infrastructure, while it must continue to re-invest in order to maintain its own customers.

Australia's relatively strong economic position and the strength of the Chinese economy should support the domestic equity market in the coming June quarter. Looking at the various forces at play, rising commodity demand and prices are pitted against rising official interest rates and fading domestic stimulus measures. Companies will need to deal with rising cost pressures in a higher interest rate environment, while investors are expecting a return of profit growth in 2010. Until global economic recovery shows clear signs of stabilisation, Australian equities will remain at the mercy of international market developments.

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International Shares



Global equities generally advanced in the first quarter but results were mixed between countries and regions. The MSCI World Index rose 3.2% in US dollars. While outperforming the Australian market in US dollars, returns were behind in Australian dollars, up just 0.9%. The Australian dollar finished the quarter with a massive annualised rise of 32.7%.

Global economic recovery is gaining traction while equity market fundamentals have improved. But investors remain anxious about the long term global economic outlook and sceptical of upwardly revised forecast profits. The fear is that this growth may not continue when policy stimulus is removed. Policy tightening, particularly in Asia is seen as a growing impediment to market progress. The dispersion of returns between developed and developing markets may continue to narrow.

The major US indices advanced and now boast impressive annual returns. The NASDAQ continues to outperform other US indices, rising 7.1%, for an annual return of 56.9%. This was followed by S&P 500, rising 5.9% quarterly and 46.6% over 12 months. The Dow Jones Industrial index rose 5.1% over the quarter and 42.7% annually. US corporate profits have recovered sharply, rising 31% in 2009. This was mainly driven by aggressive cost cutting and improved productivity growth.

Equity markets were also stronger in the Euro zone. A weaker euro has aided exporters while increased certainty over a possible Greek rescue plan has improved confidence in the region. The German DAX index returned 3.3% over the quarter and 50.6% annually. The French CAC40 rose 1.0%, for an annual return of 41.7%.

The service sector led improvements in the UK economy have been welcomed by the market. The UK FTSE rose by 4.9% in the December quarter, up 44.7% annually.

Despite ongoing economic woes, the Japanese equity market rose on a general improvement in the prospects for the Japanese economy. The Japanese Nikkei index rose 5.2% in the December quarter and 36.8% over 12 months.

While leading the world in GDP growth, China's sharemarket is very much out of vogue. The Shanghai B index was one of a handful to fall in the first three months of 2010, down 5.1%. China

is now one of the worst performing markets on an annual basis, with a return of 31.0%. The reason being that investors are increasingly concerned that the Chinese government will take strong measures to curb inflation and asset price bubbles. Although just discussing it seems to be having the desired affect on asset prices. For now, China remains focused on developing infrastructure and supporting the manufacturing and export sectors.

Investors in the world's quiet achiever continue to be rewarded handsomely. India's SENSEX index posted quarterly gains of 6.7% for a staggering 80.5% annual return. India has recovered strongly from a very modest downturn. The Indian government remains focused on developing its services sector and raising living standards. Hopefully recent market gains will assist them in the latter endeavour.

Results were mixed across the remainder of developing Asia, with each country exhibiting increasingly unique growth drivers. Malaysia (3.8% quarter, 51.3% annual) and South Korea (0.6% quarter, 40.3% annual) both rose over the quarter while Singapore (-0.4% quarter, 69.9% annual), Hong Kong (-2.9% quarter, 56.4% annual) and Taiwan (-3.3% quarter, 52.0% annual) fell.

Global markets dipped in January on the back of profit taking, but a strong late quarter rally saw these losses largely recouped. The theme for the first quarter of 2010 has been steady global economic recovery. It is difficult to find an emerging economy that does not have strong growth forecasts for the coming year, while the outlook for the developed world continues to improve.

The key issues facing the remainder of the year are the increasingly imminent need for fiscal and monetary tightening. Government spending cannot continue indefinitely. Developed world private sector debt, which created the recent financial problems, has been converted to public debt rather than being paid back. Global growth in a rising interest rate environment may be an entirely different story. Risks aside, the current non-inflationary economic recovery should continue to support global shares in the short to medium term.

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Fixed Interest



After relatively little change in the first two months of the year, March saw bond market yields rise in most developed markets. In Australia and the US, 10-year yields spiked, reaching their highest point since mid-2009. The upward pressure on bond yields came from European sovereign risk concerns, rating agencies revisions due to unsustainable fiscal deficits, and the heightened tensions developing between the US and China.

Greece announced additional EUR 4.8 billion in budget cuts to meet its fiscal deficit demands from the EU. This represents 2% of Greek GDP. Portugal made a similar announcement, but ratings agency Fitch still downgraded Portugal's credit rating to AA- citing a "negative outlook" for the country.

There is little to report from short term interest rates around the globe, with none of the major developed market central banks raising interest rates. There is still no prospect for near term rate rises but we should see gradual tightening in the US and the Euro zone towards the end of 2010.

At the longer end of the yield curve, US 10-year yields rose to 3.8%, 10-year yields on Japanese Government Bonds yields rose to 1.4% and UK 10-year government bond yields ended the quarter lower at 3.9%. The Citigroup World Index (hedged in Australian dollars) returned 2.1% for the March quarter and 5.7% annually.

Locally, Commonwealth Government followed the global trend of rising yields with 10-year yields rising from 5.6% to 5.8% over the quarter.

Short term interest rates in Australia continue to rise. The process of scaling back monetary stimulus is well and truly underway in Australia. After three consecutive 0.25% rate rises in the previous quarter, the RBA added an additional 0.25% to the cash rate in both March and April. The current cash rate stands at 4.25%. Australia was the first developed economy to raise interest rates, and no other central bank has done it as aggressively at this time.

The most recent official RBA statement in April highlights improvements in global growth, particularly in our neighbouring Asian economies

where "growth has continued to be quite strong, contributing to pressure on prices for raw materials." The RBA pointed out the obvious benefits for the Australian resource sector. "Australia's terms of trade are rising, adding to incomes and fostering a build-up in investment in the resources sector. Under these conditions, output growth over the year ahead is likely to exceed that seen last year".

In reference to other areas of the economy, the RBA noted that unemployment peaked at lower levels than expected, credit growth has resumed and business de-leveraging has moderated.

The RBA forecast inflation consistent with their target band of 2-3% in 2010. This outlook implies scope for further policy tightening and that is exactly what we should expect from the RBA. The consensus market forecast is for a further 0.75% to 1.0% by the end of 2010. Futures markets have 90-day bank bills at 4.9% by mid 2010 and 5.5% by the end of 2011.

The most interesting part of the RBA's recent statement is that it highlights a more recent focus on house prices. In commenting on loan approvals, the RBA also added that the housing market "is still characterised by considerable buoyancy, with prices continuing to increase in the early part of 2010." The RBA Governor, Glenn Stevens, also publically remarked: "I think it is a mistake to assume that a riskless, easy, guaranteed way to prosperity is to be leveraged up into property". Containing housing price growth is not a traditional function of a central bank and would mark an interesting change to the Australian regulatory landscape.

In the major Australian fixed interest and cash indices, the UBS Australian Composite Bond Index returned 1.3% over the March quarter and 2.7% annually. The UBS Australian Bank Bill index returned 1.0% over the quarter and 3.5% over the last 12 months.

Improving economic conditions, diminishing investor anxiety and large new supplies of government debt should put upward pressure on global bond yields over the coming June quarter.

June 2010 Quarterly Market Outlook as at March 2010

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Property Securities



The Australian REITs sector remains out of favour with investors. The ASX A-REITs Accumulation Index fell by 1.6% in the March quarter 2010, after falling 5.0% in the last three months of 2009. The annual figures still reflect a strong recovery with the index returning 42.0%.

While the sector has notably improved, with balance sheets repaired and weaker players being consumed, there has been little to spark renewed enthusiasm in the sector. Historically, higher yields were one of the key attractions to property security investment. The current A-REIT dividend yield of 5.8% is significantly below the sector's 20-year average of 7.7%. A-REITs still represent one of the highest yielding industry groups in the Australian market, but other income producing assets presently look more attractive on a risk-adjusted basis. Despite mention of possible merger and acquisition activity in the sector, there was limited activity in sector over the March quarter.

The Industrial REIT subsector continues to outperform its peers. It was the only sector to record positive quarterly gains, up 1.0%. In the Industrials space, Goodman Group (+3.2%), staged a strong late quarter rally as an investor trip to Hong Kong confirmed a positive outlook for its Asian business. On an annual basis the industrials sector returned 141.6%. The Industrial sector was hit the hardest during the global financial crisis and this strong annual return reflects a recovery from a lower base more than improvement in the outlook for the sector. The Commercial sector (-7.2%) has the weakest quarterly return, followed by the Diversified (-2.4%) and Retail (-0.3%) sectors.

The best individual stocks for the quarter were Challenger Diversified Property (12.9%), Centro Retail Group (9.1%) and Aspen Group (7.4%). Challenger Diversified Property rose after announcing a reduction in losses over the 2009 financial year, the outlook for Centro's US retail exposure improved valuations while sentiment improves towards Aspen group, which pays a healthy +10% dividend.

The largest contributor to index performance had a volatile quarter. Westfield Group, ended down 3.8% as investors questioned whether Westfield has the ability to complete a major capital raising to make planned acquisitions in the US.

International REITs continue to outperform domestic REITs, despite the additional pressure of a rising currency reducing gains for unhedged Australian investors. The UBS Global Property Index (hedged into AUD) returned 8.0% for the quarter and 88.4% annually. The US was the strongest performer (+9.2% in \$US), followed by Europe (+5.4% in Euros). The UK and Japan were slightly behind at around 2.8% in their respective currencies.

The recent cyclical upswing in the economy, easing financing constraints and increased investor confidence all bode extremely well for global listed property. New IPOs, which have been noticeably absent in the REIT space for months, have begun to emerge. Metric is the newest UK REITs player, after raising £175 million in March. Media speculation suggest further European REITs could appear in the not to distant future.

Problems in the US commercial real estate market present the major constraint to global REITs. A recent US Congressional report highlighted that over the next four years, around US \$1.40 trillion in commercial real estate loans will mature. In almost 50% of cases, the borrower owes more than the value of the underlying property. As it stands, the resulting bank foreclosures and associated property sales will place considerable strain on the global property securities market.

Improvements in the global economic outlook have resulted in a strong recovery in listed property prices, both locally and internationally. Price appreciation in Australia appears to have run out of steam, while international property continued to advance over the March Quarter. Despite the headwinds the US commercial market will create, a sustained global economic recovery should provide strong support for global property prices over the coming quarters.

June 2010 Quarterly Market Outlook as at March 2010

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Stock Market Indices as at 31 March 2010



Stock Market Indices	1 yr % pa	3 yrs % pa	5 yrs % pa
ASX All Ordinaries Accumulation Index	44.01	-2.40	8.03
S&P/ASX 300 Industrials Accumulation Index	43.94	-5.92	5.20
S&P/ASX 300 Resources Accumulation Index	37.36	8.22	17.51
S&P/ASX 300 Listed Property Accumulation Index	42.00	-23.27	-7.20
Dow Jones Industrial Index - US	42.68	-4.22	0.66
Standard & Poors 500 Index - US	46.57	-6.29	-0.19
Nikkei Dow Index - Japan	36.75	-13.76	-1.01
Dax Index – Germany	50.65	-3.82	7.19
FT-SE 100 Index – UK	44.66	-3.44	3.02
Hang Seng Index - Hong Kong	56.45	2.37	9.46
MSCI World Acc Index net divs in \$A	13.95	-9.56	-0.84

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